



GovernanceMetrics International®

In Focus

A Look at Recent Governance Developments from GMI

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Satyam Computer Services: The Truth Shall Set You Free (Of Your Investment)

India has been in the news recently due to the high profile US\$1.47 billion fraud at Satyam Computer Services Ltd. (Bombay Stock Exchange: 500376). Despite the headline-making scandal, the country actually maintains a relatively strong corporate governance framework compared to other emerging markets covered by GMI. Indian regulators have preserved the Common Law-based legal system inherited from the British colonial era. A number of companies, including Satyam's primary rivals Infosys Technologies Ltd. (Bombay Stock Exchange: 500209) and Wipro Ltd. (Bombay Stock Exchange: 507685), have enacted shareholder-friendly policies and earned above-average governance ratings. As a result, India sits in the top three among GMI's emerging market country rankings.

Still, the Satyam fraud stands out a vivid reminder of the need for effective corporate governance and controls over internal systems and financial reporting, qualified audit committees, and effective, independent auditor oversight. You can't just have a corporate governance framework without effective practical application.

For example, in GMI's March 2008 release, Satyam had a global Financial Disclosure and Internal Controls rating of 6.0, whereas its main rivals, Infosys and Wipro, had financial disclosure ratings of 9.0 and 8.0, respectively. While Satyam reported that its audit committee did not contain a single financial expert, Wipro's audit committee included a banking expert, and Infosys's audit committee included the former CEO of accounting giant KPMG's Indian operations. Of these three companies, Satyam also had the lowest level of board independence. While Wipro's board included only one non-independent director, Satyam's included the company's founder, his brother, a company executive, and a non-independent director who also worked as a consultant to the company.

On December 16, 2008 when Satyam's founder and chairman, B. Ramalinga Raju proposed that the company purchase two unrelated firms that were partially owned by his family, Satyam's board did not hesitate to approve the deal. Shareholders revolted, and in the aftermath of the revolt, Mr. Raju admitted that he had been hiding a billion dollar fraud in the company's books. Under the spotlight of investor and investigator inquiries, Mr. Raju disclosed that billions of rupees worth of reported cash stockpiles and interest earnings were entirely fictitious. In his confession, Mr. Raju explained covering up the fraud had been like "riding a tiger, not knowing how to get off without being eaten." Satyam, whose name means "truth" in ancient Sanskrit, saw its share prices fall by 88% between December 16, 2008 and January 21, 2009. Indian authorities have arrested Mr. Raju, along with his brother and the company's CFO.

Satyam's collapse should serve as a reminder that 21st century IT firms need solid frameworks of internal controls and corporate governance. Since these firms often have few tangible assets to fall back on, investors have heightened incentive to double-check for solid accounting procedures, transparency and accountability.

Pressure in the Pipeline: Exxon Mobil Softens Stance on Carbon Taxes

The hard rhetoric of the Exxon Mobil Corporation (NYSE: XOM), long a stalwart critic of global warming, seems to have begun to thaw amidst a rising tide of public support for corporate environmental initiatives.

Recent criticisms that have been made by investors and industry experts alike may have spurred the company to action. Investors have accused Exxon Mobil of neglecting its long term growth prospects. Complaints have also been made about the company's long-standing dismissive stance on global warming and failure to match competitors' efforts in the area of climate change.

[Exxon Mobil's 2005 Corporate Citizenship Report dismisses](#) studies that link global warming to greenhouse gasses and human activity as lacking "objective, reproducible statistical methods." Company Chairman and CEO Rex Tillerson has talked openly with the press about his both his skepticism on global warming and his reluctance expand Exxon Mobil's operations into new markets such as [biofuels](#).

But in 2008, Mr. Tillerson's tone on environmental issues began to change. He began inching towards acknowledging public concern over global warming and has adopted a more agreeable attitude towards arguments for the need to invest in alternative energy. At a speech in July 2008, Mr. Tillerson [commented](#) that Exxon had begun looking into biofuel to determine "where we can add value so it can be meaningful to us and our shareholders."

Even so, many observers were caught by surprise when in a speech in Washington D.C. on January 8 2009, when Mr. Tillerson urged the government to adopt a tax on carbon emissions,

stating that he believed that such a carbon tax is a "more direct, a more transparent and a more effective approach" to curtailing greenhouse gases.

Some skeptics have questioned Mr. Tillerson's motivations for supporting a carbon tax. Daniel J. Weiss, a fellow at the [Center for American Progress](#), a left-of-center think tank in Washington told press sources that "calling for a carbon tax could be a ploy because few observers believe such a tax is politically feasible in [the U.S.] Congress."

Many prominent members of the Democratic-led Congress as well as Exxon's key oil industry rivals like ConocoPhillips (NYSE: COP) and Royal Dutch Shell plc (LSE: RDSA) have shifted away from direct taxes and have supported using a cap-and-trade approach. Under this system, the government would establish economy-wide emission caps as well as limits for individual companies. There would be a market for firms to buy and sell pollution allowances based on whether they were above or below their caps.

Additional Governance Developments at Exxon

In an interesting corporate governance development in November 2008, Exxon announced that its board's non-management directors would begin meeting in separate sessions chaired by a newly appointed independent presiding director. Samuel J. Palmisano was elected by the company's non-management directors to serve as Exxon's first independent presiding director. This comes in the wake of a proposal at the 2008 annual meeting. In the months before Exxon's May 2008 shareholders meeting, shareholders urged the company to separate the roles of chairman and CEO. The proposal received the high-profile support of the group of 73 descendants of the founder of Standard Oil, the Exxon Mobil's predecessor company, John D. Rockefeller. Despite the proposal's failure, the appointment of a presiding director indicates a significant shift in the governance profile of the company.

The announcement of the change in conjunction with other news on the company's recent environmental initiatives may be a sign that Exxon is taking notice of mounting shareholder pressure on governance and sustainability issues. Shareholders can also expect to see a number of future changes to the company's board as long-standing directors reach the mandatory retirement age of 72. For instance in 2008, the retirement of employee director Company Vice-President Stephen Simon brought Exxon closer in line with other major U.S. corporations. Company CEO Rex Tillerson is now the only remaining Exxon employee on the board. Dr. Reatha Clark King, Walter Shipley, and James Houghton are all over age 70, and are expected to step down from the company's board in coming years. The influx of new directors could help introduce fresh viewpoints into Exxon's boardroom and serve as a further catalyst for reform.

After all, as investors in an oil company, Exxon's shareholders are well aware that time and pressure often yield long-term value.

Caught in the Storm: Bad Currency Bets by Comercial Mexicana

After five calm years of economic stability and steady growth, several Mexican companies overloaded on derivatives tied to the value of the country's peso. When an unexpected autumn storm blew in from Wall Street, many of these firms were caught unprepared and over-exposed. From June 30 2006 to June 30 2008 the Mexican peso appreciated steadily and smoothly against the dollar. During this time many Mexican companies entered into profitable derivative contracts linked to the rise of the peso. However, as panic induced by the U.S. financial crisis spread, investors scrambled to trade foreign holdings for dollar denominated assets, inducing a sharp

decline in the value of the Mexican peso. Several Mexican companies were unprepared when the country's currency devalued sharply by 29% between September 15 and October 15 2008.

The Wall Street Journal [reported](#) that the CFO of Controladora Comercial Mexicana S.A. de C.V. (BMV: COMERCIUBC), one of the company's worst affected by this crisis, was literally on vacation during late September as the world's financial markets starting showing stress fractures. He reportedly returned from Europe on October 1 2008 to find the family-controlled retailer on the brink of bankruptcy.

On October 28 2008, La Comer (as the company is colloquially known in Mexico) reported third quarter 2008 losses on derivative contracts totaling US\$0.5 billion, or 12.5% of 2007 revenues.

The company's attempts to seek bankruptcy protection in the Mexican court system have been denied. Mexican press sources have reported that La Comer is using extrajudicial proceedings to restructure its multi-billion dollar debt obligations with a list of creditors that includes among others Banco Santander S.A. (Madrid Stock Exchange: SAN), Goldman Sachs Group, Inc (NYSE: GS), Barclays PLC (LSE: BARC), and JPMorgan Chase & Co. (NYSE: JPM), all of which acted as counterparties to the company's derivative contracts. La Comer's total debt stands at US\$2.5 billion, more than 90% of total assets.

Will Landers, a Latin American money manager at Blackrock Inc (NYSE: BLK), explained to press sources that this issue highlights a need for better regulation and that "from an investor's standpoint there's got to be more disclosure."

La Comer's annual report for 2007 offers almost no description of the risks related to the company's exposure to exchange rate fluctuations. The report discloses that in 2007 and 2006 it reported net gains of MXP 360M (US\$ 27M) and MXP 26.6M (US\$ 2M) on derivative contracts, but includes only one brief sentence that explains that the company's financial standing could be affected by a devaluation of the peso relative to the dollar. By contrast, annual reports from other listed Mexican companies included several pages of detailed descriptions of risks relating to currency fluctuations as well as specific calculations of potential losses on derivative instruments linked to exchange rates. For example, one company reported that a ten percent decline in the value of the peso would translate into losses of US\$ 250M on derivative contracts.

La Comer has a GMI global Financial Disclosure and Internal Controls rating of 1.0 (the lowest possible), a Market for Control rating of 1.0, a Remuneration rating of 1.5, and a Corporate Behavior rating of 3.0, all indicating weak disclosure and accountability. Given these governance ratings, perhaps it is not so surprising that the company would be caught so unprepared and be so severely affected by recent shocks.

Financial Crises: If Hindsight is 20-20, Why Does History Repeat Itself?

In his speech at the 25th Session of the [Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting \(ISAR\)](#) held in Geneva during the week of November 3 2008, [André Baladi](#), the representative of the [International Corporate Governance Network \(ICGN\)](#), explained that the current crisis is not unique but rather part of a chain of similar cyclical crises that have periodically rocked financial markets since capitalism's inception.

Mr. Baladi mentioned collapses and crashes that took place in Europe in the early 1700s, in the U.S. in the 1900s, and more recently at companies like The Bear Stearns Companies, Lehman Brothers Holdings Inc., and Societe Generale S.A. (Paris Stock Exchange: GLE).

The notion that free market capitalism and financial markets are susceptible to periodic crises is backed by a substantial body of academic work based on the research of financial economist Hyman Minsky's pioneering research. Many economists have explained that the current crisis affecting financial markets follows the trajectory of previous boom and bust cycles. The most recent [Economic Outlook Report](#) from the [International Monetary Fund](#) explains that "financial systems are inherently procyclical" and are affected by the business cycle in which the "buildup of financial imbalances [is] followed by a sharp correction."

Public outrage in the aftermath of a crisis-induced series of high-profile corporate collapses is likewise not a new phenomenon. In 1720, investors who lost fortunes in the controversial collapse of the "South Sea" stock bubble were furious. After the crash, Thomas Gordon, an influential classical liberal whose ideas helped paved the way for thinkers like John Locke, Adam Smith, and Milton Friedman condemned the "execrable arts of stock-jobbers" and argued forcefully that the public good would be best served if harsh punishment was served to the directors who presided over the company behind the collapse.

History repeats itself. Hindsight may be 20-20, but memories of economic downturns tend to fade in the exuberance of subsequent upswings. GMI believes that in the wake of a new wave of corporate collapses, as global markets are besieged by volatility, compensation policy and corporate governance reform will yet again sail to the center of the debate and this time around is likely to be reflected in a change in investment strategies.

Using ESG Factors to Maximize Returns

To wit, a [recent study](#) published by [Aviva Investors](#)'s [Sustainable & Responsible Investment](#) team used GMI data to illustrate how extra-financial Environmental Social Governance (ESG) factors can be effectively included in investment decisions by long-term investors.

Aviva's analysis shows that the majority of a company's market value is derived from its long-term earnings, a fact which highlights the need for investors to differentiate risky companies with unsustainable short-term strategies from safe bets with strong long-term growth prospects. Aviva's research indicates that the way in which companies manage the extra-financial ESG aspects of their business may act as a proxy for overall management quality and business sustainability. Investors may not be able to sit in on every executive meeting or analyze every internal corporate memo, but the general public does have the ability to look at environmental and safety management policies and performance as a proxy for overall management quality. Strong ESG management policies are an indication of long-run vision and planning and tend to correlate with above average long-term shareholder earnings.

For example, the Aviva report explains that companies with low comparative carbon emissions and high levels of environmental certification benefit from stronger corporate reputations, a growing "green premium," and lower borrowing costs due to lower long-term risk exposure. Likewise, companies with proactive worker safety management policies that are willing to provide shareholders with detailed safety records are less likely to suffer from reputation damaging accidents and costly lawsuits and more likely to maximize long-term productivity and profitability by retaining skilled workers. Aviva's research showed that companies included in the [FTSE Index Company's](#) world developed index that do not disclose their safety records underperformed the overall index by 2.5%.

Aviva's research found that shareholder returns at companies with governance problems was below average. Aviva's research of GMI's data shows that between 2004 and June 30, 2008

companies within the FTSE world developed index that were subject to criminal litigation underperformed the index by 2.2%. Likewise, companies under formal investigation for accounting irregularities underperformed the index by 5.6%.

Overall the study confirms GMI's belief that ESG factors can – and should - be effectively incorporated into long-run investment decision making processes.

Despite Cloudy Forecasts, Responsible Investing Still Looks Like A Bright Idea

The [WilderHill New Energy Global Innovation Index](#) which tracks clean technology companies has fallen 30% since January 2006. With credit markets tight, confidence down, and oil prices dropping, investors might be expected to turn their backs on Socially Responsible Investing (SRI) practices and seek to maximize returns by any means necessary. Adam Smith, after all, argued that free markets function best when individuals make self-interested decisions to maximize their own well-being.

Some experts, however, have argued that the current crisis has actually heightened awareness of investment strategies which focus on long-term, sustainable results.

David Blood, managing partner of [Generation Investment Management](#), told press sources that he believes there is an increased need for “a more responsible and sustainable form of capital markets.” Similarly, James Gifford, the executive director of the [United Nations Principles of Responsible Investment](#) (UN PRI) program, explained that even as the financial crisis unfolded more institutional investors have agreed to adopt UN PRI principals. In October alone owners representing US\$1.5 trillion adopted UN PRI long-term equity ownership principals. UN PRI signees now control more than US\$18 trillion in assets.

Recent failures of major corporations have highlighted the need for investors to pay more attention to the companies they collectively own. Rory Sullivan, head of investor responsibility at [Insight Investment](#), recently told press sources that “We need to go back to investment fundamentals. If we didn't identify the risks [we need to ask] why not.”

Socially responsible, sustainable investing techniques can be an effective tool if they force investors too take account of extra financial risks like corporate governance, environmental and safety risk management policies, labor relations, and climate change. Investors who seek out companies with strong long-term strategies that are backed by top-notch governance practices are likely to avoid buying shares in companies whose executives push risky short-term strategies.

Matt Zuck, a member of the management team at the [AHA Socially Responsible Equity Fund](#), a [CNI Charter Fund](#), told press sources that “in so far as it forces you to ask more questions about a company, [socially responsible investing] is a valuable as an analytical tool.” Amy O'Brien, part of the social and community investing department at [TIAA-CREF](#) added that “the themes that underpin the current crisis are themes that the socially responsible investing community and corporate governance people have been talking about for a number of years.”

Chile Adopts IFRS: Are There Any Short Term Risks?

When investigators from Chile's [National Accounting Association](#) were looking into a 1994 futures trading scandal at Chile's state controlled copper producer CODELCO, they found that Chilean accounting rules included no provisions regulating the determination of the value of forward trades in the derivatives market. In the years following the CODELCO incident, regulators in Chile have worked to improve the country's regulatory framework. Most recently

regulators have decided to implement new rules that require all companies to begin adopting globally recognized International Financial Reporting Standards (IFRS), starting January 1 2009.

GMI believes that although in the long-run shareholders and companies alike should benefit from the adoption of IFRS, a common language of universally accepted accounting standards, in the short-term the shift to the new system may pose certain risks.

In the long-run the switch to IFRS should reduce operating costs for companies with operations in multiple countries as well as make it easier for international investors to analyze and invest in Chilean companies.

In the short-term, however, the transition to IFRS may pose risks for shareholders if regulators, auditors, executives, and directors are unfamiliar with the new system. Daniel Joignant, an accountant with Deloitte Chile told local press sources that “accountants being trained today are still being taught the old standards, which means that their studies will be out of date by the time they graduate.” [Chilean press sources](#) have reported that only around one fifth of the country’s accountants have a high level of familiarity with the new system. In the short term, companies will have to determine if their boards contain members with significant financial expertise who are familiar with the new system, a significant undertaking in a market where directors are often selected because of their personal connections to company insiders.

Chilean securities market laws do not require companies to form independent audit committees. The duties typically handled by audit committees in other markets are the responsibility of the executive committee.

Currently the Chilean companies GMI covers have below average Financial Disclosure and Internal Controls ratings (3.3 out of 10) and low average levels of board independence (38%), which is cause for concern.

Because IFRS is a principles-based rather than rules based system, it relies heavily on listed companies and their accountants and auditors to make decisions about how to classify and disclose accounts. By international standards Chile has a high incidence of controlling shareholders and a weak presence of independent directors. The switch to IFRS will enhance transparency but also highlight the need for increased independent oversight. Overall, the switch to IFRS will underscore the need for investors to critically analyze financial statements and monitor relationships between listed Chilean companies and their external auditors.

The increased transparency provided by IFRS and Chilean securities market laws which require company directors to take responsibility for company accounts should serve as an incentive for both directors and shareholders to become active participants in the transition process. Chile has for years been a regional leader in economic and securities market law reform. The transition to IFRS could help focus the attention of international investors on Chilean companies and serve as a catalyst for further governance reform. However, practical implementation issues highlighted here will be a challenge to the market and regulators.

Sinking Together: Korean Cross-Shareholding Networks Erode Shareholder Value

Between May 21 2008 and January 21 2009, the Dow Jones South Korea Index fell by 40%. Because 48.9% (41 out of 84) of the South Korean firms we cover are involved in cross-shareholding networks, GMI expects that in the next few months the ripple effects of the market drop will negatively impact the balance sheets many of the country’s major companies.

Cross-shareholding arrangements, which allocate company resources into non-core business investments, are designed to forge alliances among related companies and discourage take-over attempts by outsiders. These arrangements are particularly troublesome because when the market slips, shareholder value evaporates.

In South Korea, cross-shareholding networks are part of a corporate culture in which deals are conducted by insiders behind closed doors and hostile bids by foreigners are rare. Baek Yong-ho, chairman of South Korea's [Fair Trade Commission](#) recently told local reporters that takeover defense mechanisms stifle growth because "the market can only develop if companies feel the threat of losing their management rights."

GMI believes that in addition to posing short term risks, cross-shareholding networks affect long-term value by restricting the market for control and thereby removing an important tool of corporate accountability. Involvement in cross shareholding networks is one of several negative governance practices that protect South Korean executives from being held accountable to shareholders. Currently, South Korean companies covered by GMI had a sub-par average Board Accountability rating of only 3.5.

GMI research indicates that as of our December 2008 release, 96% (81 out of 84) of the Korean firms we cover have guarded against takeover by adopting staggered board election cycles. 89.3% (75 out of 84) of the South Korean firms GMI covers have controlling shareholders who are able to control the result of director elections and discourage takeover attempts. Only 27% of the directors at the companies we cover are independent.

In May 2008, South Korea's [Ministry of Justice](#) (MOJ) initiated a review of requests by the country's "chaebols," or family-controlled business conglomerates, for regulatory reforms that would allow listed firms to further bolster takeover defenses. In October 2008, [Korean press sources reported](#) that the MOJ was considering rule changes that would allow companies to adopt poison pills and dual-class stock structures, reforms that would require the revision of current Korean Commercial Code provisions which stipulate that all shares must be issued with equal voting rights.

In a country where all recent hostile takeovers by foreigners have fizzled, GMI views the prevalence of takeover defenses in South Korea as a governance risk that limits shareholder rights, discourages investment, and erodes shareholder value. Specifically, the recent slide in the country's stock market illustrates the risks of cross-shareholding networks and highlights why the practice is contrary to the interests of investors. The proposed further MOJ reforms could be a further backward step for South Korean corporate governance.

On a more positive note, a number of South Korean firms, including SK Holdings Co. (KSE: 003600), are moving away from the cross-shareholding system and have adopted holding company structures. While still not perfect, the holding company model does enhance transparency and eliminate some of the risks of cross-shareholding arrangements.

Argentine Pension Fund Nationalization: Bad News for Investors

On November 18 2008, Argentina's Senate gave final approval to a proposal by the country's left of center president Christina Fernandez de Kirchner that would nationalize about US\$25B in funds currently held in the country's private pension system. On December 9 2008, the proposal was officially signed into law. Nationalization will allow the government to divert money from the funds into economic stimulus programs and other government projects. Critics contend that

the cash-strapped government is likely to use the funds to delay what some see as an inevitable default on the country's national debt.

At the time of the announcement Claudio Loser, senior fellow at the Inter-American Dialogue, a think tank, commented that "the announced nationalization-expropriation of the Argentine pension funds constitutes one of the most blatant acts of financial piracy in the country's recent history."

On December 11 2008, a U.S. judge in Manhattan's Southern District Court moved to freeze pension assets worth US\$ 533M that are held in New York, preventing their transfer to Argentina.

Argentina has for years been a relatively high risk market for foreign investors. After defaulting on its national debt in 2001, the country has developed a reputation for macroeconomic mismanagement, political meddling in the economy, and unreliable reporting of economic statistics.

Chile, Argentina's neighbor to the west, famously fully privatized its pension system in 1980. Argentina followed suit in 1994 with an unsustainable scheme to partially privatize its pension system, giving workers the option to make payments into privately managed accounts in addition to regular social security payments to the state-run pay as you go program.

In Chile, private pension funds quickly grew into a positive force, helping to push governance reforms and spark rapid stock market development. Today Chile's savings-driven pension accounts are worth US\$116 billion, 70% of GDP, whereas Argentina's private pension funds account for less than 10% of GDP.

In the aftermath of the nationalization scheme, with private pension managers no longer active, Argentine companies may find it far more difficult to raise capital. Investor rights could be affected if the government decides to act as an activist shareholder and exert influence to push a political agenda. Shareholder value could also further deteriorate if the government moves to dump the stakes it holds in listed companies.

As the Argentine government has already announced plans to use part of the funds' assets for fiscal stimulus and public works projects, British newspaper *The Economist*, is probably right to [point out](#) that "pensioners may find their money has disappeared into holes in the ground."

The Downside to the "Cemex Way": A Lack Independent Board Oversight

After taking over as CEO in 1985, Lorenzo H. Zambrano, laid the foundation of a business model and culture that helped Cemex S.A.B. de C.V. (BMV: CEMEXCPO) build itself up and move beyond Mexico's borders with a string of successful acquisitions.

One of the first companies to effectively harness the value-adding power of information technology and centrally coordinated management, Cemex quickly became one of the world's most profitable companies and cemented its place as a global leader in the construction materials industry. Recent financial troubles indicate, however, that the company may have placed itself at risk by failing to shed many of the weak governance policies that are common in the Mexican market.

Although members of Mr. H. Zambrano's family, which founded Cemex in 1906, no longer hold a controlling stake, they continue to dominate the company's board. For example, GMI considers

only one of Cemex's 13 directors to be independent. The company has not split the positions of chairman and CEO and has not appointed an independent lead director. The company's board includes six members of the Zambrano family, two of whom serve on both the audit and the nominating/remuneration committees. (The company's CFO, Rodrigo Trevino, is also a cousin of the CEO.)

Six of the company's other directors are considered to be non-independent because they are relatives of company executives, have been involved in related party transactions with the company, or have other business relationships with Mr. H. Zambrano.

GMI considers only one of the company's five audit committee members to be independent. The fact that 80% of the committee's members are non-independent and two of them are members of the Zambrano family effectively compromises the committee's ability to provide independent oversight of risk-management policies. The fact that the company's CFO is also related to the company's founding family further complicates this issue.

Although very strong in other areas of risk-management disclosure, Cemex has never disclosed information on risks relating to its insider-controlled board structure. The lack of independent board oversight may have prevented doubts from being raised over the potential downside to Mr. H. Zambrano's strategy of borrowing heavily to finance acquisitions in mid-2007 even as warnings were being issued about the failing health of the housing and construction sectors.

After moving to acquire Australian rival Rinker for US\$14.2B in 2007, Cemex is now saddled with a debt load of US\$16B. Cemex is in particular trouble because it has only \$560M in cash and a poorly planned debt structure that will force it to refinance \$8B, half of its outstanding debt, by mid 2010.

On December 11 2008, Cemex's share prices tumbled after the company failed to swap US\$418M of short-term commercial paper for longer-term notes. In the midst of a global slowdown, Cemex is now faced with a formidable challenge to restructure its debt and is currently in talks with creditor companies. Cemex is a company built on a solid foundation. Once it regains its footing, investors should hope that the company protects itself by updating its governance policies to bring them in line with the other world-class aspects of its business.

Financial Fragility: Risk Management and Fair Value Valuation

Recent events have ruffled some feathers and served as a painful reminder that Wall Street is not some kind of golden goose that can be relied upon to unfailingly generate wealth. Investors need to keep watch over companies and guard against risks that may threaten the value of their holdings. In a December 12 2008 [op-ed piece published in the Wall Street Journal](#), Carly Fiorina, the former chair and CEO of Hewlett-Packard Company (NYSE: HPQ) argues that in the aftermath of the financial crisis "if we are to emerge stronger from our current [financial] crisis, business must restore their credibility and regain the American people's trust by embracing accountability and transparency." She focuses specifically on the "mark-to-market" accounting practices that were implemented following the collapse of Enron and calls attention to the need for further regulatory reform.

One organization, [The Basel Committee on Banking Supervision](#), a sub-committee of the Bank of International Settlements (BIS), in a consultative document published in November 2008 called "[Supervisory guidance for assessing banks' financial instrument fair value practices](#)" has already made specific recommendations on policy reforms companies can implement to maximize the effectiveness of their asset valuation and reporting processes.

The BIS report recommends that companies adopt best governance practices that ensure the separation of risk-taking and risk-management units and guarantee appropriate internal and external audit coverage of fair valuations and related systems of control. Risk-management policies relating to asset valuation should be stress-tested and backed by alternative value assessment strategies for use during times when input data becomes unavailable or unreliable. The BIS report recommends that outside experts and advisors be used to certify the “theoretical soundness and mathematical integrity” of all models used to value assets.

GMI believes that this complex issue highlights the need for investors to monitor the independence and qualification of audit committee members at listed companies. The current financial crisis is evidence of a massive systemic risk-management failure. Moving forward investors will want to make sure that audit committees at least have some highly qualified members who truly understand the complexity of the risks facing 21st century financial institutions.

CII Letter on Corporate Governance Reform

On December 3 2008, the Council of Institutional Investors, a non-profit association of public, union, and corporate pension funds with combined assets in excess of US\$3 trillion, sent a advisory letter of recommendations on key corporate governance policies to Speaker of the House Nancy Pelosi, and 98 other members of the U.S. Congress.

The letter explained that as long-term investors, the Council’s members have a “deep, abiding interest ensuring that capital markets are on a sound footing” and believe that any reforms designed to restore financial market stability should included measures that provide investors with the tools to enforce “shareowner-driven market discipline” and hold managers and boards accountable.

Among other recommendations the Council’s letter advocated for financial market regulatory reform legislation that includes provisions requiring majority voting in director elections, shareholder advisory votes on executive pay, the inclusion of independent board chairmen, stronger “claw-back” mechanisms, and stricter limitations on severance pay for poorly performing executives.

GMI research indicates that currently fewer than 8% of the U.S. companies we cover have adopted “claw-back” policies over and above the limited requirements of the Sarbanes-Oxley Act and only 34% of the U.S. companies we cover appointed a non-executive chairman. When looking at the prevalence of independent chairmen, this percentage drops to only 20% of U.S. companies covered by GMI, using GMI’s Independent Director Classifications. GMI has also “red-flagged” the presence of an excessive “golden parachute” severance package as a serious governance concern at 688 (out of 1780) U.S. companies. These statistics are an indication that across the board there is room for significant governance improvement among U.S. listed companies.

A copy of the letter 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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