

The Corporate Governance of Listed Companies: A Manual for Investors



The mission of the CFA Centre for Financial Market Integrity is to be a leading voice on issues of fairness, efficiency, and investor protection in global capital markets and to promote high standards of ethics, integrity and professional excellence within the investment community.

Its sponsoring organization, CFA Institute, is the 70,000-member, non-profit organization that awards the Chartered Financial Analyst® designation worldwide. CFA Institute was known as the Association for Investment Management and Research (AIMR) from 1990 through early 2004, and before that was two separate organizations with roots going back to 1947.

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The Purpose of This Manual

Some of the most spectacular corporate collapses and losses in recent memory have highlighted the role that corporate governance practices play in maintaining viable entities, and safeguarding Investors' interests. The governance failures at Enron, Parmalat and others since 2001 are harsh examples of the risks posed by corporate governance breakdowns. Losses of tens of billions of dollars of Investors' capital proved that the existing set of corporate checks and balances on insiders' activities could not protect Shareowners from the misplaced priorities of Board Members and the manipulation and misappropriation of Company resources by management and other groups that exercised significant and improper influence over the Company's affairs.

Thus, it is with the goal of educating and empowering the Investor that this manual endeavors to provide Investors a way of assessing a Company's corporate governance policies, and the associated risks. It is our hope that all Investors — be they existing Shareowners, potential Investors, or analysts — can use this information as part of their analyses and valuations, in light of their particular investment perspectives, objectives, and risk-tolerance levels, to evaluate a Company. In particular, we hope that use of this manual will help Investors better recognize, understand and analyze how corporate governance may affect the value of their investments, and thus help them in making informed investment decisions.

In response to wide-ranging effects of recent corporate failures on the global markets, many countries, industry groups and other constituencies have proposed or created new or amended corporate governance codes.¹ Many of these codes seek to establish internal controls or set an ethical tone that focus on Investors' interests. While these government-mandated and voluntary industry codes may help to restore a degree of Investor confidence in the markets, they provide only part of the answer. Investors also must take the initiative to evaluate the presence — or absence — of corporate governance safeguards of Companies in which they invest, as well as their corporate cultures.

To this end, the CFA Centre for Financial Market Integrity ("CFA Centre"), through the work of its Global Corporate Governance Task Force, has prepared this manual. While suggesting issues for Investors to consider, it does not provide a set of best practices, nor does it attempt in every case to decide what corporate governance structures are best for Investors. Instead, its purpose is to alert Investors to the primary corporate governance issues and risks affecting Companies, and to highlight some of the factors they should consider. It will evolve over time as listed Companies and financial markets change, and will serve as a starting point from which the CFA Centre can address revisions to this manual necessitated by such change.

¹ See a list of sources of government-mandated corporate governance codes and principles in Appendix A.

Issuers of financial securities may also find this manual useful as a reference tool for determining what corporate governance issues are important to Investors. We hope that this manual will raise awareness of their governance standards within the investment community.

The Importance of Corporate Governance to Investors

For corporate governance structures to work effectively, Shareowners must be active and prudent in the use of their rights. In this way, Shareowners must act like owners and continue to exercise the rights available to them. Benjamin Graham and David Dodd stated in the 1930s that:

*The choice of a common stock is a single act, its ownership is a continuing process. Certainly there is just as much reason to exercise care and judgment in being a shareholder as in becoming one.*²

A number of studies published in recent years have shown a strong link between good corporate governance and strong profitability and investment performance measures. For example, a joint study of Institutional Shareholder Services (“ISS”) and Georgia State University³ found that the best-governed Companies — as measured by ISS’s Corporate Governance Quotient — had mean returns on investment and equity that were 18.7 % and 23.8% better, respectively, than those of poorly governed Companies during the year reviewed. Research carried out by employees of the California Public Employees Retirement System (“CalPERS”) on the effects of the system’s “Focus List” suggests that efforts by investment funds to improve the governance of Companies which are considered poorly governed also produces good returns in excess of market performance.⁴

On this basis, one would expect Investors to reward Companies that have superior governance with higher valuations. Indeed, a study of U.S. markets by Paul Gompers of Harvard University and colleagues from

² Benjamin Graham and David Dodd, *Security Analysis*, 1st ed. (New York: McGraw Hill, 1934)

³ Brown, Lawrence D., and Caylor, Marcus, “Corporate Governance Study: The Correlation between Corporate Governance and Company Performance,” Institutional Shareholder Services (2004).

⁴ Anson, Mark, Ted White, and Ho Ho, “Good Corporate Governance Works: More Evidence from CalPERS,” *Journal of Asset Management*, Vol.5, 3 (February 2004), 149-156. Cumulative excess return is the cumulative “return earned over and above the risk-adjusted return required for each public corporation.” Also see “The Shareholder Wealth Effects of CalPERS’ Focus List” by the same authors, published in the *Journal of Applied Corporate Finance*, (Winter 2003), 8-17. The authors found that between 1992 and 2002, publication of the CalPERS’ “Focus List” and efforts to improve the corporate governance of companies on that list generated one-year average cumulative excess returns of 59.4%. Cumulative excess return is the cumulative “return earned over and above the risk-adjusted return required for each public corporation.”

⁵ Gompers, Paul A., Joy L. Ishii, and Andrew Metrick, “Corporate Governance and Equity Prices,” *Quarterly Journal of Economics*, 118(1) (February 2003), 107-155. The authors compared the investment performance of some 1,500 U.S.-listed companies against a corporate governance index the authors constructed from 24 distinct governance rules. Also see Lucian Bebchuk, Alma Cohen, and Allen Ferrell, “What Matters in Corporate Governance,” (2004), The John M. Olin Center for Law, Economics and Business of Harvard University.

Harvard and the University of Pennsylvania⁵ found that portfolios of Companies with strong Shareowner-rights protections outperformed portfolios of Companies with weaker protections by 8.5% per year. A similar study in Europe found annual disparities of 3.0%.⁶ Another study establishing and testing a governance rating system in the German market for the period from March 1998 to February 2002 shows that a portfolio consisting of the best governed Companies outperformed a portfolio of the worst governed Companies by a statistically significant average of 2.33% per month.⁷

This phenomenon is neither new nor limited to developed markets. Even before the collapse of Enron, Amar Gill, an analyst in Malaysia, found that Investors in emerging markets experienced higher investment returns from Companies with good governance.⁸ Of the 100 largest emerging markets Companies his firm followed, those with the best governance — based on management discipline, transparency, Independence, accountability, responsibility, fairness and social responsibility — generated five-year returns well above average.⁹

The conclusion is that good corporate governance leads to better results for Companies and for Investors. Corporate governance, therefore, is a factor that Investors cannot ignore but should consider in seeking the best possible results for themselves or their clients.

⁶ Bauer, Rod, and Nadja Guenster, “Good Corporate Governance Pays Off: Well-governed companies perform better on the stock market,” (2003). This study used Deminor Ratings as the basis for determining which companies [something is dropped here] relative to corporate governance quality. (<http://www.deminor-rating.com>).

⁷ Wolfgang Drobetz, Andreas Schillhofer, and Heinz Zimmermann, “Ein Corporate Governance Rating für deutsche Publikumsgesellschaften,” WWZ/Department of Finance, Working Paper No. 5/03 (2003) (in German.) (<http://pages.unibas.ch/wwz/finanz/publications/researchpapers/5-03%20CGRating.pdf>).

⁸ Gill, Amar, “Corporate Governance in Emerging Markets — Saints and Sinners: Who’s Got Religion?”, CLSA Emerging Markets, April 2001. Gill points out that CLSA assigned corporate governance ratings to 495 companies in 25 markets.

⁹ The five-year returns reported by Gill amounted to 930% for the well-governed large-cap companies in emerging markets, versus the total average return of 388% for large-cap companies in emerging markets during that period.

Summary Corporate Governance Considerations

The Board

INVESTORS AND SHAREOWNERS SHOULD:

- *determine whether a Company's Board has, at a minimum, a majority of Independent Board Members.*
- *determine whether Board Members have the qualifications the Company needs for the challenges it faces.*
- *determine whether the Board and its committees have budgetary authority to hire Independent third-party consultants without having to receive approval from management.*
- *determine whether Board Members are elected annually, or whether the Company has adopted an election process that staggers the terms of Board Member elections.*
- *investigate whether the Company engages in outside business relationships with management or Board Members, or individuals associated with them, for goods and services on behalf of the Company.*
- *determine whether the Board has established a committee of Independent Board Members, including those with recent and relevant experience of finance and accounting, to oversee the audit of the Company's financial reports.*
- *determine whether the Company has a committee of Independent Board Members charged with setting executive remuneration/compensation.*
- *determine if the Company has a nominations committee of Independent Board Members that is responsible for recruiting Board Members.*
- *determine whether the Board has other committees that are responsible for overseeing management's activities in select areas, such as corporate governance, mergers and acquisitions, legal matters, or risk management.*

Management

INVESTORS AND SHAREOWNERS SHOULD:

- *determine whether the Company has adopted a code of ethics, and whether the Company's actions indicate a commitment to an appropriate ethical framework.*
- *determine whether the Company permits Board Members and management to use Company assets for personal reasons.*

- *analyze both the amounts paid to key executives for managing the Company's affairs, and the manner in which compensation is provided to determine whether compensation paid to its executives is commensurate with the executives' level of responsibilities and performance, and provides appropriate incentives.*
- *inquire into the size, purpose, means of financing and duration of share-repurchase programs and price stabilization efforts.*

Shareowner Rights

INVESTORS AND SHAREOWNERS SHOULD:

- *determine whether the Company permits Shareowners to vote their shares by proxy regardless of whether they are able to attend the meetings in person.*
- *determine whether Shareowners are able to cast confidential votes.*
- *determine whether Shareowners can cast the cumulative number of votes allotted to their shares for one or a limited number of Board nominees ("cumulative voting").*
- *determine whether Shareowners can approve changes to corporate structures and policies that may alter the relationship between Shareowners and the Company.*
- *determine whether and under what circumstances Shareowners can nominate individuals for election to the Board.*
- *determine whether and under what circumstances Shareowners can submit proposals for consideration at the Company's annual general meeting.*
- *determine whether the Board and management are required to implement proposals that Shareowners approve.*
- *examine the Company's ownership structure to determine whether it has different classes of common shares that separate the voting rights of those shares from their economic value.*
- *determine whether the corporate governance code and other legal statutes of the jurisdiction in which the Company is headquartered permit Shareowners to take legal or seek regulatory action to protect and enforce their ownership rights.*
- *carefully evaluate the structure of existing or proposed takeover defenses and analyze how they could affect the value of shares in a normal market environment and in the event of a takeover bid.*

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Definitions

Corporate Governance

Corporate governance is the system of internal controls and procedures by which individual Companies are managed. It provides a framework that defines the rights, roles and responsibilities of different groups — management, Board, controlling Shareowners and minority or non-controlling Shareowners — within an organization. This system and framework is particularly important for Companies with a large number of widely dispersed minority Shareowners.

At its core, corporate governance is the arrangement of checks, balances, and incentives a Company needs to minimize and manage the conflicting interests between insiders and external Shareowners. Its purpose is to prevent one group from expropriating the cash flows and assets of one or more other groups.

In general, good corporate governance practices seek to ensure that:

- Board Members act in the best interests of Shareowners;
- The Company acts in a lawful and ethical manner in their dealings with all stakeholders and their representatives;
- All Shareowners have the same right to participate in the governance of the Company and receive fair treatment from the Board and management, and all rights of Shareowners and other stakeholders are clearly delineated and communicated;
- The Board and its committees are structured to act independently from management, individuals or entities that have control over management, and other non-Shareowner groups;
- Appropriate controls and procedures are in place covering management's activities in running the day-to-day operations of the Company; and
- The Company's operating and financial activities, as well as its governance activities, are consistently reported to Shareowners in a fair, accurate, timely, reliable, relevant, complete and verifiable manner.

How well a Company achieves these goals depends, in large part, on the adequacy of the Company's corporate governance structure and the strength of the Shareowner's voice in corporate governance matters, through Shareowner voting rights. The success of the Board in safeguarding Shareowner interests depends on these factors.

This manual focuses on these two areas as a means of evaluating the corporate governance practices of Companies.

Independence

A number of new national corporate governance codes and exchange-based rules¹⁰ prescribe factors to consider in determining the Independence of Board and Board committee Members. Generally, to be considered Independent under these codes and rules, a Board Member must not have a material business or other relationship with the following individuals or groups:

- The Company and its subsidiaries or members of its group, including former employees and executives and their family members;
- Individuals, groups or other entities — such as controlling families and governments — that can exert significant influence on the Company’s management;
- Executive management, including their family members;
- Company advisers (including external auditors) and their families; or
- Any entity which has a cross-directorship relationship with the Company.

Board Members

The term “Board Member” — in some jurisdictions called “directors” — in this Manual refers to all individuals who sit on the Board (defined below), including Executive Board Members, Independent Board Members, and Non-Executive Board Members.

EXECUTIVE BOARD MEMBERS

This term refers to the members of executive management. In a Unitary Board, or Committees System, Executive Board Members also serve as part of the Board in a Unitary Board Structure. In a Two-Tier Board, these individuals only would be part of the Management Board. These individuals are not considered Independent.

INDEPENDENT BOARD MEMBERS

An Independent Board Member refers to an individual who meets the qualifications listed under “Independence.”

NON-EXECUTIVE BOARD MEMBERS

Non-Executive Board Members are neither Executive Board Members nor Independent Board Members. Individuals in this category may represent interests that conflict with those of other Shareowners. These may include Board Members who are affiliated with individuals or entities that have control over management, who are part of a cross-directorship arrangement with another listed Company, or are representatives of labor organizations.

¹⁰ Please see Appendix A for a list of national and exchange-based governance codes.

Board

The term “Board” in this manual refers to both the Supervisory Board — or a Board of Corporate Auditors in Japan — in countries with a Two-Tier Board Structure, and the Board of directors in countries that use a Unitary Board. In most cases, corporate structures take the form of one or the other of these, but in some countries such as in France and Japan, Companies have the option of choosing which of the two structures they wish to use.

Two-Tier (Dual) Board

Common in some parts of Europe, particularly in Germany, the Netherlands, Austria and Denmark, this structure has two elements, the Management Board and the Supervisory Board, both of which are described further below:

MANAGEMENT BOARD

The Management Board consists exclusively of executive management and is charged with running the Company on a daily basis and setting the corporate strategy for the Company, in consultation with the Supervisory Board. Its Members do *not* sit on the Company’s Supervisory Board.

SUPERVISORY BOARD

The Supervisory Board is charged with overseeing and advising the Company’s Management Board and includes only Independent and Non-Executive Board Members.

CORPORATE AUDITORS SYSTEM

In Japan, the Two-Tier Board structure is called the Corporate Auditors System and is used by most large Japanese Companies. It includes a Board — including either Independent Board Members or Non-Executive Board Members who are elected by Shareowners and are responsible for business decisions — and a Board of Corporate Auditors — consisting of corporate auditors, including at least one full-time corporate auditor, and at least half the Members must be outside auditors. These corporate auditors are elected separately by Shareowners and are charged with auditing the performance of the Board.

Unitary Board

In a Unitary board structure, the Board may include Executive, Non-Executive and Independent Board Members. It oversees and advises management and helps set corporate strategy, though in many jurisdictions it does not engage in corporate decision-making, except in matters such as mergers, acquisitions, divestitures and sales. Jurisdictions increasingly require Independent Board Members to comprise at least a majority of the Board.

COMMITTEES SYSTEM

This is the Unitary Board structure in Japan which uses a Board consisting of Executive Board Members, Independent Board Members and Non-Executive Board Members. The system gets its name because the Board must establish three committees — the audit, nominations and compensation committees — all of which must have at least three members, a majority of whom are either Independent Board Members or Non-Executive Board Members.

Company

The Company is the firm in which the Shareowners have an ownership position, and in which Investors are considering an investment.

Investors

This term refers to all individuals or institutions who are considering investment opportunities in shares and other securities of the Company.

Shareowners

The term “Shareowners” is distinguished from the term Investors by referring only to those individuals, institutions or entities that own shares of common or ordinary stock in the Company in question.

The Board

Board Members owe a duty to make decisions based on what ultimately is best for the long-term interests of Shareowners. In order to do this effectively, Board Members need a combination of three things: Independence, experience and resources.

First, a Board should be composed of at least a majority of Independent Board Members with the autonomy to act Independently from management. Board Members should bring with them a commitment to take an unbiased approach in making decisions that will benefit the Company and long-term Shareowners, rather than simply voting with management. **Second**, Board Members who have appropriate experience and expertise relevant to the Company's business are best able to evaluate what is in the best interests of Shareowners. Depending on the nature of the business, this may require specialized expertise by at least some Board Members. **Third**, there needs to be internal mechanisms to support the Independent work of the Board, including the authority to hire outside consultants without management's intervention or approval. This mechanism alone provides the Board with the ability to obtain expert help in specialized areas, to circumvent potential areas of conflict with management, and to preserve the integrity of the Board's Independent oversight function.

These three areas, and how Investors can evaluate them, are discussed in more detail below.

Board Independence

Investors should determine whether a Company's Board has, at a minimum, a majority of Independent Board Members.

What is Independence? Independence, as it relates to Board Members, refers to the degree to which they are not biased or otherwise controlled by Company management or other groups who exert control over management. Factors to consider in determining whether a Board Member meets this definition are provided in the "Definitions" section at the front of this Manual.

Implications for Investors. A Board that is not predominantly Independent, or a committee that is not completely Independent, may be more likely to make decisions that unfairly or improperly benefit the interests of management and those who have influence over management. These decisions may also be detrimental to the long-term interests of Shareowners.

Things to Consider. Investors should determine whether:

- Independent Board Members constitute, at a minimum, a majority of the Board. A Board with this makeup and one which is diverse in composition is more likely to limit undue influence of management and others over the affairs of the Board.
- Independent Board Members regularly meet without the presence of management and report on their activities at least annually to Shareowners. Such meetings permit these Board Members to discuss issues facing the Company without influence from Executive Board Members.
- the Board chair also holds the title of chief executive. Combining the two positions may give too much influence to Executive Board Members and impair the ability and willingness of Independent

Board Members to exercise their Independent judgment. A number of national corporate governance codes require the separation of these two positions.

- Independent Board Members have a lead Member if the Board chair is not Independent.
- the Board chair is a former chief executive of the Company. If so, Investors run the risk that this arrangement could impair the Board's ability to act Independently of undue management influence and in the best interests of Shareowners. Such a situation also increases the risk that the chair may hamper efforts to undo the mistakes made by him/her as chief executive.
- individuals who are aligned with a Company supplier or customer, or are aligned with a manager or adviser to the Company's share-option or pension plan, are Members of the Board. In some cases, a Company with a large number of suppliers, customers and advisers may need to nominate individuals to the Board who are aligned with these entities to ensure that it has the expertise it needs to make reasoned decisions. Investors should determine whether such Board Members recuse themselves on issues that may create a conflict.

Where to find information about the Independence of the Board and its committees:

- In most jurisdictions, Companies disclose the names, credentials and Company affiliations of existing Board Members either in their annual reports to Shareowners, or in their annual proxy statements to Shareowners.
- Companies often devote a special section in their annual reports to a discussion of the issues confronted by the Board and Board committees during the past year.
- The websites of many listed Companies provide information about Board Members' Independence.

Board Member Qualifications

Investors should determine whether Board Members have the qualifications the Company needs for the challenges it faces.

Implications for Investors. Investors should assess whether individual Board Members have the knowledge and experience that is required to advise management in light of the particularities of that Company, its businesses, and the competitive environment. Board Members who lack the skills, knowledge and expertise to conduct a meaningful review of the Company's activities are more likely to defer to management when making decisions. Such reliance on management not only threatens the duty to consider Shareowner interests first, but also could threaten the Company's overall performance if Board Members are not capable of in-depth evaluations of the issues affecting the Company's business. (See also the discussion relating to the nominations committee, [on page 22.](#))

Other Things to Consider. Among the factors Investors should consider when analyzing Board Members'¹¹ qualifications are whether the Board Members:

- are able to to make informed decisions about the Company's future.

¹¹ The factors to consider are drawn from CFA Institute's upcoming textbook, "Corporate Finance for the CFA Program."

- are able to act with care and competence as a result of relevant expertise or understanding of:
 - the principal technologies, products or services offered in the Company's business,
 - financial operations,
 - legal matters,
 - accounting,
 - auditing,
 - strategic planning, and
 - the risks the Company assumes as part of its business operations.
- have made public statements that can provide an indication of their ethical perspectives.
- have had legal or regulatory problems as a result of working for, or serving on, the Board of another Company.
- have experience serving on other Boards, particularly with Companies known for having good corporate governance practices.
- serve on a number of Boards for other Companies, constraining the time needed to serve effectively.¹²
- regularly attend Board and committee meetings.
- have committed to the needs of Shareowners, for example by making significant investments in the Company or by avoiding situations or businesses that could create a conflict of interest with his or her position as a Board Member.
- have the background, expertise, and knowledge in specific subjects needed by the Board.
- have served individually on the Board for more than 10 years. Such long-term participation may enhance the individual Board Member's knowledge of the Company, but it also may cause the Board Member to develop an accommodating relationship with management that could impair his/her willingness to act in the best interests of Shareowners.

Investors should also review:

- disclosures made by the Company about the number of Board and committee meetings held during the past year, and individual Board Member attendance records.
- whether the Board and its committees performed a self-assessment and, if available, any information relating to this assessment. This review will help Investors determine whether the Board has the competence and Independence to respond to the competitive and financial challenges facing the Company.
- whether the Board voluntarily or under the requirement of a governance code provides adequate training for Board Members on their roles and responsibilities.

¹² Some corporate governance codes, including the code in Pakistan, put a limit on the number of Company Boards on which Board Members may participate. In Pakistan, for example, the limit is 10 Board mandates for a Board Member.

Where to find information about the qualifications of Board Members:

- Many listed Companies post the names and qualifications of Board Members on their websites. Companies also typically provide information about their Board Members in the annual report to Shareowners and, where applicable, in their annual proxy statements.
- In many countries, Companies report on the number of Board and Board committee meetings, as well as attendance by individual Board Members, in their annual reports, on their websites, or, where applicable, in their annual corporate governance reports and proxy statements.
- Some corporate governance codes in jurisdictions such as Australia, Canada, the United Kingdom, and the United States require listed Companies to disclose in their annual reports if they failed to comply with the codes' provisions and why they did not comply.
- The European Union has adopted a European Commission recommendation that the Board of listed Companies annually discuss their internal organizations, their procedures and the extent to which their self-assessments have led to material changes.
- In the United States, Companies typically list the names and qualifications of Board Members, together with the Board's report to Shareowners, in the annual proxy statement, as well as on their websites. The nominations committee also includes its report concerning its members and activities in the annual proxy statement.

Authority to Hire External Consultants

Investors should determine whether the Board and its committees have budgetary authority to hire Independent third-party consultants without having to receive approval from management.

Implications for Investors. It is important to recognize that Independent Board Members typically have limited time to devote to their Board duties. Consequently Board Members need support in gathering and analyzing a large amount of information relevant to managing and overseeing the Company.

The Board and its committees often need specialized and Independent advice as they consider various corporate issues and risks such as compensation, proposed mergers and acquisitions, legal, regulatory, financial matters and reputational concerns. The ability to hire external consultants without first having to seek management's approval provides the Board with an Independent means of receiving advice uninfluenced by management's interests.

It also ensures that the Board receives specialized advice on technical decisions that could affect Shareowner value.

Other Things to Consider. Among other issues, Investors should determine whether:

- at relevant periods in the past the Board hired external financial consultants to help it consider mergers, acquisitions, divestitures, and risk management issues.
- the nominations committee has used external advisers in the past to recruit qualified nominees for management or for the Board.

- the remuneration committee has hired external advisers in the past to help determine appropriate compensation for key executives.

Where to find information about the authority of the Board to hire external consultants:

The most likely places to find information relating to the Board’s authority to hire external consultants are:

- the corporate governance section of the Company’s annual report;
- the annual corporate governance report;
- the corporate governance section of the Company’s website; or
- the charter for the Board or its committees.

Other places to find this kind of information:

- the Company’s articles of organization or by-laws; or
- national corporate governance codes or stock exchange-mandated corporate governance requirements.

Other Board Issues

BOARD MEMBER TERMS

Shareowners should determine whether Board Members are elected annually, or whether the Company has adopted an election process that staggers the terms of Board Member elections.

Reasons for Reviewing Board Member Terms. Investors need to understand the mechanisms that provide, limit, or eliminate altogether their ability to exercise their rights to vote on individual Board Members.

Implications for Investors. Companies that prevent Shareowners from approving or rejecting Board Members on an annual basis limit Shareowners’ ability to change the Board’s composition, for example, when Board Members fail to act on their behalf, or to elect individuals with needed expertise in response to a change in Company strategy.

Things to consider. When reviewing a Company’s policy for the election of Board Members, Investors should consider whether:

- Shareowners may elect Board Members every year, or for staggered multiple-year terms (known as a classified Board). An annually elected Board may provide more flexibility to nominate new Board Members to meet changes in the marketplace, if needed, than a classified Board. Staggered Boards also may serve as an anti-takeover device.¹³ On the other hand, a classified Board may provide better continuity of Board expertise.

¹³ See especially, “The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy,” by Lucian A. Bebchuk, John C. Coates, IV, and Guhan Subramanian, *Stanford Law Review*, Vol. 54, Issue 5, pg. 887-952. The authors conclude that the ballot box route to a takeover is illusory for a company with an effective staggered Board because, in part, a bidder must foster interest and votes during two elections spread at least 14 months apart.

In Japan, Shareowners of a Company that uses a Corporate Auditors System elect Board Members for two-year terms, and Members of the Corporate Auditors Board for four-year terms. Shareowners of a Company using a Committees System elect Board Members every year.

- the Board has filled a vacancy for the remainder of a Board Member's term without receiving Shareowner approval at the next annual general meeting.
- Shareowners can vote to remove a Board Member under certain circumstances.
- the Board is the appropriate size for the facts and circumstances of the Company. A large Board may have difficulty coordinating its Members' views, be slow to act, and defer more frequently to the chief executive. A small Board may lack depth of experience and counsel, and may not be able to adequately spread the work load among its Members to operate effectively.

Where to find information about the mechanisms related to Board elections and structure:

- In most cases, the best place to find information regarding the election of Board Members is in the notice of the Company's annual general meeting. In the United States and Canada, this information is typically part of the annual proxy statement to Shareowners.
- Investors also should check the Company's by-laws and articles of organization or incorporation to determine whether management and the Board can fill any vacancies without Shareowner approval.

RELATED-PARTY TRANSACTIONS

Investors should investigate whether the Company engages in outside business relationships with management or Board Members, or individuals associated with them, for goods and services on behalf of the Company.

Reasons for Reviewing the Company's Policies on Related-Party Transactions. As they relate to Board Members, policies that cover related-party transactions attempt to ensure the Independence of Board Members by discouraging them from engaging in the following practices, among others:

- receiving consultancy fees for work performed on behalf of the Company;
- receiving finders' fees for bringing merger, acquisition or sale partners to the Company's attention;

Implications for Investors. Receiving personal benefits from the Company for which Board Members are supposed to make Independent decisions can create an inherent conflict of interest, when these benefits fall outside the role of a Board Member. Limitations on such transactions, either through the Company's ethical code or Board policies, reduce the likelihood that management can use Company resources to sway Board Members' allegiance away from Shareowners.

Other Things to Consider. When reviewing a Company's policies regarding related-party transactions, Investors should determine whether:

- the Company's ethical code or the Board's policies and procedures limit the circumstances in which insiders, including Board Members and their associates, can accept remuneration from the Company for consulting or other services outside of the scope of their positions as Board Members. The intent of

such provisions is not only to discourage actions that could compromise Board Members' Independence, but also to discourage the Company from entering into contracts that may not provide the best value to the Company and its Shareowners.

- the Company has disclosed any material related-party transactions or commercial relationships with existing Board Members or Board nominees. (See a discussion of this issue under Board Independence on page 11.)
- Board Members or executive officers have lent, leased or otherwise provided property or equipment to the Company.
- the Company has paid Board Members finders' fees for their roles in acquisitions or other significant Company transactions.

Where to find information about business transactions between the Company and its Board Members, management, or controlling Shareowners:

- The annual reports of Companies in many countries include a discussion of insider transactions and fees paid to Board Members and controlling Shareowners, often under the heading of "Related Party Transactions."
- In the United States, listed Companies are required to provide information relating to dealings with insiders in the annual proxy statement, often under the heading of "Related-Party Transactions."
- Investors also should review the prospectus of a Company preceding a public offering of securities for any related-party transactions disclosures. This document should inform Investors about transactions that permit insiders to purchase shares at a discount prior to an offering at a higher price.

Board Committees

AUDIT COMMITTEE

Investors should determine whether the Board has established a committee of Independent Board Members, including those with recent and relevant experience of finance and accounting, to oversee the audit of the Company's financial reports.

The Purpose of the Audit Committee. The audit committee's primary objective is to ensure that the financial information reported by the Company to Shareowners is complete, accurate, reliable, relevant and timely.

To this end, the audit committee is responsible for hiring and supervising the Independent external auditors, ensuring that the external auditors' priorities are aligned with the best interests of Shareowners, and ensuring that:

- other information included in the financial reports to Shareowners is complete, accurate, reliable, relevant, verifiable and timely;
- the financial statements are prepared in accordance with generally accepted accounting principles (GAAP) and regulatory disclosure requirements;

- the audit is conducted in accordance with generally accepted auditing standards (GAAS);
- that the external auditor is Independent of management influence;
- that all conflicts of interest between the external auditor and the Company are resolved in favor of the Shareowners; and
- that the Independent auditors have authority over the audit of the entire corporate group, including foreign subsidiaries and affiliated Companies.

Implications for Investors. If the Independence of the audit committee is undermined, it could compromise the integrity of the financial reporting process and raise doubts about the credibility of the Company's financial statements. Misrepresentations of, or other distortions about, the Company's performance and financial condition ultimately could have a detrimental affect on the Company's share valuation.

What to Consider. Investors should determine whether:

- all of the Board Members serving on the audit committee are Independent. Some jurisdictions permit Board Members who are not Independent to serve on the committee. Japan, for example, requires that the committee have three members, a majority of whom are either Independent Board Members or Non-Executive Board Members.¹⁴
- any of the Board Members serving on the audit committee are considered financial experts.¹⁵
- the Board submits the appointment of the external auditors to a vote of Shareowners.
- the audit committee has the authority to approve or reject other proposed non-audit engagements with the external audit firm. This should be based on a review of the committee's report on the services received from, and fees paid to, the external audit firm. Investors also should determine whether the audit committee has policies relating to any fees paid by the Company to the external auditor for non-audit consulting services and for resolving these types of potential conflicts of interest. Such non-audit fees may influence the auditors in a way that leads them to resolve conflicts regarding financial reporting issues in favor of management rather than for the benefit of Shareowners.
- the Company has procedures and provisions that determine to whom the internal auditor reports. Regardless of the reporting lines, the internal auditor should have unimpeded access to the audit committee in the case of concerns regarding the accuracy or integrity of the financial reports or accounting practices. Likewise, the audit committee should have unimpeded access to the internal auditor.

¹⁴ Japan's Commercial Code has similar requirements for remuneration/compensation and nominating committees.

¹⁵ Under SEC rules developed in response to Sarbanes-Oxley, a financial expert is a director who: (i) understands GAAP and financial statements; (ii) can assess the application of GAAP for estimates, accruals and reserves; (iii) has prepared, audited, analyzed or evaluated financial statements similar to those of the Company, or has experience supervising those who performed these functions; (iv) understands internal controls and financial reporting procedures; and (v) understands audit committee functions. They may acquire these attributes through: education and experience as or supervising a principal financial officer, principal accounting officer, controller, public accountant or auditor; overseeing or assessing companies or public accountants in the preparation, auditing or evaluation of financial statements; or from other relevant experience. See: <http://www.sec.gov/rules/final/33-8177.htm>, under "Audit Committee Financial Experts."

- there were any discussions between the committee and the external auditors resulting in a change in the financial reports as a result of questionable interpretations of accounting rules, fraud, or other accounting problems, and whether the Company has fired its external auditors as a result of such issues.
- the committee controls the audit budget to enable it to address unanticipated or complex issues.

Where to look for information about the audit committee:

Australia — Companies listed on the Australian Stock Exchange are required to disclose in their annual reports if they have not complied with the exchange’s recommendations relating to the audit committee, together with an explanation of why they did not comply.

Canada — Pursuant to Canada’s Multilateral Instruments 52–101, 102, and 110, listed Companies must report the following about their audit committees in their Annual Information Form:

- the committee’s charter and composition
- relevant education and experience of each committee member; and
- whether the Company relied on an exemption.

In addition, Companies listed on Toronto Stock Exchange markets are required to disclose in their annual reports whether:

- they have an audit committee;
- its members are non-executive;
- the Board has defined its roles and responsibilities;
- it communicates directly with internal and external auditors; and
- it is responsible for overseeing management reporting and internal control systems.

European Union — The Prospectus Directive in the European Union follows the disclosure standards of the International Organization of Securities Commissioners by requiring that Companies provide the names of committee members and a summary “of the terms of reference under which the committee operates” in the prospectus. Also, companies listed in the United Kingdom are required to report on their system of internal controls in the annual director’s report.

United States — Companies must disclose whether they have at least one financial expert on their audit committees and the name of at least one of the committee’s financial experts. They also must disclose whether the named financial experts are Independent. If they disclose that they do not have at least one financial expert, they must explain why. Companies also must disclose the following in their annual proxy statements:

- whether there is a standing audit committee and, if so, the name of each committee member, the number of meetings held, and a description of the functions performed by the committee;

¹⁶ See NYSE or NASDAQ rules relating to audit committee charters. Also see Regulation S-K, Item 401(h), 2004, <http://sec.gov/divisions/corpfin/forms/regs-k.htm>.

- whether the Board has adopted a written charter for the audit committee (if so, they must include a copy of the charter as an appendix to the proxy statement at least once every three years.¹⁶ If this information is available, one will most likely find it on the Company’s website.
- if their shares are quoted on the Nasdaq, American or New York stock exchanges, whether the audit committee members are “Independent” as defined in the applicable listing standards (together with certain information regarding any audit committee member who is not “Independent”);
- whether the audit committee has reviewed and discussed the audited financial reports with management and the Independent auditors and whether the auditors made appropriate disclosures regarding their Independence; and
- a statement by the audit committee about whether it recommended to the Board that the audited financial statements be included in the annual report.

REMUNERATION/COMPENSATION COMMITTEE

Investors should determine whether the Company has a committee of Independent Board Members charged with setting executive remuneration/compensation.

The Purpose of the Remuneration/Compensation Committee. The Remuneration Committee is responsible for ensuring that compensation and other awards encourage executive management to act in ways that enhance the Company’s long-term profitability and value. It is also responsible for ensuring that the remuneration packages offered to management are commensurate with the level of responsibilities of the executive, and appropriate in light of the Company’s performance. The committee can further these goals by:

- including only Independent Board Members on the committee,¹⁷ and
- linking executive compensation to the long-term profitability of the Company and long-term increases in share value relative to competitors and other comparably situated Companies.

Implications for Investors. The existence of the committee and its Independence from executive management bias help to ensure that the rewards and incentives offered to management are consistent with the best long-term interests of Shareowners. Committees that lack Independence could be overly pressured by management to award compensation that is excessive when compared with other comparably situated Companies, or to provide incentives for actions that boost short-term share prices at the expense of long-term profitability and value.

Other Things to Consider. As part of their analyses relating to this committee, Investors should determine whether:

- the composition of the compensation packages offered to senior management are appropriate.
- the Company provided loans or the use of Company property and equipment such as airplanes and real estate to Board Members.
- members of the committee regularly attended meetings during the past year.

¹⁷ Please see a discussion of the Independence of committees, particularly in Japan, under the discussion above concerning the Audit Committee.

- the committee has policies and procedures and, if so, what they are.
- the Company has provided detailed information to Shareowners in public documents relating to the compensation paid during the past year to the Company's five highest-paid executives and its Board Members. Investors also should review any disclosures about the major components and amounts paid to these individuals. Some jurisdictions only require Companies to provide summary information about the compensation of senior management and the Board.
- the terms and conditions of options granted to management and employees and whether the terms are reasonable.
- the Company intends to issue newly registered shares to fulfill its share-based remuneration obligations, or whether it intends to settle these options with shares repurchased in the open market.
- the Company and the Board are required to receive Shareowner approval for any share-based remuneration plans. Such plans affect the number of shares outstanding and, consequently, current Shareowners' ownership interests, as well as the basis on which earnings per share are reported and the market valuations of the Company's securities.
- senior executives from other Companies that have cross-directorship links with the Company are members of the committee. Executive remuneration is often based on compensation of similarly positioned individuals at other Companies, and if the committee has individuals who could benefit directly from reciprocal decisions on remuneration, those decisions may not be in the best interests of the subject Company's Shareowners. (Also see a discussion relating to Board Independence on page 11)

Where to find information about the remuneration/compensation committee:

Australia — Companies that list on the Australian Stock Exchange are required to disclose in their annual reports if they did not comply with the exchange's recommendations for remuneration committees, together with an explanation of why they did not comply.

Canada — The Toronto Stock Exchange requires Companies listed on its markets to report in their annual reports or their management information and proxy circulars whether they have a compensation committee and, if so, whether it is comprised of Independent or Non-Executive Board Members, and whether a majority are Independent.

European Union — European Commission's non-binding recommendations state that Companies should report their remuneration policies and amounts paid to executive management in the annual report. Also, companies listed in the United Kingdom are required to report in their annual reports on the frequency of, and attendance by, members at remuneration committee meetings. These Companies also must disclose the responsibilities delegated to the committee.

United States — Listed Companies report on whether there is a standing compensation committee in their annual proxy statements. These reports also include names of committee members, summaries of compensation strategies, and the policies and procedures of the committee.

NOMINATIONS COMMITTEE

Investors should determine if the Company has a nominations committee of Independent Board Members that is responsible for recruiting Board Members.

The purpose of the nominations committee. The nominations committee is responsible for:

- recruiting new Board Members with appropriate qualities and experience in light of the Company's business needs;
- regularly examining the performance, Independence, skills and expertise of existing Board Members to determine whether they meet the current and future needs of the Company and the Board;
- creating nominations policies and procedures; and
- preparing for the succession of executive management and the Board.

Implications for Investors. The slate of candidates proposed by this committee will affect whether the Board works for the benefit of Shareowners. It is important for this committee to remain Independent¹⁸ to ensure that it recruits individuals who can and will work on behalf of Shareowners, and to ensure that the performance assessment of current Board Members is fair and appropriate. (Also see Board Member Qualifications on page 12.)

Other Things to Consider. Investors may have to review Company reports over several years to adequately assess whether this committee has recruited Board Members who act in the interests of Shareowners. They also should review:

- the criteria for new Board Members.
- the composition, background and areas of expertise of existing Board Members, and whether new nominees complement the Board's current portfolio of talents.
- how the committee finds potential new Board Members. Among the considerations is whether the committee engages in a search for candidates, such as by using an executive search firm, or whether its members rely upon the advice of management or other Board Members.
- the attendance records of Board Members at regular and special meetings.
- whether the Company has a succession plan for executive management in the event of unforeseen circumstances, such as the sudden incapacitation of the chief operating and finance officers. Investors should examine the information provided by the Company about the plan and determine who is expected to lead and implement it.
- the report of the committee, including any discussion of its actions and decisions during the previous year (including the number of meetings held, attendance by committee members, and the committee's policies and procedures.)

¹⁸ Please see a discussion of the Independence of committees, particularly in Japan, under the discussion above concerning the "Audit Committee."

Where to find information about the nominating committee:

- The annual reports of Companies in many countries include a general discussion of the actions taken by the committee during the previous year.
- The annual reports of Companies listed in some countries, such as Australia and the United Kingdom, are required to disclose and explain when a Company fails to comply with applicable nomination committee rules.
- The corporate governance report often includes an explanation of the Company's nominations process and whether they have a specially designated nominations committee.
- In some regions, such as North America, Investors should look in the annual proxy statement to Shareowners for indications about the work of this committee, including the name of each committee member and the number of meetings held.
- The websites of many listed Companies describe the activities and members of the committee and, in some countries, provide information about the committee's charter.

OTHER BOARD COMMITTEES

Investors should determine whether the Board has other committees that are responsible for overseeing management's activities in certain areas, such as corporate governance, mergers and acquisitions, legal matters or risk management.

Implications for Investors. Depending on the purpose, committees created by the Board can provide additional insight into the goals, focus and strategies of the Company. For example, a committee dedicated to risk management might consider the identification and quantification of risks faced by the Company, and determine its optimal risk exposure.

Whether these committees consist of only Independent Members is an important factor to weigh in evaluating the degree to which the committee is dedicated to achieving what is best for the Company and Shareowners, or may be improperly influenced by management and other insiders.

Other Things to Consider. Because such committees often are not covered by national corporate governance codes or exchange-mandated guidelines in the manner that audit, remuneration or nominations committees are, they are more likely to have members who are part of executive management. Consequently, the Independence of these committees may not, and possibly need not, achieve the levels of Independence expected of such committees as audit, nominations and remuneration.

Where to find information about other Board committees:

As in the case with the audit, compensation and nominations committees, there are four primary places to look for information about special-purpose committees, namely:

- The annual reports to Shareowners;
- The annual corporate governance report, where applicable; and
- In regions like the United States and Canada, the annual proxy statement to Shareowners.
- The websites of listed Companies.

Management

While the Board helps set the strategic, ethical and financial course for a Company in consultation with management, Investors ultimately must rely on management to implement that course. Management also has the responsibility to communicate to Investors and the public about the Company's performance, financial condition and any changes in strategy or corporate initiatives in an effective and timely manner.

Investors are familiar with the reports that management issues with regard to a Company's financial performance and condition. However, they may not be aware of other sources of information that may provide insight into the corporate culture or governance practices of a Company. In fact, there are various sources of information available to Investors for evaluating management's role in corporate governance practices, aside from the financial reports that Companies issue.

To help Investors better understand management's role and responsibilities in corporate governance matters, the following section provides a general discussion of a Company's code of ethics and corporate culture, followed by specific discussions of common areas of focus on ethical practices such as related-party transactions, executive compensation, contractual arrangements, share repurchase programs and takeover defenses.

Implementation of Code of Ethics

Investors should determine whether the Company has adopted a code of ethics, and whether the Company's actions indicate a commitment to an appropriate ethical framework.

The Purpose of a Code of Ethics. A company's code of ethics sets standards for ethical conduct based on basic principles of integrity, trust, and honesty. It provides personnel with a framework for behavior while conducting the Company's business, as well as guidance for addressing conflicts of interest. In effect, it represents a part of the Company's risk management policies which are intended to prevent Company representatives from engaging in practices that could harm the Company, its products, or Shareowners.

Implications for Investors. Reported breaches of ethics in a Company often result in regulatory sanctions, fines, management turnover, and unwanted negative media coverage, all of which can adversely affect the Company's performance. Adoption and adherence to an appropriate corporate code of ethics indicates a commitment on the part of management to establish and maintain ethical practices. The existence of such a code may also be a mitigating factor from regulatory actions when breaches do occur.

Things to Consider. As part of their analyses of the Company's ethical climate, Investors should determine whether the Company:

- gives the Board access to relevant corporate information in a timely and comprehensive manner.
- is in compliance with the corporate governance code of the country where it is located, or the governance requirements of the stock exchange that lists its securities. Typically, Companies must disclose whether they have failed to adhere to such codes and, if so, give reasons for the failure. In some cases, non-compliance may result in fines or sanctions by regulators. The Company also may face informal sanctions, such as product boycotting from customers or political groups.

- has an ethical code and whether that code prohibits any practice that would provide advantages to Company insiders that are not also offered to Shareowners. For example, a code might prohibit the Company from offering shares at discounted prices to management, Board Members and other insiders prior to a public offering of securities to prevent dilution of the value and interests of those who buy at the public offering price.
- has designated someone who is responsible for corporate governance.
- has an ethical code that provides waivers from its prohibitions to certain levels of management, and the reasons why.
- waived any of its code's provisions during recent periods, and why.
- regularly performs an audit of its governance policies and procedures to make improvements.

Where to find information about a Company's Code of Ethics and other ethical matters:

- The annual reports of Companies listed in some countries such as Australia disclose when and why a Company failed to meet applicable governance standards regarding the creation and implementation of a code of conduct.
- Companies with ethical codes typically post them on their public websites, in their annual reports to Shareowners, or, in countries that require them, in their annual corporate governance reports.
- Investors may check on the requirements of a country's national corporate governance code or exchange-mandated governance requirements. A list of national and exchange codes is found in Appendix A and at http://www.ecgi.org/codes/all_codes.htm.

Personal Use of Company Assets

Investors should determine whether the Company permits Board Members, management and their family members to use Company assets for personal reasons.

Reasons for Reviewing the Company's Policies on the Personal Use of Company Assets. As they relate to Board Members, policies that limit or prohibit the use of Company assets by insiders attempt to ensure that resources are used in the most efficient and productive manner for the purpose of generating returns for the Company and all of its Shareowners. Such policies and procedures also seek to preserve the Independence of Board Members by attempting to prevent the conflicts of interest that may result when Board Members or their families use Company assets.

Implications for Investors. When insiders such as Board Members, managers and their families use Company assets for personal reasons, those resources are not available for investment in productive and income-generating activities. Such use also creates conflicts of interest for Board Members.

Other Things to Consider. When reviewing a Company's policies regarding the personal use of Company assets, Investors should determine whether the Company:

- has an ethical code or policies and procedures that place strict limits on the ability of insiders to use Company assets for personal benefit.

- has lent cash or other resources to Board Members, management or their families.
- has purchased property or other assets such as houses or airplanes for the personal use of Board Members, management, or their family members.
- has leased assets such as dwellings or transportation vehicles to Board Members, management or their family members, and whether the terms of such contracts are appropriate given market conditions.

Where to find information about insider transactions involving Board Members, management and controlling Shareowners:

- Investors may find information about loans to Company executives, Board Members or their families in the “Related Party Transactions” sections of a Company’s annual report, its annual corporate governance report, annual proxy statement to Shareowners, or its website.
- Investors also should review the prospectus of a Company preceding a public offering of securities for any related-party transactions disclosures. This document should inform Investors about transactions that permit insiders to purchase shares at a discount prior to an offering at a higher price.

Corporate Transparency

EXECUTIVE COMPENSATION

Investors should analyze both the amounts paid to key executives for managing the Company’s affairs, and the manner in which compensation is provided to determine whether compensation paid to its executives is commensurate with the executives’ level of responsibilities and performance, and provides appropriate incentives.

Reasons for Reviewing Executive Compensation Disclosures. Disclosures of how much, in what manner, and on what basis executive management is paid shed light on the Board’s stewardship of Shareowner assets. Furthermore, they allow Investors to evaluate whether the compensation is reasonable in light of the apparent return to the Company in terms of performance.

Implications for Shareowners. The manner in which executive management is compensated can affect Shareowner value in a number of ways. A flawed compensation program may encourage executives to make decisions that generate additional compensation to them through short-term gains, rather than implement an appropriate strategy that focuses on long-term growth. It also could dilute the ownership positions of existing Shareowners. On the other hand, an appropriately designed program can create incentives for Company executives to generate positive results for Shareowners.

Things to Consider. When reviewing a Company’s executive compensation disclosures, Investors should examine the reported:

- **Remuneration/Compensation strategy.** An examination of the terms and conditions of the Company's executive compensation program, together with an analysis of summaries of agreements with executives, will help Investors determine whether the program rewards long-term growth, or short-term increases in share value. This review should include a determination of whether the remuneration/compensation committee uses consultants to set pay for Company executives, or whether it relies on internal sources. Investors also should focus on whether the rewards offered to management are based on the performance of the Company relative to its competitors or other peers, or on some other metric.
- **Executive compensation.** Analysis of the actual compensation paid to the Company's top executives during recent years and the elements of the compensation packages offered to key employees can help Investors determine whether the Company is receiving adequate returns for the investment it has made in executive management.
- **Share-based compensation terms.** Examination of the terms of this type of remuneration program, including the total shares offered to key executives and other employees, should alert Investors to how the program can affect shares outstanding, dilution of Shareowner interests, and share values. Investors also should determine whether the Company seeks Shareowner approval for creation or amendments to such plans. (See "Shareowner Rights" section beginning on page 30 for other issues that may require a vote of Shareowners.)
- **Stock-option expensing.** Compensation, regardless of whether it is paid in cash, shares or share options, involves payment for services received and should appear as an expense on the income statement. International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles both require Companies to expense stock option grants.¹⁹
- **Performance-based compensation.** Investors should determine whether stock options and stock grants, as well as stock-appreciation rights and other performance-based compensation programs are linked to the long-term profitability and share-price performance of the Company relative to its competitors and peers. The purpose of compensation is to reward management for gains attributable directly to superior performance, and linking pay to performance is one way to achieve this purpose.
- **Option repricing.** Investors should remain aware of efforts by the Company to reprice downward the strike prices of stock options previously granted. Changes in the strike price remove the incentives the original options created for management, and therefore reduce the link between long-term profitability and performance and management remuneration.
- **Share ownership of management.** Investors should determine whether members of management have share holdings other than those related to stock option grants. Such holdings may align the interests of Company executives with those of Shareowners.

Where to find information about executive compensation:

- In many jurisdictions, Companies report information about executive compensation in their annual reports. In some cases, disclosures about amounts paid to individual executives is voluntary, although accounting standards setters and securities regulators are increasingly making such disclosures compulsory.

¹⁹ This requirement is applicable for U.S.-listed companies with fiscal years that end after 15 June 2005.

- In the United States, executive compensation strategies and reports of actual compensation paid to key executives are included in the Company's annual proxy statement to Shareowners.
- Investors also may find such information posted on Companies' websites.

SHARE-REPURCHASE AND PRICE STABILIZATION PROGRAMS

Shareowners should inquire into the size, purpose, means of financing and duration of share-repurchase programs and price stabilization efforts.

Reasons for Reviewing Disclosures of Share-Repurchase and Stabilization Programs. A Company will use a share-repurchase program to buy its own shares that are already trading on a public stock exchange. In a stabilization program, the Company has its investment bankers buy and sell shares following a public offering of shares as a means of reducing the price volatility of the shares.

Implications for Investors. Buying shares on the open market can have a positive affect on share values by reducing the number of shares available and increasing the value for the remaining shares outstanding. Price-stabilization programs may reduce the volatility of a security's price following an offering and permit the market to achieve a balance between buyers and sellers, but may provide insiders with an opportunity to trade at a higher price in anticipation that the share price will decline — or to buy at a lower price in anticipation of future price gains.

Things to Consider. When reviewing share-repurchase and stabilization programs, Investors should determine the:

- Intention of the Program. Investors should determine whether the Board intends to use repurchased shares i) to reduce the number of shares outstanding to increase long-term valuations, ii) to fund the future exercise of management share options, or iii) to prevent a hostile takeover. Depending on the perspective of the Investor, the program may enhance or hurt long-term share value. Fixed-income Investors, for example, may view the use of cash to repurchase shares as detrimental to the ability of the Company to repay its outstanding debts.²⁰ Equity Investors, on the other hand, may see such actions as beneficial to their valuations.
- Size of and Financing for the Program. This information, together with disclosures about whether the Company plans to use internally generated cash from operations or issue debt to finance the purchases can help equity Investors determine how the program will affect the value of the Company's shares.

In addition, Investors should review:

- regular updates on the program's progress. In particular, Investors should review the prices at which open-market purchases of shares were made, the number of shares purchased, cumulative amounts of shares repurchased to date, and the average price paid to date. This information should help them anticipate completion of the program and how that may affect share value. It also should help them determine whether the program is proceeding as planned or exceeding original intentions for scope and cost.

²⁰ Bond indentures may require that the Company repay outstanding debt securities or receive a waiver from bondholders prior to launching a share repurchase program.

- disclosures relating to stabilization activities. Following a public securities offering, a Company may contract with its securities underwriters to stabilize the price of the offering through the active purchase and sale of the securities in the open market. Investors should determine prior to investing in a public offering of securities whether the Company intends to use such stabilization services, and subsequently review updates about the number of shares purchased and sold under the program, the average price paid and received, and when the activities concluded. This information will indicate whether the Company and its advisers acted as proposed or whether they engaged in unintended or undisclosed activities.

Where to find information about share repurchase and stabilization programs:

- The annual and interim reports of Companies will, in most cases, provide the information relating to a share-repurchase program.
- The prospectus for an offering should include initial information relating to stabilization activities. Annual and interim financial reports should provide final information about the activities of stabilization programs.
- Investors should look to the prospectus of an offering to determine whether at the time of the offering the Company intended to use agents to perform price stabilization services following the issuance of the securities.
- Post-stabilization disclosure. In the European Union, Companies are required by the Market Abuse Directive to disclose whether stabilization activities were undertaken and, if so, the dates the program began and ended, and the range of prices at which such activities were conducted. The ultimate disclosures will come from either the issuer or the lead underwriter.

The U.S. Securities and Exchange Commission currently does not require post-stabilization disclosures like those of the European Union, though it is considering implementation of one.²¹ Currently Nasdaq requires market makers to attach a special symbol to an order for this purpose while other exchanges require underwriters to notify the exchange and provide disclosure to the recipient of the bid that such bids are part of a stabilization program.

Likewise, disclosure in many other jurisdictions is required to be made only to the Company and the exchange.

²¹ “Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings; Proposed Rule,” 17 December 2004, (Federal Register, Vol. 69, No. 242, page 75782), under the third question: “Should the Commission consider, in addition to the proposed disclosure, revising Rule 104 to require a general notification to the market (e.g., through a press release, a website posting, or an administrative message sent over the Tape) that [the] activity has commenced (and another notification when [the activity] has ceased)?”

Shareowner Rights

The value of a financial security is determined not only by its claim on the Company's future earnings but also on the rights associated with those securities. Among the rights associated with shares of common stock is the right to elect Board Members and to vote on matters that may affect the value of their holdings, such as mergers or acquisitions. Other rights may include the right to apply the cumulative votes of one's shares to one or a limited number of Board nominees, the ability to nominate persons to the Board, or to propose changes to Company operations.

Shareowners may not have all these rights in all cases, and even when they do they may have difficulty exercising them. For example, Companies in some regions can restrict voting only to those owners who are present at scheduled meetings of Shareowners, or prevent Shareowners from trading for a designated period prior to the annual general meeting in return for exercising that vote. In other cases, individuals and institutions cannot confidentially cast their votes. In still other cases, founding-family members or government Shareowners may exercise disproportional influence over the Companies' affairs through the ownership of special classes of shares that grant them super-voting rights.

Shareowners may have powers to remedy situations in certain cases, though such remedies are not universal. Local laws and regulations also may provide legal or regulatory redress.

Such issues are of interest not only to equity Investors, but also to Investors interested in fixed-income investments. For example, Companies that grant super-voting rights to a certain class of stock and Shareowners historically use debt financing more than equity financing to fund investments in new business opportunities.²² Such a strategy may raise the financial risk of a Company and, ultimately, increase the possibility of default.

It is important for Investors to recognize what specific rights are attached to the securities they are considering and factor that information into any investment decisions. Doing so may avoid situations that result in reduced valuations and poor investment performance.

Following is a discussion of issues that Investors should consider in evaluating the Shareowner rights of different Companies.

Shareowner Voting

PROXY VOTING

Investors should determine whether the Company permits Shareowners to vote their shares by proxy regardless of whether they are able to attend the meetings in person.

²² A December 2003 study by Gompers, et. al, found that companies with two classes of common shares that separated the voting rights from the cash flow rights resulted in underinvestment and lower valuations. See Gompers, et. al, "Incentives vs. Control: An Analysis of U.S. Dual-Class Companies," <http://knowledge.wharton.upenn.edu/papers/1278.pdf>.

Reasons for evaluating a Company's voting rules. The ability to vote one's shares is a fundamental right of share ownership. In some jurisdictions, Shareowners may find it difficult to vote their shares because the Company accepts only those votes cast at its annual general meeting, and does not allow them the right to vote by proxy or imposes other constraints.

Implications for Investors. By making it difficult for Shareowners to vote their common shares, the Company limits a Shareowner's ability to choose Board Members or otherwise to express their views on other initiatives that could alter the Company's course.

Things to consider. In examining whether a Company permits proxy voting, Investors should consider whether the Company:

- limits Shareowners' ability to cast votes by conditioning the exercise of their right to vote on their presence at the annual general meeting.
- coordinates the timing of its annual general meeting with other Companies in its region to ensure that all of them hold their meetings on the same day but in different locations. In some regions that require Shareowners to attend such meetings to vote, such actions seek to prevent Shareowners from attending all the meetings, and, therefore, from exercising their voting rights.
- permits proxy voting by means of paper ballot, electronic voting, proxy voting services, or by some other remote mechanism.
- is permitted under its national governance code to use share blocking, whereby it prevents Investors that wish to exercise their voting rights to trade their shares during a period prior to the annual general meeting to permit the Company and various financial institutions certify who owns the shares.

Where to find information about the Company's proxy voting rules:

- Investors also can look to the Company's corporate governance statement for information about whether proxy voting is permitted.
- In the United States, the proxy statement will describe the mechanisms by which Shareowners can cast their votes by proxy.
- Investors can look to the Company's articles of organization and by-laws to determine the mechanisms Shareowners can use to vote their shares.
- Also in the United States, state corporation law regulates issues relating to proxies. Consequently, Investors may have to determine the state in which a Company is incorporated — typically found in the Articles of Incorporation — to review the proxy regulations governing the Company.

CONFIDENTIAL VOTING AND VOTE TABULATION

Investors should determine whether Shareowners are able to cast confidential votes.

Reasons for determining whether Shareowners are able to cast confidential votes. Shareowners are more likely to vote and to do so conscientiously if they are assured that Board Members and management will not find out how they voted.

Implications for Investors. Confidentiality of voting insures that all votes are counted equally, and that the Board Members and management cannot re-solicit the votes of individuals and institutions who vote against the positions of these insiders until the votes are officially recorded.²³

Things to consider. In examining whether Shareowners can vote anonymously, Investors should consider whether:

- the Company uses a third-party entity to tabulate Shareowner votes.
- the Company or its third-party agent retains voting records.
- the vote tabulation performed by the Company or its third-party agent is subject to an audit to ensure accuracy.
- Shareowners are permitted to vote only if they are present at a scheduled Company meeting. (See “Proxy Voting” on page 30 for a discussion of this issue.)

Where to find information concerning confidentiality of voting rights:

- Investors should look to the Company’s by-laws or articles of organization to determine the procedures for counting and tabulating Shareowner votes.

CUMULATIVE VOTING

Shareowners should determine whether Shareowners can cast the cumulative number of votes allotted to their shares for one or a limited number of Board nominees (“cumulative voting”).

Implications for Investors. The ability to use cumulative voting enables Shareowners to vote in a manner that enhances the likelihood that their interests are represented on the Board.

Things to Consider. In evaluating how a Company handles cumulative voting, Investors should consider whether:

- the Company has a significant minority Shareowner group, such as a founding family, that might be able to use cumulative voting to elect Board Members that represent its specific interests at the expense of the interests of other Shareowners.

Where to find information about whether a Company permits cumulative voting:

- The articles of organization and by-laws frequently provide information regarding how a Company regards Shareowner initiatives and rights.
- The prospectus that a listed Company must file with the local regulator will typically describe the circumstances under which Shareowners can exercise their voting rights.

²³ In the case of pooled investment funds, CFA Institute has taken the position that the funds should disclose to investors how they voted the shares of each company on behalf of the fund’s beneficiaries. Such disclosures are different from disclosing those votes to management and the Board in that the investment fund is disclosing its voting record to the beneficiaries on whose behalf it is acting.

- In the United States, Investors may look to the Form 8-A that listed Companies must file with the Securities and Exchange Commission for a description of the rights afforded a Company's common shares.

VOTING FOR OTHER CORPORATE CHANGES

Shareowners should determine whether Shareowners can approve changes to corporate structures and policies that may alter the relationship between Shareowners and the Company.

Reasons for Considering Shareowner Input on Corporate Changes. Changes to certain corporate structures have the ability to affect the value, ownership percentage, and rights associated with the Company's securities. Among the issues Shareowners should review is the ability of Shareowners to effect changes to the Company's:

- articles of organization,
- by-laws,
- governance structures,
- voting rights and mechanisms,
- poison pills, and
- change-in-control provisions.

Implications for Investors. Certain changes to the Company's by-laws or articles of organization can affect the Shareowner's interests in the Company. For example, the introduction or modification of an anti-takeover mechanism might make a takeover too expensive for potential acquirers to consider, thereby denying Shareowners full market value for their shares. Likewise, providing large quantities of stock options to management and employees might dilute the value of shares held by existing Shareowners, while redistributing Company resources to insiders without Shareowner approval.

Things to Consider. In reviewing what issues require Shareowner approval, Investors should determine whether Shareowners:

- must approve such proposals with supermajority votes.
- will have an opportunity to vote on the sale of their Company, or a substantial portion of their Company, to a third-party buyer. Investors also may wish to consider whether Shareowners have an opportunity to vote on significant acquisitions and divestitures that could increase or reduce annual revenues by 10% or more and whether there is a threshold for approval of such transactions.
- will have the right to vote on certain aspects of executive compensation. (See the discussion of executive compensation on page 26.)
- have the right to approve a new anti-takeover measure, and whether such measures are subject to periodic review and retention by Shareowners. (See the discussion of anti-takeover measures on page 39.)
- have the ability to periodically reconsider and re-vote on rules that require supermajority voting to revise the Company's by-laws, articles of organization or other governance documents. While these

supermajority requirements may have been useful in making unwanted changes more difficult at a particular time in the Company's development, they may not serve the same purpose in light of the Company's evolution. Such provisions can make even changes overwhelmingly supported by Shareowners more difficult to enact.

- have the ability to vote for changes to the Company's:
 - articles of organization,
 - by-laws,
 - governance structures,
 - voting rights and mechanisms.
- may attempt to use their ownership of a limited number of shares to force a vote on special interests that are unrelated to the Company's operations. Such actions could cause the Board to make it more difficult for other Shareowners to propose resolutions that are relevant to the Company's operations.

Investors also should review the following issues to determine whether or under what conditions Shareowners may vote on:

- share buy-back programs, particularly if their purpose is to fund share-based compensation grants. (See the discussion on share buy-backs on page 28.)
- Amendments, additions to, or revocation of, corporate charters and by-laws.
- Issuance of new capital stock, including both common shares, and instruments that convert into common shares.

Where to find information whether certain corporate changes require Shareowner approval:

- The Company will provide information to Shareowners that relates to specific issues requiring a vote. This will often occur as part of the Company's disclosures relating to the annual general meeting, or as part of disclosures related to a special meeting of Shareowners.
- A Company typically will provide information on which issues require Shareowner approval in the Company's by-laws and articles of organization. These documents will also provide information about whether management and the Board can fill any vacancies without Shareowner approval.

Shareowner Proposals

SHAREOWNER-SPONSORED BOARD NOMINATIONS

Investors should determine whether and under what circumstances Shareowners can nominate individuals for election to the Board.

Reasons for determining whether Shareowners can propose Board nominees. The ability to nominate one or more individuals to the Board can prevent erosion of Shareowner value. When a Board and management fail to remedy existing problems and to improve the Company's financial performance, Shareowners may use this power to ensure that at least one nominee is Independent of the existing Board and its nominations committee.

Implications for Investors. If Shareowners have the right to nominate Board Members, they have the ability to force the Board or management to take steps to address Shareowner concerns.

Things to Consider. In evaluating whether Shareowners can propose nominees to the Board, Investors should determine:

- under what circumstances Shareowners have the right to nominate Board Members, such as when the Board ignores a Shareowner initiative.²⁴
- whether Shareowners can vote to remove a Board Member under certain circumstances.
- how the Company handles contested Board elections. At many Companies, particularly in the United States, a single vote cast in favor of a nominee is sufficient for an uncontested nominee to get elected to the Board. In cases where the nominations are contested by Shareowners, different rules for determining winners may apply.

Where to find information about the ability of Shareowners to nominate individuals for the Board:

- The notice of the annual general meeting also may provide information related to the election of Board Members.
- In the United States, Investors also may look to the Company's annual proxy statement.
- In most jurisdictions, the articles of organization and by-laws frequently provide information regarding how a Company regards Shareowner initiatives and rights.

SHAREOWNER-SPONSORED RESOLUTIONS

Investors should determine whether and under what circumstances Shareowners can submit resolutions for consideration at the Company's annual general meeting.

Reasons for determining whether Shareowners can propose corporate initiatives. Investors need to understand what they can do if the Board and management fail to remedy existing problems or improve the Company's financial performance. Investors also need to understand the extent to which outside institutions or individuals with specific interests or biases are able to influence Company activity. The ability to propose needed changes can prevent erosion of Shareowner value.

Implications for Investors. The right to propose initiatives for consideration at the Company's annual general meeting is one way for Shareowners to send a message that they do not like the way the Board and/or management is handling one or more Company matters. If the proposal receives an overwhelming number of votes, it could pressure the Board and management either to make the changes called for or, if they fail to do so, to justify their inaction.

²⁴ Please see http://www.cfainstitute.org/advocacy/03commltr/03shd_nominations.html for a complete discussion of the position of CFA Institute on this issue. Also see the original SEC proposal at <http://www.sec.gov/rules/proposed/34-48626.htm>.

Things to Consider. In evaluating the ability of Shareowners to propose changes for the Company, Investors should determine whether:

- the Company requires a simple, two-thirds or other supermajority vote for passing a Shareowner resolution. By comparison, the Company may require a simple majority vote to pass Board- or management-sponsored initiatives.
- Shareowners can request a special Shareowner meeting to consider specific issues.
- initiatives proposed by Shareowners will benefit the long-term interests of all Shareowners, or whether they represent the narrow interests of those making the proposals.

Where to find information about Shareowner authority to propose voting initiatives:

- In the United States, Shareowners may look to the annual proxy statement for information about how to submit proxy initiatives.
- In most jurisdictions, the articles of organization and by-laws frequently provide information regarding how a Company regards Shareowner-sponsored proposals.

ADVISORY OR BINDING SHAREOWNER PROPOSALS

Investors should determine whether the Board and management are required to implement proposals that Shareowners approve.

Reasons for determining whether Shareowner proposals are binding. Unless the Company is required to implement an initiative that Shareowners have approved, the Board and management may tend to ignore those and other Shareowner concerns.

Implications for Investors. Requirements that the Board and management must implement approved Shareowner-sponsored initiatives could make them more accountable to Shareowners.

Things to consider. When reviewing the Company's rules regarding Shareowner initiatives, Investors should determine whether:

- the Company has implemented or ignored approved Shareowner-sponsored proposals in the past.
- the Company requires a supermajority of votes to approve changes to its by-laws and articles of organization.
- national regulatory agencies have pressured Companies to act on the terms of approved Shareowner initiatives.

Where to find information about the enforceability of Shareowner-sponsored proposals:

- The articles of organization and by-laws typically provide information about whether Shareowner initiatives are binding and, if so, the size of the majority vote needed to enforce the measure.
- Investors also may look to the regulatory agency in the local market where the Company is headquartered to determine whether it has taken steps to enforce Shareowner initiatives in other cases.

Other Shareowner Rights Issues

OWNERSHIP STRUCTURE

Investors should examine the Company's ownership structure to determine whether it has different classes of common shares that separate the voting rights of those shares from their economic value.

Reasons for Examining the Ownership Structure of the Company. A Company that assigns one vote to each share is more likely to have a Board that considers and acts in the best interests of all Shareowners. Conversely, a Company with different classes of common shares in which the majority, or all, of the voting rights are given to one class of Shareowners is more likely to have a management team and Board that are focused on the interests of only those Shareowners. The rights of other Shareowners may suffer as a consequence.

Implications for Investors. Companies with dual classes of common equity could encourage potential acquirers to deal directly with those Shareowners who own the shares with super-voting rights. Moreover, studies have shown that Companies that separate the voting rights from the economic rights — which entitle a Shareowner to a pro-rata share of the earnings and residual asset value of the Company — of their common shares find it more difficult to raise equity capital to invest in capital improvements and product development than Companies that combine those rights.

Things to Consider. When analyzing the ownership structure of a Company, Investors should consider whether:

- the Company has safeguards in its articles of organization or by-laws that protect the rights and interests of those Shareowners whose shares have inferior voting rights.
- the Company was recently privatized by a government or governmental entity and whether the selling government has retained voting rights that could veto certain decisions of management and the Board. If so, it could prevent Shareowners from receiving full value for their shares.
- the super-voting rights granted to certain classes of Shareowners have impaired the Company's ability to raise equity capital for future investment. Investors may find the inferior class of shares unattractive, which could harm the company's ability to finance future growth by means other than raising debt capital and increasing leverage.²⁵

Where to find information about whether the Company has more than one class of shares:

- In certain jurisdictions and in certain Companies, Investors might find information about the different classes of shares in the annual proxy statement to Shareowners.
- The Company's website also is likely to describe the differences between shares of common stock and may provide hyperlinks to the Company's articles of organization, annual and interim financial reports, prospectuses, and proxy statements.
- The prospectus relating to the initial or follow-on offerings of common shares to the public is likely to include a discussion about different classes of common shares, including whether any entity or group of Investors retains sufficient voting power to overrule certain management or Board decisions.

²⁵ Ibid.

- The notes to the financial statements, particularly in the annual report, will likely disclose the existence of different classes of common shares.

SHAREOWNER LEGAL RIGHTS

Investors should determine whether the corporate governance code and other legal statutes of the jurisdiction in which the Company is headquartered permit Shareowners to take legal or seek regulatory action to protect and enforce their ownership rights.

Reasons for determining the legal remedies available to Shareowners. In situations where the Company has failed to fully recognize their rights, Shareowners may have to turn to the courts or national regulators to enforce their rights of ownership.

Things to consider. When reviewing the local governance code and legal statutes regarding legal and regulatory actions, Investors should determine whether:

- local legal statutes permit Shareowners to take derivative legal actions — which permit Shareowners to initiate legal actions against management or Board Members on behalf of the Company — and, if so, what conditions must be met.
- the regulator in the local market where the Company is headquartered has taken action in other cases to enforce Shareowner rights or to prevent the denial of Shareowner rights.
- Shareowners, either individually or as a class, are permitted to take legal or regulatory action to enforce fraud charges against management or the Board.
- Shareowners have dissenters' rights to require the Company to repurchase their shares at fair market value under certain circumstances.

Where to find information about legal and regulatory relief for Shareowners:

- The regulator in the local market of the Company's headquarters may provide information about the remedies available to Shareowners in a variety of legal regulatory matters.

TAKEOVER DEFENSES

Shareowners should carefully evaluate the structure of existing or proposed takeover defenses and analyze how they could affect the value of shares in a normal market environment and in the event of a takeover bid.

Reasons for Reviewing Disclosures Relating to Takeover Defenses. Such disclosures should provide Shareowners with information about the situations in which takeover defenses — such as so-called golden parachutes, poison pills and greenmail — could be used to counter a hostile bid.

Implications for Investors. By forcing an acquiring entity to deal directly with management and the Board, takeover defenses — often referred to as “Shareowner rights plans” — may reduce the potential for the acquirer to succeed, even in situations that would benefit Shareowners. Defenses against takeovers also may

cause Investors to discount the value of the Company's shares in normal trading because of the conditions and barriers they create.

Things to Consider. When reviewing a Company's anti-takeover measures, Investors should:

- inquire whether the Company is required to receive Shareowner approval for such measures prior to implementation. It is likely that each Company will structure its measure differently from others. In some cases, Investors may find that the Board is permitted to implement an anti-takeover measure, subject to approval by Shareowners within a set period of time. Others may not require Shareowner approval at all.
- inquire whether the Company has received any formal acquisition overtures during the past two years.
- consider the possibility that the Board and management will use the Company's cash and available credit lines to pay a hostile bidder to forego a takeover. In general, Shareowners should take steps to discourage the Board from taking such actions. If the Company agrees to such payments, Shareowners should review any publicly available information about the terms of such so-called "greenmail" payments.²⁶
- consider whether, in some cases, change of control issues are likely to invoke the interest of a national or local government, which might then pressure the seller to change the terms of a proposed acquisition or merger. In such cases, it is unlikely that the Investor will find specific government directives decreeing such defenses, although Investors may find indications about the likelihood of such actions by examining the government's past actions relating to the Company or relating to other Companies in similar situations.
- consider whether change-in-control provisions will trigger large severance packages and other payments to Company executives.

Where to find information about takeover provisions:

- A Company's articles of organization are the most likely places to find information about existing takeover defenses.
- Newly created anti-takeover provisions may or may not require Shareowner approval. In either case, the Company may have to provide information to its Shareowners about any amendments to existing defenses.

²⁶ Greenmail is a premium paid by the object of a hostile takeover bid to the entity making that bid in return for an agreement that the bidding entity will halt its takeover bid for a certain period.

Appendix A

Sources for Existing and Proposed Corporate Governance Codes and Principles

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