

# 4

## WHAT TO DO: KEY GOOD GOVERNANCE PRACTICES





# Chapter 4

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### KEY MESSAGES

**Specific measures are unique to your company.** They will depend on many factors: legal and regulatory framework, ownership structure, size of the company, motivation for improvements, stage of the company's development and prevalent corporate culture and traditions.

**Base your measures on recognized standards of best practices, tailored to the Latin American context.** Despite the uniqueness of individual company governance frameworks, good governance practices are based on internationally and domestically recognized principles and standards of best practices. Modify practices depending on regional and country context.

**Focus on multiple governance fronts.** Governance improvement actions focus on committing company leadership to good governance, strengthening the role and responsibilities of the board of directors, improving the control environment, promoting disclosure and transparency and protecting shareholder rights.

The previous chapter highlighted processes for developing a realistic and prioritized action plan for governance improvements.

Now, it's time to consider specific governance measures that might be a part of such a plan.

This chapter provides more detail on important and common governance improvement measures that Latin American companies can undertake. Keep in mind that the universe of such improvements is large. While your company should consider a wide range of specific governance measures, there are some recognized best corporate governance practices, recommended by leading companies, investors and regulators. Here, the most frequently recommended are highlighted, under the following umbrellas:

- › Formalizing governance policies: codes and guidelines
- › Functioning of the board of directors and relations with executive management
- › Strengthening of shareholder rights
- › Improving the control environment
- › Transparency and disclosure of information
- › Ensuring the sustainability of the business

Specific corporate governance actions for family-owned firms are addressed in Chapter 5.

# 1 Formalizing Governance Policies: Codes and Guidelines

To formalize their policies, companies typically create a corporate governance code or establish guidelines. Other companies prefer to use a set of documents instead of a code. Embedded within the code is a framework that envisions the company's ultimate governance structure and processes. The code, guidelines or documents usually encompass the main principles of the company's governance system:

- › Relations between the shareholders, the board and senior management
- › Information disclosure
- › Control environment

This said, the way in which a company elects to formalize its governance policies and practices will depend on its culture and unique circumstances. This variation is seen in the different approaches taken by Companies Circle members, explored here.

## **Argos follows best practice recommendations to set its code**

From the beginning of the governance improvement process, leaders at **Argos** understood the importance of formalizing a corporate governance code. Developing the code was one of five pillars of the firm's initial governance structure, which also included:

- Fair treatment of shareholders
- Strengthening the board of directors and its performance
- Development of procedures to supply complete and precise information in a timely manner
- Managing relationships with the many stakeholders involved

The Argos' team conducted extensive research on governance codes to identify useful experiences similar to Argos' philosophy, articulated in its slogan, "Add Value Every Day." The company takes its relationships with all stakeholders very seriously and sought guidance relevant to this approach.

After evaluating and analyzing all relevant experiences, the company adopted and published its Code of Good Governance in 2004, based on good governance recommendations by the Brazilian Institute of Corporate Governance, the NYSE and the American Bar Association.

Argos' code details the company's governance, management practices and conduct of all employees. It includes specific provisions on:

- Conflicts of interest
- Confidentiality
- Use of privileged information
- Acceptance of gifts, especially from provider
- Basic principles of good conduct

Of note, internal and external auditors have verified Argos' compliance with its code to provide information to the market on the company's compliance.

## Marcopolo's code ensures appropriate business conduct

Concerns about business conduct and clarifying ethical practices were among the motivating factors for setting down a governance code at **Marcopolo**. Company leaders realized that adherence to corporate governance principles meant committing to the creation of a code to establish:

- Ethics and morality norms
- Protection of minority shareholder rights
- Equitable treatment of all shareholders
- Accounting and administrative transparency in preparing and submitting accounts

Marcopolo's code—part of the company's series of governance policy documents that also includes a code of conduct—places strong emphasis on minority shareholder rights. Company leaders say that this is critical as Brazilian corporate law grows increasingly protective of minority shareholder interests. In addition:

- The code stipulates that minority shareholders are entitled to share in the profits. It sets up mechanisms through which minority shareholders can oversee the management of corporate business, such as nomination of a director to the board or a member to the company's fiscal council.
- The code requires majority shareholders to accept that decisions—such as amending the company's Articles of Incorporation or voting at shareholders' meetings—cannot be made with the purpose of obtaining personal advantages or causing harm or loss to minority shareholders.

Similar to Marcopolo, some companies prefer to use a set of guidelines to regulate their governance structure, instead of writing a code or issuing a single document on principles. CPFL Energia took this approach, detailing procedures for the company to follow as presented in the box on the following page:

### CPFL Energia

#### CPFL Energia's Corporate Governance Guidelines

- Share capital comprised exclusively of ordinary shares with the guarantee of equal treatment of controlling and minority shareholders in share disposal – 100 percent of tag-along rights
- Free-float of 27.6 percent
- Insider trading policy for individuals with some form of connection to the company and with access to confidential information
- Dividend policy that establishes a minimum allocation of 50 percent of net income for payment of semi-annual dividends
- Board of directors to have an independent director and to focus on strategic issues and decision-making
- Three permanent advisory committees to the board of directors and four ad hoc Commissions
- Evaluation of the board's and fiscal council's performance.
- Formal mechanisms for interaction between the board and executive officers to ensure permanent flow of information

- Governance guidelines of the holding company and the controlled companies aligned by means of by-laws
- Fiscal council to be entrusted with audit committee functions as required under the US Sarbanes-Oxley Act
- Annual reports developed in accordance with the Global Reporting Initiative – GRI
- Succession planning and managerial development program based on key competencies established in the strategic plan
- Compliance with Brazilian and international legislation
- All related parties transactions examined by related parties committee prior to submission to the board
- Code of ethics and corporate conduct consistent with requirements of the Sarbanes-Oxley Act and best governance practices, covering all stakeholders
- Whistleblower channel for receiving complaints and/or denouncements regarding financial information
- Manual for participation in general shareholders' meetings, to provide, in a clear and summarized form, information relating to the company's shareholders' meetings, including a standard power of attorney, which may be used by shareholders who are unable to be present at the meetings to appoint an attorney in fact to exercise their voting rights with regard to issues on the agenda
- Commitment to submit disputes to the Arbitration Chamber of BM&FBOVESPA's Novo Mercado
- Certification of internal controls by the CEO, the CFO and by independent auditors as required under the Sarbanes-Oxley Act

Source: CPFL Energia Corporate Governance Directive ([www.cpfl.com.br/](http://www.cpfl.com.br/))

### **Ferreiros focuses on business conduct and accountability**

In Peru, **Ferreiros** decided to focus on establishing business conduct rules and defining who would be accountable for achieving success. Company leaders based its code of conduct on: seriousness and transparency, equality, service excellence, market leadership, quality products and optimal organizational climate.

The resulting document:

- Features several chapters:
  - Code of conduct towards society
  - Code of conduct for the company, including employees and other internal stakeholders
  - Code of conduct towards third parties
- Addresses information disclosure
- Ensures compliance with obligations resulting from the registration of securities with the public registry of the securities market: rules lay down internal procedures that allow the company's stock market representative to disclose material facts to the market within the required deadlines

- Establishes the company's stock trading policy: spells out obligations and procedures for directors, officers, employees and advisors who deal with privileged information
- Prohibits any misuse or unauthorized disclosure of inside information and penalizes insider trading on that basis

Ferreiros sends the document to all consultants who provide services to the company and therefore have access to privileged information. This reminds them that they cannot pass privileged information to others or benefit themselves by using it in buying or selling company shares.

### **Natura's "Relationship Principles"**

In Brazil, **Natura** found that the approaches taken by other companies did not quite fit its corporate culture.

In late 2005, as the company concluded its strategic planning process, leaders set two projects into motion that had been in the works for several years: writing a code of ethics and creating a dialogue channel—an ombudsman's office—that would ensure alignment of all stakeholders with the new code.

Initially they wanted a document similar to the codes of conduct found in so many other organizations. As board discussions progressed, directors realized that they wanted a text that would encompass not only the recommended content from other codes, but also something that reflected the Natura way.

The result: the Natura Relationship Principles, inspired by the company's core mission and providing guidelines for policy elaboration. It reaffirms the company's beliefs, reason for being and mission in a concrete manner. It guides the company's daily actions, process for formalizing commitments and expectations with all constituencies.

The first step was to explain to Natura's leaders how the new guidelines complement the set of existing documents. In this process, the group reaffirmed that quality relationships are not based on norms, but on ethics, transparency, human values and enriching all stakeholders.

The next challenge was to make sure that various key players—the board, senior managers, securities analysts, coordinators and operating team—would be willing to assist with the preparation and clearance of the text and making sure the writing would be simple and easy to understand.

The involvement of many stakeholders in text validation required time and skill in reconciling the potential conflicts of interest and in testing the company's ability to materialize written concepts that it committed to follow. The effort was critical, though: it helped make the content clear, ensure that it related to the several target audiences and that it touch people's hearts and minds—embraced by all as true guidelines for organizational actions

As of now, only principles relating to company employees and direct sellers have been formalized. The company will continue emphasizing the commitments and expectations regarding consultants, vendors, communities and customers, among others.

## Case Study: Natura

### Natura Creates an Ombudsman's Office

Natura's leadership established the ombudsman's office to enable an additional dialogue and relationship channel that helps improve the quality of relationships with all stakeholders.

Based on the premise of strict impartiality, the office ensures anonymity for all those who contact it. The office's procedures prescribe different treatment for technical and behavioral requirements, and call for participation by the board's ethics committee in deliberations on critical issues. This committee, headed by Natura's chief executive officer, is the main sponsor for ethics in the organization. The committee ensures compliance with the Relationship Principles and proposes document improvements to the board of directors.

This office is also tasked with reviewing the implementation of the Relationship Principles based on the analysis of demands and requests received from various channels in the company. Such analysis allows the office to develop useful lessons learned, provide feedback to all parties involved and make recommendations as to how the implementation of the principles may be improved.

### Suzano Group's code applies across all companies

In June 2006, the **Suzano Group** published its code of conduct and made it applicable to all of its companies. The code includes guidelines and rules of behavior for all personnel working in Suzano Group. It formalizes the practices and values that have been part of the day-to-day routine at the company for more than 80 years, and reaffirms the company's commitment to the capital markets. It emphasizes core company values: attributing value to its people, sustainable development and focusing on ethical principles that guide business conduct throughout the company.

Similar to other companies whose stories were highlighted in this section, Suzano sees its code as an important tool to give the market confidence that the company is committed to ethical principles.

Still, company leaders understood that they needed to find the right time to launch the code, in a way that respected internal dynamics and prioritized alignment so that they could obtain this commitment. It took some time to align these principles among all companies, even though some of guidelines spelled out in the code were already reflected in company practices.



### For Your Consideration

1. Once you have developed and agreed to corporate governance policies, it is equally important to communicate them in the right way throughout the company.
2. Be sure to establish an appropriate corporate body for ongoing oversight. This will ensure compliance with the principles and rules set forth in your governance code or guidelines.



3. This same corporate body can clear up doubts raised by employees, shareholders and other stakeholders.

## 2 Functioning of the Board of Directors and Relations with Executive Management

### 2.1 The Board of Directors: Governance Machine

The board of directors is at the core of governance in an organization established as a modern corporation. It is the body that will shape and mold the other governance structures and practices, evaluating results and controlling effectiveness. It is the forum where the most important and strategic questions are debated and decided on.



#### Best Practice

The OECD Principles of Corporate Governance state: “The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.”<sup>25</sup>

The board is the entity that defines company strategies, assigns those who are responsible for implementing them and identifies the people who will supervise and control managerial performance. The board’s mission is to protect and add value to the company’s equity and maximize the return on investments to all shareholders.

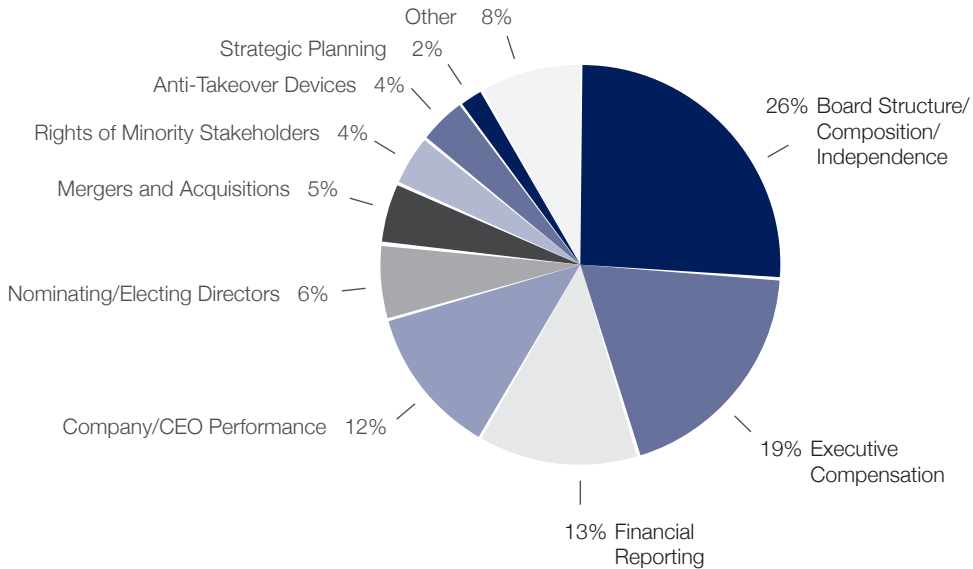
The corporate scandals at the beginning of the decade and again following the more recent financial crisis turned the spotlight on boards. Why did the directors of those companies fail to see or act to prevent the disasters that led to enormous losses for shareholders and all stakeholders?

The fear experienced by markets has made the demand for improved boards even stronger, particularly among investors. A survey was carried out in 2006 by Institutional Shareholder Services, a wholly owned U.S. subsidiary of RiskMetrics Group, Inc., specializing in consulting services for shareholders. This survey included 322 institutional investors around the world, identified board improvement as the most important priority for these investors. The survey asked a number of questions designed to understand the specific issues investors believe will be the most important over the next several years. There were strong similarities among investors’ responses, as shown in Figure 4.1.

<sup>25</sup> OECD, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2004). Principles of Corporate Governance. Available at <http://www.oecd.org/DATAOECD/32/18/31557724.pdf>.

**Figure 4.1 The 2006 Global Institutional Investor Study by ISS (a subsidiary of RiskMetrics Group)**

**Most important Corporate Governance Issues in Near Term** (Total Sample n=322)



Source: RiskMetrics Group, Inc.

The survey interprets the institutional investors' perspective and reveals that they believe better boards consist of several elements:

- The process for nominating and electing directors to ensure independence and the right mix of skills and qualifications
- Independence at the level of the full board and key committees
- Board accountability
- Board responsiveness to shareholders

It is broadly recognized that one of the board's central functions is approving the company's mission and vision—the definition of the company's corporate philosophy and its strategic development perspectives. The board participates in the strategic decision-making process and supports management in defining the strategy. In addition to ensuring that a well-defined strategic plan is in place, the board is supposed to monitor the plan's implementation and discuss with management opportunities to improve it along the road. The knowledge existing within the board should enhance the quality of strategic proposals and help the selection of the best alternative among the possible options proposed by management. Clearly, a high level of involvement with corporate strategy is a major contribution of a board of directors. The board's oversight role is nicely presented in the OECD Principles of Corporate Governance, as "OECD Annotation to Principle VI," shown here:<sup>26</sup>

<sup>26</sup> OECD, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2004). Principles of Corporate Governance. Available at <http://www.oecd.org/DATAOECD/32/18/31557724.pdf>. For more concrete examples of boardroom practices and advice, see OECD, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2008). Using the OECD principles of good governance: a board perspective. Available at <http://www.oecd.org/dataoecd/20/60/40823806.pdf>.



## Best Practice

Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. In order for boards to effectively fulfill their responsibilities they must be able to exercise objective and independent judgment. Another important board responsibility is to oversee systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labor, environmental, equal opportunity, health and safety laws. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

### Strategy sessions at CPFL Energia

At **CPFL Energia**, board members work with executive officers to discuss and deepen their collective understanding of long-term company strategies. Strategy sessions are designed and facilitated by external consultants, with the purpose of allowing the board and management to be totally immersed in relevant issues. Workshops are held to discuss the external context and increase the depth of dialogue on long-term strategy.

## 2.2 The Board's Composition: Size, Skill Mix and Experiences

The composition of the board should support the establishment of an environment that is fitting for this important decision-making body to properly exercise its role and add value to the company and all shareholders. The number of directors, diversity and experience, skills and knowledge, and the directors' ability to independently challenge the management and provide strategic advice on the direction of the company are all elements that shape the board's effectiveness.

- › **Size:** In a comparative study<sup>27</sup> involving 30 documents and codes on corporate governance from 22 countries, only two of them<sup>28</sup> indicate the ideal number of board members at between 5 and 10. The decision on the optimal size of the board is unique to each company. It is driven by the notion that the board should not be too small or too large—either way would discourage efficient and effective decision-making.
- › **Experience and skills:** A fundamental aspect of good board composition is choosing directors who have a specific set of experiences and skills with the right mix of both. The sum of diverse experiences and skills will contribute to the knowledge, strategic vision and appropriate judgment for the Board to perform its main responsibilities.

<sup>27</sup> GREGORY, H. J. (2007). *International comparison of selected corporate governance guidelines and codes of best practice*. New York: Weil, Gotshal and Manges.

<sup>28</sup> IBGC, (2003). BRAZILIAN INSTITUTE OF CORPORATE GOVERNANCE. Code of best practice of corporate governance. Third edition. Available at: [www.ibgc.org.br](http://www.ibgc.org.br) and Brazilian CVM – Comissão de Valores Mobiliários – Recommendations.





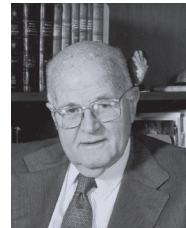
## For Your Consideration

Think carefully about the composition of your board—to perform its functions, the board must have the proper mix of skills, experience and backgrounds. Consider also needs to form board committees.

On average, Companies Circle members have eight members on their boards of directors. Members emphasize that the composition of their boards strives to ensure diversity and balance of skills, experiences and knowledge from different fields appropriate for the requirements of the business.

*“...It is important that the board members realize that their role is to vote according to the company’s interest and not to a particular group whom they may represent. For this purpose, the board should include persons with experience in different disciplines such as accounting, finance and politics.”*

— **Alberto Benavides de la Quintana,**  
Buenaventura, Chairman of the Board.



### Diversity on the board

**Buenaventura’s** board of directors is responsible for the company’s policy decisions and overall direction, in addition to other corporate matters in accordance with its by-laws and the law regulating Peruvian corporations. It is composed of seven members. Directors are appointed for three-year terms at the company’s annual shareholders meeting based on nominations from the company’s nominations committee.

This committee defines the profile for board directors according to the role they will play, taking into account nationality, professional experience and background.

The company has had some difficulties in attracting foreign director-candidates due to geographic and political uncertainty in Peru and the need for directors to physically attend every board meeting. Still, some foreign directors have always been on the board—the company has always believed that the interaction of different cultures will benefit the company’s ability to compete internationally and will help increase shareholder value.

## 2.3 Director Independence

In addition to an appropriate number of directors and their personal qualifications and skills, best governance practices advocate that directors “should be able to exercise objective independent judgment on corporate affairs.”<sup>29</sup>

Such directors can make a substantial contribution to important company decisions, especially in evaluating executive performance, setting executive and director remuneration, reviewing financial statements and dealing with other situations where there is a potential for conflict of interest. This independence gives investors additional confidence that the board’s deliberations will be free of obvious bias.

How to ensure that the board is capable of exercising independent judgment?

Best corporate governance guidelines in many countries advocate for the inclusion of so-called independent directors. There are several definitions of an independent director developed by various codes of good practices, stock exchange requirements and recommended by international organizations. Each definition has its positives and shortcomings and is suited for specific markets. IFC uses a definition that can be more generally applied, based on the organization’s global outlook.<sup>30</sup>

In markets dominated by corporations with dispersed ownership where managers are very powerful, independence is defined mostly in relation to senior management—non-executive directors.

The context in Latin America is somewhat different. In countries where ownership concentration prevails, the focus of defining independence shifts to relations with the controlling owners who are often also the senior managers. Having representatives of the controlling owners in major power positions of the organization is a concern for outside investors. They are worried about this power concentration from two perspectives:

- › There is a risk that decision-making is concentrated in the hands of some individuals with their own interests in mind
- › There is the possibility of abusing the rights of outside investors

Because of this, such investors appreciate the presence of directors on the board, who are independent from controlling owners and management.

Data from the United States and Europe indicate that more and more companies are including non-executive or independent directors on their boards.

According to a survey of governance practices published in March 2006 by The Business Roundtable, an influential organization of US executives, 85 percent of the top US companies report that at least 80 percent of their boards consist of independent directors. These findings are confirmed by research from the headhunting company Spencer Stuart.<sup>31</sup> This study of companies listed on the S&P 500 index in 2006 revealed that 81 percent of directors are independent.

<sup>29</sup> OECD, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2004). Principles of Corporate Governance. Available at <http://www.oecd.org/DATAOECD/32/18/31557724.pdf>.

<sup>30</sup> See Appendix 4 for the indicative definition of independent director, International Finance Corporation, 2009.

<sup>31</sup> SPENCER STUART. (2006). The changing profile of directors: Spencer Stuart Board Index.

In Europe, where the focus is also on directors who do not play an executive role in the company—the so-called non-executive directors—surveys indicate that many board chairmen endorse increasing the proportion of non-executive board members, with 70 percent rating it as valuable or very valuable.<sup>32</sup>

In the Latin American context, it is much more unusual for boards to feature a majority of directors with independence from both controlling shareholders and management. This is because controlling shareholders typically can elect at least a majority of the board with their votes.

In certain countries such as Chile, independence is defined not in terms of economic, family or other relationships to management, but rather as the directors who are elected by the non-controlling shareholders. So, only a minority of directors on Chilean boards can meet the legal definition of independence.

In most Latin American countries—Argentina, Brazil, Colombia and Peru— independence is defined by relationships either to the controlling shareholders or management, not by who votes for them. Their regulatory or listing requirements seek to ensure at least a minimum number of independent directors, so they can play an influential role on the board. These requirements also ensure strong roles for independent directors on board sub-committees: audit, remuneration, corporate governance and others dealing with potential conflicts of interests issues such as related party transactions.

For example, BM&FBOVESPA's special corporate governance listing standards require that at least 20 percent of directors be independent. Other Latin American countries have similar or less restrictive requirements for independent directors.

Companies Circle members—and their leaders—clearly understand the importance of board independence—on average their boards now include 40 percent independent directors.

*“...It is legitimate for family-run businesses to want to remain privately-held. However, having professional and renowned independent directors is what ensures an effective balance between the family and the business itself, guaranteeing continuity in the future.”*

— **Roque Benavides**, *Buenaventura*, CEO



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<sup>32</sup> RUSSEL REYNOLDS ASSOCIATES. (2006). Governance for good or ill. *Europe's Chairmen Report*.

Here's a look at company-level practices:

- › Although **Buenaventura** is publicly listed, the founding family still maintains significant stake in the ownership of the company. However, the company still values the presence of five independent directors in a seven-member board.
- › **CPFL Energia**'s board of directors is comprised of seven members, all non-executive directors. Six members and their alternates are appointed by the controlling shareholders, and one is an independent member as defined by BM&FBOVESPA's Novo Mercado regulations.<sup>33</sup> They have created an efficient system to handle all the information received and made the necessary adjustments to stay on course, while streamlining the structure along the way.
- › For many years, **Ferreyros** had two independent directors. In the 2005 board elections three independent directors, selected by pension fund managers, joined the company. Today the board has four independent directors. As noted earlier in this chapter, independent directors sit on all of the company's board committees.

Clearly, independent directors can make a substantial contribution to a company's important decisions, especially in evaluating managerial performance, setting executive and director remuneration, reviewing financial statements and in resolving conflicts of interest. Independent directors give investors additional confidence that the board's deliberations will be free of obvious bias.



### For Your Consideration

If there are many definitions of independent directors in a given country, each company should specifically investigate what is the accepted definition most commonly used in the market where the company operates and has its securities listed. Once the definition is selected, it should be disclosed publicly to allow the investors to evaluate the company's policies on this matter.

## 2.4 Specialized Committees: Analyzing Matters In-Depth

As the business environment becomes increasingly complex, the demands on and responsibilities of the board and its members will continue to grow. Boards will need to develop a degree of specialization on matters within their purview. Many boards have opted to create smaller groups of directors with specific knowledge and experience: board committees.

Committees help the board become more effective, allowing closer focus, oversight, and monitoring of selected areas. Boards may opt for committees that focus on areas of interest to the company or the board. More specifically, committees:

- › Permit the board to handle a greater number of complex issues in a more efficient manner, by allowing specialists to focus on specific issues and provide detailed analysis back to the board
- › Allow the board to develop subject-specific expertise on the company's operations, most notably on accounts, risk and internal control
- › Enhance the objectivity and independence of the board's judgment, insulating it from potential undue influence of managers and controlling shareholders

<sup>33</sup> Novo Mercado rules require that 20 percent of the board be comprised of independent directors.

Companies Circle members have taken different approaches to committee structure and assignment of tasks.

### **Argos:**

All independent members of **Argos'** board actively participate in the audit committee, which meets quarterly and maintains close relations with company auditors. This committee has improved over time and is becoming more active, with specific and easily implemented recommendations. Two other board committees—the Compensation and Development Committee and the Board Matters Committee—meet less frequently since the issues they discuss relate to setting policies and general rules of operation. “Our experience with our board committees has been very positive,” company leaders say.

### **Buenaventura:**

The company established its audit committee, comprised of three independent board members, one year after compliance with the US Securities and Exchange Commission's regulations. This committee is responsible for assisting the board of directors in appointing independent auditors and reviewing the scope of internal and external audits. The audit committee also reviews internal control systems, quarterly and annual financial statements presented to the Comisión Nacional Supervisora de Empresas y Valores, the Lima Stock Exchange, and the SEC. The board is charged with ensuring that this committee is led by a financial expert and that all members of the committee are independent directors. The company also established compensation and corporate governance committees, to ensure high level and independent scrutiny for both activities that would consider all board members' perspectives. Although membership is the same in both committees, each committee has a specific set of rules described in the charter and holds separate meetings.

- The Compensation Committee is responsible for evaluating executive performance and approving the compensation of senior executives, including the company's chief executive officer, in addition to any stock option compensation plans.
- The Nominating and Corporate Governance Committee is responsible for preparing proposals for general shareholders meetings concerning the composition of the board, along with director fees to be approved by the shareholders. The committee also monitors issues and practices related to corporate governance and proposes all necessary actions.

### **CPFL Energia:**

According to company leaders, **CPFL Energia's** experience with board committees has undergone a significant transformation. Until recently, there were seven committees with a total of 37 positions. In 2006, these committees were dissolved and their responsibilities distributed among three new permanent advisory committees, with only nine total positions. The committees do not have a mandate for making decisions, and their recommendations are non-binding on the board. The chairperson of each committee reports on activities at the board's monthly meetings.



Figure 4.2 Companies Circle Members’ Board Committees



## ISA:

The company's three board committees are comprised of an interesting mix of independent and non-independent members.

- The audit committee has five independent board members, meets quarterly and interacts closely with the company auditors and governmental agencies given **ISA**'s mix of public and private capital.
- The New Business and Investments Committee's six-person membership includes four independent members and two representatives from the controlling shareholder, the Republic of Colombia. The members of this active committee meet whenever a business opportunity arises. They define and supervise the growth strategy of the company in Colombia and in the other Latin American countries where the company does business.
- The four-person Board Matters Committee has two independent members and two from the controlling shareholder. This committee oversees compensation, human resources development, nomination, corporate governance issues, labor and other general policies.

**Relationship between audit committees and other special bodies.** Latin American companies should also be aware of an additional issue—the relationship between board audit committees and other legally-mandated groups that oversee the financial and accounting practices of companies. These special structures, existing in several Latin American countries, are a step removed from the board but serve similar functions to an audit committee with preliminary approval of the company's annual financial statements. These groups go by different names depending on the country: in Brazil,<sup>34</sup> they are called fiscal councils. In Mexico they are known as comisarios.<sup>35</sup> And in Colombia, they are called revisores fiscales.<sup>36</sup> The addition of such bodies can pose challenges as they co-exist with audit committees. The NET case study demonstrates ways in which a company can resolve the potential problems that might arise when both groups are part of a firm's organizational structure.

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<sup>34</sup> Fiscal councils in Brazil are non-mandatory bodies of the company. Their purpose is oversight of the actions of the company's administrative bodies and to provide opinions on certain matters to the owners. Councils operate independently from management and from a company's external auditors—members are elected directly by shareholders at shareholders meetings. The council's main function is to monitor the activities of management, examine the financial statements each fiscal year and provide a formal report to shareholders. On the other hand, audit committees are comprised of board members and have broader responsibilities than the fiscal council. A number of codes and market participants have expressed a preference for an audit committee as best practice because it tends to be a stronger, permanent body with its own budget and greater powers, for example, to determine who is hired as independent auditor. The main tasks of an audit committee are to analyze financial statements in detail, support financial oversight and accountability, ensure that management adequately develops and adheres to sound internal controls, that the company's internal audit department satisfactorily fulfills its role and that the company's independent auditors assess and review management and internal audit department practices. According to IBGC's Code of Best Practices, the fiscal council does not replace the audit committee, since the latter is a monitoring instrument with functions delegated by the board and the former is a controlling instrument with functions directly defined by the owners. According to the Institute's code, when both are in place, some overlapping of functions might be expected and the two governance bodies should coordinate their activities.

<sup>35</sup> In Mexico, the comisario can only be removed if the company adopts a SAPI (closely-held company or Sociedad Anonima Promotora de Inversion) status and appoints an audit committee. However, the company can decide to keep the comisario, even if it has an audit committee.

<sup>36</sup> The revisor fiscal serves the same function as an external auditor and does not replace the function of an audit committee.

## Case Study: NET

### Fiscal Council vs. Audit Committee Case: Going Beyond Regulations

As a Brazilian company, NET faced the delicate issue of fiscal councils and audit committees.

Brazil's corporate laws mandate the installation of a fiscal council at the request of shareholders with defined criteria. The company had to decide whether to maintain its audit committee, which has broader responsibilities than a fiscal council and a more direct link to the board, or expand the scope of its fiscal council, popularly known as a "turbinated fiscal council."

Company leaders acknowledge that the decision was difficult.

From the start, NET realized that the company should not maintain both structures. The reason: having both would create unnecessary costs and mean more time in meetings. It also might create a situation in which responsibilities could overlap, increasing the risk for conflicting decisions.

The NET team sought guidance from other firms that maintained both the council and the committee. These firms noted that in reality one body would wind up considerably stronger than the other. The situation could waste resources and make it harder to attract top candidates for committee/council positions.

#### **NET Bucks Brazilian Trend, Turbinating its Fiscal Council**

At one point, there had been a clear trend in Brazil towards having an audit committee and not having a permanent fiscal council. But the SEC decided in support of a Brazilian group proposing that a fiscal council could satisfy the SEC's requirement for establishing audit committees in Brazil. Meantime, many major listed Brazilian companies already had established audit committees with a broader scope and farther reach than the legally-required fiscal councils.

The company ultimately decided to go with a turbinated fiscal council.

To minimize overlaps, shareholders decided that the council would also act as an audit committee. It would be totally independent, work in close coordination with the board, and hold a broader range of responsibilities than a regular fiscal council would.

#### **Consultants Help with Implementation**

An independent consulting company with a good and proven track record in the market was hired by the company—not the board. The consultants drove the entire process with independence and technical accuracy. The consultants started by defining the mission, role and internal statutes for the fiscal council. The process ended with defining compensation and hiring fiscal council members.

In parallel, the board nominated one of its members to act as a permanent liaison between the two bodies so decisions would be coordinated, understood and implemented in a timely and efficient way. As a result, the work happens in close collaboration, with no overlap. The board also has grown more comfortable in making use of the fiscal council's skill sets in various topics and discussions.



### For your consideration

This experience, though unique to the Brazilian market, can help your company as you consider various options in following a good practices path, especially when you are pioneering some of the practices, as NET has done.

## 2.5 Board Procedures

The number of directors, diversity in experience and knowledge, processes and operational dynamics are all elements that shape an efficient board.

The effectiveness of the board often depends on the organization of its operations—the meetings. Key elements for organizing and holding efficient board meetings include:

- › A clearly defined agenda
- › A complete set of materials to enable directors to make informed decisions
- › Advance notification
- › Assistance from the company secretary
- › Clear rules of board meeting procedures

Companies often want prominent persons to accept board positions. But they may not fully understand all the pre-existing demands on prominent people's time. And sitting on a board involves a significant time commitment. Board directors must dedicate time to read material prior to board meetings. They have to learn about the business. They have to understand operational details, market forces and future perspectives.



### For your consideration

Consider time availability when selecting your directors. Your directors' roles extend beyond attending board meetings. To make the hours spent in meetings effective, they must devote many more hours preparing and educating themselves. Sitting on a board involves a significant time commitment

The time each director dedicates to this activity varies greatly depending on the size and complexity of the company's business, its phase of development and the level of the director's participation in different committees. Even within the same board, directors' workloads may vary, depending on their committee appointments.

**Advance notice expedites decision-making.** Clearing the agenda of routine items by sending information ahead of time and managing discussion time frees more time to discuss big issues vital to the long-term interests of the company.

Some boards dedicate full-day meetings for strategy or policy-building topics, and this approach has proven effective. With more time together, and single critical topic on which to focus, directors can go deeper in certain themes that require more discussion and collective

reflection. This also contributes to the one of the objectives of the board of directors and the management: to develop a constructive relationship.

Sometimes, boards run the risk of adding so many agenda items to a meeting that they can become a major time drain, lengthy and unwieldy. There are steps you can take to avoid this—or to reverse course if things are getting out of hand.

### **CPFL streamlines board meetings**

Here's how **CPFL Energia** streamlined its board meetings, which have always focused on presenting material information in a way that provides context and effectively transmits executive officer perspectives on the issues.

- The company undertook a study of its meeting agenda topics, looking at meetings between February 2003 and March 2006. The topics were classified in 21 groups, requiring differentiated treatment, and separated into three categories, according to the type of contribution required from the board: topics that require a decision, issues that simply require monitoring and items for information purposes only, such as reports or files on the board's Web site.
- The study looked at a total of 665 topics, covered at board and committee meetings.<sup>37</sup> Of these topics, the study found that 28 percent were not subject to further discussion, 20 percent required simple monitoring, and 37 percent were in need of further discussion and decision.
- The study results were used as the company drafted a new corporate governance model agenda: CPFL Energia was able to eliminate 43 percent of the topics that needed to be addressed in such meetings. Now, they cover 378 topics.
- Board members receive documents nine days in advance, through an intranet board portal. This helps them prepare for meetings, clarify doubts and address questions to the officers ahead of time.

## **2.6 Better Boards Require Performance Evaluation**

Following good practices on composition, structure and procedures for board meetings is desirable. But these efforts alone are not enough to ensure that you will have a better board.

There must be continuous development of directors as well. This is key to meeting the growing demands and increased complexity of the business world. Development means increasing information flow and technical knowledge. It also involves growth of leadership and relationship skills.



### **Best Practice**

According to the OECD Principles of Corporate Governance, "In order to improve board practices and the performance of its members, an increasing number of jurisdictions are now encouraging companies to engage in board training and voluntary self-evaluation that meets the needs of the individual company."

<sup>37</sup> Find more details on CPFL Energia's revision of all board processes in Chapter 6 of this guide.

The results of the 2006 Business Roundtable Corporate Governance Survey confirm this: 38 percent of companies performed board evaluations in 2005, the survey found.<sup>38</sup> Moreover, 45 percent said they were planning board evaluations in 2006, up from 27 percent recorded in the 2004 survey.

Your board's performance should be reviewed regularly against both measurable and qualitative indicators. The governance system should include a process for evaluating the board's work, its committees, and individual directors. The idea is to improve performance in setting and achieving goals that add value. The Corporate Governance Progression Matrices, designed by IFC, the World Bank Group's private sector financing arm, state that companies achieving better levels of governance should conduct annual evaluations of the board.<sup>39</sup>



### Studies Show...Evaluations Build Better Boards

An international comparison of codes of good practices<sup>40</sup> by Weil, Gotshal and Manges reveals: 29 out of 30 codes of practice analyzed mention an evaluation of the board; of these, two codes mention evaluations in an indirect way.

61 percent of respondents to a Russel Reynolds survey<sup>41</sup> believe board evaluation is useful. The study involved 145 chairmen from 11 European countries.

In practice, many companies undertake board evaluations in one form or another. Most commonly, directors do a self-evaluation of their individual performance. They also express their opinions about the functioning of the board as a whole. The results of such evaluations:

- › Contribute to improved board operations
- › Enable better interaction between the directors
- › Help identify strengths and weaknesses in board's operations
- › Highlight areas in which directors and the board as a whole need improvement

It is one thing to discuss theoretical notions of why evaluations are important. It is another thing entirely to implement such evaluations in real life. Companies Circle members understand the importance and benefits of a structured evaluation process.

*"...Formal evaluation of corporate governance began at the outset and it was very important for our evolution. It is performed not to identify the negative points, but to permit opportunities for improvement. The board is evaluated, not the individuals. The directors and their alternates*

<sup>38</sup> BUSINESS ROUNDTABLE. (2006). Corporate governance survey.

<sup>39</sup> For IFC Corporate Governance Progression Matrix for listed companies see Appendix 1, Matrices for other types of companies are available at [http://www.ifc.org/ifcext/corporategovernance.nsf/Content/CG\\_Tools](http://www.ifc.org/ifcext/corporategovernance.nsf/Content/CG_Tools).

<sup>40</sup> GREGORY, H. J. (2007). *International comparison of selected corporate governance guidelines and codes of best practice*. New York: Weil, Gotshal and Manges.

<sup>41</sup> RUSSEL REYNOLDS ASSOCIATES. (2006). Governance for good or ill. *Europe's Chairmen Report*.

*receive questionnaires that are answered anonymously. The directors evaluate themselves and the CEO. The CEO evaluates himself and the board. An outsourced company analyzes and consolidates the results. Everything is then discussed in a meeting. The advantage is that it becomes clear what is expected of the directors and the CEO and what needs to be done to solve deficiencies. Everything becomes transparent with the result. A full day meeting is held to analyze the results and make decisions. The process has contributed greatly not only to the evolution of governance, but to the evolution of the whole company as well.”*



—**Eduardo Andrade**, CCR, Shareholder,  
Director and Chairman of Corporate  
Governance Committee

### **An anonymous questionnaire**

For **Ferreyros** the internal evaluation process begins with a questionnaire that is answered anonymously by all board members. Through several questions members can review the board's performance on issues such as attendance and quorum, relevance of matters discussed, minutes of the board and contribution of board members among others.

### **Evaluating the fiscal council**

**NET** has taken the concept of evaluation one step further. The fiscal council's evaluation process is totally implemented and managed by a third party. This has not only provided independence to the evaluation process, but credibility as well. The results went far beyond the perceived benefits, creating a positive impact on the board's operation as well. Of note, all involved take the evaluation process very seriously and spend considerable time discussing the results. They are committed to implementing any recommended changes that can lead to improvement.

## 2.7 Board Effectiveness Requires Attention to Various Details



### For your consideration

Keep in mind that all of these aspects of board effectiveness discussed in the previous sub-section are inter-related and complementary. Addressing all of them together is the best way to create a board that adds value to the company. Remember, too, that failure to deal with one or several board attributes—the composition, or the committee structure, or procedures for meetings—will significantly impair the board’s ability to perform its strategic guidance and oversight functions.

The Companies Circle members understand the importance of having a holistic approach to the board. How do they handle things?

### All the pieces of puzzle create value-added

At **Argos**, the company considers the structure and operation of the board as a key pillar of its code. Board members are independent and can always count on receiving information on time, thus strategic topics are discussed on a timely basis. The directors are well-remunerated and they can contract external advisers, visit company facilities anywhere in the world and arrange interviews and meetings with any company employee. Furthermore, the directors receive specific courses and lessons to improve specific professional skills. They have their own budgets, and use a self-evaluation system for their performance. All of these elements together create a board that acts in the best interests of the company and its shareholders.

The more recent practice takes the director self-evaluation to another level: each director is also asked to review the performance of other individual board members. This approach allows for each director to receive 360 degrees of feedback about their individual contributions to the operations of the board. Along with the demand for structured and objective evaluations, the market also has started to recommend the involvement of external and independent experts to help the chairperson of the board and the governance committee to carry out the task of board evaluation with as much objectivity as possible.

### Diversity for Ferreyros’ board

**Ferreyros** seeks diversification and independence for its board. According to company by-laws, the board must include between eight and twelve members to encourage diversity of opinions. Currently, the Ferreyros’ board has eight directors, four of them independent and each with different professional expertise. This contributes to better decision-making for the benefit of the company.

Additional board features:

- Board committees: Since 2005, the number of board committees increased from one to three—the General Management and Corporate Governance, the Audit, and the Organizational Development and Human Resource Committee. Each committee is composed of five directors, one or two of which are independent.



- Meetings: The board holds monthly sessions and provides updated minutes of meetings. In the last few years, there has been an 80 percent attendance rate at all of these board sessions.
- Remuneration: Board remuneration is based on company results. The by-laws stipulate that the board is entitled to 6 percent of freely available profits. Board members receive no other form of payment.

## 2.8 Relationship Between the Board of Directors and Senior Management

*"... It is fundamental to have harmony between management and the board. I have seen, at other companies, where the board becomes a restraint in management's life, and where management has tried to manipulate the board. In every board meeting at CCR, a presentation is made about a segment in the company. The board cannot remain in an illusory or abstract world. The board must know the details about the company. Another fundamental point is having an alignment of shareholder and management interests. At CCR this is achieved through a variable remuneration system based on the results obtained and a long-term incentive based on "Phantom Stocks". "*



—**Eduardo Andrade**, CCR, Shareholder,  
Director and Chairman of Corporate  
Governance Committee

Regardless of the board's composition and structure, it is important to consider how to develop good relationships between the board and management. Positive interaction can help foster appropriate conditions for making important decisions for the company.

The relationship between the board of directors and the CEO is not commonly covered in many national codes and international guidelines on corporate governance, although their respective roles are extensively considered. The issue is critical, though, due to the real-life challenges that such relationships pose.

There must be an appropriate balance between exercising oversight over the CEO and allowing him sufficient autonomy to conduct corporate affairs. The dangers of weak oversight are well-known; managers can operate in their own personal interests, and defraud shareholders. There are, on the other hand, dangers associated with excessive oversight, including micro-management, and the politicization of managerial decision-making. Both weak and excessive oversight can lead to economic inefficiencies and legal problems.



## For your consideration

Your company's internal documents should clearly define and divide responsibilities between the board and senior management. While oversight tasks should be carried out by the board, executive tasks should, clearly, be left to professional managers.

*"...It is important to understand that a board should not only be comprised of individuals representing different shareholder interests. The board is a collective body of professionals acting together to contribute to the sustainability of the company over time. Its main objective is to have a strong say in deciding who should be the chief executive officer and his possible replacement. In our view and despite family ownership, the CEO does not necessarily have to be a family member."*

—**Roque Benavides**, *Buenaventura*, CEO



How to establish a clear boundary between the roles and responsibilities of the board and the CEO? When does the board interfere too much in the day-to-day operations and, on the other hand, when does the CEO dominate the board? These are questions companies often face.

*"At CPFL Energia the roles the board and management play in the company have been clearly defined, the chairman of the board not being the CEO. The shareholders also made the decision to professionalize the management of the company. The CEO is selected by a top-rated headhunter and appointed by the board. The board makes it incumbent on the CEO to adopt the same process for hiring the other executive officers."*

*I believe that three important corporate governance factors have facilitated a constructive dialogue and a collaborative relationship between the board and the management:*

*Firstly, we have both a team of executives composed of the best professionals in their respective fields and board members who are experienced executives drawn from senior positions in business with an intimate knowledge of the company's activities. As officers develop strategies and share them with the board, the whole group is a party to the strategic plan, taking advantage of their different and complementary views, which leads to common understanding of the company's strategy.*

*Depending on its complexity, the time needed for the maturation of a decision can be lengthy. On the one side, we have management's profound knowledge of the business they run, and on the other side, we have the advice board members bring from a wider framework of experience. The second contributing factor is the decision of creating committees (permanent) and commissions (ad hoc) to assist the board on either relevant or complex matters which need sufficient time to mature and improve the quality of decisions. Board members participating in the works of the committees/commissions dedicate a great deal of their time to examining and discussing in-depth specific issues, such as the long-term strategy, information disclosure, management processes, and related parties' transactions. These interactions make board meetings more effective, help to make efficient use of relevant information and improve its dynamics.*

*The third important issue is that within an agenda for creating company value over a long-term horizon, we have a systematized method of verifying value. Monthly meetings are held so that the company results may be followed periodically by the board. The performance of the company is evaluated through the VBM, which is metric-based with a long-term vision and an important tool for investment decisions.<sup>42</sup> Through per-*

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<sup>42</sup> Value Based Management (VBM) is the management approach that ensures corporations are managed consistently on value (normally: maximizing shareholder value). The three elements of VBM are: creating value—how the company can increase or generate maximum future value, similar to strategy; managing for value—governance, change management, organizational culture, communication and leadership; measuring value—valuation.

*manent interaction, officers can count on the board advice and support whenever important issues need to be discussed. Hence, despite CPFL Energia Group being composed of a large number of subsidiaries, we have a competitive advantage in being able to move quickly with respect to implementing decisions.”*

—**Wilson Ferreira Jr.**, CPFL Energia, CEO



**Role of the CEO.** The position of the CEO has grown in importance and attention as companies have become larger, and their status sometimes rivals that of political leaders:

- › Vision and leadership are fundamental skills for the one in charge of the company’s affairs to propose business strategy and implement it, creating value for all stakeholders.
- › The board delegates to CEOs the authority to achieve the corporate objectives, offering them flexibility in running their companies within the limits established by the board.
- › The CEO reports regularly to the board and is accountable to it.
- › The board monitors the company’s and CEO’s performance, ensuring that corporate objectives are being pursued and achieved.

A major part of the CEO’s role is to keep the board fully informed about the operations of the company and progress in achieving the goals set by shareholders and the board in a timely manner. This information helps keep the board apprised of what is happening in the company and enables it to oversee management’s performance.

### **Linking board and management**

At **Marcopolo**, that the job of the top manager—CEO—involves the way the organization reacts to its environment to achieve the objectives and goals as agreed by the board. The CEO must attend to all operations, with particular focus on the way the business division works and its relations with supporting areas such as finance and administration. Here, the CEO contributes to the management process of the company by maintaining a seamless link between board decisions and the lower levels of management.

Marcopolo asks its CEO to:

- Understand and transfer the board's vision to the executives
- Put this vision into action
- Provide feedback to the board about the business environment and what is desired and feasible according to management capacity, skills, and time available
- Participate in all board meetings, except when his performance and/or any related item is under discussion

## 2.9 The Board Chairperson/CEO Relationship

The board chairperson/CEO relationship is a crucial aspect of the governance of any company.

Many corporate governance codes and principles recommend that the roles of the chairperson of the board and the chief executive officer be exercised by different people. The rationale here is that there is a conflict of interest when playing the dual role—of the director who is responsible to the company and all shareholders and of the most senior manager who should be overseen by the directors.

Aside from the oversight issues, there is another argument here—distribution of power minimizes risk. The reason: decisions stemming from balanced power permit challenging the proposed plans.

In the US the trend to combine the roles has thus far gone against international norms. The 2006 Spencer Stuart survey shows a gradual decline in the practice, from 74 percent of firms that combined the two roles in 2001 to 67 percent of firms in 2006.<sup>43</sup> As a counterbalance, most US boards have created the position of lead or presiding director, an independent director with a strong role in the board. The survey reveals that 96 percent of the responding companies feature boards with a lead or presiding director.

*"...In 2006, Ultrapar took another important step in the improvement of its corporate governance, nominating different individuals for the roles of chief executive officer and chairman of the board. In October, Paulo G. A. Cunha's succession was announced. Mr. Cunha is currently dedicating himself exclusively to the post of chairman of the board, a position he occupied together with his role as chief executive officer since 1998. As a consolidation of this process, from January 1, 2007, the post of chief executive officer of Ultrapar was taken over by Pedro Wongtschowski, who assumed the responsibility of continuing to run Ultrapar's businesses based on sustainable growth. This move also rep-*

<sup>43</sup> SPENCER STUART. (2006). The changing profile of directors: Spencer Stuart Board Index.

*resented an important step in the renewal of the company's Executive Board. Today, the Executive Board of Ultrapar is formed by a new generation of company leaders."*

—**André Covre**, Ultrapar, CFO



**Relationships with the controlling shareholder at issue as well.** In Latin America, where concentrated ownership prevails, the relationship typically is about the nexus between the chairperson and CEO, and with the controlling shareholder on the other hand.

In most businesses founded by the family, in the initial stage of the firm's development the founder is typically both the CEO and the chairperson. In such cases, the CEO's role is more dominant due to the need to develop and expand the business, while the chairperson's role and that of the board in general is weaker.

Where it exists, the board is largely an advisory structure for the founder. As the business grows, and the founder ages, the next generation of the family assumes a more prominent role in the senior management.

In some cases, one of the founder's children becomes the next CEO, while the founder remains as the chairperson. In other cases, family-owned companies decide to bring an outsider to serve as the CEO. Again, the founder remains as the chairperson. In both cases, unlike many Anglo/American corporations, it is actually the chairperson who is a more dominant figure.

Keep in mind, though, that this context is changing rapidly all over the world. The separation of the roles of CEO and chairman is required even for smaller companies and firms where the first generation is still running the business. The market views this as a prudent approach on the part of the founders. It takes into account business continuity regardless of the family ownership environment. Still, given the predominance of family-owned firms in the region, the relationship between the chairperson and the CEO is mainly shaped by the chairperson /controlling shareholder.<sup>44</sup>

**Building a bond of trust.** Although the CEO relates to the entire board, in cases where the chair and CEO are separate, building an effective relationship between them is crucial in order to create an environment of cooperation and trust. Considerable attention has been given to the effect of a board keen in its watchdog role, but reluctant to pursue its strategic advisory function.

A constructive relationship should prevail over an adversarial one, which does not mean that the board has to be weak in supervising the CEO's and the company's performance. This is not always an easy task—particularly when the chairperson used to be the CEO of the company.

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<sup>44</sup> Chapter 5 covers specifics of the relationship between management and controlling shareholders.

Developing common grounds for understanding will ensure that distinct roles are maintained but are integrated and aligned. A positive bond will help create a close working relationship.

All Circle companies separate the positions of chairperson of the board and CEO. Of the Circle members, only **Buenaventura** took a slightly different approach, inspired by the US system. In 2003, the company created the position of lead director to counterbalance the family members who sat on its board.

Buenaventura's lead director oversees and supervises the board, providing leadership to ensure it operates independently. The director also makes sure that all board committees are functioning properly and that results are reported to the entire board in a timely manner. This director also chairs a meeting with non-executive directors to discuss concerns or differences of opinion.

*"...At Marcopolo, the chairman of the board is the former chief executive officer, one of the company founders and the largest single shareholder. This experienced executive (60 years with the company), although he is no longer involved in daily activities, is an insurmountable source of historical information and knowledge and also an internal cultural adviser about the company and the bus body industry. The contacts with such a person provide very good opportunities for the exchange of ideas and the discussion of business-related aspects, present and future. However, such conversations do not preclude the CEO from his responsibilities in what concerns his job."*



—José Rubens de la Rosa, Marcopolo, CEO

## 2.10 Succession Planning for Senior Executives

Succession planning is the process of ensuring that the company has systems and a strategy in place for the development of future leaders. This process generally focuses on succession of the management team and especially the top management position, or the CEO. It is important to conduct this planning whether or not the management team in place is working well, as management succession issues could arise at any moment for any number of reasons, many of which are unforeseeable.



## For Your Consideration

Plan for continuity and cultivate new leaders within your organization. Conduct ongoing monitoring of your leadership needs.

Succession planning should be an integral part of the overall personnel management policy. Because of the particular importance and strategic nature of this issue, it should be overseen by the board of directors. If the board has a committee structure, the committee that covers staffing and remuneration policies should be involved in oversight as well.

Succession planning for key positions is an important feature of a well-developed corporate governance system and provides the following advantages:

- › Gives shareholders a reliable expectation of business continuity in case of the loss of key managers and helps resolve any potential conflicts within the controlling family, if the company is owned or controlled by the family
- › Sets the tone for personnel management for the whole company and can be a model for company-wide career development planning
- › Provides motivation to mid-level managers, through development activities and recognition

*“For more than twenty five years my role in the company was to lead it in a process of change and growth. Having been a company originally owned by a small group of owners, we transformed it into a very open public company, run by a team of professional managers. The principles of corporate governance were easily adopted and we were able to succeed having the permanent support of shareholders and other stakeholders while we made the company ten times larger.*

*Today, I am proud to have successfully participated in a succession program to turn the general management of the company into a very able representative of a new generation which has taken the responsibility to keep moving the company to new heights. I feel honored to continue serving the company, its shareholders and its employees in a new posi-*



tion assuring that the principles of good corporate governance will keep ruling our company.”



—**Oscar Espinosa Bedoya**, *Ferreyros*,  
Principal and Chairman of the Board

Companies with well-developed governance systems generally have succession planning for key positions in place. Such plans typically include:

- › Emergency succession plans for the CEO, all senior management and other key positions in the organization
- › System for assessing the qualifications and skills needed for any given position
- › Program for the professional development of personnel
- › System to facilitate the search for potential candidates from outside the organization for key positions

In most modern corporations, the selection of the CEO is the responsibility of the board requiring its active participation in succession planning for that position:



In succession planning for other members of the senior management team, the board and the CEO must collaborate closely. Remember that the CEO plays an important role as the architect of the management team.

Shareholders should be provided with general information about the succession planning system in place. Within the ranks of senior management, the emergency succession plans for key positions should be well-understood, but not publicly disclosed.

In family-owned companies, there is a unique dynamic around attracting and retaining senior management. External managers may be reluctant to join a company that lacks clear rules of development and promotion, where family members will always receive priority when the time comes to appoint successors. Succession planning issues specific to family-owned companies are addressed in the next chapter.

## 2.11 Monitoring Systems to Measure Performance and Management Evaluation and Compensation

Putting the right talent in place and driving their actions toward corporate objectives requires constant monitoring. It also requires a proper reward and compensation system with effective links to shareholder goals.

Previous chapters highlighted the importance of indicators in measuring progress toward implementing governance practices. Indicators are equally valuable when it comes to measuring your company's performance and how well it aligns with the defined strategic plan.

There are all sorts of options for measuring results through indicators and follow-up mechanisms. Some of these systems use profoundly different methodologies, particularly in how they measure the value created by the companies. In some cases, this measurement is linked to the remuneration system adopted for executives and board directors.

The Circle members are a diverse lot when it comes to the indicator systems they use. Some use the Economic Value Added system. Others use value-based management methodology. Still others use a mix of approaches. Here's a look.

In 2001, **Ultrapar** introduced the Economic Value Added (EVA®)<sup>45</sup> system. The project was completed in the second half of the year and was deployed in 2002. It served as the basis for variable remuneration for executives in the company's business units. Top management supported the implementation of EVA® as a way of measuring performance. Its implementation process and the control of results it provided strengthened the culture of discipline in allocating capital and shareholder return. Every three years, EVA® projections are revised for each business, and EVA® targets are drawn up as guidelines. Notes Ultrapar's chairman, Paulo Cunha, "The success of EVA implementation in Ultrapar comes from the fact that interests are not only aligned among shareholder groups, but also among shareholders and executives." Adds CEO Pedro Wongtschowski, "Our executives are recognized by the financial market as prudent people. Naturally, they put their money where their mouth is."

At **CPFL Energia** there is an integrated system of performance evaluation. Executive performance is evaluated by a mix of short, medium and long-term targets. The process is based on the value based management methodology—VBM.<sup>46</sup> The compensation framework is designed to align objectives at the senior management level and at the employee level with the achievement of quantitative and qualitative targets that support the building of the intrinsic value of the business.

VBM is dependent on the corporate purpose and the corporate values. The corporate purpose can either be economic (Shareholder Value) or can aim at other constituents directly (Stakeholder Value).

VBM aims to provide consistency of:

- Corporate mission—business philosophy
- Corporate strategy to achieve the corporate mission and purpose

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<sup>45</sup> For the definition of the term, see Glossary.

<sup>46</sup> Executives' evaluation methodology is the same applied to the strategic planning, i.e. it considers value generation in the short and long term. Executives' short-term goals are linked to the strategic planning goals and they are of two types —by corporate and by management unit results. Long-term goals are based on value generation to the business and to shareholders and use TBR—Total Business Return, and TSR—Total Shareholders Return metrics.

- Corporate governance—who determines the corporate mission and regulates the activities of the corporation
- Corporate culture
- Corporate communication
- Organization of the corporation
- Decision processes and systems
- Performance management processes and systems
- Reward processes and systems, with the corporate purpose and values a corporation wants to achieve, which typically is maximizing shareholder value

At **Marcopolo**, executives from the level of supervisor on up to the executive directors are evaluated by the Balanced Scorecard system. The BSC purpose is two-fold: to align and focus the entire organization on implementing and improving the strategy and policies determined by the board and to be a tool for management valuation and variable remuneration purposes. The BSC translates the long-term perspectives of the board for the vision, values and mission of the company. The short-term aspect determines the objectives—either of a general or quantitative nature—goals, action plans, value drivers and key performance indicators that will be used in the performance measurement. Marcopolo rewards its executives based on their degree of achievements, using annually-established goals that they have agreed to meet. The CEO translates this into a balanced scorecard, and submits it to the board for approval.

Scoring, based on team results, is quantified by the achievement of goals. Marcopolo's company philosophy aligns with the VBM concept, leading to improved bottom-line results. The main performance indicators may change over time as market conditions change. Typical measures include:

- Level of cash value added, based on cash generation
- Net profit
- Customer satisfaction
- Growth
- Innovation
- Competitiveness

### 3 Strengthening of Shareholder Rights and Maintaining Alignment

Shareholders commonly rely on the rights they receive in return for their investment. For most, this includes the right to participate in the profits of the company. Other rights are also important, such as the right to vote in annual general meetings to elect board members, approve the company's major decisions, capital changes, the annual report and financial statements, and the right to access information about the company and its activities. These rights give shareholders some comfort that the managers of the company will not misappropriate their investment.

The quality of investor protection depends on several factors, including the depth of capital markets, ownership patterns, dividend policy and the efficiency of allocating resources.<sup>47</sup> Where laws are protective of shareholders and well-enforced, shareholders are willing to invest their capital, and financial markets are broader and more valuable. By contrast, where laws and companies do not adequately protect shareholders, the development of financial markets is stunted.

<sup>47</sup> LA PORTA, R., LOPEZ-DE-SILANES, F., SHLEIFER, A., & VISHNY, R. (2000). Investor protection and corporate governance. *Journal of Financial Economics*, 58, pp. 3-27.

When shareholder rights are protected by the law and the company, outside investors are willing to pay more for financial assets such as equity. They pay more because they recognize that, with better legal protection, more of the firm's profit will return to them as dividends and/or capital gains as opposed to being expropriated by the managers or controlling shareholders.

### 3.1 Organizing Shareholders Meetings

The annual shareholders meeting, or AGM, is a company's most important forum for deliberations with the participation of all shareholders. Latin America does not have a strong tradition of extensive shareholder participation at such meetings. The historical concentration of ownership in a few individuals or groups has led to a decision-making environment in which a firm's main activities often get discussed behind closed doors.

But the demand for better governance practices is gradually beginning to change this picture. The main challenge involves attracting the largest possible number of shareholders to the AGMs. Regulations often constrain achievement of this objective. Now, though, some countries are examining this issue.

This is seen in Brazil, where the regulator is reviewing how to amend the regulatory framework to facilitate shareholder participation and ensure that all rights are preserved. This is of particular importance since the nation is starting to see companies with what is known as "pulverized" or dispersed ownership, as explained in the box on page 98.

In cases of dispersed ownership, the meetings are of vital importance, so the owners can make decisions on the main aspects related to the company's future. A less concentrated ownership structure, like what is starting to happen in Brazil, makes an efficient approach to shareholders meetings even more important.



#### For Your Consideration

Make good use of AGMs—shareholders meetings are your company's most important forum for discussion and decision-making with the full participation of all.

**Risk of domination by controlling shareholders.** Setting aside the case of dispersed ownership, most AGMs in Latin America have the potential problem that the controlling shareholders, often the family, is in the position to make whatever decisions he/she wants and thus controls the management.

The main challenge here is to ensure that the rights of non-controlling, non-family, minority shareholders are protected. Without this, it will be very difficult—or even impossible—to attract outside investors.

As a result, companies must have in place certain rules and processes to ensure that all shareholders have access to AGMs and are involved in decision-making. Such processes include:

- › Quorum for the meeting
- › Advance agenda notification for all shareholders on decisions to be voted on and materials

- › Choosing the venue of the AGM that is convenient for the majority of shareholders
- › Possibility for proxy representation
- › Informing all shareholders of the decisions made after the AGM
- › Possibility to use electronic means for AGM voting

The Companies Circle members provide some examples of how they have structured their AGMs to encourage shareholder participation.

### **Ferreyros engages minority shareholders**

**Ferreyros** prioritizes participation and voting at AGMs as an important shareholder right. But investors—usually minority shareholders—are not always interested in participating in meetings, in large measure because some companies treat such gatherings as a mere formality to approve financial statements.

But Ferreyros took an alternate approach, differentiating itself from other companies.

The firm uses the occasion of the AGM to provide detailed information on the company's business and its strategy for the future. A typical meeting follows this pattern:

- A video demonstrates the performance of the capital goods the company sells to different economic sectors.
- Graphs and data are presented as part of the presentation of the annual report.
- Financial statements are presented with an explanation of main figures.
- Financial statements submitted by management and reviewed by the board are approved by shareholders after a detailed presentation and a question and answer session.
- Other items on the agenda are presented with plenty of supporting data.
- Some years, shareholders are invited to visit company offices at the conclusion of the meeting to get a sense of day-to-day operations.

Ferreyros encourages the participation of all shareholders, including minority participants. The company does this by using legally-mandated channels such as ads in newspapers. It also posts information on the company Web site, mails an invitation to each shareholder's reported address and sends an email notice to shareholders who sign up for this service.

If shareholders are unable to attend the meeting, they can delegate rights to any person, without any restriction to act as their proxy.

Recent innovations for 2008 included use of new media as a way to expand participation even more: the March AGM was transmitted live and shareholders could access it in real time streaming across the Internet. Figure 4.3 demonstrates that such efforts have resulted in strong attendance rates in recent years.

**Figure 4.3 A Historical Perspective: Attendance Rates at Ferreyros AGMs**

Meeting Date	Quorum (%)
March 2008	92.13
March 2007	94.00
March 2006	86.41
March 2005	97.41
March 2004	93.47
March 2003	91.03
March 2002	74.88
March 2001	74.02

**Marcopolo’s tradition of participation**

**Marcopolo** has long encouraged shareholders participation at shareholders meetings, making it easy for them to vote by proxy or use other channels if they cannot attend in person.

In the 1980s, long before good governance practices were making headlines, the company’s shareholders meetings had a significant minority shareholder presence. At these meetings, leaders shared information on the state of the company.

Even 20 years ago, attendance at meetings in the company’s base of Caxias do Sul in the nation’s southernmost state would reach 700 shareholders—quite a surprising number for the time. Meetings always ended with a meal featuring the state’s famous barbeque, transforming these business gatherings into a signature event for the entire city.

Today Marcopolo’s articles of incorporation stipulate that general shareholders meetings will be held regularly, within four months after the end of the fiscal year. They can be called for other times as well if corporate interests so dictate. Shareholders can be represented at these meetings by their legal representatives, who may be shareholders, company managers, lawyers or a financial institution granted a proxy within the previous year. In facilitating this, the company is putting its words into action, doing all it can to ensure that all shareholders have equal opportunity to attend and vote.

**3.2 Shareholders Meetings in Companies with a Large Shareholder Base**

Companies with a large shareholder base face special challenges in trying to convene AGMs. Such firms must be more effective and creative in how they attract shareholders, so they can meet minimum legal quorum requirements—they need to make it clear that regardless of the overall number of shareholders or number of shares they hold, each vote counts.

**Dispersed Ownership: a New Phenomenon in the Region**

In a market characterized by concentration of ownership, a new phenomenon is beginning to take place—most notably in Brazil. Since 2005, some companies have enhanced the dispersion of shares. A few of them decided to sell the majority of their shares on





the stock exchange, as happens in the Anglo/American landscape, beginning with retailer Lojas Renner in Brazil.

So, the first Brazilian corporations have become a reality—companies without a controlling owner or a block of owners organized by way of a shareholders agreement. By June 2008, 8 percent of companies listed on the BM&FBOVESPA could be considered dispersed or diffusely-owned—approximately ten Brazilian companies had assumed this structure. And fully one-third of the firms listed on Novo Mercado—the exchange’s special corporate governance segment—have dispersed and diffused ownership.

The novelty of this ownership structure has posed some challenges for the pioneers. In some cases, the legislation is not suited to address the specific challenges that these so-called “pulverized” companies face, since the law regulating AGMs was designed for companies with a small number of owners.

For instance, the law requires that the AGM takes place in the company headquarters city. This may mean a small, remote town where the factory is located, easy for the controlling owners to get to but a bit more challenging for large numbers of investors based in the country’s big cities. The Brazilian regulation is currently under revision to adapt to the new circumstances of the market.

### Shareholders at Embraer vote for change

In March 2006, **Embraer’s** shareholders approved a capital restructuring proposal that made it one of the first large Brazilian companies with dispersed ownership. The corporate restructuring process unified the company’s outstanding shares into one class of common voting shares. The primary goal of corporate restructuring was to create a basis for the sustainability, growth and continuity of Embraer’s businesses and activities. For the company, the restructuring into one class of shares:

- Broke apart controlling blocks of shareholders
- Facilitated Embraer’s access to capital markets
- Increased the company’s prospects for obtaining new sources of financing
- Will likely result in more liquidity for all shareholders and greater voice in the company’s affairs, because of the voting rights afforded to all shareholders

The idea here is that without a permanently-defined controlling block shareholders will have to meet, assess, and align their interests to make decisions at each general shareholders meeting.

As shareholders approved the restructuring, they also approved new by-laws. These by-laws include protective mechanisms to ensure the dilution of shareholding control and that Brazilian shareholders hold the majority of votes. Keeping decision-making power in the hands of Brazilian owners is consistent with the 40 percent restrictive conditions set forth during the company’s privatization process.

*“...When we were offered studies of a capital restructuring whereby the company could offer to the totality of its shareholders 100 percent tag-along and voting rights, internal discussions started immediately and*



*strong efforts were driven to make those studies become a reality. The company had full commitment of the management and the board of directors to join efforts and work together for the completion of Embraer's capital restructuring.*

*From the first meeting until the approval by the shareholders almost two years went by. Embraer is a public company so it required the approval of its shareholders. Of equal importance, the company has one special class share—"the Golden Share"—held by the Brazilian government, which has veto power over seven issues stated in our by-laws. The approval of the capital restructuring by the Brazilian government was mandatory for the success of the company's initiative, and after a few meetings with official representatives, we received full support from the government, too.*

*Becoming listed at BM&FBOVESPA's Novo Mercado meant the achievement of success for the capital restructuring because this represents the most advanced corporate governance practices a company can adhere to in the Brazilian market. The unification of all Embraer shares into one single class brought the company many opportunities to access capital markets for future plans of growth."*

**—Antonio Luiz Pizarro Manso,**  
Embraer, Executive Vice President,  
Finance and Investor Relations



### **ISA finds a way for thousands of investors to make their voices heard**

For **ISA**, shareholders meetings are a vital instrument of corporate governance. This formerly state-owned company has sold shares to over 70,000 investors and the AGM has become a very important event, a powerful opportunity to display the company's corporate governance practices.



Since 2001, attendance at shareholders meetings has been impressive—1,500 - 2,000 people typically show up. But this also created logistical challenges that the company needed to resolve. Here's how the company handles this challenge today:

- Design rules governing the meetings: ISA developed its Internal Rules of the Meeting for the functioning of both regular and special general meetings. The document is distributed to all attending shareholders. It provides a wide range of information:
  - pre-established meeting schedule
  - venue
  - agenda
  - information disclosure
  - planned speakers
  - procedures on collecting free souvenirs
  - instructions on how many guests a shareholder can bring
  - interventions comprising reports of special auditors hired by shareholders
  - elections
  - voting systems
  - commissions to count votes and review the documents,
  - suggested behavior and protocols on requesting the right to speak, ask questions or make comments
  - coffee breaks and other “housekeeping” items
- Make it as easy as possible for shareholders to participate by communicating early: ISA views the AGMs as the best opportunity for the company to get closer to its owners. As soon as the board of directors determines the date, time and place for the meeting, the information is reported to the Colombian Securities and Exchange Commission and the general public. ISA also posts this information on its Web site. Shareholders and the public typically receive this information at least two months prior to the meeting. Those who live outside Colombia receive the same information by air mail or fax.
- Postal reminder announcements in news outlets: Fifteen days prior, all information about the meetings is published in two of the most important and widely-circulated newspapers in the country. The Sunday before the meeting, the company announces the meeting once again, in the same publications, with a goal of reaching as many shareholders as possible.
- Make use of the Web site: The company posts the same information on its Web site, including proposals for decisions and the annual report. The site also includes the resu-més of each candidate, as soon as the company finalizes the list of candidates for the board.
- Use the meeting to hold the senior leadership accountable: At each meeting, ISA's CEO must render accounts to the shareholders. The board chair must present a report on the board's functioning, including details of meetings and their frequency, attendance by each principal and alternate director and issues covered. This gives shareholders the opportunity to hear a report on how the company's business has been conducted directly from its top officials.
- Allow time for feedback: Shareholders also have an opportunity to ask questions and request explanations of company results.

### 3.3 Tag-Along Rights

Many conflicts in companies have to do with issues of ownership rights. Investors are often wary of the risks associated with companies in which majority shareholders hold control in excess of their cash-flow rights. The OECD Principles and Latin American White Paper on Corporate Governance both allow for voting and dividend rights to diverge.



## Best Practice

The White Paper suggests that “Large differences in voting rights among the same class of shareholders may create incentives for those with disproportionate voting rights to take decisions that are not in the common interests of all shareholders.”

The document recommends that in such cases, “The regulatory framework for protection of minority shareholders should be commensurately stronger and more effective.”<sup>48</sup>

However, the region has seen numerous cases in which majority shareholders’ disproportionate control has been abused, generating distrust among investors.

Members of the Companies Circle realized the need to build investor confidence by extending broader rights to shareholders. They introduced a series of changes that ensured better valuation of their companies.

A good example is what the marketplace calls tag-along rights—in which companies provide all shareholders with the same rights as controllers in the event of a change of control.<sup>49</sup>

### Ultrapar grants tag-along rights after IPO

One year after its 1999 IPO, **Ultrapar** granted tag-along rights to all shareholders, guaranteeing equal treatment to minority shareholders in the event of a change in corporate control when the controlling shareholder sells its stake in the company.<sup>50</sup> This pioneering move was not immediately recognized, as it took some time for the market to realize that the company was seriously overhauling its corporate governance. Ultrapar’s stock price struggled in its first years as a publicly-traded company. However, in the first follow-on offering six years later, the market’s reaction completely changed, and the firm was valued in line with Brazilian market indicators.

In 2004, Ultrapar included tag-along rights in its by-laws. At the same time, it distributed equal dividends to holders of common and preferred shares. The objective was to align the interests of common shareholders with those of preferred shareholders, making it easier to place new shares in the market, meeting the demands of the market for greater liquidity.

<sup>48</sup> White Paper on Corporate Governance in Latin America, agreed by the participants to the Latin American Corporate Governance Roundtable, p. 15, 2003.

<sup>49</sup> Tag-along rights refer to the concept of mandatory bid rule, in which minority shareholders have the right to receive at least a given percentage of the price paid to controlling shareholders in case of selling of their control stake. Prior to May 1997, the acquirer of a control block was required to make an offer to the remaining voting shareholders at the same price offered to controlling shareholders. Therefore, under the “original” corporate law (Law 6.404/1976), a tag-along right of 100 percent for minority voting shareholders was in place. However, Law 9.457, enacted in May 1997, amended the previous corporate law, abolishing the tag-along rights. A new amendment to the corporate law, Law 10.303, enacted in October 2001, partially reinstated tag-along rights for minority voting shareholders, this time with 80 percent of the price offered for the controlling block. On the other hand, since 2001 some firms voluntarily decided to grant tag-along rights to minority shareholders (even non-voting shareholders) beyond the legal requirements in Brazil. Companies Circle members were among the first to offer such rights. This decision was taken as part of the process that some firms carried out to adopt best corporate governance practices. The granting of tag-along rights of at least 80 percent for non-voting shareholders and 100 percent for voting shareholders today is a requirement for listing on BM&FBOVESPA’s special listing segment of Level 2.

<sup>50</sup> See more details in sub-section 5.2 of Chapter 6.

*“This is a very important step towards the materialization of a very important principle of corporate governance—the alignment of all shareholders’ interests. With this decision, they all have the same economic rights as the founder family members have.”*



—Paulo Cunha, Ultrapar, former CEO and current Chairman

Other Companies Circle members realized the importance of tag-along rights as well.

**NET** realized that to be a leader in corporate governance, 100 percent tag-along rights had to be extended to all shareholders with no exception. This decision has had a clear payback. All major institutional long-term investors that have become NET shareholders have indicated clearly that this practice was taken into account when they made their investment decisions.

Until August 2008, **Suzano Petroquímica** was listed on BM&FBOVESPA’s Level 2 special corporate governance listing segment. This required offering 100 percent tag-along rights to shareholders with common shares and 80 percent tag-along rights for those with preferred shares. At the time when the company opted to list on this segment in 2004, the 80 percent tag-along rights for preferred shares was higher than the 70 percent required by BOVESPA’s Level 2. The company’s decision to go above and beyond the benchmark set by the special corporate governance segment sent a signal to the market that the company was aiming to be an attractive option for investors, offering even more benefits and protection.



## Good Governance Pays

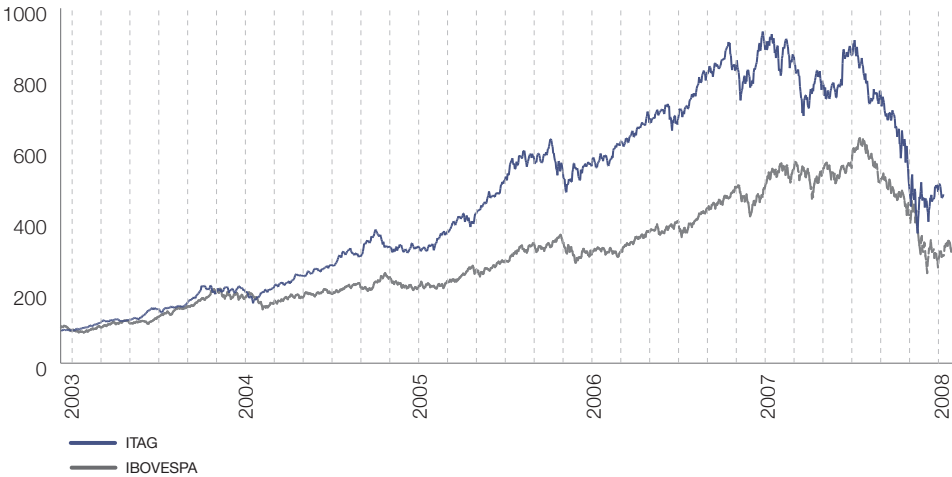
Academic research from September 2007 reveals that the efforts of Brazilian companies granting tag-along rights extending beyond legal requirements were recognized and priced favorably by investors.<sup>51</sup> The study analyzes 75 companies offering some tag-along rights in addition to the minimum rights provided by legislation between 2002 and 2005.

The result confirms the business case: good governance pays. The share price of these companies appreciated 60 percent in the case of voting shares (ON) and even higher—78 percent for non-voting shares (PN).

<sup>51</sup> NICOLAU, J. E. (2007). Tag along mínimo: vale a pena ir além? *Dissertação (Mestrado em Administração) Instituto Coppead de Administração.*

Figure 4.4 compares the main indicator of the Brazilian stock market to the performance of a theoretical portfolio of companies that offer tag-along rights. The theoretical portfolio was created in 2002. Tracking of the portfolio began in 2003.<sup>52</sup>

**Figure 4.4 IBOVESPA v. ITAG : Comparative Stock Price Performance**



Source: Economatica

### 3.4 Creating Clear Rules to Address Conflicts of Interest

Clear guidelines are key to effective handling of situations involving potential conflicts of interest. Planning in advance will help resolve situations in which interests might not be aligned.

CCR faced such a situation as it planned its growth strategy. The company was considering a well-designed shareholder structure that would include an IPO on the Novo Mercado.

The main issue was how to address the potential conflict between the roles of the construction companies and concessionaires, who had greater share of the controlling block. To respond to that concern, the company developed built-in protection mechanisms to handle any service with related parties. All contracts over R\$ 1 million (approximately US\$ 470,000) involving related parties and any other transactions with non-related parties over R\$ 2.7 million (approximately US\$ 1.26 million) had to be approved by the board of directors. In addition, any contract over R\$ 1 million with a related party could be preceded by an independent evaluation, if requested by any company director. If, in spite of a positive conclusion by independent evaluators, doubts remained, a provision was set allowing a no vote on the contract if 25 percent of the board vetoed it.

CCR's 10-member board has eight representatives of the four controlling shareholders and two independent board members. The mere existence of an explicit mechanism for all provided the kind of transparency that resulted in mutual trust. The mechanism appears to have provided

<sup>52</sup> The IBOVESPA Index is the main indicator of the Brazilian stock market's average performance. The ITAG—Special Tag-Along Stock Index is designed to measure the return of a theoretical portfolio composed of shares of companies which offer, in case of control sale, better conditions to minority shareholders than those required by law. Source: BM&FBOVESPA.

an effective deterrent to potential conflicts of interest in the company's contracts: so far the veto mechanism has not been used.



### For Your Consideration

In any case, it is recommended that the company adopts a clear definition of conflict of interest and the way it deals with it. Companies could choose having a stand-alone conflict of interest policy or making it a part of the company's code of conduct.

## 4 Improving the Control Environment

Among the elements that comprise the corporate governance system, the independent external auditor plays a fundamental role, generating confidence for other agents: the auditor ensures that the financial statements fairly represent the financial position and performance of the company. To do so, external auditors perform audits independently from the company, its management and controlling shareholders. This gives shareholders and other governance agents confidence in the corporation's accounting information and improves the company's ability to attract investments.

The objective of an audit is to enable the external auditor to express an opinion on whether the financial statements of the company are prepared, in all material respects, in accordance with the financial reporting framework recognized in the relevant country, and whether the statements are reliable. It gives all stakeholders an independent opinion about the company's financial position and, if performed properly, should attest to the accuracy of the accounts.

It is generally recommended that auditors be hired for a pre-established period, with the potential for rehire after a formal and documented evaluation of their performance by the board's audit committee. The primary responsibilities of this committee are to assist the board in:

- › Overseeing the integrity of the financial statements of the company
- › Reviewing the company's internal financial controls, internal control and risk management systems
- › Monitoring and reviewing the effectiveness of the company's internal audit function
- › Recommending the external auditor, who is then submitted by the board for shareholder approval and approving the external auditor's remuneration and terms of engagement
- › Monitoring and reviewing the external auditor's independence and objectivity and the effectiveness of the audit process
- › Developing and implementing policy on the engagement of the external auditor to supply non-audit services
- › Ensuring the company's compliance with all legal and regulatory requirements and other internal regulations of the company in the area of internal controls

In many jurisdictions, standard practice dictates that companies should state their position on contracting services other than the audit from the external auditors and concerning conduct that would be regarded as adversely affecting auditor independence.



## For Your Consideration

The external auditor will often submit what is known as a “management letter” in addition to the audit report. Companies seeking to implement good corporate governance should require such a letter. This document typically covers all material weaknesses in the company’s internal controls, and accounting and operating procedures. The purpose of the letter is to provide constructive suggestions to management concerning improvements in internal control procedures.

The findings contained in the management letter are considered to non-reportable to third parties, but they require corrective action by management. If your company wants to attract external finance be aware that investors will typically request a copy of the management letter.

Are you looking to raise external finance for your company? Be prepared, because investors may ask to see the management letter from your external auditor.

**Don’t ignore internal control systems.** The board should also ensure that management establishes and maintains an efficient system of internal controls to safeguard shareholders’ investment and company assets. Internal control is a process conducted jointly by the board, the management and the company’s employees, the aim of which is to provide reasonable guarantees that the following company objectives are met:

- › Reliable and accurate financial reporting
- › Efficient and effective operations
- › Company compliance with legislation and its own internal rules and guidelines

How to set up such a system of internal control?

Consider following a generally recognized framework like the structure established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which issued its Internal Control—Integrated Framework in 1992.<sup>53</sup> In 2004, COSO issued a second guidance, Enterprise Risk Management—Integrated Framework.<sup>54</sup> This document expands on the issue of internal controls to focus on enterprise-wide risk management.

The internal audit function is a key component of a successful internal control framework. Internal audit can be defined as an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations.<sup>55</sup> It helps a company accomplish its objectives by introducing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, controls, and corporate governance processes.

Internal audits encompass financial activities and operations including systems, production, engineering, marketing, and human resources. They are intended to help management,

<sup>53</sup> COSO, Internal Control—Integrated Framework, [http://www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm).

<sup>54</sup> COSO, Internal Control—Integrated Framework, [http://www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm).

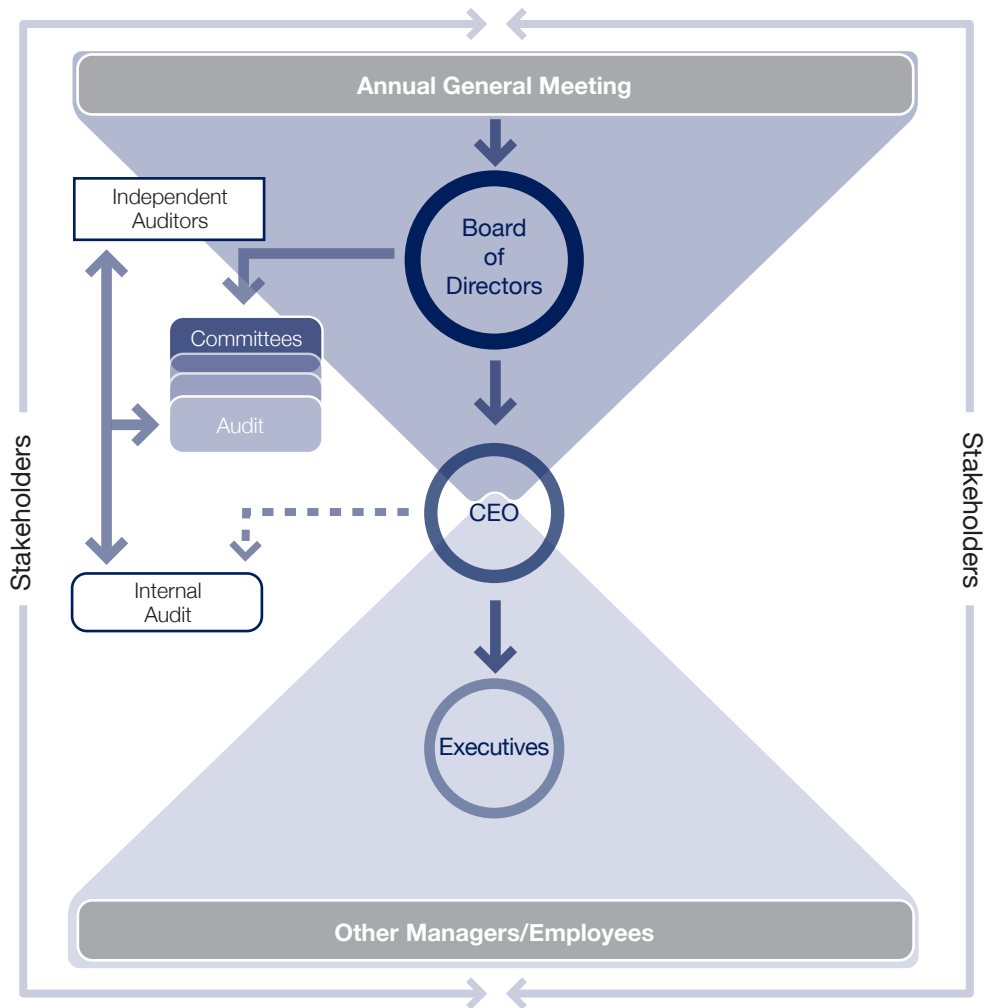
<sup>55</sup> THE INSTITUTE OF INTERNAL AUDITORS, [www.theiia.org](http://www.theiia.org).

but good corporate governance practice suggests that the chief of internal audit also provide a report to the company's audit committee or the full board. Internal audits review and ensure:

- › Reliability and integrity of information
- › Compliance with policies and regulations
- › Cost-effective and efficient use of resources
- › Safeguarding of assets
- › Attainment of established operational goals and objectives.

See Figure 4.5 for a sample internal control governance system.

**Figure 4.5 Independent Auditor and Internal Auditing in the Governance System**



Source: Better Governance

As would be expected, Circle companies have addressed these issues in different ways, depending on their own unique circumstances.

### Audit committee selects Atlas' external auditors

At **Atlas**, the decisions regarding selection and compensation of independent external auditors are made by the board's audit committee. Every year, a formal proposal is requested, according to the next year's activities. This is done by the CEO, who presents his recommendation to the audit committee. Through the audit committee, the board has final sign-off on the selection of the audit firm and on auditor's compensation. The decisions are documented as part of the minutes of meetings.

*"...The internal auditor at Atlas reports directly to the audit committee of the board of directors. Since 2005, this internal audit has been externally contracted and the service is performed by a world-renowned auditing company. An agreement was reached where this external provider presents a work plan on an annual basis that takes into account the risk assessment of the company. After discussions within the audit committee and management, a detailed work plan is elaborated and annual fees are negotiated. Every three months an update is given to the audit committee on work progress. The decision to externally contract the internal audit was done to take advantage of the contracting firm's strength in risk assessment and internal controls and procedures. As a worldwide firm, it could easily bring global best practices to this job. Through the years, our audit committee has been able to attest this fact."*

—**Roberto Truque Harrington**,  
Atlas, CFO



### Ferreyros' internal audit department ensures quality

At **Ferreyros**, the company set up an internal audit department as a way to ensure information quality and transparency. Highlights of the arrangement:

- The board selects the firm that audits the company's financial statements.
- The company's contract policy allows contract renewal on a yearly basis.
- Extension of renewal terms to five years requires a more thorough assessment of the level of performance.
- Even when the contract is renewed, the lead audit partner must rotate out.



- Contract policy prohibits hiring the audit firm to perform services other than the audit of financial statements.
- Legal and tax consultancy services are provided by other, unrelated firms.

### Independence for Buenaventura's internal audit department

At Buenaventura, in accordance with corporate governance best practices, and adhering to the Sarbanes-Oxley Act, the internal audit department is independent, reporting directly to the company's audit committee. This department is responsible for:

- Testing, evaluating and analyzing the system of internal controls established and maintained by management to safeguard the company's assets and ensure the accuracy of financial records
- Reviewing processes for compliance with all company policies and procedures
- Promoting operational efficiencies when appropriate
- Providing an annual general audit plan for review and approval by the audit committee

## 5 Transparency and Disclosure of Information

Timely and accurate disclosure is essential for shareholders, potential investors, regulatory authorities, and other stakeholders. Access to material information helps shareholders protect their rights and improves the market participants' ability to make sound economic decisions. Disclosure makes it possible to assess and oversee management, as well as to keep management accountable to the company and shareholders. Disclosure benefits companies since it allows them to demonstrate accountability towards shareholders, act transparently towards the markets and maintain public confidence and trust. Information is also useful for creditors, suppliers, customers, and employees to assess their position, respond to changes, and shape their relations with companies.



### Best Practice

A European expert advisory group, the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, notes the importance of Information disclosure:<sup>56</sup>

Requiring disclosure of information can be a powerful regulatory tool in company law. It enhances the accountability for and the transparency of the company's governance and its affairs. The mere fact that, for example, governance structures or particular actions or facts have to be disclosed, and therefore will have to be explained, creates an incentive to renounce structures outside what is considered to be best practice, and to avoid actions that are in breach of fiduciary duties or regulatory requirements or could be criticized as being outside best practice. For those who participate in or do business with companies, information is a necessary element in order to be able to assess their position and respond to changes that are relevant to them.

<sup>56</sup> Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe (November 4, 2002), Brussels, [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf).

More stringent rules apply to publicly-listed companies than to private, family-owned firms. Tight regulation of disclosure among listed companies is needed because of the greater impact of potential fraud when a company may have many thousands of shareholders. Given the importance of capital markets in a modern economy, governments are, understandably, keen on ensuring the integrity of the financial system. The increased number of disclosure obligations for listed companies is the price to be paid in order to access the large funds available on the capital markets.

Private companies, on the other hand, usually only need to comply with minimal disclosure requirements. Still, private companies should disclose enough financial and non-financial information so that the market and potential investors can understand their strategy and operations. This is particularly important when the company is interested in attracting new investors.



### For Your Consideration

Disclosure requirements are different for publicly-listed companies and for private, family-owned companies. If your company is preparing to go public, keep in mind that you will need to adhere to stricter regulatory requirements.

## 5.1 Organizing Information Disclosure



### Best Practice

The OECD Principles of Corporate Governance suggest that “...timely and accurate disclosure be made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.”<sup>57</sup>

The key concept that underlies the OECD’s recommendation is the concept of materiality. Simply put, materiality means information that could affect economic decisions taken by the users of information if it is omitted or misstated. Materiality may also be defined as a characteristic of information or an event that makes it sufficiently important to have an impact on a company’s stock price.

Information must be organized and well-prepared before disclosure so it can be readily absorbed by the market. Companies must define for themselves:

- › Information to add on top of what is legally required
- › The kind of information they want to—or commit to—communicate to the market and other stakeholders of the company
- › Who is authorized to disclose that information on behalf of the company

<sup>57</sup> OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004), Principle V on Disclosure and Transparency, <http://www.oecd.org/DATAOECD/32/18/31557724.pdf>.

- › How the relevant information is collected and verified
- › Who is responsible for information collection and verification

Typically, companies with advanced governance practices will have an information disclosure policy that regulates such matters. In general, these firms designate a corporate body or an officer responsible for ensuring that everyone complies with the disclosure policy. Often, this is a board-level entity, like an audit committee, or another stand-alone committee.

### Homex's internal control committee plays informational role

**Homex** has established an internal control committee to inform the investor community, regulatory agencies and third parties about relevant events related to the company's corporate governance changes, accounting and financial situation, as well as administrative, operational and extraordinary or non-recurrent events. The company's policy on disclosing information that might have a direct impact on the stock price is focused on communicating such information to the financial community in a timely manner. The main objectives of Homex' internal committee are to:

- Identify and disclose financial and operational events according to the disclosure policy as required by the SEC and CNBV rules
- Ensure that the revealed information is registered, processed and reported in the established reporting periods by the internal control department based on deadlines provided by the Mexican Stock Exchange
- Confirm, attest and disclose the existence, implementation, maintenance, design, and evaluation of the control system and disclosure procedures by the board of directors, CEO and CFO

### Case Study: Buenaventura Buenaventura's Disclosure Committee

Buenaventura's disclosure committee includes top management. Buenaventura created this committee, comprised of the CFO, the explorations vice-president and the controller, to evaluate the content and timing of the information to be released to the market. For quarterly releases, the information is reviewed and discussed at the board meeting prior to dissemination.

Part of the evaluation process has involved a review of the effectiveness of the company's design and operation of disclosure controls and procedures, beginning with year-end 2006. The company's top management, including the CEO and CFO, are part of this team. The conclusion: the company is effective in providing reasonable assurance that information required will be disclosed in reports filed and submitted under the United States Securities and Exchange Act.

#### Why did Buenaventura take such steps?

Company leaders feel strongly that providing the market with timely and accurate information will help the company gain and maintain the market's confidence, leading to positive impacts on liquidity and in the value creation.

In fact, Buenaventura has a sophisticated process to comply with requirements for listing on the Lima Stock Exchange and NYSE, which smaller companies could also use as a starting point, to consider ways to deliver relevant information to their different stakeholders.

The basic concept, regardless of company size:

- Organize your content
- Involve relevant people in the company to validate the content
- Plan your information release taking into account the needs of all target audiences



## For Your Consideration

Like listed companies, unlisted firms should consider disclosing more information on equal terms to all stakeholders—as Buenaventura recommends in the case study above. This will ensure adherence to the principle of fairness and transparency, and will help to avoid misunderstanding or creating a conflict among various stakeholders due to inequality of the information received from the company. This is especially applicable in relation to a company's varied sources of capital, including creditors and groups of minority shareholders. Release of simultaneous information to all financial stakeholders with the care have highlighted in this section will generate a positive perception of the company and help prepare it for future endeavors that may involve other capital market sources.

## 5.2 Communication with the Market: Much More than Transparency

In this world of instant, round-the-clock communications, competing for capital requires much more than transparency. You also have to master the art of communication with existing and potential investors.

Effective communication of a company's activities requires the existence of efficient channels, clarity in treating the content to be released and a strategy to address the community of investors. Typically, companies create internal structures or designate an officer to handle relations with investors. Here is what investor relations (IR) departments do:<sup>58</sup>

- › Develop and maintain a corporate disclosure policy and establish the process for timely disclosure of material information
- › Manage the set of required financial reporting to shareholders, regulatory agencies, and stock exchanges
- › Develop programs to increase awareness and understanding of the company
- › Build and maintain relationships with the investment community

The IR function in companies is currently undergoing changes, triggered by the new demands of a round-the-clock communications environment. Today, communication with the market may target a broader audience than investors alone. Communications efforts tend to focus on all of the company's stakeholders.

So, as IR directs its efforts towards investors along with multiple other communications targets, the department must interact with other parts of the firm to promote a correct understanding of the company and its business operations.

<sup>58</sup> COLE, B. M. (2003). The new investor relations: expert perspectives on the state of art. Bloomberg Press.

This is a new development, a novel concept in the marketplace but likely to become increasingly common in the future.

Communication extends beyond the economic dimension. It covers social and environmental aspects, governance practices, rules for ethics and conduct and more. Companies must present information on their operations and results. They also must share detail on how they achieved the results and the kinds of practices they have adopted to accomplish the results.

This new approach to corporate communication is very different from the old forms of unilateral corporate communications. In the past, companies shared only the good news—positive messages that might help enhance market perceptions.

Increasingly, company relationship channels are replacing the old practices. Such channels enable firms to listen to shareholder perspectives and consider these perspectives as part of operations. Your communication with stakeholders should take into account principles of transparency, accountability, fairness and corporate responsibility. The efforts should include sharing information about all the company's positive factors. They should also include the bad news, which could impact various stakeholders.

The result of this two-way communication: improved credibility and stronger relations. These principles apply to companies of any size, although they are of particular importance to listed companies where communication is more sophisticated. As you consider your communications strategy, be sure to establish a broad-based set of communication instruments with stakeholders, including:

- › Corporate Web site
- › Annual report
- › Annual shareholders meeting
- › Press-releases
- › E-mail communication
- › Face-to-face meetings
- › Conference calls

Some of the content presented in these communication vehicles includes:

- › Corporate policies, including:
  - + Disclosure
  - + Insider information
  - + Risk
- › Corporate governance principles and structure:
  - + Ownership structure
  - + By-laws and internal rules
  - + Corporate conduct code
  - + Corporate governance code
- › Financial reporting:
  - + Analyst reports
  - + Material facts
- › Annual corporate agenda (corporate calendar)
- › Notification and minutes of meetings (AGMs and Board meetings)

Here it is important to underscore, once again, that compliance with legal formalities is only one part of the effort to communicate effectively with the market. The over-arching objective of the IR function is to build an effective communication channel with the stakeholders.

Companies Circle members go beyond the letter of the law. They say they have gone beyond legal requirements in establishing their investor relations functions, as they continually search for better results.

*"...Although the market has its own system to communicate, our learning has been that it is not enough. Companies should not rely on the formal channels that regulators and market organizations have in place to communicate and assume the challenge to get to brokers and desirably into the target investor group. Meetings and road-shows are good means to do this, and the effort and time to prepare and run these are well compensated."*

**—Diego Artiñano, Atlas, CEO**



## Case Study: Natura

### Natura's Vision on Investor Relations

Natura set up an investor relations department specifically to serve investors, shareholders and capital market analysts. Here are the responsibilities of the department's management:

- Attending to investors
- Commenting on performance by developing a document with comments on the company's quarterly results: the company is required to disclose its results on a quarterly basis, via a result comment report, which may or may not present expected information. The best guidance is knowledge of the company and the industry.
- Coordinating and managing conference calls in Portuguese and English with investors
- Creating and setting an investor relations policy into motion
- Disclosing and negotiating policy
- Creating and setting a procedure policy in motion
- Defining information disclosure
- Developing IRM activity reports

The investor relations department's director is in charge of explaining the company's results in a credible manner, influencing investor perception of risks positively and, thus, reducing the cost of capital. In addition to financial skills, the activity requires solid marketing abilities to convey the investment message efficiently. Ultimately, the director's task is to help capital market participants—sell side and buy side analysts, fund managers and

individuals—to understand the company’s business. These participants provide market intelligence, and management must build its image and its credibility with this in mind.

Natura’s experience is that investor relations management must be lean: a senior manager, a full-time manager, a coordinator and an assisting secretary. With a small department and the need for backup staff on issues involving IR manager and coordinator responsibilities often overlap. Still, one person is always directly in charge of any given issue.

- **The full-time manager:** analyzes results, elaborates quarterly performance commentaries, deals with direct contacts with investors, and, together with the senior manager, organizes conference calls, presentations, and other activities
- **The coordinator:** supports the Web site, the “Investor” e-mail system, reports issued by the department, share custody at the custodian bank, updating information at BM&FBOVESPA’s Novo Mercado and contacts with investors associations and regulatory agencies

Because of its small size, the department typically needs additional help, engaging third-party services to:

- Organize events such as meetings with investors, conference calls, presentations at the Capital Market Investment Analysts and Professionals Association (Apimec) and for capital market perception surveys
- Ensure consistency in investment language and message, identify and support best market practice deployment—particularly with the Web site, IR’s most important communication tool. This helps the company access to equity and debt resources.
- Supply services such as conference calls, business wires and translators

**Attracting and retaining top communications talent at issue.** The Investor Relations (IR) function is complex and requires highly skilled people, backed by effective training, to obtain desired results—and it is not always easy to find the right people, as NET’s experience shows. The company also had a difficult time obtaining desired results and in securing the involvement of its CEO, like other companies in Brazil.

With the fast growth of equity markets in Brazil, all public and soon-to-be public companies are facing difficulties in identifying and retaining talent for their IR teams. These teams are relatively new in companies and in some cases still have an unclear role inside the organization. Besides finding staff who enjoy traveling between São Paulo, London and New York, they need people with high energy levels and determination, solid accounting training, a good strategic view and proficiency in English. Although extending long-term compensation to senior IR team members has helped in the retention process, this alone does not solve the issue.

To motivate its investor relations team—and as a way to increase retention of top talent—NET gives it internal exposure as well, bringing the group to strategic meetings as often as possible, sponsoring outside training and involving the CEO in the process. The goal: a team that doesn’t merely parrot what is written in the company’s financial statements, but a team that is capable of understanding the company’s strategic direction, feels as part of the management team and is committed to the company’s success.

## Case Study: Homex

### Broad-based Responsibilities for Homex Investor Relations Team

The **Homex** investor relations program is a comprehensive approach. Among the team's responsibilities:

- Communicate effectively and in a timely manner the company's business perspectives and financial results to the financial community, analysts, rating agencies, government, press and representative chambers, members of the board and management team, by distinguishing between the different interests of each target group.
- Assist in the definition, integration of the communication strategy for financial results and corporate business perspectives.
- Analyze, integrate and communicate the financial results: As a Mexican company with a dual listing on the New York Stock Exchange and Mexican Stock Exchange, all communication efforts are in Spanish and English so that both markets can execute their investment decisions based on the same information. This way, the company maintains open and credible communication in both markets, ensuring consistency of communications.
- Keep the company's management team and board informed: The IR team prepares quarterly reports that include a comparative results analysis, which looks at company results compared to other main competitors. The reports help managers identify and define operational differentiators that can help the firm to build a stronger message for the financial community and other constituencies.
- Retain and attract new investors: Twice a year the IR team conducts a perception and targeting analysis. This helps set a plan for continuous contact. It also increases the company's exposure to capital markets. Targeting analysis helps the firm to identify sources of demand, diversify the shareholder base and generate trading activity and liquidity, making IR efforts more efficient.
- Organize road shows: Based on the results of the targeting analysis the IR team plans a non deal-related road show. The CEO and CFO, together with the IR team meet with the company's most important investors to provide updates on company strategy, expand knowledge and deepen understanding of the homebuilding industry.

Once a year, along with the other four public home-building companies in Mexico, Homex sponsors "Mexican Housing Day", to enhance the investment community's understanding of Mexico's housing industry. Events include presentations by government housing agency officials who provide updates on the current state of the industry and future prospects. This event has been held for five years in a row in New York, and the last two years has been repeated in London. It has been well-received and has had a favorable impact on attendees' and participants' perceptions of the market. The Homex IR team plays a critical role in organizing these programs.

The group also puts together the company's annual "Homex Day", to which key shareholders and analysts are invited. This day is an opportunity to share with important players more about the Homex' story, the company's business fundamentals and the homebuilding industry in general.

The company's Web site has become an important communication channel as well. Company investors clearly rely on the site to verify company data, search for financial information and evaluate and reaffirm the investment they have made in the company. In 2007, Homex was awarded first place for Best Investor Relations Web site. The company also



earned the award for Best Earnings Release and Disclosure Process in Mexico by IR Global Rankings.

Homex's investor relations team helps the company explore other opportunities to gain additional exposure. For example, the company has a strong presence at the major analyst conferences every year, because they are a great way to communicate with existing shareholders and to meet new investors interested in the company.

This chapter took an in-depth look at the issues associated with developing specific corporate governance improvements. It is a complex process. Even though similarities across companies exist, determining an individual company's approach depends on its own unique set of circumstances. To assist companies with this process, a benchmarking questionnaire is provided in Appendix 3. This is a self-assessment tool, comprised of 100 questions, to help companies identify specific governance gaps and needs, and to define and refine their approaches.

## For Further Thought and Discussion

- Based on the earlier discussion about board composition, performance and monitoring think about your own company, and how you would approach this. What kinds of board enhancements would you need, based on your company's circumstances?
- Identify some ways to make your shareholder meetings more inclusive for a broader range of shareholders, based on the experiences you read from the Companies Circle members.
- What kinds of transparency and disclosure improvements are needed at your firm? Identify some steps towards making these improvements.
- How effective are your company's communications? Make a list of ways to enhance your communications.