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In Focus

A Look at Recent Governance Developments from GMI

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Spotlight: Majority Voting in the US

Historically, all that was needed to win election to the board of a US company was a plurality of the votes cast. With the exception of proxy contests for full or partial control, it was unheard of for a director nominee to fail to win election or re-election under a plurality voting standard. As shareholder interest in corporate governance kicked into high gear in the wake of various corporate governance and accounting scandals, practitioners looked to reform the process for nominating, electing and removing US public company directors in an effort to increase overall board accountability.

While “proxy access”, which refers to reform measures that would allow institutional investors greater participation in the director nomination process, remains in limbo at the SEC, another change continues to gather momentum – majority voting. While individual company specifics can vary, in general under a majority voting standard a director nominee must tender his or her resignation if they fail to win a majority of the votes cast. It is, in essence, a practice that allows shareholders to remove incumbent directors or oppose new nominees whom they do not feel adequately represent shareholder interests. The significance of majority voting was made clear last month at Washington Mutual Inc. (NYSE: WM), when director Mary E. Pugh resigned from the board following the company's annual meeting. As head of the board finance committee, Ms. Pugh had been taken to task by some shareholders who claimed she failed to shield the company

from exposure to risky mortgages that have left the company with punishing losses. To many observers, this was a watershed event in US corporate governance.

GMI has been tracking the adoption of a majority voting standard by US companies since 2006. Interestingly, we observe a clear correlation between market capitalization and a company's willingness to move to a majority voting standard: a GMI database search found that 58% of the S&P 500 companies now use some form of majority voting, compared to 20% of the S&P MidCap 400 and 14% of the S&P SmallCap 600.

For additional information on majority voting or GMI database query tools in general, please [contact GMI](#).

Samsung Hamstrung: Company Chairman Indicted

In the aftermath of the Asian financial crisis, Samsung Electronics Co., Ltd (KSE: 005930) CEO Jong Yong Yun gained a reputation for slashing costs and trimming the workforce as he transformed the company from a sluggish giant to a streamlined global competitor. The company's chairman Lee Kun-Hee, the third son of the company's founder, may be gaining a new reputation, but for decidedly different reasons.

On April 17, special prosecutors indicted Mr. Lee and other Samsung executives for tax evasion and breach of trust. Mr. Lee is accused of evading 112.8B Korean Won (US\$113M) in taxes on 4.5T Korean Won (US\$4.5B) in assets he kept in accounts opened in his executives' names. Mr. Lee and his associates have also been accused of working to illegally transfer corporate control of Samsung affiliates to his children. Prosecutors did not issue indictments for bribery and embezzlement, citing lack of sufficient evidence. Special Counsel Cho Joon-woong said he found no trace of systematic bribery.

In a statement which provides insight into why prosecutors have sometimes been accused of being slow to take action against company executives, Special Counsel Cho told reporters that senior company executives had not been arrested out of concern that seriously disrupting Samsung's business operations could have a "negative impact on the national economy amid ever-intensive global economic competition."

Mr. Cho added that it "is the hope of our investigation team that this probe would serve as an opportunity for Samsung to shed these problems and be reborn as an undisputed ultra first-class global company." Mr. Lee is not being prosecuted in response to allegations that, alongside other senior Samsung executives, he used slush funds to run a bribery network involving Korean politicians and government officials. However, Samsung's reputation has taken a battering of late as a result of the myriad of allegations that were being investigated by Mr. Cho.

Since we first initiated coverage of Samsung in September 2006, GMI's analysis has revealed numerous warning signs regarding governance risk, including limited board accountability. The company's board features only one independent member. Samsung has most recently received an overall global rating of 1.0, the lowest possible, and sits among the lowest ranking companies covered by GMI. The eleven Samsung group companies covered by GMI have an average global rating of only 3.0. Eight of these companies have received red flags because of major governance concerns. In the past year significant concerns with governance issues at Samsung Electronics have been raised in three separate articles in GMI's *In Focus* publication.

Korean authorities have made a statement that infractions will no longer be tolerated or ignored. Mr. Lee, his son, and several key aids have already resigned in disgrace. GMI will continue to have concerns about the Samsung group until it brings its governance policies up to global standards. As the leading company in its market, if Samsung made some positive governance changes, its leadership on governance would also help to take Korean companies forward.

Leading the Pack: Foreign Shareholders Take Action in Germany

In a major victory for shareholders, on March 17, 2008 Germany-based TUI (Berlin: TUI), Europe's largest travel company, announced that it was conceding to pressure to give up its "two pillar" tourism and shipping strategy. The two-pillar business model had for years been doggedly defended by TUI's high-profile CEO, Michael Frenzel.

Despite some market practices seen as drawbacks, German companies generally have reasonably good governance policies and Germany is one of the top ten countries in GMI's country rankings. Germany also does well on shareholder rights with a global average for Shareholder Rights of 8.0. However, despite the fact that German stockholders are provided with relatively good shareholder rights, there have been few recent activist campaigns initiated by German investors. Foreign investors tend to galvanize the charge against stubborn managers and entrenched bosses. The London-based Children's Investment Fund (TCI) attracted attention after winning a high profile victory in 2005 when it forced the management of the Deutsche Börse (Frankfurt: DB), Frankfurt's stock exchange, to give up its plan to take over the London Stock Exchange. Likewise, it was foreign activist investors who led the charges to topple Frank Rheinboldt, the CEO of the fashion firm Escada (Frankfurt: ESCD) and Hans Fahr, the boss of IWKA, a major German engineering and automotive supplier. Even the more recent stand-off at TUI was initiated by John Fredriksen, a Norwegian shipping tycoon who is also one of TUI's largest shareholders. Mr. Fredriksen has continued his campaign to shake up TUI. At the company's May 7, 2008 annual meeting his proposal to unseat company chairman Jürgen Krumnow was narrowly defeated. This may indicate that the battle at TUI is not over.

Since mid-2007 German firms have started fighting back and have made requests that BaFin, the country's financial watchdog, provide protection from this recent wave of shareholder activism. However, the final draft of legislation first introduced in late 2007, which was released on April 18, 2008 by Germany's Ministry of Finance did not include several proposals that would have limited shareholder activism. For example, the draft does not include broad 'acting in concert' restrictions on shareholders with common concerns over a portfolio company's governance. The new draft also leaves out a proposal that would have required shareowners who acquire a 10% stake in a company to disclose whether they have plans for an eventual full-scale takeover attempt. Regulatory watchdogs have opted not to put a leash on activist investors. Corporate Germany's old dogs may now have to learn new tricks or risk being pushed aside by a new breed of activist investors. It remains to be seen if this will occur or if further lobbying will occur in relation to the proposed legislation. In the meantime, activist investors can be expected to continue to put pressure on underperforming boards and management in Germany.

Avoiding the Next Credit Crunch: A Collaborative Approach

The meltdown in the U.S. sub-prime mortgage market and the resulting global credit crisis are merely the latest examples of periodic crises in the financial markets. Danyelle Guyatt, winner of the [French Social Investment Forum's](#) 2006 Best PhD Thesis Award and former economist at the Commonwealth Treasury of Australia, takes an interesting approach to the issue. In a study funded by the [Rotman International Centre for Pension Management](#) titled "Identifying and Mobilizing Win-Win Opportunities for Collaboration between Pension Fund Institutions and their

Agents” she uses a combination of game theory and empirical analysis to explain how collaboration between market participants might better prevent future financial market crises.

She explains that a combination of disjointed financial incentives, “excessive leverage, herding behavior, and permissive regulatory and monetary policies” has contributed to the destabilization of the world’s financial markets. Guyatt is one of a growing number of academics and market participants looking for alternatives to the top-down regulatory model that has proven ineffective in periods of instability.

One group already taking these principles into action is the [Network for Sustainable Financial Markets](#), which brings together a diverse group of experts to collaboratively discuss regulatory reforms that seek to contribute to long-term financial market stability. The Network is a decentralized, international group of economic, finance and law professionals working to design policies that ensure that markets fulfill their economic and social purpose of creating long-term sustainable wealth. The group has established a list of problem areas in the current system and plans to work collectively following a set of [guiding principles](#) to improve the existing regulatory framework.

The NSFM intends to tackle issues such as an excessive focus on short-term results and the pressing need for governance improvements at all financial institutions. In addition to working with market participants like pension funds and investment banks, the network will provide financial watchdogs and central banks with evidence that existing regulatory models ignore systemic risk and that a coordinated global approach is needed to better protect financial markets.

Individuals interested in the network can email contact@sustainablefinancialmarkets.net.

Take Me to Your Leader: Focus on CEO Succession Planning

A recent [article](#) in *The Economist* likens Walt Disney Co.’s (NYSE: DIS) current CEO, Bob Iger, to the star of “Ratatouille,” the company’s latest animated feature. Like Remy, the fictitious chef from “Ratatouille,” Mr. Iger has been credited with restoring the prestige of a once great institution. The financial news press often grants celebrity status to successful corporate CEOs. Chief executives attract the limelight when a company emerges from the brink of disaster or excels under a new business model. Likewise, the top boss is also often the first to be ushered out after a corporate scandal or missed earnings target. The presence of an able CEO is a vital asset to any strong company. Given the high costs of ineffective leadership and the potential cost of unplanned replacements, the attention that a board devotes to CEO succession planning is often an indication of the overall quality of a company’s governance policies, board effectiveness and long-range planning.

A recent [article](#) in *ICD Director (CANADA)* by David Anderson, president of the [Anderson Governance Group](#), explains that time-sensitive issues often monopolize directors’ attention, and succession planning is often relegated to back burner, or ignored entirely. Still, the number of companies that do not disclose information on succession planning to shareholders is surprising.

Nearly half of the companies covered by GMI do not disclose the extent which they engage in CEO succession planning. In Israel, Taiwan, Japan, Italy, and South Korea, less than 10% of the companies rated by GMI disclose succession planning policies. Interestingly, GMI data analysis finds that on a country-by-country basis, the number of firms that disclose their succession policies tends to correspond with the overall corporate governance rankings. Canada, Finland, Germany, New Zealand, South Africa the U.S are all known for their relatively strong governance practices and all appear in both the top ten of GMI’s country rankings and the

rankings based on CEO succession planning disclosure. By contract, China, Indonesia, Israel, Japan, Russia and South Korea have a reputation for relatively weaker governance and appear in the bottom ten of both lists.

Facebook: The Next Frontier of Investor Activism?

[Facebook](#), the popular social networking site, has proven to be an unlikely but effective tool to provide cohesion to a disparate group of almost two thousand frustrated investors with money locked up in Canada's non-bank asset-backed commercial paper (ABCP) market.

Investors who collectively hold more than C\$300M in the ABCP market have grown increasingly uneasy since the market was frozen in late summer 2007 due to troubles connected to the U.S. sub-prime woes. One such investor, Brian Hunter, a Calgary-based oil and gas engineer with several hundred thousand dollars of his retirement nest egg tied up in ABCP, created a Facebook group to serve as a meeting place and discussion forum for investors interested in taking an active role in fighting for their rights.

Since the [group](#)'s inception, Mr. Hunter has devoted his time to posting newspaper stories, updates, and TV clips, and working with consultants and group-members to coordinate lobbying efforts.

Despite the fact that Facebook caters to a young demographic, Mr. Hunter's group has recruited over 280 members. The group's e-activism showed its first returns when on April 9, 2008 Canaccord Capital Inc (Toronto Stock Exchange: CCI), the dominant player in Canada's ABCP market agreed to buy back C\$138M of ABCP from almost fifteen hundred individual investors.

Mr. Hunter's group is not alone on Facebook. Corporate Governance and CSR groups like "Governance Focus," "CSR International," and "Corporate Social Responsibility" have membership bases that range from around one hundred to over one thousand. Specific issue based groups advocating divestiture or product boycotts for political reasons often have several thousand members. Recent activity indicates Facebook can be used as an effective tool by activist investors. However, the influence of the networking site should not be overstated. After all, the members of the "Boycott Wal-Mart" group are vastly outnumbered by the members of groups like "I love pointless trips to Wal-Mart!!!"

Some U.S Firms Saying "Nay" to Demands for "Say on Pay"

In the current environment of economic uncertainty the subject of executive pay has received a flurry of media attention as America's general public and elected politicians from both parties demand explanations for high-level executive pay packages. On April 5, 2008 Republican John McCain publicly stated his belief that it is "unconscionable" for certain executives to "make huge amounts of money when Americans face the threat of losing their homes." Democratic presidential candidate Barack Obama has pledged to work to "realign incentives and compensation packages" to better serve the interests of shareholders. Both Mr. Obama and rival Hillary Clinton have argued that new federal legislation should require companies to provide more detailed disclosure of their compensation policies.

Shareholder advisory services and activist organizations like the American Federation of State, County, and Municipal Employees (AFSCME) and the California Public Employees' Retirement System (CalPERS) generally support proposals giving shareholders advisory votes on executive pay. However, many major corporations facing say-on-pay type proposals are voicing their opposition. An April 8, 2008 roundtable discussion in New York organized by the corporate-

investor Working Group on Say on Pay and Yale School of Management's Millstein Center for Corporate Governance and Performance was an opportunity for the representatives of some major U.S. corporations to voice their doubts and concerns about the proposals. Some argued that the first companies to provide shareholders with increased "say on pay" might place themselves at a competitive disadvantage by diminishing their ability to recruit top level executives. Other companies argued in favor of standardized guidelines for all corporations to follow.

Despite being a hot-button topic in the press, "Say on Pay" has met resistance from the companies facing shareholder proposals on the topic. In the 2008 proxy season the shareholders of almost one hundred major corporations will have (or have had) the opportunity to vote on say-on-pay type initiatives. The directors from many of the companies facing shareholder proposals on the issue this year have publicly stated their opposition to the measures. For example, the boards of Goldman Sachs (NYSE: GS), Morgan Stanley (NYSE: MS), U.S. Bancorp (NYSE: USB), Occidental Petroleum (NYSE: OXY), and ConocoPhillips (NYSE: COP) all strenuously opposed say-on-pay type shareholder proposals.

In 2008, these say-on-pay resolutions have yielded mixed results. So far this year say-on-pay proposals have been defeated at companies such as Goldman Sachs (NYSE:GS), Morgan Stanley (NYSE:MS), Merrill Lynch & Co. (NYSE: MER), Citigroup (NYSE: C) and WellPoint Inc (NYSE: WLP). So far in 2008 proposals have been approved at Apple Inc. (NASDAQ: AAPL), Lexmark International Inc (NYSE: LXX), Motorola Inc (NYSE: MOT) and voluntarily adopted at Aflac Inc (NYSE: AFL). However even without strong initial support from corporate leaders and investors, the issue has picked up some political momentum. Senator McCain has publicly blasted Goldman Sachs for rejecting the say-on-pay proposal and voiced his support for legislation requiring increased accountability. A bill that would give shareholders at all public companies advisory votes on executive pay has already been introduced in the U.S. House of Representatives. So far, the piecemeal approach company-by-company has faced staunch opposition from company directors and elicited a mixed response from shareholders. This may result in continuing political pressure for new universally applicable regulations on say on pay to fill the void. However, it is also too early to rule out the possibility that over time the movement might gain more widespread approval at individual companies and gain momentum on its own.

Money Talks: Using Executive Pay to Maximize TSR

Stephen F. O'Byrne, president of [Shareholder Value Advisors](#), a consulting firm that works with companies interested in increasing shareholder value by optimizing executive performance measurement and incentive compensation, presented his [ideas](#) at the March 14, 2008 meeting of the New York Society of Security Analysts. O'Byrne, an [outspoken critic](#) of current executive pay policies, explained that compensation policies of public companies should be optimally designed to provide managers with incentives to take risks, and help companies retain key talent during market and industry downswings without imposing excess costs on shareholders.

Byrne argues that conventional executive compensation strategies systematically undervalue shareholder costs and fail to take account of the incentive effects of stock and option holdings. His statistical research indicates that conventional methods of evaluating incentives, such as calculating the proportion of performance-dependent pay, are actually negatively associated with shareholder return. He also argues that using competitive position targets (e.g. 50th percentile pay) can be a disincentive to performance, as an executive may receive less options or stock following a year of good stock price performance in order for the board to retain the target pay.

Byrne argues that long-term incentive compensation programs should increase executive wealth leverage (the ratio of executive wealth return to shareholder wealth return) and thereby help better

align shareholder and management interests. He suggests that companies can improve their compensation policies by adopting policies that balance strong incentives with a tolerable level of retention risk and reasonable costs to shareholders. In order to achieve this, he recommends fixed share stock or option grants, and cash bonuses that are tied to multi-year performance as optimal policies that tie future pay to current performance. He also believes compensation paid in deferred stock creates strong incentives.

According to O'Byrne's research, companies can also avoid potential misalignments of executive and shareholder interests by setting performance targets that are independent of prior performance such as setting the target against peer company averages (e.g. target ROIC would be the peer company average). O'Byrne suggests that companies evaluate how their pay policies align director and shareholder goals and compare the wealth leverage of their top managers to industry averages. He also advises companies to monitor how top management wealth leverage is likely to change as a result of future option grants, vesting and possible sale of incentive equity or the retirement of key executives.

Japanese Regulators Step up Enforcement

In an attempt to lure investors back to the slumping Tokyo Stock Exchange (TSE), regulators have stepped up enforcement of timely disclosure rules. In 2007, the TSE found almost 300 cases in which companies listed on the exchange had violated its timely disclosure rules. In fifteen cases, the TSE required listed companies to submit improvement reports. As auditors grow increasingly vigilant, inappropriate accounting treatments that would have escaped detection in the past are being spotted and scrutinized. Representatives of the TSE have expressed dissatisfaction with the scant attention many firms give disclosure and explained that some Japanese firms may not yet be fully aware of the need to make adequate disclosures.

There have been complaints of confusion over the new requirements and several companies including Solid Group Holdings Co. (Tokyo: 7602) and Nittoc Construction Co. (Tokyo: 1929) have been asked to rewrite their improvement reports. Amongst the companies asked to submit revised improvement reports is Autobacs Seven Co. (Tokyo: 9832), a company flagged by GMI for issues relating to financial disclosure and internal controls. Autobacs is one of many Japanese firms that have struggled to adapt to increasingly complex accounting rules and comply with tighter deadlines for disclosure of earnings results. Yoshihiro Nomura, senior strategist for accounting and tax policy at Nomura Securities Co. explained that "as accounting rules become more complicated and firms are pressed to disclose their earnings quickly, the risk that a company may release incorrect information is growing." There has been an increase in the number of companies that are making the kinds of simple accounting mistakes that are subject to verbal warnings from the TSE. Despite a few kinks in the process, the increased vigilance on the part of the TSE is a positive trend for a country that has consistently ranked poorly in GMI's country rankings and is considered to have weak corporate governance and disclosure practices.

Nordic Shareholder Representatives Help Nominate Directors

Many companies in Sweden and other Nordic countries include shareholder representatives on their Nomination Committees. These committees generally have several shareholder representatives, but may also include a board member (usually the board chairman). This is quite different from most other markets, where the Nomination Committee is strictly a committee of the board.

GMI views the inclusion of non-executives with independent opinions and representing owners as a strong governance policy. Outsiders, be they independent directors or shareholders, are often best suited to select nominees based on their professional qualifications, shareholder needs and

the requirements of the board. It also has the effect of potentially heading off disputes between the board and shareholders over a particular nominee that the board may favor.

In Sweden, the Swedish Corporate Governance Board published information in 2007 on the system applied in that market under the Swedish Corporate Governance Code and found that the majority of members of nomination committees represented institutional holders with a minority being board members. The vast majority of “representative” members were from large shareholders.

Interestingly, there are current proposals to amend the Swedish Corporate Governance Code to include an obligation on nomination committee members “to promote the interests of all Shareholders”. The Swedish Code also excludes executives from the Nomination Committee. The [new proposals](#) would go further and ensure that a majority of committee members be independent of the company and management and at least one member will need to be independent of the largest shareholder. Clearly, the Swedish market will not be resting on its laurels in terms of showing leadership in shareholder representation on Nomination Committees.

Passed Expiration: Japanese Firms Phase out Poison Pills

In response to a few high-profile hostile bids, such as U.S.-based Steel Partners offer for Bull-dog Sauce Co. (Tokyo: 2804) many Japanese companies scrambled to protect themselves from unsolicited takeover attempts, and many firms have adopted “poison pills.” Of the 450 companies rated by GMI 21% have implemented poison pills, a 5% increase from one year earlier. In contrast GMI finds that 38% of the US companies we cover have poison pills, down from 43% one year earlier. As a general trend, Japanese firms appear to be adopting poison pills just as U.S. firms are starting to phase them out. Some smaller Japanese firms, however, are choosing not to renew their poison pills.

On March 26, 2008 Nihon Optical Co. (Tokyo: 2680) allowed its poison pill defense to expire. The decision not to seek shareholder approval for an extension to the poison pill might be a sign of a coming shift in Japanese governance policies. Three years after the first “poison pills” were adopted in Japan, some companies including Nihon Optical and Nissen Holdings Co. (Osaka: 8248) are already moving to dismantle their defense mechanisms.

Local press sources reported that Nihon decided not to renew its shareholder rights plan out of concern for the poison pill’s potential to adversely affect the company’s share price. Japanese financial law allows all targeted companies substantial protection and provisions for time to conduct proper negotiations with suitors. Companies have been encouraged to not renew their poison pill plans by the fact that to date there have been no successful hostile takeover attempts in Japan. GMI views the removal of elaborate takeover defense mechanisms as a positive trend.

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

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