Practical Guide to Corporate Governance

Experiences from the Latin American Companies Circle

Motivation

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to Corporate Governance

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International Finance Corporation (IFC)

The International Finance Corporation (IFC) is part of the World Bank Group and was established in 1956 to encourage private sector-led growth in developing countries. IFC fosters sustainable economic growth in developing countries by financing private sector investment, mobilizing capital in the international financial markets, and providing advisory services to businesses and governments. IFC helps companies and financial institutions in emerging markets create jobs, generate tax revenues, improve corporate governance and environmental performance, and contribute to their local communities.

In Latin America and the Caribbean, IFC focuses on key development challenges facing the region. We work to improve the business environment, broaden and deepen access to finance, and encourage infrastructure development. IFC's strategic priorities for the region also include

"Promoting sustainability – environmental and social, and corporate governance standards".

The goal is to improve lives, especially for the people who most need the benefits of growth.

Organisation for Economic Co-operation and Development (OECD)

The Organisation for Economic Co-operation and Development (OECD) is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalisation, in close co-operation with many other economies. One of these challenges is corporate governance, a topic on which the OECD has developed internationally agreed Principles of Corporate Governance, which have served as a basis for regional policy dialogue programmes throughout the world. The Latin American Roundtable on Corporate Governance, which meets annually, is one such initiative, organized by the OECD in partnership with the IFC/World Bank Group and with the support of the Global Corporate Governance Forum. In this way, the OECD provides a setting where governments and other stakeholders can compare experience, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

Global Corporate Governance Forum (GCGF)

The Global Corporate Governance Forum is an International Finance Corporation (IFC) multi-donor trust fund facility located within IFC Advisory Services. The Forum was co-founded by the World Bank and the Organisation for Economic Co-operation and Development (OECD) in 1999. Through its activities the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crisis, and provide incentives for corporations to invest and perform efficiently in a socially responsible manner. The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform programs. In addition to the IFC, the Forum is currently funded by the governments of France, Luxembourg, The Netherlands, Norway and Switzerland.

Contents

A Word from the Chair about the Companies Circle

I am pleased to share with you this great initiative from the Latin American Companies Circle—a very special moment in its history.

The Companies Circle was launched in May 2005 by recommendation of the Latin American Corporate Governance Roundtable—a network of public officials, investors, non-governmental institutes, stock exchanges and associations as well as others interested in corporate governance improvement in the region. It brings together a group of Latin American companies in order to provide private sector input into the work of the Roundtable and to share with each other and the public their experiences in putting principles of good corporate governance into practice. The Companies Circle is composed of 14 member companies from five countries that have demonstrated leadership in embracing good corporate governance practices, helping to build stronger businesses and companies: Atlas from Costa Rica; Argos and ISA from Colombia; Buenaventura and Ferreyros from Peru; Homex from Mexico; and CCR, CPFL, Embraer, Marcopolo, Natura, NET, Suzano and Ultrapar from Brazil.

The members of the Companies Circle are firms whose securities are listed on local and international exchanges and who have a significant presence in their capital markets. Their experiences are of most immediate relevance to listed companies. However, Companies Circle members believe that many of the steps they have taken in areas such as boards of directors, shareholder and stakeholder relations, internal controls and transparency also present important lessons for closely-held private corporations, including family firms. Accordingly, the efforts to share experiences with other firms in the region are not limited to the community of large, listed companies.

These 14 member companies work together in order to:

- Promote better governance in the region by improving the understanding of corporate governance and assist in developing policy responses
- Promote an ongoing dialogue on experiences between private and public sectors
- Monitor and evaluate corporate governance progress in the region
- Identify demand for technical assistance and encourage the creation of supply to respond to such demand
- Inform the international community about national and regional reform initiatives.

Today the Companies Circle does more than share experience. It works to be recognized as a knowledgeable, experienced and active think-tank on corporate governance practices in Latin America.

This book constitutes the result of our efforts to attain this ambitious mission. We are confident that these efforts will also help all corporate governance enthusiasts to develop a culture of values for professional and ethical behavior, on which the well-functioning of markets depends.

Enjoy the reading,

Andre Covre
Chairman of the Companies Circle

Foreword

In a short time, the Latin America Companies Circle has become one of the most vibrant and effective advocates for corporate governance improvements across the region. The Circle was established in 2005 by the International Finance Corporation (IFC) and Organisation for Economic Co-operation and Development (OECD), at the request of the Latin American Roundtable on Corporate Governance. It quickly gained a reputation for the generous and open way that its members shared their experiences in awareness-raising events throughout Latin America. The experiences of Companies Circle members in building better corporate governance rules and practices are highlighted in their previous publication, *Case Studies of Good Corporate Governance Practices.*

The IFC's and OECD's joint efforts with regional and local partners to improve corporate governance, in Latin America and globally, have led to real progress at both company and policy level. An important initial result was the stage-setting *White Paper on Corporate Governance in Latin America* from the Latin American Roundtable on Corporate Governance. Progress includes legal and regulatory reforms, the development of country codes of best practice, the creation of advocacy and support institutions, the pioneering efforts of the Novo Mercado in Brazil, and heightened attention to corporate governance by many market participants. But improvements are not universal and more needs to be done.

As the Companies Circle demonstrates, the business community is an important driver for reform. While policymakers and regulators have a key role in setting the overall framework, it is the private sector that ensures successful implementation on the ground. We therefore welcome this initiative by some of Latin America's leading listed firms to develop this *Practical Guide to Corporate Governance: Experiences from the Latin American Companies Circle*. It is the first guide of its kind produced for Latin American companies and reflects a diverse range of company experience from the region. Its practical, hands-on guidance and tangible, relevant examples should be of enormous help to companies starting on the path to improved corporate governance.

When the idea of creating this guide was born, markets around the world and in Latin America in particular were expanding rapidly and successfully. Part of that expansion was no doubt due to corporate governance advances in the region. Today, the global economic situation is changed, with the widespread financial crisis and economic downturn. But the crisis underlines the importance of strong corporate governance to build strong companies. The *Practical Guide* could not have come at a better time.

We are convinced that this guide will be widely disseminated and used by Latin American companies, resulting in further improvements in their corporate governance. We would like to thank all of the members and supporters of the Companies Circle and particularly its able Chairmen Roque Benavides of Buenaventura in Peru, Carlos Yepes of Argos in Colombia, and Andre Covre of Ultrapar in Brazil. They have all played an important role in making the Companies Circle such a success.

Toshiya Masuoka

Director of Corporate Advice Department
International Finance Corporation

Carolyn Ervin

Director of Financial and Enterprise Affairs
Organisation for Economic Co-operation and Development

Acknowledgments

The preparation and publication of this Practical Guide has involved the participation and efforts of a large number of dedicated people and has been a productive, collaborative effort.

On behalf of the International Finance Corporation and the Organisation for Economic Co-operation and Development, we would like to express our sincere gratitude to Sandra Guerra, the Circle's coordinator, for all her efforts in the production of this guide. Ms. Guerra was instrumental in conceiving and developing the outline of the guide and preparing the first draft of the guide by patiently soliciting, collecting, coordinating and editing the input from the Companies Circle members. Ms Guerra diligently worked with the sponsoring organizations to further improve the original draft.

Our sincere thanks go to the many companies and individuals whose efforts have helped make this guide a reality. Their support has been a constant ever since the first meeting of the Companies Circle in May 2005 when the kernel of the idea began to form.

The guide weaves together concepts and contributions from numerous shareholders, board directors and key managers, representing 14 firms, based in five countries across Latin America. They share a common bond—a commitment to enhancing and diffusing knowledge of best governance practices. The pages of the guide reflect this strong commitment and we are deeply indebted to them.

Our contributors have supplied mountains of qualitative and quantitative data. They have dedicated their valuable time to explore their reasoning and motivations in implementing better corporate governance practices. And they have articulated both the highs and the lows of the experience. Their willingness to undertake this enormous amount of work has resulted in an extremely practical, wide-reaching volume that does not merely narrate events. Instead, the book highlights motivations and methods, details quantifiable results, offers helpful lessons from real experiences and provides clear guidance on steps to take.

In some cases, contributors who started the journey with us and whose enthusiasm for the cause far exceeded our expectations have moved on. We are grateful that their successors have maintained their level of commitment and input.

Our deepest appreciation goes to the dedicated individuals of Companies Circle member-firms who made this work possible and who secured the contributions of key participants: Maria Uriza and Carlos Raul Yepes at Argos; Diego Artiñano and Roberto Truque Harrington at Atlas; Roque Benavides and Daniel Dominguez at Buenaventura; Eduardo Andrade, Francisco Bulhões, Silvia Salmeron, Renato Vale and Massami Yueda at CCR; Marco Da Camino Soligo, Gisélia da Silva, and Wilson Ferreira at CPFL; Anna Cecilia Bettencourt Cochrane, Carlos Eduardo Camargo and Antonio Luiz Pizarro Manso at Embraer; Mariela Garcia de Fabbri and Patricia Gastelumendi Lukis at Ferreyros; Eustaquio De Nicolás Gutierrez, and Javier Romero at Homex; Juan David Bastidas Saldarriaga at ISA; José Rubens De La Rosa and Thiago A. Deiro at Marcopolo; Helmut Bossert, Fernando Mesquita, José Guimarães Monforte, Pedro Passos and Moacir Salzstein at Natura; João Elek, Leonardo P. Gomes Pereira and Marcio Minoru Miyakava at NET; Maria Cecilia de Castro Neves, David Feffer, Andrea Pereira, João Nogueira Batista and Bernardo Szpiegel at Suzano; and André Covre, Marcelo De Simone, Maria Fernanda Leme Brasil, Fabio Schvartzman and Pedro Wongtschowski at Ultrapar.

The determination of the three sponsoring organizations and their leaders—Darrin Hartzler of IFC, Mats Isakson of OECD and Phil Armstrong of the Global Corporate Governance Forum—helped ensure that the guidebook idea would become a reality.

Gratitude also goes to the hands-on efforts of several individuals—former and current staff at the sponsoring organizations. Mike Lubrano embraced the challenge of putting this guide together when he was the manager of the Corporate Governance unit at IFC, and continued as a tireless supporter of the work after he left IFC. Without him, this guide would not be in people's hands today. Nancy Metzger, at the GCGF when the project began, proposed

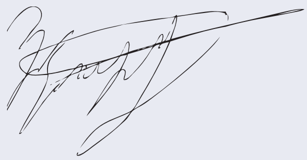
and implemented practical solutions to help the team overcome complex operational challenges. Santiago Chaher, her successor, demonstrated the same level of dedication and insight. Cuauhtémoc Lopez-Bassols of OECD had also provided valued support to this project.

Alexandre Di Miceli da Silveira, PhD and MSc, Professor of Accounting and Finance, School of Economics, Business and Accounting at the University of Sao Paulo, proposed the research framework for the last chapter. He supervised the data collection and analysis that formed the basis of the results detailed in this chapter. We are grateful for his extensive contributions.

Corporate governance is a continuum. As circumstances change over time, corporate governance efforts will change as well. We hope this volume will serve as companion and guide for those interested in addressing governance at their firms, no matter where they are along the continuum.

Daniel Blume, Principal Administrator of OECD's Corporate Affairs Division.

Davit Karapetyan, Corporate Governance Officer of the IFC Corporate Governance Unit.



INTRODUCTION

Introduction

An initiative of 14 leading Latin American companies, ***Practical Guide to Corporate Governance: Experiences from the Latin America Companies Circle*** distills the lessons learned from their experiences in improving their own governance. The book is intended as a roadmap to guide other Latin American companies interested in improving their corporate governance.

Although the guide has been in the works for several years, the timing of its publication coincides with a global financial crisis that has catapulted corporate governance to a top spot on the global policy agenda. With gaps in governance—from inadequate risk management to distorted incentives structures—factoring in as contributing to the crisis, good corporate governance practices will be an important part of the response needed for Latin American economies, as well for others around the world.

Beyond the immediacy of the crisis, Latin America possesses a unique set of corporate governance and market characteristics: a predominance of conglomerates and a highly-concentrated, frequently family-based ownership structure. In addition, domestic capital markets are still in the early stages of development. All of this poses special challenges to attracting investment and elevates the importance of governance practices. Among the challenges: ensuring that minority shareholders are confident enough to invest in listed companies by enhancing the protection of shareholders' rights and interests.

Within this context, there has been a remarkable growth in awareness and activity surrounding corporate governance during the last decade, as recognized by the Latin American Roundtable on Corporate Governance. This is an ongoing initiative of the Organisation for Economic Co-operation and Development and the International Finance Corporation/World Bank Group that has brought together policy-makers, regulators, stock exchanges, investors, companies and other stakeholders on an annual basis to promote improved policies and practices specific to the Latin American context. The Roundtable's White Paper on Corporate Governance in Latin America, issued in 2003, was a first attempt to outline public policy priorities and good practices specific to the region. Recognizing that much remains to be done, the Roundtable followed this with the establishment of the Companies Circle in 2005 to promote corporate governance implementation at the company level.

This practical guide is an outgrowth of these efforts, involving many steps along the way. When members of the Roundtable called for greater participation from private sector companies in the Roundtable's corporate governance improvement efforts, the Companies Circle was born. A first book of case studies was launched in 2005, with an expanded second edition issued in 2006. Members of the Circle were keen to share experiences and believed a wider audience of Latin businesspeople would benefit from a practical guide exploring the ways and whys of their governance improvements.

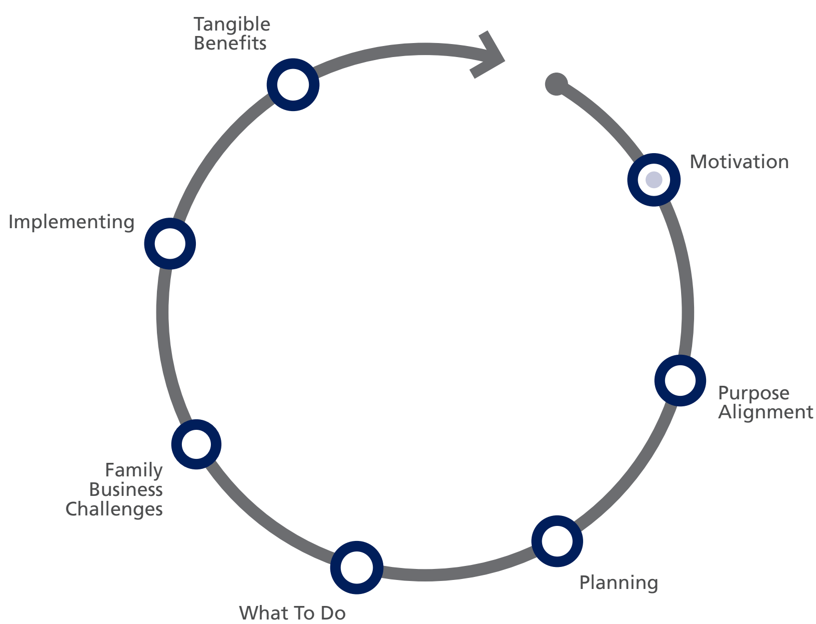
Practical Guide to Corporate Governance: Experiences from the Latin America Companies Circle offers an opportunity for business leaders in Latin America to learn from the experience of peers who have successfully implemented substantive improvements in governance standards and practices. It provides rare access to top executives, shareholders and board directors of pioneers in the governance implementation in Latin America. These companies include: Atlas of Costa Rica, Argos and ISA of Colombia, Buenaventura and Ferreyros of Peru, Homex of Mexico and CCR, CPFL, Embraer, Marcopolo, Natura, NET, Suzano and Ultrapar of Brazil.

The guide is unique in bringing together four different dimensions: cases from companies themselves, results of market and academic studies providing supporting evidence of the benefits of governance, best practice standards from institutional references, including IFC, OECD and the Global Corporate Governance Forum, and empirical evidence comparing Circle members' results to their Latin American peers.

The practical nature of the book stems from the real-life experiences of leaders, who talk about why and how they implemented corporate governance policies and practices. The guide offers readers an unusual level of access to a wide range of stakeholders who affect and are affected by governance: from shareholders to board directors to key managers. Rich, first-person testimony is integral to the book, as experienced leaders share motivations, thought processes and experiences, and offer practical solutions that have been tried and tested and can be implemented.

The same range of interested parties that provided information stand to gain most from this guide, particularly listed companies or firms that are actively considering a listing and want to understand the depth and range of impact from profound governance changes. The guide also will prove beneficial to managers and owners of privately-held corporations who are interested in deepening their knowledge of best practice and in drawing on the experiences of leaders who have chosen this path. The family-owned business, which is so predominant and relevant in Latin American markets, fits this category.

Structured over seven chapters, the guide re-creates the journey that business leaders make when implementing change. The guide starts with motivations and ends with benefits, helping the reader navigate logically through the governance implementation process. Some readers may wish to start with later chapters first—the tangible benefits section at the end may be useful in defining motivations—or they may want to dip into various chapters. The approach of each individual reader will vary according to his/her motivations and interests.



Chapter 1 Motivation: The Whys Define the Ways

This chapter introduces the motivations underlying the decisions by leaders of the 14 Latin American Companies Circle member firms to implement governance changes and explores ways leaders might seek to define motivations for implementing good governance. It shows the importance of identifying clearly desired benefits and working to achieve them, while demonstrating the variety of possible motivations, with differences dictated by ownership structure, the life cycle of the company, its industry sector, and the institutional and regulatory framework of the country. All of these elements will play a role, and will impact a company's desired outcomes. The chapter underscores the fact that motivation for governance improvements will drive the agenda and pace of actions.

Chapter 2 Purpose Alignment: Changing Attitudes and Generating Commitment

This chapter examines ways to bring together the varying interests of individual shareholders and stakeholders under one proposed governance change framework. It explores ways to build common understanding on aspects of governance, to spur changes in attitude and to generate commitments from diverse groups of individuals with differing viewpoints. The chapter also addresses dissenting voices and discusses sensitive approaches to changing attitudes associated with beliefs and sometimes conflicting cultural viewpoints. It offers suggestions for reaching out to stakeholders and methods for including all of these various parties.

Chapter 3 Planning and Setting Priorities

Chapter 3 details the planning process, how to prioritize and set key goals, and how to define aims by identifying the desired outcomes from governance. It highlights the importance of balancing several short-term, highly achievable aims with deeper, longer-term change, and measuring the benefits of each. The chapter highlights ways that change leaders can make use of local and international benchmarking to establish an achievable plan with clearly defined responsibilities and timeline: a "roadmap" supported by a rewards and incentives system. The chapter also emphasizes the importance of flexibility and creating realistic expectations for the timetable of change —leaders need to recognize that even the best-laid plans may experience some delays.

Chapter 4 What to Do: Key Good Governance Practices

This chapter provides practical examples on the implementation and execution of plans and best practices. It covers governance mechanisms— the annual general meeting, the board and its committees, management—and the relations among them. Practices and policies are described, drawing upon the Circle members' rich experience.

The governance improvements are grouped and presented in six sections:

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

Chapter 5 Governance Challenges for Family-Owned Businesses

Chapter 5 looks at the specific benefits and challenges faced by family-owned businesses. It presents various perspectives, including those of family members and investors, and introduces academic research on the topic. This chapter investigates the most common problems, including managing conflicts of interests of various family members, professionalizing management, and institutionalizing good practice and policies. It incorporates a business case from a third-generation, family-controlled company, showing how members resolved these issues.

Chapter 6 Implementing Governance

This chapter details the specifics of implementing policies, practices and new structures. It includes advice on how to take the first concrete steps on the corporate governance journey, monitor results and ensure that they are aligned with initial expectations. The chapter also suggests ways to fine-tune governance policies to make them responsive to reactions from shareholders and other stakeholders. The material covers initial actions as well as monitoring and continuous revision of the governance process to achieve best results and to continue learning and improving, a process dubbed "governing governance."

Chapter 7 The Tangible Benefits of Good Governance

Chapter 7 provides the bottom line on governance: a series of quantitative results using five different approaches to evaluate the benefits of corporate governance across a broad range of indicators. The analysis focuses on the impact of governance on operational indicators and on the cost of capital. These data reinforce the view that governance yields benefits. The data demonstrate the strength of financial and operational results achieved by governance leaders when compared to all Latin American listed companies.

Companies Circle members reported higher levels of profitability, share prices and liquidity, and lower cost of capital than their Latin American counterparts. Additionally, in the short term, public announcements of governance improvements were followed by an immediate 8 percent average increase in share value beyond what would normally have been expected. For shareholders, the analysis underscores the benefits of investing in companies with strong corporate governance policies.

This chapter also takes a first look at the impact of the crisis on corporate governance results during the second half of 2008, again comparing the Circle group with all Latin American listed companies. The results presented show that even after the first reactions to the financial turmoil, Circle members registered better market and operational results. Of even greater significance, the analysis showed that the Circle group enhanced its lead for price/earnings ratios and share price/book value ratio when compared to 2005-2007 results. Clearly, investors have perceived that Circle companies offer better value than the broader Latin American group in a time of market distress.

The chapter also details the stock market reaction during this period. The results show that the declines were not as steep for Circle group stocks. Given that this outcome could be attributed to other factors, another test using a more complex methodology and putting aside other corporate attributes was applied. Once again, the results offer a clear sign that being part of the Circle group and/or cross-listing in a stricter market are factors that soften stock declines during market stress.

These qualitative and quantitative results are particularly timely, coming at a time when many companies are struggling with what may prove to be the worst economic downturn in generations and when they may be tempted to shelve their governance plans.

In the appendices to the guide, there are tools to help companies start their corporate governance journey. A 100-point benchmarking questionnaire, designed for listed companies, provides a reference for self-evaluating corporate governance practices. The IFC Corporate Governance Progression Matrix is another helpful tool for listed companies. Both may be of use in structuring an initial assessment of governance practices. Additional references to other sources are provided along with a glossary of terms to help navigate through concepts and definitions.

In an era that promises to be more competitive for financing and investor attention, this book is a useful reminder that governance is of vital importance for sustainable growth and creation of value for all actors in the governance chain: shareholders, managers, board directors, investors and all other stakeholders who contribute to the wealth creation of companies. The book is designed to serve as a practical guide for those companies keen to embark on the governance voyage.

All that remains is to welcome readers to the journey with hopes that this guide will provide food for thought and lead to rewarding places.

Sandra Guerra

Companies Circle of the Latin American Corporate Governance Roundtable
Coordinator

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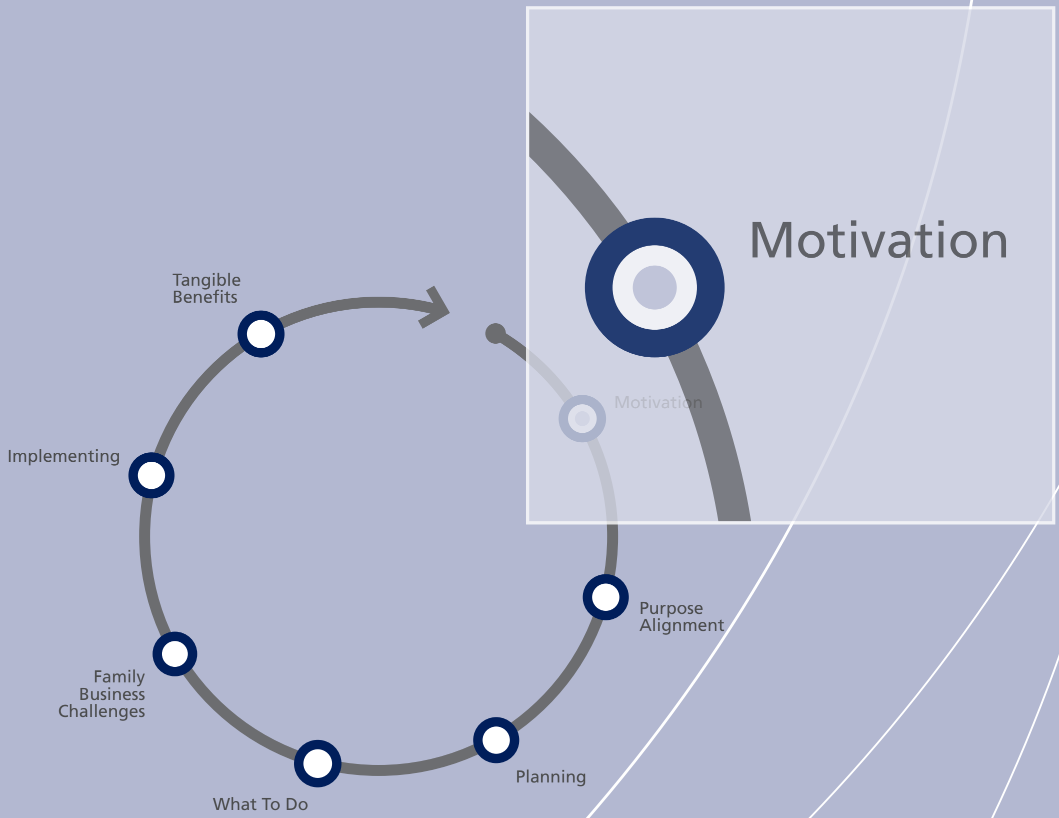
MOTIVATION: THE WHYS DEFINE THE WAYS



Chapter 1
Motivation: The Whys Define the Ways

KEY MESSAGES

Define the motivation. When starting to think about improving the corporate governance of your company, define the underlying reason or reasons—the motivation— behind those improvements.

Identify the business benefits. Your motivation for governance improvements should result from identifying desired business benefits.

Tailor specifics to desired business benefits. Your motivation for governance improvements should shape the specific governance measures the company will undertake, as well as their pace and priority.

As in many other aspects of business life, corporate governance practices should not follow the one-size-fits-all principle. Quite the contrary: real experience indicates that the ways to implement and achieve better governance can differ considerably from country to country and company to company, even in the same industry.

The reasons that drive a company to pursue corporate governance improvements are as numerous and varied as the ways to implement these improvements. In many cases, the decision to undertake specific corporate governance measures comes only after a relatively long period of building understanding about the costs and benefits of such an effort. During this period, key players in the company gain a greater appreciation of what better corporate governance can bring to the business and to its various internal and external stakeholders. In some few cases, the survival of the company hangs in the balance. Here, key players must make governance-related decisions immediately and implementation must be expedited.

The company's motivating factors typically determine prioritization of governance improvement actions and the pace of implementation. Urgent capital needs or the sudden absence of the founder without a succession plan may elevate the importance of adopting practices that resolve such problems. Other companies may move more gradually towards an understanding of the value of good corporate governance, resulting in a slower pace. Either way, specific needs will dictate the implementation process.

The experiences of the 14 Companies Circle[1] members reveal a variety of motivation and actions. Here, the various motivating factors are grouped into categories, which are explored in this chapter.

1 The Companies Circle was made up of 14 member companies that have demonstrated their leadership in adopting good corporate governance practices, from five Latin American countries. They are: Atlas of Costa Rica, Argos and ISA, from Colombia, Homex, from Mexico, Buenaventura and Ferreyros, from Peru, CCR, CPFL, Embraer, Marcopolo, Natura,

- Accessing capital or reducing the cost of capital
- Facing and responding to external market pressures
- Balancing (sometimes) diverging shareholder interests
- Resolving governance issues in family-owned businesses
- Ensuring company sustainability
- Achieving better operational results

Note that in most cases, a number of motivating factors will play a role in driving governance improvements.

NET, Suzano and Ultrapar, from Brazil. Since its acquisition by the Mexican company Mabe in 2008, Atlas is no longer a member of the Companies Circle. The practices referred in this guide are from before the acquisition. Now, the Companies Circle is made up of 13 members.

Motivation

1 Accessing Capital or Reducing the Cost of Capital

"Buenaventura was perceived as a family company with operations concentrated in a developing country. We needed to show the market that we were as open and reliable as any other company in the world. Applying best practices of corporate governance gave us the credibility the market requires of a "new company in the market." Internally, this meant being more transparent, having better information and being able to improve decision-making. Within Peru we gained additional respect from the business community and other stakeholders. Overall, I estimate that the governance improvements we implemented have resulted in an additional 20 percent increase in our market valuation, a significant contribution to improving shareholder value."

—Roque Benavides, Buenaventura, CEO

Company leaders frequently cite the need to access capital as the main reason to initiate corporate governance improvements. In fact, all of the Companies Circle members have cited accessing outside capital and/or reducing cost of capital as one of the important motivating factors behind improving their governance policies and practices.

In many instances, the initial capital contributed by company founders and the capitalization of profits is enough to start up the business and to fund some expansion. Ultimately, though, company success may depend on the ability to access external funding.

The more a company grows, the greater the need for additional capital. There is also an ever higher risk associated with the unilateral financing of the business by a single person or a small group of shareholders. How can the company's leaders tap into the pockets of others? Good corporate governance practices can provide an answer and influence the ways in which companies are able to access additional funding.

Much attention to corporate governance issues in emerging markets has focused on the role good governance can play in improving access to global financing sources. Investors need to feel secure in the knowledge that their rights are being properly protected by controlling owners and management. And they need to know that the company has set up minimum governance mechanisms to reduce the risk of the company's controlling group abusing their powers.

The experiences of some of the Companies Circle members, all publicly-listed firms, highlight the ways in which the need to find additional sources of funding can shape a corporate governance agenda.

The search for "other people's money"

The six founding partners of **Cemento Argos**, Colombia's largest cement company, understood early on the need for more partners. In 1934, when they started the company, they knew they would need other people's money to finance operations and expansion plans. In the ensuing decades, the group launched eight additional companies in different regions of the country and started operations abroad, backed by a steady stream of funding from external investors.

This path and the pace of constant growth required business practices that would generate confidence among the new partners and facilitate access to investments. Corporate governance improvements were a natural answer to Argos' challenges, even in the absence of accepted governance benchmarks in the country at that time. Argos entered the public bond market in November 2005, with an issuance of US$ 197.5 million that was oversubscribed threefold.

Thinking global, listing local—and international

The quest for growth is part of the DNA of **Buenaventura**, the leading mining company in Peru and one of the largest gold and silver producers in the world. Operating in a capital-intensive industry, Buenaventura decided, from its inception in 1953, that growth through explorations and acquisitions would be its path.

From the beginning, the firm considered joint ventures and offerings through Peruvian and United States capital markets as potential sources for funding its growth plans. The company took some first steps to improve its governance early on. But the decision to make an initial public offering of American Depositary Receipts on the New York Stock Exchange in 1996 triggered a comprehensive shift towards good governance. The initiative drove the company to meet the requirements of American laws and Securities and Exchange Commission's regulations. Extensive commitments of management time and company resources were needed so that Buenaventura could meet these requirements. In addition to receiving the funding benefits of the new listings, other tangible results included enhanced company decision-making on critical aspects of its business, particularly relative to future directions.

1.1 Good Governance Leads to Higher Market Valuations

A growing body of empirical evidence shows that well-governed companies receive higher market valuations. Such firms are perceived as investor-friendly, and this gives investors confidence that their investment will generate returns without violating shareholder rights.[2] These higher valuations are seen not only when companies are acquired by larger firms or when they are newly listed on a stock exchange, but also when their stock price reflects higher multiples.

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2 See BLACK, B., JANG, H., & KIM, W. (2006). Does corporate governance predict firms' market values? Evidence from Korea. *Journal of Law, Economics, and Organization, 22, n. 2*, pp. 366-413.; SILVEIRA, A. DI M. DA , & BARROS, L. A. (2007). Corporate governance quality and firm value in Brazil. *Available at http://ssrn.com/abstract=923310*; LEAL, R. P., & CARVALHAL-DA-SILVA, A. L. (2005). Corporate governance and value, in Brazil (and in Chile). *Inter-American Development Bank, Latin American Research Network.* Research Network Working Paper #R-514. *Available at http://www.iadb.org/res/pub_desc.cfm?pub_id=R-514* ; BLACK, B. (2001). The corporate governance behavior and market value of Russian firms. *Emerging Markets Review, 2*, pp. 89-108.

Studies Show Business Benefits: Well-governed Companies Attract Premium Valuations

Well-governed firms in Korea traded **160 percent higher** than poorly governed firms, a study by Korean and US researchers found.

In Brazil, poorly-governed companies could **increase their market capitalization by 85–100 percent** with an overhaul of their governance activities and a shift to good governance, according to two recent studies using broad corporate governance indices.

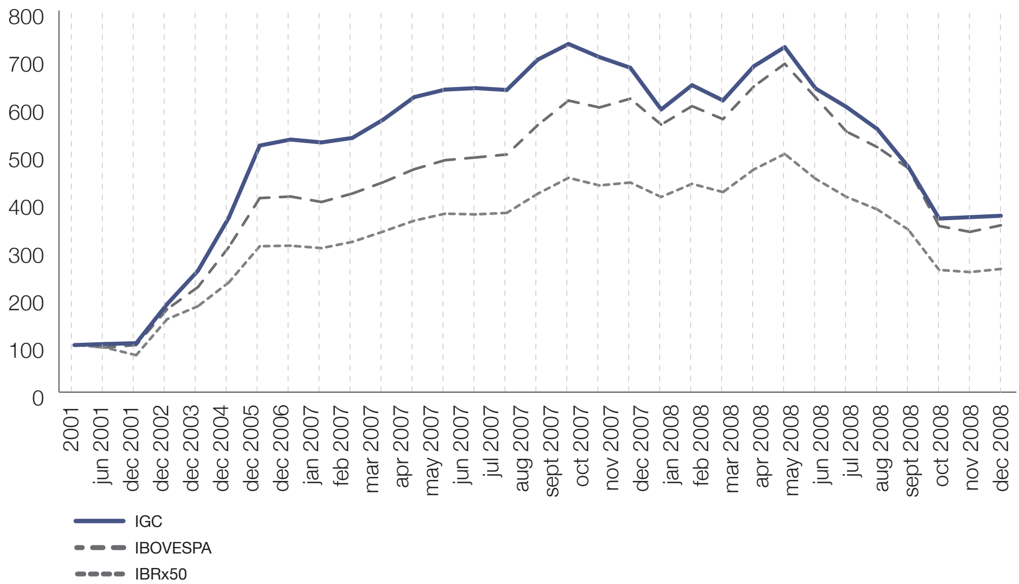
Brazil-based firms with the best corporate governance ratings earned **2004 P/E ratios that were 20 percent higher** than firms with the worst governance ratings, notes a recent ABN AMRO study.

In Russia, companies improving from worst to best in corporate governance could see a **70,000 percent increase in firm value**, according to one small study. While a larger study sample might not show similarly vast increases, the link between good governance and growth in firm value is clear.

A look at the special listing segments of the Brazilian stock exchange, BM&FBOVESPA, demonstrates the connection. The performance of shares of companies on the Novo Mercado, Level 1 and Level 2, launched in 2001 and requiring commitment to higher standards of governance, shows that the stock prices of better-governed companies perform better as well.[3] While better governance practices of the companies listed on the special segments might not be the sole reason for the outperformance of their stocks, it is broadly recognized that these firms needed to make significant improvements to their governance policies and practices to attract the investors in the first place. Figure 1 shows the comparison.

3 In 2001, BM&FBOVESPA launched its special corporate governance listing segments designed for shares issued by companies that voluntarily commit themselves to higher standards of corporate governance in addition to those already required by Brazilian law and the Brazilian Securities and Exchange Commission. The premium listing segments include Level 1, which requires additional disclosure practices. Level 2 requires everything in L1 plus an assortment of corporate governance practices to strengthen the rights of minority shareholders, such as determining a minimum acceptable price for preferred (non-voting) shares during changes of corporate control, and providing voting rights on certain major decisions of the company. Novo Mercado (New Market–NM) is similar to L2 with the additional requirement that the capital stock must be comprised solely of common (voting) shares. By the end of July 2008, BM&FBOVESPA had 443 listed firms, of which 103 were listed at the NM, 18 at L2, 44 at L1, representing 61.6 percent of its total market capitalization. Details of all special listing segments can be found on BM&FBOVESPA's website *http://www.bovespa.com.br/Home/redirect.asp?end=/BovespaEv/Publications/publ_grai.asp?Origem=investor&idioma=i.*

Figure 1: IGC x IBOVESPA x IBrX 50: Comparative Stock Price Performance[4]



Source: Economatica

Governance improvements precede listing

The experience of **CPFL Energia** is particularly telling. The largest private company in Brazil's electricity sector, CPFL Energia was formed during a tumultuous period in August 2002, a few months after the start of nation-wide electric power rationing. Market participants were confused about the energy supply activity in the country. This environment, coupled with a high exchange rate for the US dollar against the Brazilian real in an election year, created a wave of uncertainty about the country's future. As 2003 began, higher interest rates affected CPFL Energia's operating cash flow. The company needed to raise US$ 570.5 million, in part to settle debt of more than US$ 298.4 million coming due that April.[5]

Meanwhile, CPFL Energia had an aggressive investment plan for its distribution operation and for the construction of six hydroelectric plants—four of which are in operation at this writing. To raise the necessary funds, the company restructured its corporate governance, establishing a system to provide a reliable, low-risk relationship between the company and investors, to attract new capital and improve the company's capital structure. Among the positive outcomes of the governance initiatives contributing to higher market valuations:[6]

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4 IGC - Special Corporate Governance Stock Index—is designed to measure the return of a theoretical portfolio composed of shares of companies with a good level of corporate governance. Such companies should be traded on BM&FBOVESPA's Novo Mercado or should be classified at BM&FBOVESPA's Level 1 or Level 2.

IBOVESPA is the main indicator of the Brazilian stock market's average performance, relevant because of two factors: it reflects the variation of BM&FBOVESPA's most traded stocks, and it has tradition, having maintained the integrity of its historical series without any methodological change since its inception in 1968.

IBrX-50 is an index which measures the total return on a theoretical portfolio composed by 50 stocks selected among BM&FBOVESPA's most actively traded securities in terms of liquidity, weighted according to the outstanding shares' market value.

5 USD values provided for Latin American company transactions throughout this guide reflect the exchange rate with local currencies in place during the respective time period.

6 CPFL Energia's share price rose 64.7 percent from R$ 16.43 (US$ 6.22) on December 31, 2004 to R$ 30.15 (US$ 12.90) on December 31, 2008.

- Improved financial indicators
- Longer time period to amortize debts
- Lower cost loans

"The energy sector plays an important role in providing infrastructure for the growth of the Brazilian economy now and in the future. For the expansion of this sort of business we need large investments and long-term investors, like the ones we already have, i.e., pension funds and major corporations, and attracting potential partners in the capital market. We need to offer more than competitive rates of return. We need to ensure high levels of corporate governance in order to build a reliable and solid relationship based on clear information to the market about the way we run the company and our long-term strategies. Since the IPO in 2004, CPFL Energia has been capturing a series of business opportunities, and offered to investors of our subsidiaries the possibility to migrate to the holding company, thus participating in our successful history. All along this path, our Corporate Governance Guidelines have been an important tool, helping us to reintroduce the concept of trust in the electricity sector."

—Wilson Ferreira Junior, CPFL Energia, CEO

1.2 Attracting and Retaining Shareholders

Improving governance is a critical element of accessing new sources of finance. With all other factors equal, surveys show that when investors have a choice of how to allocate their funds, they tend to prefer better governed companies.[7] But this does not mean that governance improvements should be one-off measures. Companies need to pay constant attention to maintaining high standards of governance. As governance improvements help firms attract new investors and mine new sources of finance, it motivates many companies to keep improving

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7 Global institutional investors managing more than 1 trillion in assets will pay a premium for well governed companies. See, MCKINSEY GLOBAL INVESTOR OPINION SURVEY ON CORPORATE GOVERNANCE (2002), *http://www.mckinsey.com/clientservice/organizationleadership/service/corpgovernance/pdf/globalinvestoropinionsurvey2002.pdf.*

their governance practices to retain their existing shareholders or to attract new retail and/or portfolio investors.

Insufficient internal capacity drives search for outside funding

The founders of **CCR**—Companhia de Concessões Rodoviárias—a consortium of toll-road operators, knew that their own investment capacity would be insufficient to respond to the opportunity offered by the privatization of the huge Brazilian highways network. Although CCR was formed by strong players in the construction business, they understood that they would also need to attract other investors to their capital-intensive toll-road operation.

They knew the task would not be easy. After all, who would consider investing in a company controlled by its main suppliers? The potential for conflicts of interest was obvious and only a credible guarantee of transparency and fairness would satisfy new investors. Balanced governance was the initial response to the challenge. CCR invited Brisa, an international toll-road operator that was not active in Brazil's highway construction industry, to become part of the controlling shareholder group and act as a transparency champion. The restructuring of ownership was the first step towards good governance—equal ownership stakes of controlling shareholders ensured a balance of power. Next, the company implemented a series of procedures and practices that signaled to the market that its governance structure would protect minority shareholders' rights. The result: CCR attracted the additional investors it sought, while retaining the confidence of its existing shareholders.

Expanding the shareholder base

Grupo ISA is Colombia's largest energy transmission company and a mixed-ownership public utilities company. The company was originally established in 1967 as a wholly state-owned enterprise to connect the various regional transmission grids existing at the time in Colombia. But after fulfilling the country's energy requirements, the company drew up plans to expand beyond the country's borders. For this new vision, the capital structure was reconsidered, supported by improved governance practices that led to the following:

- In 2000, ISA became the first mixed-ownership public utilities company in Colombia to democratize its ownership, welcoming new retail shareholders who held 13.62 percent of the company's equity.
- Realizing that the state-as-shareholder might make it more difficult to attract more investors, ISA introduced additional good governance practices to address the doubts.
- This led to a successful IPO, quickly followed by a second tranche in 2002.
- ISA's new private shareholders soon controlled 30 percent of the company.

Capital-intensive industry requires capital

NET Serviços, the largest cable television operator in Brazil, operates in a business that demands significant capital to build its infrastructure. From the beginning, the intent was to include strategic shareholders. These shareholders would take the company public as a way to tap into equity markets, giving it an efficient and diversified capital structure. In the mid-1990s, NET made improvements to its governance practices that enabled it to go public in both the Brazilian and U.S. capital markets.

- In the late 1990s, with corporate governance issues gaining more publicity, NET's shareholders decided that the company should align its governance with what investors were demanding.

- In 2001, the company adopted a first round of good governance practices, joining Level 1 of BM&FBOVESPA's Corporate Governance listing segment.
- Faced with a turbulent macroeconomic environment, even as it aimed to become the leader in the cable television sector, the company realized that it needed fresh, outside capital to meet its obligations and sustain growth.
- To attract this new funding, NET committed to higher corporate governance standards, becoming the second company to advance to BM&FBOVESPA's Level 2.

1.3 Decreasing Cost of Capital, Diversifying Capital Structure

The impact of improving corporate governance can go beyond attracting global equity and debt. Domestic sources of equity and debt can also be expected to flow to companies that demonstrate a strong commitment to good governance. Companies may wish not only to obtain new and cheaper sources of equity to fund their operations, but also to diversify their capital structure.

It is a commonly accepted understanding in the corporate world that as investors' risks increase, so will the cost of capital. In recent years, investors providing debt capital have tended to include a company's corporate governance practices, such as a transparent ownership structure and appropriate financial reporting, as key criteria in their investment decision-making process. So, having a good corporate governance system in place ultimately should result in lower interest rates and longer maturity on loans and credits.[8] Bottom line: companies practicing better corporate governance are more likely to obtain reduced costs when incurring debt and financing for operations, thus decreasing the cost of capital.

Better Governance Can Have a Positive Impact on Cost of Capital

Credit rating: In Romania in late 2004, FitchRatings upgraded the individual credit rating of Banca Comerciala Romana from D to C/D. Standard & Poors raised the bank's long-term counterparty rating from B+ to BB-. Both agencies cited improvements in corporate governance and risk management as the major reasons for the upgrades.

Valuation: In Brazil, Credit Suisse raised its valuation of Brasil Telecom in May 2006 from "hold" to "outperform" directly because of improvements in the corporate governance practices by the firm.

Libor rates and spread reduction: PREVI, Brazil's major pension fund, compared a portfolio of five investee companies that adopted good governance practices against a group of eight companies with poor governance, by credit rating and costs. The good governance group received a significantly better rating, with improvements achieved after adopting governance best practices. This comparison was considered particularly meaningful due to the strong credit restrictions on the companies' industry sector.

[8] It can be argued that banks and other providers of debt capital may not necessarily require that companies adhere to high governance standards to the extent that certain equity investors would (particularly active institutional investors). This is explained by the fact that banks commonly have better information about the companies they lend to, due to arms-length and one-on-one relationships. Plus banks also have other, additional mechanisms for protecting their rights, such as requiring security for loans. Nevertheless, many banks are active proponents of better governance practices, including of their own clients.

- The governance group accessed the external debt market from 2004–2006. Financing that once cost Libor + 3.875 percent was renegotiated at Libor + 1 percent after governance improvements.
- When issuing debentures, the governance group companies also profited from a spread reduction of 3.5 percent over CDI in 2004 to 1 percent after governance reforms, in 2005.

This section notes that attracting outside capital and reducing its cost is a prime motivator of corporate governance improvements. While this motivation originates largely inside the company and its leadership, other motivations for governance improvements may come from external sources.

2 Facing and Responding to External Market Pressures

External pressures can come from global competition, scarce raw materials or changing costs of other company inputs. A central source of pressure also comes from the investor community. Investors have a true interest in reducing their risk by improving governance in investee companies. Studies have shown that corporate governance environments with poor standards and weak enforcement continue to face barriers to investment, with foreign investors facing greater difficulties in obtaining good quality information in such countries. While investors may invest less overall in such countries, for various reasons, like portfolio diversification, they still may consider investment despite weak governance standards, securities regulation and enforcement. In such cases, investors are more likely to select the companies that can be differentiated through their commitment to better governance.[9]

In some cases, external market demands trigger or accelerate the pace of governance improvements at a company.

Regulatory compliance

New legislative or regulatory requirements can provide an important opportunity for companies to rethink and reshape their governance processes to add more value. **CPFL Energia** took this approach, using requirements for companies listed on the New York Stock Exchange and local listing requirements to find an efficient way to comply with market rules.

The company created a compliance unit to ensure adherence to the market regulations of the exchanges on which it is listed—BM&FBOVESPA and NYSE. The unit also makes sure that the company complies with the various provisions of the Sarbanes-Oxley Act. Company leaders recall that compliance with Section 404 of the Sarbanes-Oxley Act, which deals with internal controls in the preparation of financial statements, required a significant alteration of the company's processes.

Expanding the capital base

When **NET**'s shareholders started discussing the best way to increase the company's capital as a key element in its restructuring process, issues immediately arose. If not handled properly, the situation could have led to a different treatment of holders of voting and non-voting shares.

9 LEUZ, C., LINS, K. V., & WARNOCK, F. E. (2008). Do foreigners invest less in poorly governed firms? *ECGI Finance working paper n. 43/2004.*

Aware of the potential problems, the company took the case to the Brazilian Association of Minority Investors, ANIMEC. After extensive and candid discussion at ANIMEC, NET's management shared the Association's recommendations with the company's board of directors.

It is interesting to note that the company anticipated the possible external pressure and handled the situation in a way that would address the concerns. The lively and frank give and take, which brought all parties—including minority shareholders—to the table resulted in a general acknowledgement that sound corporate governance measures could align the interests of all stakeholders. The board identified ways to simplify the capital restructuring process, and resolve the problematic issues.

3 Balancing (Sometimes) Diverging Shareholder Interests

In certain cases companies may wind up in situations in which their shareholders have differing interests in the overall direction of the company. Since such situations could hurt the company, these potential conflicts can trigger the introduction of specific governance structures, policies and processes aimed at reassuring all shareholders that their interests ultimately will be protected.

Enabling shareholder agreement

Consider **CPFL Energia**'s situation. The company's complex ownership structure involves eight controlling shareholders, three of which are huge industrial groups, and the other five are comprised of pension funds. Clearly, balancing the relationships posed major challenges.

The controlling shareholders interacted through three vehicles:

- The Bradesco[10] Votorantim[11] and Camargo Côrrea groups through VBC Energia
- The Banco do Brasil Employees' Pension Fund—Previ—through a company known as 521 Participações
- The four pension funds of state-owned companies—Fundação Cesp, Petros, Sistel and Sabesprev—through a company called Bonaire Participações

Given the diverse nature of the controlling shareholders, it was essential to structure the decision-making process in a way that would prevent the kinds of potential conflicts between shareholders that could hinder the company's development. To accomplish this, the shareholders signed an agreement in March 2002 that defined the conduct, rules and decision-making processes applying to all shareholders in the controlling group. In December 2007, the shareholders' agreement was amended to account for new corporate governance improvements implemented by the company and to adapt corporate mechanisms to the current context.

Shareholders' push for liquidity elevates the need for governance improvements

From November 5, 1997, with CPFL Paulista's privatization, to the end of 2004, the controlling shareholders—including pension funds with 55 percent holdings in equity—made huge investments in the make-up of **CPFL Energia** by acquiring CPFL Paulista, CPFL Piratininga, Rio Grande Energia. They made additional investments in energy generation as well.

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10 In December 2006, Bradesco left the control group. It remains a shareholder but its shares now are part of the free float.

11 In February 2008, Votorantim left the control group.

Given the nature of these shareholders, liquidity was of utmost importance, considered an added value by the capital market and a long-term value-generating prospect. To ensure such liquidity, the company took steps to improve its corporate governance by aligning its practices with the standards of BM&FBOVESPA's Novo Mercado. The company also worked to comply with the requirements of the New York Stock Exchange, by issuing Level III ADSs.[12] These governance improvements included measures explicitly aimed at aligning the interests of different shareholders:

- The migration of minority shareholders of the subsidiaries CPFL Paulista, CPFL Piratininga, CPFL Geração, and RGE to CPFL Energia following a share swap arrangement worth R$ 560 million and involving approximately 57.000 shareholders
- The alignment of the subsidiaries' corporate by-laws with CPFL Energia's corporate by-laws: CPFL Paulista, CPFL Piratininga, CPFL Geração, Rio Grande Energia, and CPFL Santa Cruz

Other issues to consider when trying to balance sometimes divergent shareholder interests:

- **Implementing practices to avoid favoritism:** The motivation to align founding shareholder interests was also one of the reasons that CCR adopted certain governance measures, such as designing an ownership structure in which controlling shareholders were historical competitors in the construction business. By bringing in an additional controlling shareholder who was not in the construction sector but only in the business of operating toll roads, and by taking other measures such as ensuring a certain percentage of free float of shares and creating an explicit mechanism to evaluate contracts between related parties, CCR was able to demonstrate that it had a structure in place that would ensure a balance of all shareholder interests, rather than favoring the interests of its controlling shareholders engaged in construction.
- **Balancing controlling and minority interests:** There is also a need to balance shareholder interests when dealing with relations between the controlling and minority shareholders. The minority shareholders may be concerned that the controllers will abuse their controlling position—to the detriment of the minority group. This may create problems also for controlling shareholders, as they might be interested in attracting new investors.
- **Appealing to a broader universe of investors**: Many companies may be motivated to improve their governance to make their securities more appealing to a broader universe of investors. These governance improvements will be geared towards providing adequate confidence to existing or potential minority shareholders that their rights will be properly observed and protected. The more actively that the company's shares are traded on the stock market, facilitated by maintaining a high level of free float, the easier it is for non-controlling investors to get in and out of the company. It ensures that shareholders can exit if they disagree on the strategy of the controlling owners and the board, or if they are dissatisfied by the performance of the management. Availability of exit in a liquid market also increases the potential for investors to receive the full value for their stake in the company. To gain agreement on increasing liquidity controlling shareholders, whose control and stake in the company will be diluted, must understand that by giving up some of their shares, they may be able to attract other investors—a move that will likely increase the value of their company and their shares.

[12] American Depositary Shares (ADS) are the individual shares of a foreign corporation represented by an American Depositary Receipt (ADR).

Suzano Group seeks share price appreciation.

The main short-term objective of the capital markets strategy adopted by **Suzano Group**[13] was the fast appreciation of the share price. Its board and management needed to demonstrate positive results in the short- to mid-term to ensure a quick win—that the value and benefits of the pro-capital markets movement would be quickly recognized by controlling shareholders.

Why was this needed?

Because implementation of best corporate governance practices as a prerequisite for the capital markets strategy implied the immediate concession of certain control and economic rights to minority shareholders by the controlling shareholders. The controlling shareholders also needed to understand that this would also come with the potential appreciation of share price. The rapid appreciation of the share price would be possible by reducing the risk associated with the company's low stock market liquidity, which could be achieved through equity offerings in the marketplace.

How did the company accomplish this?

The company undertook governance improvements dictated by BM&FBOVESPA's special listing segments, Levels 1 and 2. The appropriate appreciation of company share price together with higher liquidity offers a simple, fair and attractive exit for minority shareholders, including the members of the controlling family and the family's future generations who would want to pursue other business or personal interests, without jeopardizing the company's activities.

4 Resolving Governance Issues in Family-Owned Businesses

"For Suzano, ...(corporate governance) is the warranty of continuity of what founders have seeded. It is the evolution of a dream. We may have accidents along the way, which is natural. But good governance practices favor the continuity of Suzano's companies and make their foundations resistant to the incontestable movement that is globalization."[14]

—David Feffer, Suzano, Chairman of the Board

[13] The group used to be composed of Suzano Papel e Celulose and Suzano Petroquímica, the latter was sold to Petrobrás in 2007. Today the company is Latin America's largest vertically-integrated producer of paper and eucalyptus pulp.

[14] IBGC, BRAZILIAN INSTITUTE OF CORPORATE GOVERNANCE (2005). Uma década de governança corporativa—história do IBGC, marcos e lições da experiência. *São Paulo: Saraiva.*.

Family or founder-owned companies face unique governance issues. In Chapter 5 these issues and challenges are addressed in detail. But it is important to touch on the issues here as well, because they create motivation for improving corporate governance practices in ways that differ from other publicly-held companies.

Many things in a family business can go wrong. Over time, as the business and the family grow, the family that had been considered the principal source of success could become the source of potential disaster. Among the potential pitfalls that can cause a family-owned company to lose all of its value if they are not handled properly:

- Ownership and management succession
- Family employment policies
- Relations between the family salary-earners and family dividend-receivers
- Intra-family decision-making processes
- Providing incentives for hiring and retaining qualified professional non-family managers

Dealing with such challenges to allow the company to survive and grow is yet another motivation for companies to seek governance improvements.

"Ultrapar had the option to transform itself into a true corporation in the process of succession of its family leadership. It chose to become a leading Brazilian corporation in the capital markets. Professionalization of its management was the way chosen and, in order to materialize the objective, corporate governance started to change. Several milestones occurred: 1997—professionalization of the board, 1999––IPO, 2000—tag-along rights for all shareholders and 2002—the incorporation of Oxiteno and Gipóia. The process of professionalization with the implementation of sound corporate governance practices had culminated with my succession as the CEO by professionals of the group. In 2007, the acquisition of Ipiranga occurred using Ultrapar's shares as currency, which was a successful process based on corporate governance best practices."

—Paulo Cunha, Ultrapar, former CEO and current Chairman

Buenaventura transforms

Apart from accessing capital required to expand the company's operations, **Buenaventura**'s plans for improving its governance policies and practices were motivated by the desire to transform the company from a family firm to a professionally-managed company. This would align the family's objectives with long-term shareholder objectives, and, eventually, maximize value for all shareholders. Proper governance structures also would help the company to avoid the risks of disagreements among family members capable of harming the company

Generational shift at Ferreyros.

It is not unusual to witness fights for power among members of second and third generations. Fortunately, this was not the case at **Ferreyros** —a Peruvian company focused on the import, sale and rental of construction machinery and equipment and product support—as heirs had other interests for their careers and lives.

The pattern of ownership and control at Ferreyros has evolved since its founding in 1922, with the number of shareholders and the structure of their holdings changing over time, due to these family factors. The first generation of founding partners passed on their ownership to a second generation, but this generation included some family members who were not interested in the business.

So, more than 30 years ago, Ferreyros' owners turned over the reins of management to professional managers and decided to create a diverse base of shareholders. This turnover required governance changes to ensure that the interests of the family would still be protected and that non-family managers would exercise their best efforts to act in the interests of the company. The governance changes were also motivated by the company's strategic goal to list its shares on the Lima Stock Exchange.

After registering its stock on the Lima exchange in 1971, the company determined that capital markets would become a key funding source. Today, Ferreyros is a well-known player in Peruvian capital markets.

Suzano and succession planning

The deaths of Leon Feffer, **Suzano**'s founder, and Feffer's son Max within a two-year interval motivated an acceleration of the company's corporate governance improvements. While David Feffer, the founder's grandson, was prepared for his new leadership role, it was also clear that family dynamics would likely become more complicated in the future. The governance improvements to address this issue also moved the company toward greater reliance on non-family managers. The company continued to improve on its governance model, with a focus on respecting the company's culture and internal dynamics, while profiting from short-term results. An important milestone: a 2004 strategic planning initiative with action plans that led to continuous governance improvements going forward.

Unique challenges for a family business.

An understanding of the unique challenges family-owned companies face drove Pery Igel, son of **Ultrapar**'s founder, to make an unprecedented move in the local market. In 1984, he arranged for a restricted stock issue to the company's managers as part of a twenty-year employment contract. This would align their interests with the interests of the controlling family and other shareholders. It also would ensure that they would help build a solid company for themselves as well—as long-term co-owners, they would have a financial stake in the company's well-being.

This was the first step in a series of corporate governance initiatives that Igel took, at a time when the term "corporate governance" was not even used. The reason for such bold steps? The desire to ensure the future of the business regardless of family uncertainties and potentially divergent interests.

5 Ensuring Company Sustainability

Most companies are formed with no sense of limits on how long the company will operate. It is likely that the founders of many—if not most—founder-owned firms hope that their companies will outlive them. This desire to secure the long-term survival of the company is a motivation for governance improvements. Company owners can help ensure the long-term success and sustainability of the company—by implementing sound corporate governance practices.

Perpetuating the business and approach to doing business

Finding a way to finance the business was not a concern for **Natura**, the leading company in Brazil's cosmetics, personal hygiene and perfumery products. The company's operation was a strong cash generator. In addition, the controlling shareholders' approach to business generated market trust and created a strong environment for the company's business activities.

> *"What are the reasons for that (going public)?...It is a vision of the future, of thinking about how to perpetuate the company. We had a dream, we began in a backyard. It is a company that grew based on values and has a social role that transcends the interests of the founders. It turned out to be a tool for social and economic development and going public is linked to that, to a process of perpetuating this culture, these values. We want new partners as allies in preserving this culture of commitment to economic development, but also to responsible social and environmental development."*[15]

—Guilherme Peirão Leal, Natura,
Co-chairman of the Board

[15] BOVESPA (2004), Como e porque tornar—se uma companhia aberta (Unofficial translation: How and why to become a public company).

The motivation driving the company to take its first steps towards better governance was a little different: the desire to ensure continuity of a particular way of doing business rooted in certain values and beliefs. There was no rush: over the years, the three shareholders, called "commanders-in-chief", implemented governance practices that were common to publicly-traded companies even though Natura was not publicly-held. Before finally going public, the company received an award for the Best Annual Report, in 2003. The path to better governance was steady and consistent.

Natura wanted to perpetuate not just the business itself. Sustaining Natura's approach to doing business was also key, because the company believes that corporate social and environmental responsibility is as important for its performance as its financial results.

With its triple bottom line orientation, Natura was motivated toward governance improvements because of its intent to institutionalize and perpetuate the business model and the company's culture. The three controlling shareholders also wanted to diversify their personal portfolios.

The decision was made: Natura's shareholders listed the company's shares on the stock exchange.

For Natura's owners, this was the way to attract new partners who would help them monitor business conduct—part of a process toward separating ownership and management. As a publicly-traded company, Natura would also be better positioned for future expansion projects, raising funds at lower cost in the market, rather than at commercial lending rates. There were management benefits as well: company owners also understood that a publicly-traded company would have an easier time attracting and retaining top executive talent.

Sustainability through privatization

Brazil's **Embraer**, one of the largest aircraft manufacturers in the world, was founded in 1969 as a state-owned company, but was privatized in 1994. In the aftermath of the privatization, the company not only regained its financial soundness, but was able to embark on a new expansion process. The development of new products by Embraer, as well as its future growth, depended on its flexibility to access capital markets. This was the case in 2000, when the company accessed international capital markets through an IPO of American Depositary Receipts (ADRs) on the New York Stock Exchange to finance the development of a new family of commercial jets.

At the time, prior to 2006, Brazilian corporate law limited capital structures in the distribution between common and preferred shares. The nature of Embraer's structure further limited the company's access to capital markets. It also restrained the liquidity of company shares, since it constrained the adoption of higher levels of corporate governance standards.

The company realized it needed to take action. On March 31, 2006, the majority of Embraer's shareholders, including owners of common and preferred shares and ADRs approved a capital restructuring proposal. The plan simplified the company's capital structure, turning all types of holdings into one—common shares. This move enhanced corporate governance practices and transparency.

The primary goal of the corporate restructuring was to create a basis for sustainability, growth and continuity of Embraer's operations. Effectively, the restructuring divided up controlling blocks of shareholders. As a result, Embraer became the largest public company in Brazil with fully-dispersed ownership.

Bottom line: without a permanently-defined control block, Embraer's shareholders must meet, discuss and reach consensus on how to align their interests as they make decisions at each general shareholders meeting, and this has contributed to greater transparency.

Institutionalizing the company

Ensuring the company's sustainability was **Homex**'s main motivation for adopting good governance practices. Envisioning its future, its management proposed designing several strategies focused on long-term, constant growth of the company, which the board agreed to pursue. Homex's leadership calls this keystone strategy "the institutionalization of the company." Among the steps taken were the creation of a solid governance infrastructure and decision-making procedures emphasizing that the development of the company depends on its governance system and not on specific individuals and establishing conditions to perpetuate the company through time and for future generations.

5.1 Attracting and Retaining Managers to Ensure Strategy Implementation

"People who are vested with managing responsibilities in all sorts of companies have the obligation of ensuring that these companies will continue into the future and, furthermore, comprehend their real social duties. They must understand that a company is much more than just the property of one or more individuals; it is a part of society itself, providing job opportunities and a setting in where a great number of people may pursue their professional development."

Roque Benavides, Buenaventura, CEO

Financial resources flow to organizations with a solid and outstanding team gathered around a common vision and mission, able to implement the strategic plan. A management team comprised of non-family professionals or one that combines competent family managers with outsiders is often the governance agent that makes things happen in a family-owned company. It is important that the selection of senior managers be done in an objective manner to ensure the company hires the best people to run the business—not on the basis of the manager's association with the controlling family.

Increasingly, talented professionals are seeking additional opportunities to make the difference in businesses, and an inconsistent governance system can prevent them from doing so. Here are a few common pitfalls, making it difficult for managers to focus on performing their direct responsibilities of running company affairs:

- Uncertain criteria for promoting managers
- Absence of a merit-based pay system
- Obscure compensation schemes
- Erratic and non-transparent decision-making that impacts human resources issues and responsibilities for running company affairs

Attracting and retaining top talent committed to the company's value system

Natura's leaders believe that the success of its governance is based on the commitment and engagement of all employees, at all levels, as well as on a common understanding of the company's strategy throughout the firm. To retain talented employees committed to Natura's principles and beliefs—and with the ultimate goal of improving company operations—Natura undertook a series of governance-related steps:

- Offering competitive wages and benefits
- Promoting the motivated employees who are key to the company's success
- Conducting annual employee satisfaction surveys through an independent firm since 1995

Creating company value

Ultrapar became more focused on the professionalization of its management team in the early 1980s, when the concept of alignment of interests was introduced. Company leaders looked to create value for the company by retaining certain key members of the Group's management and ensuring success through succession. The introduction of executive compensation packages, which included a payment in the form of shares, was one of the key steps taken. Company owner Pery Igel initiated this pioneering concept. Igel's legacy in this regard has been significant: the granting of shares to management and aligning the interests of the executives to those of the original shareholders has helped build harmonious relationships between Igel's heirs—the controlling family shareholders—and the company's senior executives.

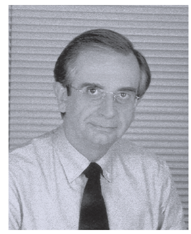
"To become a true corporation—that was Pery Igel's dream. The company succeeded in achieving this dream, by implementing outstanding corporate governance practices."

—Pedro Wongtschowski, *Ultrapar, CEO*

6 Achieving Better Operational Results

"Corporate governance has been developed and molded in a modern company context, with participation of minority shareholders in a very transparent way. All this resulted in increasing its agility, level of efficiency, being modern and undoubtedly it was a very beneficial transformation to the company."[16]

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



Efficient management depends on accountability of decision-makers and employees and on the timely flow of relevant information to those who need it to perform their functions. A desire to achieve better operating results and productivity is yet another strong motivation for companies to improve their corporate governance practices.

Managers, directors and shareholders are all likely to make more informed, quicker and better decisions when the company's governance structure allows them to clearly understand their respective roles and responsibilities, and when communication processes are regulated in an efficient and effective manner. This, in turn, should significantly enhance the efficiency of the financial and business operations of the company at all levels. Top quality corporate governance streamlines all of a company's business processes, and this leads to better operating performance and lower capital expenditures,[17] which, in turn, may contribute to the growth of sales and profits.

Numerous academic empirical studies have shown that good governance brings many improvements contributing to the better overall performance of companies.[18]

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16 BOVESPA (2004), Como e porque tornar—se uma companhia aberta (Unofficial translation: How and why to become a public company).

17 GOMPERS, P. A., ISHII, J. L., & METRICK, A. (2003). Corporate governance and equity prices. *Quarterly Journal of Economics, 118, n. 1*, pp. 107-155.

18 Some examples of such studies are:

- A study of the 100 largest emerging market companies by Credit Lyonnais Securities Asia (CLSA) in 2001 showed that companies with the best corporate governance in each of a large number of emerging market countries had EVA (economic value added) scores eight percentage points higher than firms in their country average.
- A Harvard/Wharton team also found that US-based firms with better governance have faster sales growth and were more profitable than their peers.
- An ABN AMRO study (previously mentioned) showed that Brazilian firms with above-average corporate governance had ROEs (return on equity) that were 45 percent higher and net margins that were 76 percent higher than those with below-average governance practices.
- A study of S&P 500 firms by Deutsche Bank showed that companies with strong or improving corporate governance outperformed those with poor or deteriorating governance practices by about 19 percent over a two-year

By having a structured process, where rights, responsibilities and structures for decision-making are clearly described, companies are in a better position to avoid conflicts of interest and support better, informed decisions.

Better governance as competitive differentiator

For **Atlas Eléctrica, S.A**., the holding company of a white goods manufacturer in Costa Rica, governance improvements were motivated in part by its desire to differentiate the company from other companies in the industry operating in Costa Rica—specifically its international competitors.

Atlas, founded in a small shack in 1961, grew to be the first company to issue shares in Costa Rica's stock exchange in 1976. Corporate governance was viewed by the company's owners and management as a way to attract additional investors, given the relatively small size of Costa Rica's capital market. Company owners also saw that better governance would help the company beat out its foreign competition for local suppliers. A higher level of governance would give suppliers an additional measure of comfort in their partnership with Atlas.

Enabling rapid action and fast decision-making

CPFL Energia has a complex structure, the result of combining several companies. This made it essential to set up effective and streamlined information flows, which would support efficient decision-making and problem-solving. As an electricity business, a basic input for companies and people's lives, the company also must take into consideration the risk of accidents that may stem from its activities.

Company leaders saw that good governance, including effective internal controls, would bring gains to company operations. The decision-making process at the top management and board levels needed to be structured to enable fast, effective decisions, aimed at maximizing the economic efficiency and return on invested capital. To reach this goal, seven committees—later reduced to three—were set up to assist the company's board of directors. These committees provide agility and consistency to the board's decisions. The committees explore in detail various issues to be decided by the board:

- Setting executive compensation levels
- Evaluating the overall performance of executive officers
- Assessing the risk profile and internal controls of the company and its subsidiaries
- Reviewing the quality of information feeding the board decision-making process
- Reviewing supply and services transactions involving related parties

The process, fixed in the company's shareholders' agreement, has created a consistent framework for decisions and a higher level of certainty that all aspects of an issue will be discussed or explored as necessary.

Accountability is key. Better operational results and clearer accountability also play an important role in enhancing a company's reputation. A company's reputation and image effectively constitute an integral, if intangible, part of its assets. Companies that respect the rights of shareholders and creditors, and ensure financial transparency and accountability, will be regarded as an advocate of investors' interests. As a result, such companies are more likely to be considered worthy corporate citizens and, accordingly, will enjoy more public confidence and goodwill.

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period. See GRANDMONT, R., GRANT, G., & SILVA, F. (2004). Beyond the numbers—corporate governance: implications for investors. *Deutsche Bank.*

This public confidence and goodwill can lead to higher trust in the company. A company's positive brand image or goodwill plays a significant role in the valuation of a company. In accounting terms, "goodwill" is the amount that the purchase price exceeds the fair value of the acquired company's assets. It is the premium one company pays to buy another.

The path to good governance is unique for each company. Ownership structure, cultural aspects, the profile of managers, risks and urgency involved are among the aspects that mold the route each company takes towards better governance.

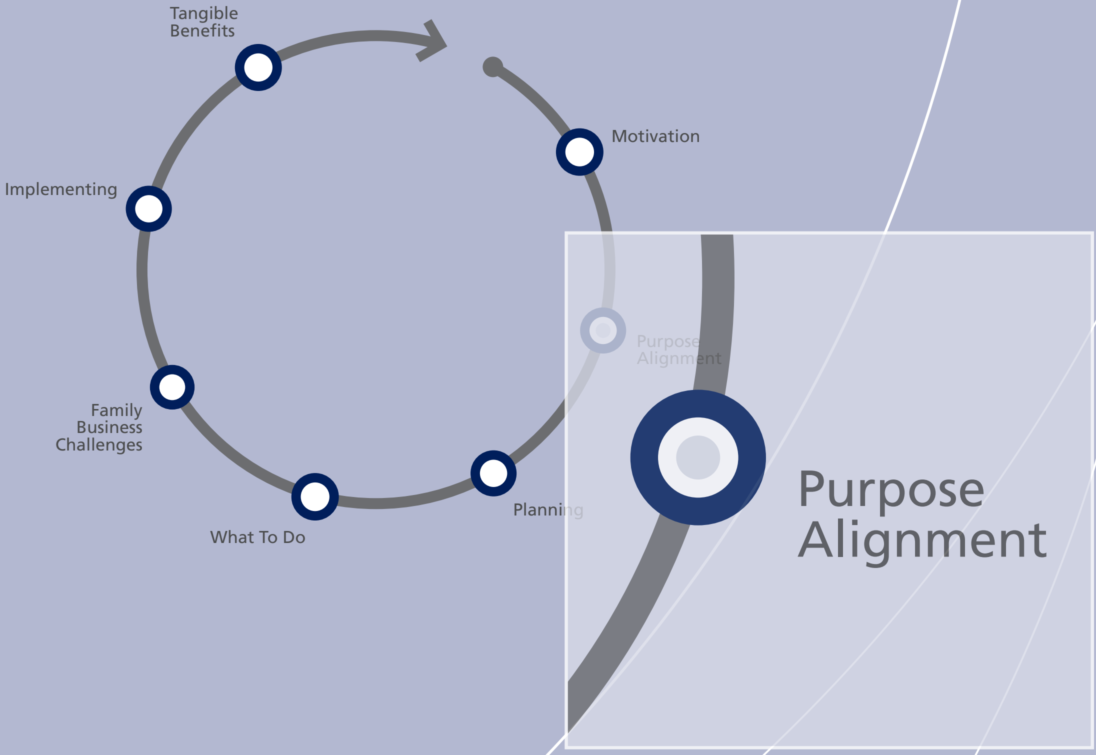
For Further Thought and Discussion

This chapter has identified the whys and the ways—the various categories of motivations that drive a company's quest for governance improvements. Now, consider your company's situation:

- ➤ What are your company's main motivations to improve corporate governance practices?
- ➤ What examples of the Companies Circle are most relevant to your situation?
- ➤ What are the key challenges and barriers that your company faces to improve governance?

2

PURPOSE ALIGNMENT: CHANGING ATTITUDES AND GENERATING COMMITMENT



Chapter 2
Purpose Alignment: Changing Attitudes and Generating Commitment

KEY MESSAGES

Gain agreement on a common strategy. After company leaders identify a shared vision of improvements to the corporate governance framework and practices, take steps to obtain agreement from all company stakeholders on your corporate governance strategy.

Identify resistance points and clearly communicate goals, approaches and anticipated results. Governance changes can affect everyone associated with the company, across all levels of the company's hierarchy. Be sure to identify possible resistance to changes and clearly communicate objectives, specific actions and anticipated results so that everyone is on board.

Make use of internal "champions". Governance champions can play an important role in addressing existing and potential concerns, changing attitudes and generating commitment to improved governance policies and practices.

Companies may have clear motivation for choosing the path to improving their governance policies and practices. Still, most firms face obstacles in aligning the vision and understanding of all interested parties and changing attitudes to meet the chosen objectives.

This chapter details ways in which company leaders can change attitudes inside their organizations, creating the momentum to pursue a new approach to doing business and leading their companies towards better governance practices. The lead actors in this process of governance transformation are introduced here: the "champions", who persevere and inspire others, ensuring that everyone is working towards a common objective.

Of course, changing attitudes and shaking up entrenched beliefs and practices to lead companies to success requires much more than a state-of-the-art plan. It is also necessary to work on people's will. Good corporate governance is a process, both in terms of defining frameworks and implementing best practices. It requires a change in attitude that needs to be built into the strategy of the business as a whole.

Companies Circle members report that they took risks in the beginning when they made corporate governance changes, because there was no guarantee that the changes would pay off and that good governance would really become a winning strategy. In this chapter, members detail their efforts to change attitudes and beliefs and describe how these efforts paid off, giving them competitive advantages over other firms.

1 Agree on the Common Vision; Align Interests

Simply stated: one of the main challenges in kicking off a process of corporate governance improvement is to align interests among all key players involved in governing a business.

The understanding of the need to change is not uniform. Some doubt that the proposed transformation is useful. They may have differing opinions on the best way to go about making changes. Others might resist because of their personal interests.

As a result, the people inside the organization who are driving the initiative will need to devote significant time to creating a common vision that answers these questions:

- What changes will be implemented?
- How will the changes be implemented?
- When will they be implemented?
- What benefits they will bring to the company?
- What risks may impede achieving the intended results on time?

This applies to all companies, from relatively small, family-owned businesses to huge organizations with complex ownership structures.

Alignment requires all key players—owners, boards of directors, management, other key stakeholders—to be united from the outset, thus shaping a common interest, a common purpose. These parties often have inherently diverging interests, which makes the agreement over the strategy for governance improvements even more difficult.

How can shareholders ensure that the managers will run the operations of the company in the interests of the owners and not in their personal interests?

1.1 Overcoming the Agency Problem: Bringing the Interests of Managers and Owners Together

This question gives rise to a fundamental corporate governance theory discussion. On a practical level, it is a major issue for entrepreneurs as well: the managers are paid to run the business in the best interests of the owners but they may make decisions based on personal interests that differ from those of owners. With owners considered the "principals" in this relationship and managers their "agents," this divergence of interests can be understood in economic theory as the principal-agent or agency problem.[19]

The agency perspective is useful not only for understanding the divergence of interests between owners and managers in capital markets where ownership is dispersed and companies are typically run by outside hired managers. It is also applicable in the case of Latin American companies, where ownership tends to be concentrated. This perspective offers insight into the relationship between controlling shareholders and minority shareholders.

In such cases, minority shareholders might worry that their rights could be abused by managers aligned with controlling shareholders. Thus, the agency problem in such markets shifts from the relation between owners and managers to the one between minority, non-controlling

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[19] For a better understanding of agency theory, see JENSEN, M., & MECKLING, W. (1976). Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics, 3*, pp. 305-360. See also the glossary of this guide for a brief explanation of agency theory.

shareholders and controlling shareholders. The controlling shareholders may run the company based on their own interests—which may not always coincide with the interests of other shareholders.

How does this drama play out? Here are some examples of what are known as private benefits of control, which today translate into a price discount if proper processes and oversight mechanisms are not in place to avoid them.

Action	Why It's a Problem
The controlling owner appoints unqualified family members to managerial positions	› The owner and family benefit at the expense of other owners › The action puts the business at risk due to the lack of proper leadership
The controlling owners hire a third party service from a company related to friends or relatives	› The action takes into account the friends' or relatives' value creation, and not what is the best option for the company and all shareholders
Owners who control and manage the company pay excessive compensation to themselves or to their relatives	› The action takes value away from the other shareholders

Clearly, this is an issue for business leaders. The agency problem can drain value and hinder company performance and growth possibilities unless sufficient governance mechanisms are in place to monitor and ensure that all shareholders' interests are respected. Ideally, they should be aligned as well. Understanding these relationships will help company leaders find governance solutions that provide the comfort level needed to attract investors.

One way to align the interests of shareholders and managers is with a well-designed compensation policy that is linked to specific targets. This helps clarify objectives to be pursued. Governance practices that offer transparency and fair treatment to all shareholders can all ensure the alignment of interests of different groups of shareholders. Chapter 4 explores these specific governance practices in greater detail.

1.2 Identify Corporate Governance Champions

In general, bringing about changes is easier when the people responsible for their implementation and success are convinced of their value and show strong commitment to them. Every important change needs a person or a group of persons who are committed to seeing it through and who will make sure that it achieves the intended results.

In particular, the need for these internal champions is critical when it comes to corporate governance improvements. Since some improvements may require changes in the company's fundamental principles and standards, it is always good to have support from the highest possible level of leadership.

Best case scenario: when the controlling shareholder, in many cases the founder or the patriarch of the family, is such champion.

In reality, though, the initiative and leadership often comes from the younger generation of the owners. Non-family professional managers also may lead such an effort. Bottom line? Such leaders are critical to spearheading efforts. They help overcome existing or potential resistance. They dedicate time and resources needed for the success of the transformation. And they rally all interested parties around common goals.

The examples below demonstrate that a change in attitude and broad-based commitment to the principles of good corporate governance can help obtain agreement from all stakeholders—or, at a minimum, can help ensure that there is no resistance in the company's new purpose and new governance structures and processes.

- Identifying the leaders was part of **CPFL Energia**'s route to improved governance. The company established the Corporate Governance Support Committee, with a team exclusively dedicated to developing and improving governance at the company. It supported the board's activities, facilitated the information flow and identified opportunities for improvement.
- **Ferreyros**' CEO and CFO have been the primary champions of a recent round of governance improvements, proposing changes in the by-laws that would appeal to a broader base of investors and to attract independent directors to sit on its board. They also spearheaded the creation of important documents such as statutes for shareholders meetings and for the board. These documents facilitate corporate governance and ensure that governance is an embedded aspect of the company's code of conduct—not the pet project of specific individuals.
- **NET** secured sponsors at both the board and the senior management levels. These sponsors helped drive the changes.

1.3 Building a Common Understanding from Top to Bottom

For governance transformation to succeed, all interests must align at all levels of the organization, from top to bottom. The commitment from the top is crucial, because of the key roles that the controlling shareholders, the board of directors and senior managers will need to play to improve the company's governance.

Governance improvements with generational leadership shift and company reorganization

At **Suzano**, governance improvements came along with an ownership reorganization initiated in 2001 when David Feffer, the founder's grandson, took the helm of the company following his father's death. Among Feffer's first steps: implementing a new holding company management model. A team of specialized consultants helped with the process, including strategic planning and clearly defining the company's vision, mission, values and strategic objectives.

The effort extended to subsidiaries **Suzano Papel e Celulose** and **Suzano Petroquímica**, which implemented their own strategic planning sessions, based on parent company guidelines.

The subsidiaries dismissed 80 employees, including some family members who held positions created with the sole purpose of attending to the heirs' interests. This action reduced overhead costs by 30 percent. It also sent a clear signal to all employees—and to the market—that a real governance transformation was underway, with the goal of prioritizing company interests over the interests of individual family members.

"Besides increased share liquidity, share appreciation and access to new funding at lower costs, being a capital markets-driven company has the side benefit of having external stakeholders exercising daily pressure for results, issuing appraisals, research reports, among others. Since corporate governance is all about alignment of interests, the introduction of short- and long-term incentive plans linked to value creation and share performance for executives are essential elements of a well-defined governance plan. But the strategic long-term commitment of the controlling shareholders is the essential element of success. Only with such a long-term approach can the status quo of a company be shaken and a change in behavior take place."

—João Pinheiro Batista Nogueira,
Suzano, former Co-CEO

Top management as agents of change

At **Buenaventura**, the board of directors and top management were the leaders who signaled that the company had decided to move seriously towards adopting better governance practices. From the outset, they were committed to making real changes.

Driving this group to think and act in unison: the notion that better corporate governance could create value through better corporate governance.

In the ensuing years, this notion was affirmed as the company's market value continually increased. The growth made Buenaventura's leadership even more committed to good corporate governance. The board and senior management took additional steps after they implemented the round of initial changes.

- They defined the vision, mission and values of the company with the support of external consultants.
- They established strategic objectives and an action plan to implement the new structure at all levels in the company.
- They remained aligned and fully committed to the process, communicating the strategy to achieve the company's corporate governance goals across all quarters of the organization.
- They established a long-term compensation plan for senior management that would help align their interests with the strategy and interests of shareholders, ensuring implementation of this strategy.

"The members of Natura's board established strict conditions for preparing for our initial public offer. A series of variables were established to be achieved before implementing the IPO. This in itself already represented an extraordinary commitment, since the decision to go directly to BM&FBOVESPA's Novo Mercado segment demanded prior preparation by the company. Based on this decision, all members of the board of directors had to become aligned with the governance principles that were being proposed to the company at that time."

—**David Uba,** *Natura, former CFO*

Improvements require hands-on involvement. External advisors or consultants can facilitate the governance reform process, in part due to their objectivity. But complete, hands-off reliance on external consultants to implement a governance initiative could doom the effort to failure.

Here's why: the implementation of new ideas must be driven by company leaders—shareholders, board members and senior managers. Before putting governance improvement plans into action, these ideas need to be discussed in detail to ensure an internal agreement around common approaches and goals is achieved.

The vision and the plan must be shared with all levels of a company that in one way or another will impact or be impacted by changes. Explicit, firm commitment of managers, directors and main shareholders to the corporate governance project's goals must be achieved. Showing future project returns to all stakeholders is one of the ways to make their commitment a reality.

CPFL Energia builds internal momentum

For **CPFL Energia**, long-term strategies were defined in an internal consensus-building process and then implemented throughout the group in ways that ensure best practices and respect the company's culture. Communication was essential. The leadership team, with guidance from its external consultants spread the word by way of clear, simple documentation in print and web formats so that shareholders, employees and investors alike understood what was happening. The firm's 20-plus subsidiaries—whose leadership is part of the company's executive team—were also aligned through by-laws amendments and similar management processes. All companies in the group adhere to the same corporate governance rules. By sharing the same governance practices, corporate processes are optimized and decision-making is improved, allowing the companies to focus on their core businesses.

In agreeing to share future benefits across the entire group, CPFL Energia's leadership further cemented commitment to governance improvements throughout the entire organization. Among the steps taken: offering minority shareholders of CPFL Paulista, CPFL Piratininga, CPFL Geração and RGE the option of a share swap of both common and preferred shares for common shares in the holding company, and listing on BM&FBOVESPA's Novo Mercado. These recently acquired companies, with a handful of minority shareholders, will have the same possibility to migrate to the holding company for a fair price.

Benchmarking builds commitment. Another way of helping to ensure that all levels of a company share in the understanding of and commitment to corporate governance improvements is to embark on a discussion of benchmarking the company's practices against existing references in the market—codes of best practices and corporate governance guidelines produced by associations, regulators and institutional organizations and the like. For more on benchmarking, please see Chapter 3, Section 2.

"When we first heard about "corporate governance" in Peru, although the name was quite new, the content of it was fairly known by our company, which had always been managed under values such as fairness, equal treatment and transparency. However we realized certain details in how we managed the company could be improved, specifically in the way the board could add value by bringing new experiences and points of view with more independent directors and having board committees. We also found some articles in our by-laws that made great sense for a company owned by four shareholders more than 70 years ago, but were not relevant in a company owned by almost 1,000 shareholders, some local, some from abroad. We dedicated a lot of time to studying the OECD Principles and then the Peruvian corporate governance code,[20] and brought some ideas to our board, where we always found great openness."

—Mariela García de Fabbri, Ferreyros, CEO

[20] OECD, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (2004). Principles of Corporate Governance. *Available at http://www.oecd.org/DATAOECD/32/18/31557724.pdf*. CENTRO DE ESTUDIOS DE MERCADO DE CAPITALES Y FINANCIERO (2001), Perú: Código de Buen Gobierno Corporativo para Empresas Emisoras de Valores.

Building a common understanding for corporate governance needs

Ferreyros' leaders understood early on that to attract investors and differentiate itself from other companies participating in the capital markets, it was important to constantly adopt changes that ensure transparency, equitable treatment of shareholders and efficiency in its operations.

This on-going commitment to continuous improvement was possible because members of the board and top management have always been clear on the role corporate governance practices play in Ferreyros.

This became even clearer as Peru adopted a new governance code—spearheaded by Ferreyros' leadership—and the company embarked on a new round of improvements, implementing changes in its by-laws to appeal to a broader base of investors and to attract independent directors to sit on its board.

With their total involvement with governance reform, Ferreyros' leaders could demonstrate through their positive results that companies with good corporate governance standards—implemented after first gaining solid top-to-bottom internal commitment—have a strong competitive advantage over other companies that don't understand its importance.

1.4 Understanding Sources of Resistance; Taking Actions to Overcome

When looking at sources of resistance, a good place to start is at the highest level—the controlling shareholders. There will be resistance from senior managers and employees as well. At the ownership level, the founders/older generation are, in some cases, the source of resistance because they do not want to change the way the company is run. Some family members may resist the reform because they may lose power or their jobs. Others may want to hold up the process until they are convinced of their potential personal gain.

Senior management's resistance may come because some managers might be close to the controlling family. They also might be afraid of losing their jobs. Others might see danger, because more qualified people could be brought into the company or because there could be required more accountability. A third group might resist simply because it lacks a clear understanding of the changes.

And then there are the employees. Workers at all levels can be a major obstacle to the successful implementation of corporate governance improvements. Typically, this resistance is due to:

- Lack of awareness about the changes and the value the changes can bring
- Discomfort with the ways things are being done or how changes will affect the way they do their jobs
- Fear of losing their jobs
- Concern about an overload of additional responsibilities

The team implementing governance improvements will need a strategy to overcome—or, at the very least, to minimize—resistance and to align goals.

For Your Consideration

If your company has a history of confrontational relationships between employees and key executives, consider organizing collaborative teams that include workers and these same executives. This will help uncover the underlying reasons for hesitation and reduce the cultural resistance to change.

Companies Circle Members Tackle Resistance

Problem	Solution
CPFL Energia	
The implementation of governance improvements such as the development of a succession plan, the introduction of an anonymous and confidential communication channel concerning accounting and other fraud issues, and the automation of controls for the preparation of financial statements have sometimes been met with some measure of resistance, which is natural in change processes.	To deal with this resistance, the changes have been introduced with consistency after discussion with all the stakeholders. Additionally, management's sponsorship and support was helpful.
Buenaventura	
There was some resistance to change and particularly to the process of formalizing the governance policies at the company. Commitment and active participation by the whole organization was expected, principally from top management.	To address this resistance, the formalization of governance policies was done over time of almost a year as part of a permanent improvement process. With the new written policies, employees are now able to speak the same language at all levels of the organization, and the company has increased its efficiency and effectiveness.
NET	
As one of the first companies to enter this process, NET faced the challenge of making an internal case to prove that the company's corporate governance changes were here to stay and that all major companies would soon follow suit. Not everybody had the same vision.	NET embarked on a vigorous benchmarking exercise to make the case that the corporate governance wave was coming and that it would prove positive, creating strong shareholder value if the company could be at the forefront of the process and not a follower. NET's investor relations team met with staff to demonstrate the workings of capital markets and how transparency impacts on company valuation. This process continues to work well for the company as it builds on its corporate governance improvement efforts. When NET began to consider a Level 1 listing on Brazil's special corporate governance exchange segment, the company's investor relations and legal departments worked closely with BM&FBOVESPA, to understand the implications of adhering to Level 1 and in anticipation of a potential Level 2 listing. Staff in these departments knew that many companies had resisted one of the listing requirements—Market Arbitration Panel—and they wanted to be prepared with responses to anticipated resistance. The earlier coordination contributed to the alignment and saved time.*

* The Market Arbitration Panel (CAM - Câmara de Arbitragem do Mercado) is a forum designed by BM&FBOVESPA to settle corporate disputes outside the official Brazilian judicial system. It provides an agile, cost-effective and independent environment for dispute settlements in line with the directives of the Arbitration Law. Companies listed on BM&FBOVESPA's special listing segments (the Novo Mercado and Levels 1 and 2) must comply with CAM.

External consultants can ease the resistance and bring people together. Sensitive issues in a group can seem irreconcilable because the disagreeing individuals may not understand the real reasons behind their disagreements. They may object not because of resistance to change, but because of underlying and unstated attitudes or objectives. In the case of family members or senior managers, resistors may see the company as their main focus in life or they may prefer to spend more time on other activities and delegate the running of the company to others. Such attitudes will inform their approach to governance initiatives.

External consultants can bring shareholders with opposing views together. They can facilitate agreement on a common strategy to create a constructive environment for building consensus. One approach involves individual meetings with company leaders and main shareholders. Such meetings lead to a better understanding of their personal objectives. The meetings also explore ways to overcome personal differences to achieve a shared vision of how the company should be controlled and managed.

2 Changing Attitudes

In general, changing attitudes can be a sensitive task. It is even more difficult when the changes concern the ways the company is managed and controlled.

Building a solid conceptual base for change

Argos began to believe in the philosophy and attitude of good corporate governance long before legal norms in Colombia required this. The company's leaders understood that the foundation of governance improvements had to be built over a solid conceptual base. Their first step: creating a strong code of ethics and governance that clearly defined important aspects concerning the company and indicated the expectations for each employee.

Later, the code was amended to conform to international benchmarks. The revised code, which emphasized aspects of disclosure and the free flow of information, was discussed with all internal stakeholders, from the employees to the board of directors. The code discussion process served as a means to align the understanding of future governance changes within the company and mobilize people around them.

Untimely death propels shift

At **Suzano**, a change in attitude was accelerated by the unexpected death of its chairman Max Feffer. Although he had already started to cultivate a strong team of professional managers and prepare his heirs for eventual transition, his sudden absence made it impossible to postpone decisions concerning the company's new path.

In a single meeting, over the course of one afternoon in April 2003, the family decided to implement a new governance model, making important changes to the role of the controlling shareholders. Feffer's son David invited his brothers and their main advisor, Boris Tabacoff, to a meeting with external executives who were already working on a transition plan. The consultants presented their initial conclusions, the proposed management model and the basic action plan. They identified the consequences of implementation, many of which would be painful to family members. The proposal was fully approved, with family members understanding that the approval would establish a long-term strategic vision. The family decided to step away from the executive function and focus on strategic direction and management oversight. From that time forward, the family adopted a new motto: 'One should not live off the company, but off the company's results.'

Leadership succession

Yet another example of a change in attitude and strong commitment can be seen at **Ultrapar**, which has a history of corporate governance that dates back to the 1980s. As presented in the previous chapter, Ultrapar's decision to adopt better corporate governance practices was intimately related to the company's management professionalization process and the leadership succession issue. Thus, ensuring continuity and institutionalizing the company to guarantee its long-term success were the main reasons for adopting better governance practices, including a pioneering remuneration system to commit and align executives with the long-term interest of the owners.

Such examples demonstrate that change requires a solid understanding of the goals the companies wanted to achieve. Companies must create opportunities for management, board members and shareholders to interact with other leaders within the firm, listening and learning from each others' experience.

Companies Circle members also underscore the importance of reaching out to experts in their own countries and abroad to obtain the necessary information, references and knowledge. At the time these firms started their journey toward better governance practices, other examples of implementing good practices were still hard to find. This forced shareholders and directors to reach outside their circles to find the guidance they needed, an effort that included business meetings, informal gatherings, business association events, training programs and seminars and conferences.

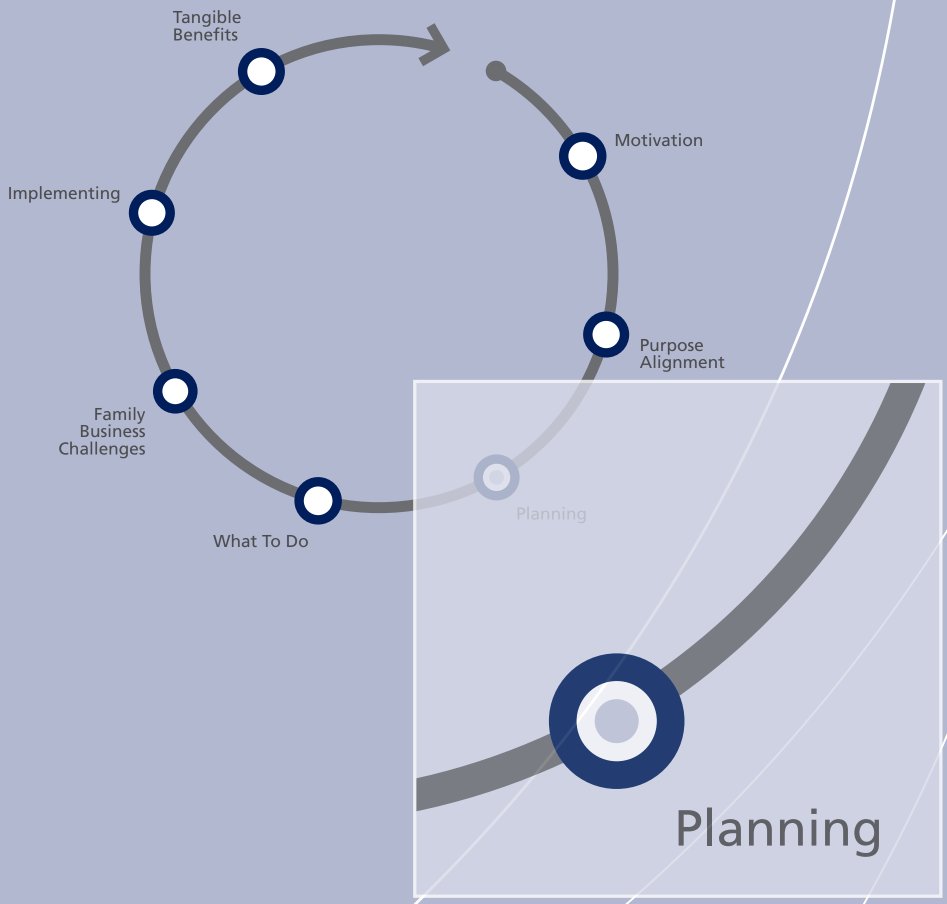
Now that the main initiatives to align governance actors and generate commitment to change have been addressed, it is time to move on to the details of how to carry out planning.

For Further Thought and Discussion:

- How would you go about obtaining agreement for governance improvements in your organization?
- Who are your company's key players to include in the process of initiating and implementing governance improvements?
- Make a list of your company's key resistance points. How would you overcome the resistance?
- Create a sample agenda for a meeting that would bring together key executives and employees as a way to find common ground and overcome a history of confrontation.

3

PLANNING AND SETTING PRIORITIES



Chapter 3: Planning and Setting Priorities

KEY MESSAGES

Prioritize specific measures. Companies motivated to improve governance should seek to prioritize specific measures to ensure that proper attention is given to the most urgent tasks.

Look at what other companies are doing. Review governance practices of other companies in similar situations and examine the relevant corporate governance principles, standards, guidelines and literature to benchmark the current governance framework and practices and identify gaps and shortcomings.

Design a formal action plan. Putting the identified and prioritized corporate governance improvement measures into a formal action plan is critical. This will ensure that everyone in the organization understands what needs to be done, when and why. It will identify expected results and benefits and identify those responsible for implementation. A formal plan will also create accountability of all involved in the governance transformation process.

Planning

As in every complex transformation, setting priorities and balancing the desired results with efforts allocated are fundamental for success.

This chapter addresses factors to consider in the effort to prioritize governance improvement measures. It looks at the importance of self-examination and corporate governance benchmarking to get a clear vision of the current governance policies and practices. The chapter highlights sources of governance guidance and advice and lays out recommendations for the development of a formalized action plan for governance improvements. Companies Circle member experiences are presented throughout the chapter.

When leaders of companies first become familiar with good governance practices and become aware of the benefits achieved by those who have adopted them, they may find themselves confronted by two types of diametrically-opposed attitudes: excessive pessimism or over-optimism can both present obstacles to progress.

The pessimists. On the one hand, improvements may seem unachievable since the company's existing policies and practices may seem far from the desired goal. The company's leaders may lack a clear understanding of where to start or how to achieve desired results given available resources. They may not know that they can take intermediate steps towards better practices if it is not possible to reach best governance practices at once.

This attitude can force companies to question whether to embark on the process of governance transformation at all. The gap may seem insurmountable. Pessimistic leaders will need some time and some persuasion that implementing better governance practices can happen.

They will need to understand that while the process of improving governance may seem daunting, the progress achieved will reap benefits for all.

The optimists. On the other hand, some leaders may be excessively optimistic. They may not be realistic in assessing the difficulties they might encounter along the way toward implementing improved governance practices. They may believe that they can replicate in full the experiences of best-governed companies without considering whether doing so fits with their own goals and resources. Overly-optimistic leaders might feel that simply making the decision will allow the rest of the process to flow. This attitude carries significant risks as well, resulting in poorly-planned projects that jeopardize implementation and discredit the entire initiative.

1 Setting the Priorities

"We have established the fact that the implementation of corporate governance practices is a permanent process. But we must keep in mind that to implement all the best ones simultaneously, especially when a company is just starting out in the process, is virtually impossible. Many steps demand considerable analysis of future impacts and possible developments. Furthermore, the internal culture and dynamics of every company and its controlling shareholders must be respected. Otherwise, the entire process may be put in jeopardy."

—Leonardo Pereira, *NET, former CFO*

Every initiative should start by establishing the most important goals the company wants to achieve.

- What is the business case for improved corporate governance of the company?
- What are the areas of greatest risk that can be addressed by corporate governance improvements?
- Which decision processes and practices will produce immediate benefits?
- Which ones will have the greatest impact at least cost and effort?
- What transformations can be brought about most easily in the initial stages with the least resistance?
- What is realistically possible to achieve, based on the company's existing financial and human resources?

To find answers to these and other questions, companies should define their priorities or desirable actions in the short- and mid-term time frames to create the structure, flexibility, purpose and accountabilities needed to achieve the intended results. Reaching these initial targets will help convince the skeptics and encourage the indifferent.

Many factors influence the prioritization of governance improvement measures. Companies might have some relatively good governance policies and practices in certain areas, while in other areas their practices could be weak or non-existent. For example, at some firms, governance shortcomings might be more apparent in the area of board practices, while for others internal controls and auditing may pose significant problems.

Some governance measures require pre-conditions, while others are stand-alone and can be implemented independently of other measures. Some may be relatively easy to implement as single measures with little potential for resistance; others may be more complex, involving a more difficult set of trade-offs and greater potential for resistance. These measures might require a lengthy period for implementation.

With such a variety of measures and intricacies of implementation, how should a company identify its priorities?

1.1 Motivations Drive Prioritization

As discussed in Chapter 1, the motivation for governance improvements will drive the agenda and pace of actions.

- For companies looking to attract minority investors, measures aimed at boosting potential investors' confidence that their interests will be respected is a good place to start. Thus, governance policies on shareholder rights, information disclosure, tag-along rights for preferred (non-voting) shares, and board representation might be some of the measures to undertake.
- For companies seeking to improve decision-making processes and operational results, rules and procedures for decision-making at shareholders' meetings, board meetings and at the senior management level may be the priority.
- For family-owned companies interested in expanding or optimizing the organization, family business governance measures might be the focus of governance improvements. For more detail on such issues, see Chapter 5.

Often, companies face more than one of these situations at the same time. In such cases, it would be up to the company leaders to decide where to start, depending on the areas that require the most urgent intervention.

Prioritization of governance improvements will also be affected by the size of the company, the financial and human resources that are available, and the specific demands of the market and investors. Other factors include internal compromises on priorities among the various stakeholders of the company.

Start Here: A Checklist for Prioritizing Your Governance Actions

- Analyze your current governance practices
- Define resources to be dedicated
- Look at what other companies in similar circumstances are doing or have done
- Compare your practices to the competitors' to understand the value

External consultant helps set CCR priorities.

CCR needed to focus internally, given the nature of the company's formation as a group comprised entirely of minority shareholders—and competitors in the heavy construction business.

Because the company itself was created with the help of an international consultant, this process was used to set governance priorities as well. The partners came together and learned about the importance of effective corporate governance especially tailored for CCR. Together, with the help of the consultant, they identified a corporate governance to-do list.

Ferreyros' governance self-assessment helps prioritize changes

At **Ferreyros**, company leaders realized that continuous change is best implemented when a company's current status has been assessed internally and benchmarked both domestically and abroad. As described in Chapter 2, the company joined into an association with other firms interested in corporate governance practices. Each company in the group was asked to complete a governance self-assessment questionnaire looking at several areas:

- Transparency of ownership
- Financial transparency
- Board structure and procedures
- Shareholder relations

In general, the company scored well on the assessment, but in some areas, the company was not as strong. Company leaders used the results of the assessment as a starting point to implement improvements based on areas in which progress was not as satisfactory.

Suzano prioritizes listing on Brazil's corporate governance exchange

Part of the capital markets strategy of **Suzano Papel e Celulose** and **Suzano Petroquímica** included goals to list the first on Level 1 and the later on Level 2 of BM&FBOVESPA's corporate governance segments. Improvement priorities were geared towards meeting the requirements for inclusion in these select groups. A number of steps were taken to meet these goals:

- Adding three independent members to the boards of directors at both Suzano Papel e Celulose and Suzano Petroquímica, including one elected by minority shareholders
- Publishing Suzano Petroquímica's financial statements in US GAAP, meeting BM&FBOVESPA's Level 2 corporate governance requirements within the established deadline

- Completing the implementation of the Suzano Group's code of conduct in mid- 2006, following extensive discussion
- Defining the new board committee structure for Suzano Papel e Celulose and Suzano Petroquímica, including implementing an audit committee and expanding the scope of the strategy committee to incorporate sustainability
- Formalizing the new co-CEO structure at Suzano Petroquímica: the chairman of the board of directors stepped away from the CEO position, and a management committee under the board of directors was created in September, 2006. Suzano Papel e Celulose had a similar structure in place already.

2 The Role of Benchmarking

In the process of planning governance improvements and setting priorities, benchmarking[21] plays an important role in guiding the company as shown below.

	Benchmarking Process
Purpose of Benchmarking	› Identify and verify the company's position relative to governance policies and practices › Define what the company could/should do to improve › Define the path and prioritize the actions for governance changes › Verify that the company is on the right track once improvements are underway › Evaluate and uncover trouble spots that do not conform with the identified standard
Sources of Benchmarking	› Surveys, academic studies and other publications of corporate governance practices – Interaction with other companies – External partners – Corporate governance associations – Stock exchanges – Regulators – Multilateral organizations – Research and academic centers – Professional and trade associations – Governance rating agencies
Types of Benchmarking	› Against peers in the industry, country, region or worldwide › Against recognized national or international corporate governance principles and standards

An efficient way to benchmark is to search for governance developments in peer companies of the same industry. It is critical to find companies with properly-implemented governance practices to understand the implications and justifications for following such practices, as well as to get a sense of how to implement them in your own company.

21 For a list of Latin American and other international sources of information on corporate governance that may also support guidance on benchmarking against best practices, see Appendix 2

What kinds of outputs are expected from a benchmarking exercise?

- Framework for discussion among company leaders, where differences may arise
- Consensus on directions to take[22]
- List of corporate governance deficiencies that improvement efforts will address
- Clear, feasible direction and pace of change to which all parties at the table agree
- Governance improvement plan with properly established priorities

While benchmarking is a recommended approach, Companies Circle members can attest that finding full and relevant information in Latin America remains a challenge.

Argos Searches for Governance Benchmarks

In Colombia, governance regulation was not yet well developed when **Argos** sought to compare its governance policies and procedures with what other comparable firms in the country were doing. Argos wanted to make sure its practices were consistent with or better than these other companies.

Argos also looked abroad to review the corporate governance framework and practices in other markets. The company analyzed the guidelines of the NYSE and the Brazilian Institute of Corporate Governance. Leaders also reviewed the discussions and publications of the Latin American Corporate Governance Roundtable, organized annually by OECD and IFC/World Bank Group since 2000.[23]

The company engaged external consultants to assist in developing the benchmarking framework. Argos' leaders say that the process itself was important, enabling the company to consider the views of clients, shareholders, regulatory agencies, capital markets analysts and financial media. The result: Argos created an excellent code, which is currently applied and against which the company's practices are assessed.

Next steps include evaluating existing policies. With all references in hand, the next step is to proceed with a meticulous evaluation of existing governance policies, processes and practices within the company, comparing them against the benchmark. This means producing a technical assessment. It also means generating significant discussion and analysis among company leaders about current practices and what they say about the company's culture and way of doing business.

To help with this assessment this Guide produced a 100-point benchmarking questionnaire to serve as a self-evaluation tool that will allow companies to compare its governance practices with those valued by market agents. The benchmarking questionnaire is explained in Chapter 4 and included in Appendix 3

Following the benchmarking analysis of current governance successes and shortcomings, companies may find it useful to learn more about relevant governance policies and structures they will need to put in place and how better practices can be implemented.

22 Given the impact of possible changes on the organization, do not expect immediate consensus. Unrevealed reservations in the beginning may become important obstacles to future developments, so it is crucial to understand sources of resistance wherever they may originate, and to discuss them frankly.

23 See *www.oecd.org/daf/corporate-affairs/roundtables*.

3 Sources of Advice and Guidance

The good news is that there is no shortage of resources on governance assessments, action plan development and implementation of improvements. Much of what you find useful will depend on the internal culture of your firm, though. Some companies use external consultants. Others contact corporate governance institutes or chambers of commerce. Still others may educate themselves by visiting corporate governance websites, reviewing the relevant literature, and networking to learn from other companies' experiences.

One such source for self-evaluation your company's governance policies and procedures is from IFC, which has developed a series of progression matrices for different types of companies. The matrix for listed companies identifies main areas of corporate governance covering:

- Company leadership's commitment to good governance principles
- Functioning of the board of directors and the senior management
- Control environment, including internal control, risk management and compliance systems
- Information disclosure and transparency
- Protection of shareholder rights

In each of these areas general practices are identified that are recognized as acceptable, good, advanced or best (levels of governance development). While the main purpose of the matrix is to provide a framework for the company's leadership to discuss the big picture of the required governance improvements, it also is very useful for defining the ultimate goal of the company in each area and the next logical steps to move up the corporate governance ladder towards best practices.

See Appendix 1 for the listed company matrix,[24] and Appendix 2 for other sources of information.

Planning

Case Study: Short Timeframe for Compliance Drives Atlas' Hiring of Consultants

New rules from Costa Rica's stock market regulators included a speeded-up deadline for compliance. Given the short time frame, **Atlas**' board of directors decided to hire outside consultants to help them in the efforts that would be required, especially when it came to internal control procedures. They contacted the local office of an international consultancy, which immediately dispatched a team . The team held several meetings with the company's management, and the project was initiated.

Divide and conquer—splitting the tasks. Based on the consultants' advice, company leaders divided responsibilites among various key players:

- The general manager and CEO was the sponsor of the project
- The CFO held the lead role for project implementation
- A consultant from external firm handled project coordination

The company set up a steering committee as well. The workplan that evolved from the

[24] Other progression matrices of IFC as well as additional useful resources can be found on www.ifc.org/corporategovernance.

initial assessment was discussed and approved by the board's audit committee. Work was initiated on developing a list of priority procedures, based on a risk matrix prepared by the steering committee.

Evaluating the results. Company leaders report that progress has been slow but steady.

- Priority has been given to the development of internal control policies and procedures because they have the largest impact on the company.
- The mix of external consultants and company officers has worked well: although the company's officers were the ones who could best describe their roles and define specifics of what was needed, they could not stop their day-to-day responsibilities to dedicate themselves full-time to the implementation of the needed governance changes.

Here is how Atlas CEO Diego Artiñano describes the situation:

> *"Once the CONASSIF came out with the new regulation we were faced with the fact that to be able to ensure compliance with it, something for which both the chairman of the board and myself had to deliver a sworn statement, the proper systems and controls had to be in place. By evaluating the task in front of us, the required knowledge to do it effectively and the effort required, we searched for options and ended up deciding on the external consulting firm. The challenge was not to do the effort to please the regulatory agency and comply, but also to bring some value to the business processes. This approach has made the difference. Processes must be adequate to perform under new requirements and not involve adding "second stage operations and controls" to make them compliant. Although this approach has taken some more time to complete, we cannot report a relevant increase in costs due to the new controls and compliance requirements. Atlas has been a leader in Costa Rica in several areas. Being the first publicly traded company in Costa Rica, we feel that we also are called to lead related actions."*

—Diego Artiñano, *Atlas, CEO*

Companies Circle members took divergent approaches as they sought improving their corporate governance policies and procedures. Here is a look:

Single-source advice

Atlas decided to engage external consultants after Costa Rica's stock market regulator introduced new regulations on corporate governance, with shorter deadlines for compliance than previously mandated.

Multi-source advice

At **Ferreyros**, the company accepted input from all its stakeholders, including:

- Investors
- Market intermediaries
- Corporate governance institutes
- Documents published by corporate governance institutes
- OECD guidelines and the Peruvian principles published by Conasev
- Involvement in the Procapitales Association's corporate governance committee
- Institutional investors: specifically, the company implemented their suggestion to include more independent directors.

"In the early 90's many foreign investors took an interest in Peruvian companies by investing directly in the Lima Stock Exchange, including in our company. We started getting calls from investment bankers to visit with analysts who were traveling to Peru. Then, in 1997 we placed capital stock internationally and our arranger and placer recommended that we include elements such as a dividend policy, distribution of press releases and hosting a conference call. By this time, local institutional investors such as pension funds also started to invest in our company and to meet with us. We always received—and continue to receive—valuable comments at these meetings about managing risks, structuring financings, and relating to the capital markets, among others. We try to implement most of them."

Mariela García de Fabbri, *Ferreyros, CEO*

Planning

4 Less Is More: Design an Easy-to-Understand Roadmap

Once all the analysis has been done and priorities set, it is time for the company to put together an action plan for implementing corporate governance improvements.

Sometimes, company leaders will keep the plan in their heads. Still, a formal action plan will serve to institutionalize the changes and introduce accountability for those responsible for implementation and oversight. The formal action plan clearly sets the expectations as to when governance measures will be implemented and when expected results of improvements will materialize.

With a formal action plan readied, you can create a simple roadmap to identify the actions. Items in the plan might include:

- Indicating specific governance actions
- Setting up information communication mechanisms: intranet, email
- Specifying each expected result of the governance improvement process
- Defining the amount of time allocated for implementing each element of the plan
- Identifying the milestones that will indicate the progress achieved and clear and measurable indicators for each intended result
- Naming the person responsible for each action

> ✓ Keep it simple! The simpler your action plan, the easier it will be for everyone to understand their roles and for company leaders to monitor the implementation.

Figure 3.1 shows what an action plan might look like. This chart groups possible corporate governance improvement measures into the CG Action column. These measures are consistent with the recommendations of the OECD Principles of Corporate Governance, specified in the CG Area column.

An actual plan also would include timelines for completion, designation of responsible parties and comments to highlight any challenges or special considerations in relation to the specific action.

Figure 3.1 Sample action plan

	CG Area	CG Action	Timeline	Responsible Party	Comments
1	Commitment to CG	› Hire a CG consultant to assist in reviewing and implementing CG reform			
2		› Develop a corporate CG code			
3		› Establish corporate governance committee and develop TORs for the new committee			
4		› Develop a code of ethics: implement whistle-blowing procedures			
5					
6	Board Practices				
7	Control Environment				
8	Information Disclosure and Transparency				
9	Shareholder Rights				

Note that the example here is illustrative, and not prescriptive. There is a wide range of possible actions to consider and adapt, according to your company's unique circumstances and priorities. You will find further guidance on recommended governance actions in the next two chapters of this guide.

Once your plan is formalized, it must be communicated to all stakeholders.

Hint: setting incentives or rewards for each level of the team involved in the process can help to motivate their efforts in the implementation process.

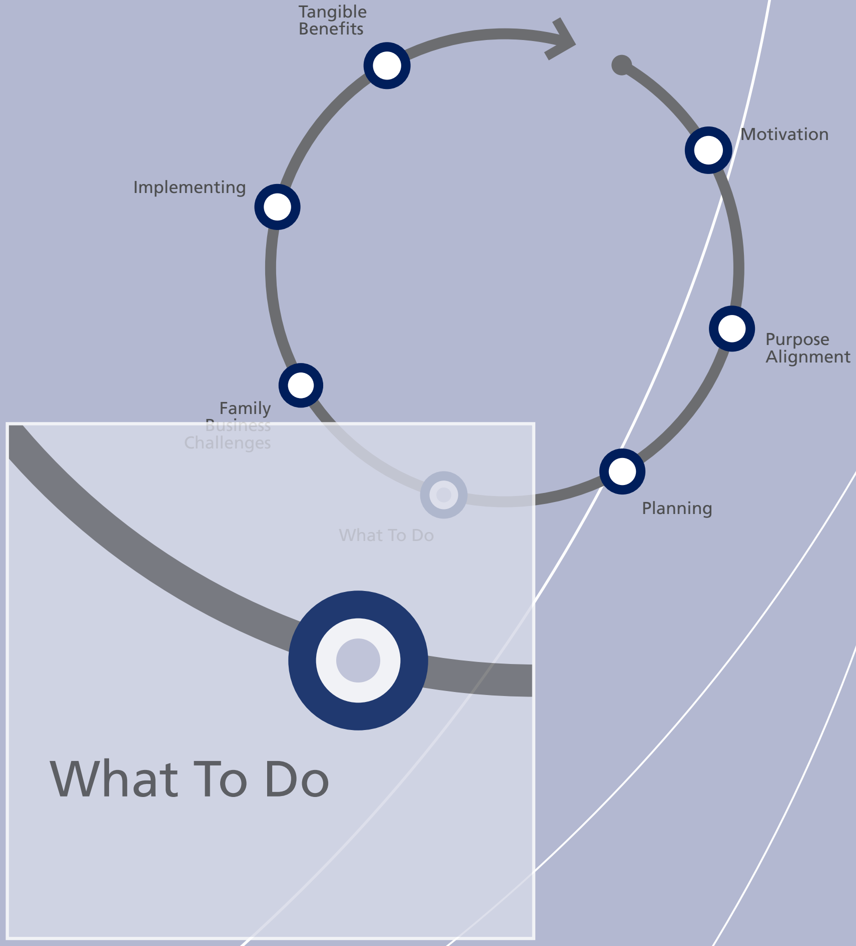
This chapter addressed the need for good preparation before starting out on the journey towards implementing governance improvements. It explored the importance of understanding the company's current stage of development and highlighted the value of setting priorities and knowing the direction in which the company is heading. The next chapter looks at specific improvement measures companies can make.

For Further Thought and Discussion:

- ➤ How would you prioritize the efforts to improve governance policies and practices in your company?
- ➤ What corporate governance improvement measures would you seek to implement immediately?
- ➤ What relevant resources are available or could be mobilized to develop an action plan specific to your situation?
- ➤ Have you identified governance benchmarks to evaluate where your company is compared to others and what actions require prompt response?
- ➤ Using a framework similar to the figure above, start to think about specific actions that will drive these improvements.

4

WHAT TO DO:
KEY GOOD GOVERNANCE PRACTICES



Chapter 4
What To Do: Key Good Governance Practices

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/)

Ferreyros focuses on business conduct and accountability

In Peru, **Ferreyros** 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

Ferreyros 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."[25]

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.

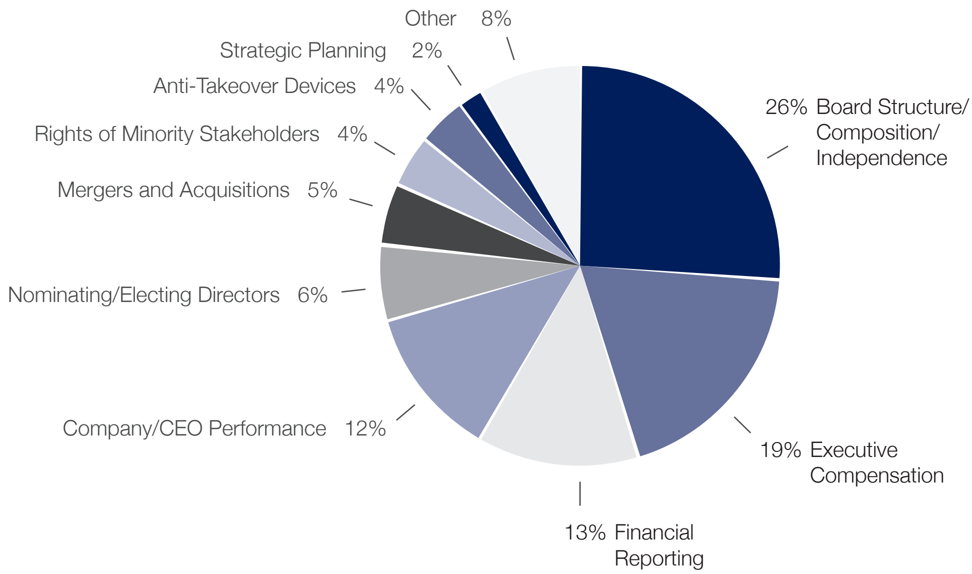
The corporate scandals at the beginning of the decade and again following the more recent financial crisis turned the spotlight on boards. Why did the directors of those companies fail to see or act to prevent the disasters that led to enormous losses for shareholders and all stakeholders?

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.

25 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 Government 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:[26]

[26] 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). *U*sing 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[27] involving 30 documents and codes on corporate governance from 22 countries, only two of them[28] 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.

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

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

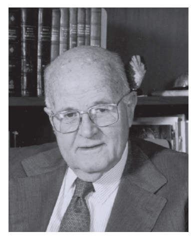
For Your Consideration

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."[29]

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.[30]

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.[31] This study of companies listed on the S&P 500 index in 2006 revealed that 81 percent of directors are independent.

What To Do

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

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

31 SPENCER STUART. (2006). The changing profile of directors: Spenser 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.[32]

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*

32 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.[33] 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

33 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

Argos

- Audit & Finance
- Corporate Governance
- Nomination & Compensation

Atlas

- Audit
- Compensation

Buenaventura

- Audit
- Compensations
- Disclosure
- Nominating and Good Corporate Governance

CCR

- Audit
- Finance
- Governance
- Human Resources
- New Business
- Strategy

CPFL Energia

- Fiscal Council—also has Audit Committee role
- Human Resources Management
- Management Processes
- Related Parties

Embraer

- Audit—also has Fiscal Council role
- Executive
- Human Resources

Ferreyros

- Audit
- Management and Corporate Governance
- Organization Development & Human Resources

Homex

- Audit
- Corporate Governance and Compensation
- Executive
- Risk Management

ISA

- Audit
- Board Matters
- New Business and Investments

Marcopolo

- Audit & Risk
- Executive
- Human Resources & Ethics
- Strategy & Innovation

Natura

- Audit
- Corporate Governance
- People & Organization
- Risk Management & Finance
- Strategic

NET

- Financial
- Fiscal Council—also has Audit Committee role

Suzano

- Audit
- Management
- Sustainability and Strategy

Ultrapar

- Ethics
- Financial Management and Risks
- Fiscal Council—also has Audit Committee role

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,[34] they are called fiscal councils. In Mexico they are known as comisarios.[35] And in Colombia, they are called revisores fiscales.[36] . 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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34 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.

35 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.

36 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.[37] 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.

What To Do

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."

37 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.[38] 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.[39]

Studies Show…Evaluations Build Better Boards

An international comparison of codes of good practices[40] 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[41] 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

38 BUSINESS ROUNDTABLE. (2006). Corporate governance survey.

39 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.

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

41 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.

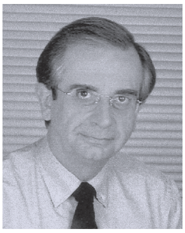
Additional board features:

- 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.[42] *Through per-*

[42] 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.[43] 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-

43 SPENCER STUART. (2006). The changing profile of directors: Spenser 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.[44]

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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44 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

What To Do

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®)[45] 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.[46] 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

45 For the definition of the term, see Glossary.

46 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.[47] 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.

47 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 resumés 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."[48]

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.[49]

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.[50] 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.

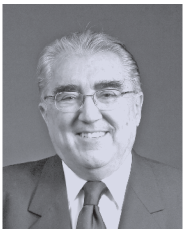
In 2004, Ultrapar included tag-along rights in its by-laws. At the same time, it distributed equal dividends to holders of common and preferred shares. The objective was to align the interests of common shareholders with those of preferred shareholders, making it easier to place new shares in the market,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

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

49 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.

50 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

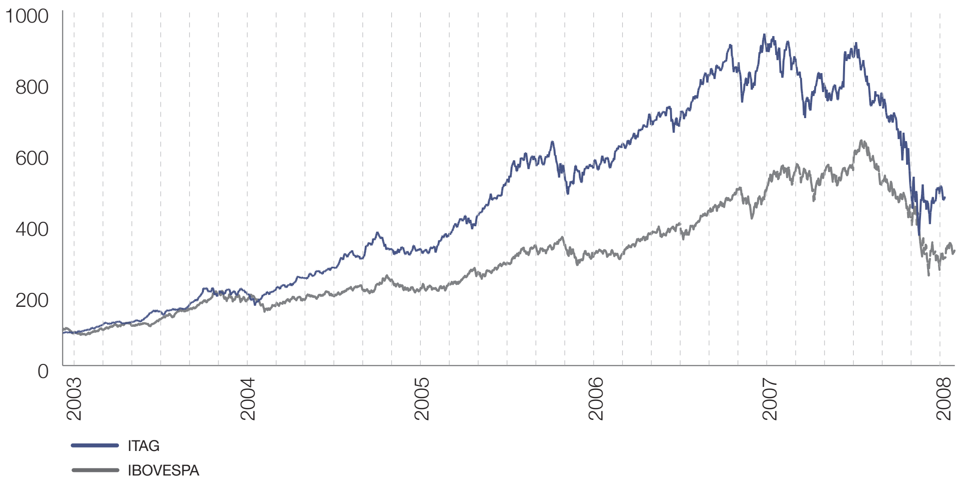
Academic research from September 2007 reveals that the efforts of Brazilian companies granting tag-along rights extending beyond legal requirements were recognized and priced favorably by investors.[51] The study analyzes 75 companies offering some tag-along rights in addition to the minimum rights provided 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).

[51] 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.[52]

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

52 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 chose 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.[53] In 2004, COSO issued a second guidance, Enterprise Risk Management—Integrated Framework.[54] 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.[55] 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,

53 COSO, Internal Control—Integrated Framework, *http://www.coso.org/publications/executive_summary_integrated_framework.htm.*

54 COSO, Internal Control—Integrated Framework, *http://www.coso.org/publications/executive_summary_integrated_framework.htm.*

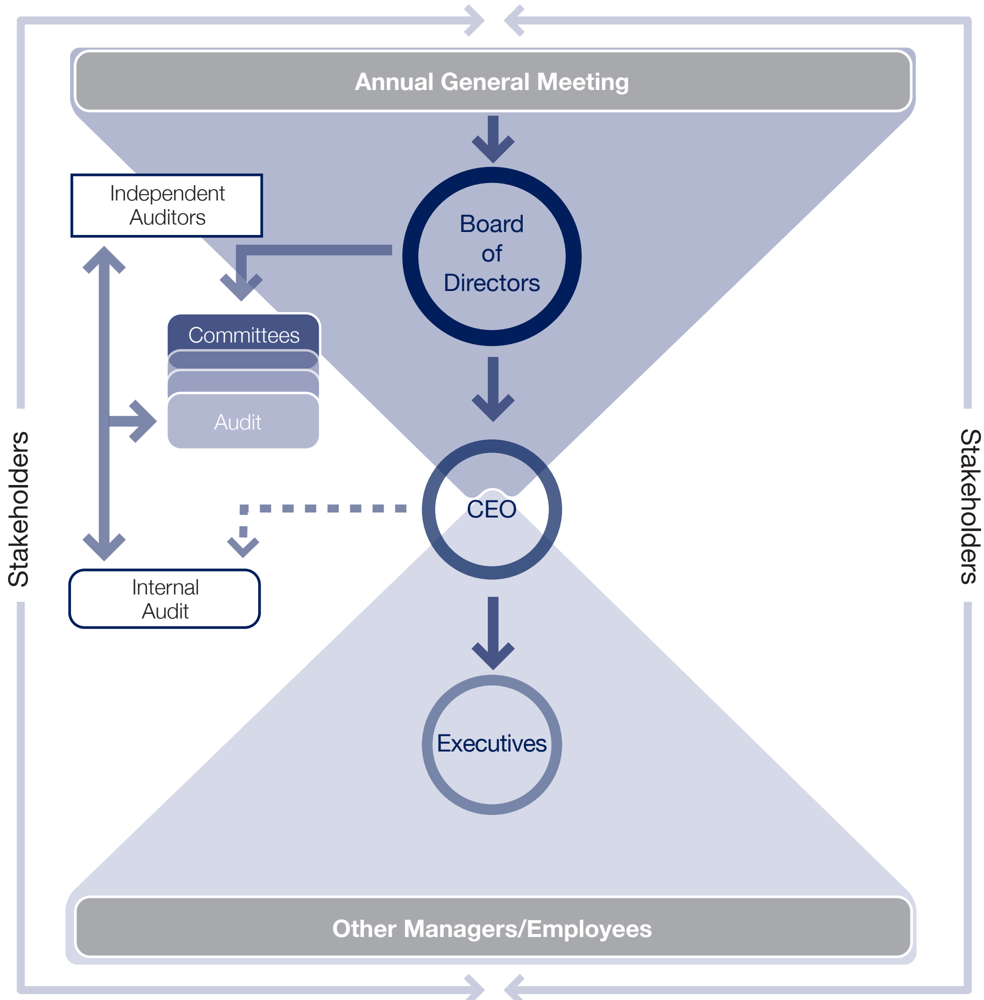
55 THE INSTITUTE OF INTERNAL AUDITORS, *www.theiia.org.*

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.

What To Do

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:[56]

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.

[56] 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.*

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."[57]

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

[57] 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:[58]

- 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.

[58] 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.

5

GOVERNANCE CHALLENGES FOR FAMILY-OWNED BUSINESSES

Chapter 5
Governance Challenges for Family-Owned Businesses

KEY MESSAGES

To an extent, family control yields benefits. Academic research and experience from many companies and investors all show that a certain degree of family ownership/control provides positive benefits to the family business and its shareholders.

Family-owned firms face unique challenges. However, many failures of family-owned companies indicate that such firms also face a multitude of challenges which risk destroying shareholder value or even the business itself.

Corporate governance measures lead to long-term success and keep peace in the family. Corporate governance measures at the family and business levels provide good solutions to family ownership challenges and often are indispensable to the long-term success of the family business—and peace in the controlling family, especially with succeeding generations.

"…We have two options; there is no right or wrong decision, nor one that is better than the other. But whatever is to be done, will be definitive. There is no turning back. We can continue being a family business, like in my grandfather's and father's days, or become a professional company with a strong and clear capital market strategy."

—David Feffer, Suzano, Chairman of the Board, speaking to his relatives after his father's death

Family-owned or controlled companies are the leading form of business organization in Latin American countries, even among large listed companies: one recent study from Brazil revealed that 51.5 percent of the 200 largest listed companies are family-controlled.[59]

This predominance of family companies shapes particular corporate governance challenges and opportunities not always considered in markets where ownership is dispersed and management is mainly composed of external and hired specialists. But for Latin American markets, any discussion of corporate governance improvements must address the unique governance challenges that family companies face.

This chapter examines:

- How investors view family businesses and the benefits of family ownership
- Challenges related to family control
- Governance solutions to address investor concerns related to family ownership
- First-hand stories of governance challenges in family-controlled companies

1 Family Business Edge

Family ownership may be seen as an opportunity or a threat, depending on a variety of factors. The family ownership and commitment to the business may be understood as adding value, provided that the company and the controlling family can respond to the concerns of the investor community.

Investors—both shareholders and creditors—may look with distrust on family-controlled companies, because of the risk that the controlling family may abuse the rights of other shareholders. So investors likely will scrutinize such companies with care before taking the plunge and investing.

There is a long and storied history of family-owned companies with highly-concentrated ownership, poor transparency and absence of accountability and fairness principles that led to abuse of minority shareholder rights.[60]

From an investor perspective, the key is to establish the right corporate governance conditions so that the positive aspects of family ownership are coupled with assurances that investor interests will be recognized and addressed.

Investor perception on ownership concentration, and the value associated with it, is revealed in a report of emerging market firms published at the beginning of 2007 by Citigroup Global Markets. The analysis suggests that investors place a three percent valuation premium on firms in which family insiders wield significant, but not absolute, control. Conversely, for emerging market firms where families are majority owners, investors assign a valuation discount of 5-20 percent. See Figure 5.1.

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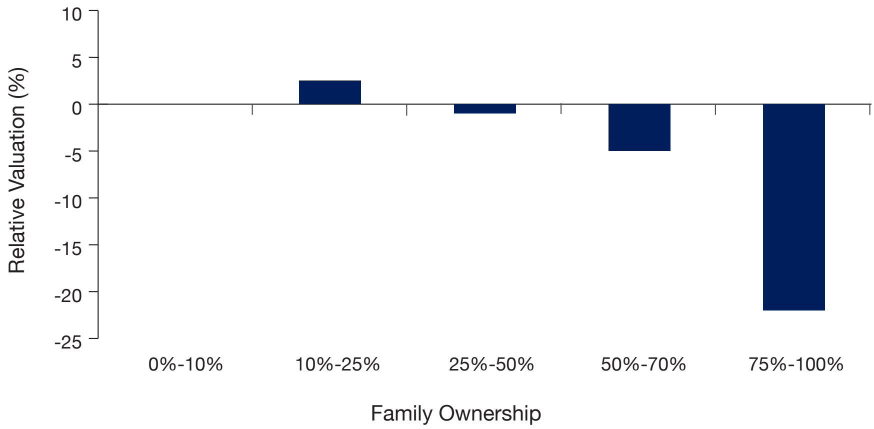
59 SILVEIRA, A. DI M. DA, LEAL, R. P., CARVALHAL-DA-SILVA, A. L., & BARROS, L. A. (2007). Evolution and determinants of firm-level corporate governance quality in Brazil. Available at SSRN <http://ssrn.com/abstract=995764>

60 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.

ANDERSON, R. C.; REEB, D. M. (2004), Board Composition: Balancing Family Influence in S&P 500 Firms. Administrative Sciences Quarterly v.49, *http://ssrn.com/abstract=590305,* pp. 209-237.

CLAESSENS, S.; DJANKOV, S., and LANG, L.H.P (1998), Expropriation of Minority Shareholders: Evidence from East Asia, Mimeo, World Bank, Washington D.C., Research Paper 2088, pp. 33.

Figure 5.1 Relative Valuation by Family Ownership in Emerging Markets[61]



Sources: FactSet and Citigroup Financial Strategy Group

Research quantifies the value of good governance in family businesses. In a study by Professor Panikkos Poutziouris[62] of the Cyprus Institute of Management of 42 companies on the London Stock Exchange, listed family firms outperformed their listed non-family rivals by 40 percent from 1999 to 2005. But the study also shows that the outperformance of the Family Business[63] Index only applies when the interests of shareholders and management are aligned.

Credit Suisse[64] research also showed that family-owned companies perform better: over the long term, such firms tend to achieve superior returns and higher profitability than companies with a fragmented shareholder structure. Credit Suisse analysts compared the stock performance of European companies with a significant family influence to firms with a broad shareholder base. The study uncovered several factors that contribute to the success of family-owned firms:

- Longer-term strategic focus of the controlling shareholders and management, instead of operational focus on trying to surpass quarterly results
- Better alignment of management and shareholder interests
- Focus on core activities

Anderson and Reeb found a similar result when investigating the link between founding-family ownership and firm performance in large, publicly-traded U.S. firms listed on the S&P 500 in 2003.[65] The main finding: family firms outperformed non-family firms and had higher valuations as well.

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61 CITIGROUP GLOBAL MARKETS. (2007). What investors want: how emerging market firms should respond to the global investor. This report examines shareholder patterns among 1,500 largest listed firms in the emerging markets (the "EM 1500"). The EM 1500 represents the top 1,500 firms by US dollar market capitalization at the end of 2005. It is a subset of the Citigroup/BMI and IFC indices that essentially comprises every listed company with a market capitalization above $ 300 million across Asia (excluding Japan), Central and Eastern Europe, the Middle East, Africa and Latin America. All financial data for the EM 1500 is from Bloomberg.

62 POUTZIOURIS, P. Z. (2004). Views of family companies on venture capital: empirical evidence from the UK small to medium-size enterprising economy. *Family Business Review, 14, n. 3*, pp. 277-291.

63 A family business was defined by the study as one where at least 10 percent of the shares of a company were owned by the founding family and also had a family member on the board.

64 Credit Suisse Family Index, 2007.

65 ANDERSON, R. C., & REEB, D. M. (2003). Who monitors the family. *SSRN Discussion Papers*. Available at SSRN: http://ssrn.com/abstract=369620 or DOI: 10.2139/ssrn.369620.

The research shows that family businesses can generate value for all shareholders, based on several factors, known as 'the family business edge.' This is what attracts many investors to invest in family-owned/controlled companies:

- Long-term view in decision-making
- Ability and willingness to adopt unconventional strategies, enabling family businesses to respond rapidly to changing market circumstances and giving them the flexibility to take advantage of opportunities and address emerging risks
- Desire to build a business for future generations, translating to a focus on sustainability and reducing the risk that controlling shareholders will run down company assets and destroy value
- Commitment of family management to their company, providing continuity in the way the business is run

"I am certain that high ethical standards and good corporate governance in business generate value and increase the public investors' trust."

—Eustaquio de Nicolás Gutierrez,
Homex, Chairman of the Board

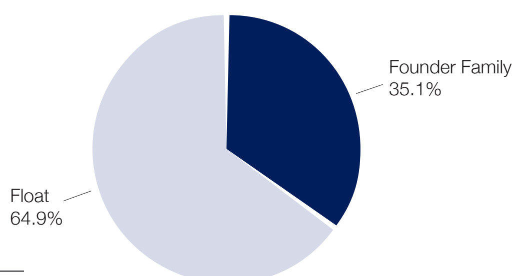
A number of Companies Circle members have significant experience in the area of governance for family-owned companies. Here is a highlight.

Homex implements governance practices

With the goal of generating value for all shareholders, Homex has implemented a series of governance practices.

Since going public in 2004, the company's controlling family has held a sizeable stake in the company. Still, the family has relinquished a larger portion of shares for public purchase over the years: the 2005 IPO launched with 22.2 percent of shares available for purchase. Today, other shareholders control 64.9 percent[66] of ownership, as shown in Figure 5.2.

Figure 5.2 The Ownership Structure of Homex



Source: Homex

[66] As of October 31, 2008.

This ownership structure demonstrates the De Nicholas family's commitment to the Mexican housing market, and confidence in the company's continued prosperity and ability to create value for all its shareholders. In turn, Homex' controlling family has found that this approach resonates with other investors, giving them greater confidence in the company.

Homex sought to do its best to ensure all shareholders that their rights and interests will be properly protected by introducing high corporate standards in its by-laws that focus on protection of minority investors' rights. Moreover, it has never incorporated provisions like anti-takeover practices, diluting schemes or the existence of different types of shares that provide for different voting privileges.

Homex' leaders see additional advantages of having 35.1 percent of company's ownership such as:

- Aligning shareholder interests that leads to better decision processes
- Attracting investment and increasing share liquidity
- Increasing investor confidence: high percentage of shares in the market gives minority investors confidence that a dominant group will not make decisions contrary to their interests—an important factor in Homex' success.

"Walking the path of true institutionalization and creating value with it requires a powerful level of commitment, internal control and high corporate governance practices are critical tools to get this job done."

—Gerardo De Nicolás, Homex, CEO

2 Family Business Governance Challenges

Together with certain advantages in comparison to non-family owned firms, family businesses also face a set of challenges which they need to address to obtain the trust of investors and, in many cases, to make the company sustainable in the long run.

Through the years, numerous academic studies have looked at some of these challenges and weaknesses:

› In 1988, Holderness and Sheehan[67] found that among US corporations, family firms have a lower market value than non-family firms.[68]

67 HOLDERNESS, C. G., & SHEEHAN, D. P. (1988). The role of majority shareholders in publicly held corporations. *Journal of Financial Economics, 20*, pp. 317-346.

68 The study measured companies' "Tobin's Q," a proxy for corporate market value calculated as the market value of a firm's assets divided by replacement value of the firm's assets.

- In 2001, Pérez-González found that the stock market reacts negatively to the appointment of family heirs as managers.[69]
- In 2004, Villalonga and Amit reported that family control exhibits specific weaknesses when descendants are involved in top management.[70]

So, even if family businesses are recognized as a valuable asset, the risks associated with concentration can drive away additional sources of finance, thereby reducing the company's value or restricting available credit terms.

The main challenge in family business governance relates to the existence of an additional layer of relationship that the owning/controlling family brings to the business.- For shareholders this complexity includes understanding the various interconnections among the owning/controlling family members. These roles include:

- Family member/owners
- Family member/directors
- Family member/managers
- Family member/employees
- Family members who are not shareholders, but are extended family and heirs
- Family members who are some combination of these roles

Typically, family businesses in the first generation—and sometimes in the second generation—are managed by the founders and other family members. These businesses often face the challenge of attracting good specialists to assume management positions. They face even more difficulties in retaining such qualified professionals. The relationship between family/managers and non-family professionals must be carefully crafted to maintain a well-functioning management team and to lead the company to success.

Relations between the family as shareholders and non-family investors also present challenges. Non-family external investors often have significant influence over the shaping of the family business' governance. Their views on corporate governance are converging due to economic globalization and emergence of global investors.

Despite convergence of governance patterns in the competition for capital, differences are likely to remain, from country to country and from industry to industry.

There is also a trend toward standardizing understanding of good governance for investors and international capital markets. Notes one institutional investor in response to a 2006 global study of institutional investors:[71]

> *"Global capital markets have become more integrated. Corporate governance becomes a common theme in the global investment community. It can serve as a screening tool to nail down the portfolio candidates. Moreover, it can also serve as a benchmark for our investment portfolio." —Institutional investor 2006*

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69 PEREZ-GONZALEZ, F. (2001). Does inherited control hurt firm performance? *Working paper Columbia University.*

70 AMIT, R., & VILLALONGA, B. (2006). Benefits and costs of control—enhancing mechanisms in U.S. family firms. *SSRN Working Paper.*

71 2006 ISS Global Institutional Investor Study, by RiskMetrics' wholly owned subsidiary, Institutional Shareholder Services (ISS), 2006. Reproduced by permission of RiskMetrics Group, Inc. . ©2006-2009 RiskMetrics Group, Inc. All rights reserved.

This study, from RiskMetrics' subsidiary, also finds that the majority of investors say that corporate governance is more important today than it was three years ago. They also say that it will become even more important in the next three years—including for family businesses. Investors place a strong value on corporate governance, minority shareholder protection and transparency. As a result, they want family businesses to have structures and processes that are globally recognized as good practices without necessarily considering the family business governance specifics.

In addition, family-controlled firms often face a difficult choice as they confront the need to fund growth by attracting equity: do they cede partial control to external shareholders and change their old habits and ways of running the business, promoting tangible improvements in corporate governance in exchange for capital for growth?

This discussion shows that family companies must consider a variety of sometimes conflicting issues when competing for resources alongside global companies, particularly in countries with institutions, regulatory frameworks and enforcement mechanisms that do not inspire the confidence of investors. There are additional challenges as well:

- Quite often, especially during the early, start-up stages of the family business, the company and family relationships are not clearly distinguished. This is particularly true with respect to financial relations and accounts—the company's and family's assets are not legally separated. This causes problems in distinguishing company-owned assets, and how company-owned assets can be used by the family as a shareholder.
- Existing governance-related policies are informal, as a general rule. This can lead to reliance on key people rather than on structures and processes. Such "common" understandings may not be as universally-held or understood when situations change. As a result, there could be some uncertainty on the part of external investors and non-family employees.
- Weaknesses in governance systems of family businesses are most evident in internal controls, internal audit and risk management. Since many family businesses are managed by the founders or their children, the control environment is largely tailored to their needs. The problem: the controls do not grow along with the company, as the business becomes more complex. This gap is a primary area of concern for external investors.
- Governance challenges only increase as the family and business grow more complex with each succeeding generation.

3 Governance Solutions to Family Business Challenges

This section looks at various governance solutions to the challenges unique to family-owned businesses, and covers a variety of topics:

- Distinguishing governance solutions in different ownership stages of the family business
- Family governance institutions
- Family governance documents
- Specific solutions to some family governance challenges
- Succession planning in family-owned business
- Case study: Ultrapar

To address the challenges detailed in the previous section, family businesses have come up with many governance solutions that are specific to their ownership structures.

Research published by IBGC in 2006 analyzed 15 family-controlled companies and found that these companies had five main motivations for seeking improvements in their governance policies and practices:[72]

- To institutionalize and perpetuate the business model
- To provide the means to implement the defined strategic plan
- To add value for shareholders
- To enhance the potential for attracting debt financing, resources and shareholders
- To improve the company's image abroad, facilitating globalization and reaching a base of foreign investors

The study provides clear evidence of the value of good governance to such companies. The study sample was comprised of listed companies with certain liquidity levels. They also met a certain standard of relatively advanced corporate governance practice. The research found a relevant and meaningful positive correlation between the quality of corporate governance at these companies and their operational and market success.

The analyzed companies are on average larger and are worth more. They have higher market multiples. They are operationally more profitable, with more liquidity. They pay higher dividends. And they are more solvent in the short term and more leveraged than the average of all listed companies on BM&FBOVESPA. The study also concluded that the analyzed companies typically follow better corporate governance practices than an average company listed with BM&FBOVESPA.

Family-owned members of the Companies Circle have faced a similar set of motivations. The stories that follow provide concrete illustrations of the reasons to initiate corporate governance improvements in family companies and the benefits they afford to the controlling family, the family business and outside investors.

> *"I don't know cases of families in Latin America that had become more united because of money, but I do know of many cases where families have destroyed companies because of money. The lesson to be learned here is that company value is what unites shareholders, irrespective of whether these are family members, institutional shareholders or investors who are external to the controlling groups."*

—Roque Benavides, *Buenaventura, CEO*

[72] IBGC, BRAZILIAN INSTITUTE OF CORPORATE GOVERNANCE (2006). Corporate governance in family cotrolled companies: relevant cases in Brazil. *São Paulo: Saint Paul Institute of Finance.* The companies analyzed include Gerdau, Gol, Itaú, Klabin, Localiza, Marcopolo, Natura, NET, Pão de Açúcar, Randon, Sadia, Saraiva, Suzano, Ultrapar and Weg..

Buenaventura transforms from family-run firm to professionally-managed company

In Latin America, as elsewhere, family fights have destroyed value and companies to the detriment of all. **Buenaventura** set out on the corporate governance improvement path as a way to avoid this situation, transforming the company from a family-run business to a professionally-managed firm. With a focus on aligning the family's objectives with those of long-term shareholders and ultimately maximizing value for all shareholders and implementing good corporate governance, the company's founders and their successors believe they have avoided the kinds of family disagreements that could have harmed or destroyed the company.

As a listed company on both the NYSE and the Lima Stock Exchange, company leaders have seen that investors really care about corporate governance, and adopting such practices truly pays off. The company underwent an entire culture shift, affecting all shareholders, including family members, to focus on the benefits for the company as a whole. The family's objectives with respect to the company and non-family shareholders' objectives are the same, as all are interested in enhancing shareholder value.

Generational shift at Ferreyros

This company's significant change in the pattern of ownership and control over time is rooted in family factors. The first generation of founding partners passed on their ownership to the second. But not every second generation family member wanted to participate in the business, since the heirs had other interests for their careers and lives. So the owners opted to turn over the company's management to professional non-family managers and to create a broad and diverse base of shareholders. To facilitate the transfer of the company's stakes to new owners, **Ferreyros** registered its shares on the Lima Stock Exchange, an initiative that required the implementation of corporate governance improvements to attract investment and enhance the company's controls and performance.

3.1 Distinguishing Governance Solutions in Different Ownership Stages of the Family Business

Corporate governance solutions that family businesses can adopt will vary depending on the stage of the controlling family's ownership. Some structures and processes are adapted to situations in which there is a single person, the founder/patriarch of the company, in charge of the company. Other solutions are better suited when the next generation takes over the business. And a third set of governance solutions are appropriate for companies controlled by family members of later generations.

Harvard professor John Davis developed a model to help understand the three-phased evolution of family companies, shown in Figure 5.3.[73] The initial phase, in which all dimensions are concentrated in one family, groups of families or the individual founder is known as the "founders stage." As time goes by, the company grows and transitions ownership to the next generation, a stage called the "siblings' partnership." As more time passes, the company transitions to future generations, reaching maturity—a stage Davis calls the "cousins' confederation". When the firm reaches maturity, according to the model, the challenge is to renew and recycle in order for the company to continue.

[73] GERSICK, K. E., DAVIS, J. A., HAMPTON, M. M., & LANSBERG, I. (1997). Generation to generation: life cycles of the family business. *Boston: Harvard Business School Press.*

Figure 5.3 Development and Transition of Family Businesses Over Time

Source: Better Governance, based on GERSICK, Kelin E., DAVIS, John A., HAMPTON, Marion M., and LANSBERG, Ivan I. Generation to Generation: Life Cycles of the Family Business. (1997)

For Your Consideration

Remember that what works at one stage of this ownership cycle usually does not work well at other stages. So controlling families should take a careful look at the governance solutions recommended for their particular stage of development.

The governance solution you choose for your family business should depend on the ownership stage your company is in.

3.2 Family Governance Institutions

Transferring the values and business knowledge of the founders to future generations becomes more difficult as the family grows. The challenge is to keep the generations and all family members united and their interests aligned over the years. When families reach the third and fourth generations, their members may barely know each other. It becomes more difficult to maintain aligned interests within a large family, especially given that the demand for creation of wealth for future generations increases as time passes.

As the competition for resources and power within the family intensifies, it becomes increasingly difficult to maintain a common purpose. How does a family maintain a shared vision about the company? All sorts of diverging views can arise: on ownership, on the degree of control that the family intends to retain, on the family's involvement in the company's governance either through the board of directors or executive management.

The good news: help is available. Family business consultants and groups focused on governance say that several easily accessible publications can help families and their business with finding answers to these and other relevant questions. The IFC Family Business GovernanceHandbook,[74] published by the International Finance Corporation, recommends the

[74] IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *http://www.ifc.org/*

establishment of family governance institutions that can help strengthen family harmony and its relationship with the business.

The handbook, aimed at guiding families as they initiate best governance practices on the corporate and family levels, suggests that allowing family members to gather under one or more organized structures, strengthens communication links between the family and its business. This approach also provides opportunities for family members to network and discuss issues related to the business and the family. Table 5.4 highlights the types of governance structures families might establish, depending on the stages of the family company's development. In addition to governance-related structures presented in the table below, families might consider establishing other structures, such as family office, education committee, share redemption committee and career planning committee.

Table 5.4 Family Governance Institutions

	Family Meeting	Family Assembly	Family Council
Stage	Founder	Sibling partnership/ cousin confederation	Sibling partnership/ cousin confederation
Status	Usually informal	Formal	Formal
Membership	Usually open to all family members. Additional membership criteria might be set by the founder	Usually open to all family members. Additional membership criteria might be set by the family	Family members elected by the family assembly. Selection criteria defined by the family
Size	Small size since family still at founder stage. Usually 6–12 family members	Depends on the size of the family and membership criteria	Depends on criteria set up for the membership. Ideally 6–12 members
Number of meetings	Depends on the stage of the business' development. When business is growing rapidly, can be as frequent as once a week	1-2 times a year	2-6 times a year
Main Activities	› Communication of family values and vision › Discussion and generation of new business ideas › Preparation of the next generation of business leaders	› Discussion and communication of ideas, disagreements, and vision › Approval of major family related policies and procedures › Education of family members on business issues › Election of family council and other committees' members	› Conflict resolution › Development of the major family-related policies and procedures › Planning › Education › Coordination of the work with management and the board and balancing the business and the family

Source: IFC Family Business Governance Handbook

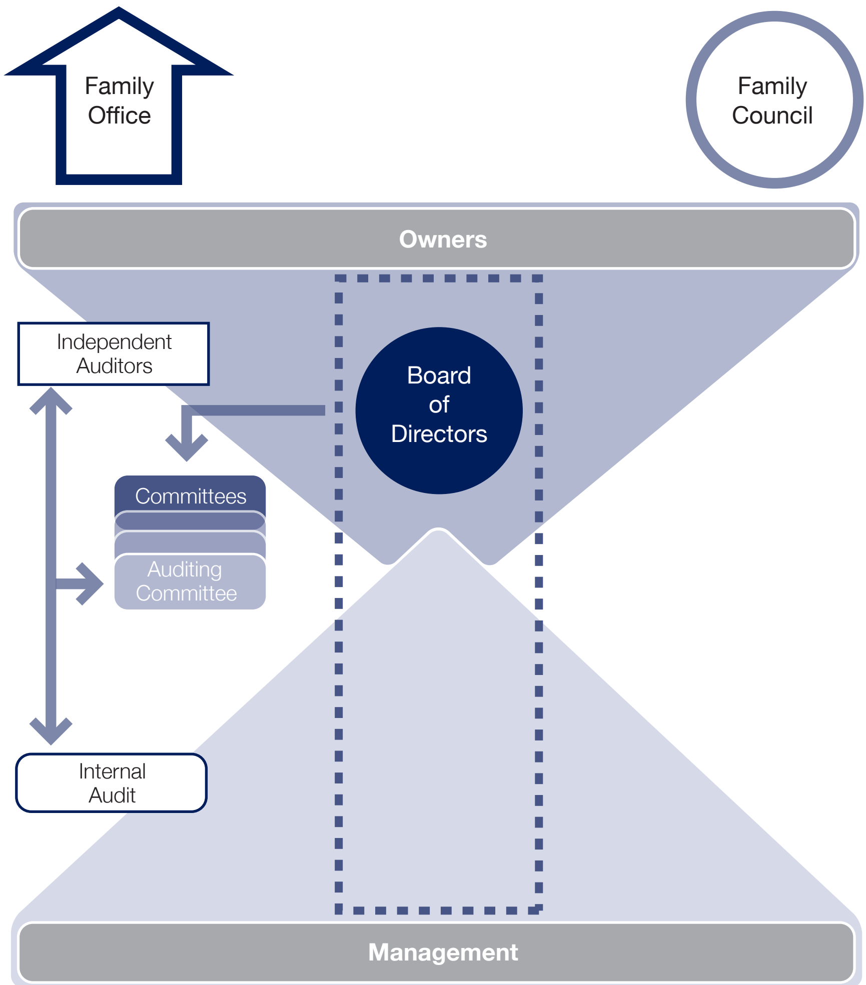
Figure 5.5 shows that once the "cousins' confederation" stage is reached and the company opts for renewal and recycling, the company adopts good governance practices for the company and the family with the creation of the family office and the family council.[75] This action

ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf, pp. 31-32.

75 The family office is an investment and administrative center that is organized and overseen by the family council commonly in large and wealthy families. The office is the mechanism through which advice on personal investment planning, taxes, insurance coverage, estate planning, career counseling and other topics of interest is provided to individual family members. For more detail, see IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *<http://www.ifc.org/*

separates the various dimensions and establishes practices that generate greater transparency and the trust of outsiders. This stage involves the most extensive family governance institutions and business governance structures. Good communication between the two sets of structures is key to business success and family peace.

Figure 5.5 The Governance Structure of Family-Controlled Companies with Good Practices



Source: Better Governance

3.3 Family Governance Documents

Family governance structures and institutions require a certain degree of formalization if they are to function well. As families adopt policies on the family's approach to the business and on governing the business, they will formalize these efforts with documents that will differ depending on their ownership stage.

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ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>, pp. 32-33.

Typically, in the earlier stages when the company is governed by the founder or his/her children, many aspects of family and business governance are informal. Any efforts to formalize relate mostly to the business itself. First attempts at written policies usually are brief documents that state a general family vision and mission with respect to the company.

The next level of formalization comes with the need to develop a family employment policy. This becomes more apparent when the company reaches the sibling partnership stage. The family employment policy sets clear rules on terms and conditions of family employment within the firm. For some families, these rules stipulate conditions of entry, retention and exit from the business. The policy also should cover the treatment of family member employees vis-a-vis non-family employees.[76]

In third, fourth and succeeding generations, family businesses can barely survive unless full family governance policies are written and communicated within the family and the business, as well as to other outside stakeholders. The document covering all of these policies is commonly called a family constitution. This document expresses the family's principles regarding the family commitment to core values, vision, and mission of the business. It often defines the roles, compositions, and functions of family governance institutions and the company's own governance bodies, such as the shareholders' meeting, the board of directors and senior management.[77]

For Your Consideration

Creating a family constitution will codify all of your family-related governance policies.

3.4 Specific Solutions to Some Family Governance Challenges

As companies focus on maintaining all the benefits afforded by family ownership and supplementing them with good governance processes and structures to enhance competitiveness and foster growth, they will face challenges.

Solutions used will include mechanisms to:

- Separate functions of ownership, control and management
- Create family offices to clarify the boundaries between the family's and company's accounts
- Develop the skills and knowledge of heirs so they can become responsible owners, as they can assume various roles as an owner, director or an employee

Processes and structures for decision-making will vary: it is one thing to decide on family matters and quite another to tackle company business, with issues such as division of equity and the like. The family council, created to address family issues should remain completely separate from the board of directors and from shareholders meetings, both of which focus on company-related decisions.

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[76] IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, <http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>, pp. 23-27.

[77] For more information on family constitutions, see IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *<http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>*, pp. 24-25.

It is true that introducing governance measures will not resolve every investor concern about family-owned or controlled firms. Still, instituting structures and processes for the family and the business can address some key challenges.

Keeping peace in the family: Keeping peace in the family is important for inter-personal, social and business reasons.

The problem

Conflicts among the siblings who run the business or misunderstandings between different family branches may spill over to the company's domain and create problems for other shareholders.

- How to manage relations between family members who work for the family business and those who are only owners and rely on dividend income from the success of the company: These two groups may have diverging interests and varying degrees of access to company information, which may lead to an atmosphere of distrust in the family.
- How to manage situations in which some family members want to work for the company, and others want to pursue their own interests, possibly leaving the family business entirely.

Suggested solutions

Family governance institutions can play an important role as places where sensitive issues can be discussed and solutions found.

- A family assembly or family council can mull over the issues and develop policies on how dividends are determined and distributed to make sure that the family is satisfied in ways that are not detrimental to the success of the business. Putting things on the table and openly discussing contentious issues is often the fastest way toward finding a solution acceptable to all concerned parties.
- The family can create a liquidity fund, which could be used by the family to redeem the shares of family members who wish to pursue their own interests outside of the family business. Some companies even establish special committees with oversight for the redemption policies.

Presence of outside, non-family shareholders: This situation poses its own set of challenges.

The problem

- How can the company ensure that these external investors are fairly treated? These investors might have interests and views on the role and results of the business that diverge from the controlling family's point of view. Investors also might have different levels of access to company information. In some cases, external investors have even less information than non-management, family shareholders.

Suggested solution

Corporate governance improvements may help.

- Empower the board of directors to arbitrate between the family and outside shareholders. A board that performs classic functions of management oversight and helps management define and pursue the company's strategic direction is capable of aligning the interests of all types of investors.

- The presence of independent directors can reinforce the board's mediating role. Independent directors can provide an outside, objective perspective for business decision-making. They can act independently to resolve conflicts of interest and family governance problems, such as employment issues.

3.5 Succession Planning in Family-Owned Business

Succession planning is a sensitive issue and involves such dilemmas as:

- How to maintain objectivity when family feelings are involved.
- How to make objective judgments unimpaired by emotions.

Some useful steps for dealing with executive succession are presented in the checklist in Table 5.6.

Table 5.6 Checklist: Ensuring Strong Senior Management for the Family-Owned Company[78]

- ☑ Analyze the organizational structure and contrast the current and optimal roles and responsibilities (compared to peer companies) of each senior manager.
- ☑ Design a formal organizational structure that clearly defines the roles and responsibilities of all senior managers. This should be based on the company's current and future business operations' needs.
- ☑ Evaluate the skills and qualifications of the current senior management based on the new organizational structure.
- ☑ Replace and/or hire senior managers.
- ☑ Decentralize the decision-making process and approval levels as necessary. Decision-making powers should be linked to the roles/responsibilities of managers and not to their ties to the family.
- ☑ Establish a clear family employment policy and make its content available to all family members.
- ☑ Develop an internal training program that allows skilled employees to be prepared for taking on senior management assignments in the future.
- ☑ Establish a remuneration system that provides the right incentives to all managers depending on their performance and not on their ties to the family..

Over the years, the Companies Circle members have confronted the succession issues head-on. Here is a sampling of their approaches to resolving the problems.

[78] IFC, INTERNATIONAL FINANCE CORPORATION (2008). Family Business Governance Handbook, *<http://www.ifc.org/ifcext/corporategovernance.nsf/AttachmentsByTitle/Family+Business_Second_Edition_English+/$FILE/Englilsh_Family_Business_Final_2008.pdf>, p. 47.*

"…The times we live in, where competition for capital is fierce and globalization forces us to compete globally, the international competitive scenario requires companies to be experts in adapting to ever-changing scenarios. The preparation of an advance succession plan will allow for the transition from one stage to another to be carried out smoothly, avoiding interruptions."

—Roque Benavides, *Buenaventura, CEO*

Buenaventura separates board and management

This firm's initial succession process involved separating the position of chairperson of the board from that of general manager. This was a controlled and natural process, approved by most shareholders.

The next stage—succession planning at the general manager and other senior management levels—is a topic of frequent discussion at **Buenaventura**'s board meetings. Now, the company is in the preliminary process of identifying and evaluating potential in-house candidates, with the idea of developing new capabilities. The search also will extend to consider outside candidates.

As a company and as a family, Buenaventura seeks to ensure continuity of the corporate vision. The executives who are appointed to manage the business in the future must be the candidates best equipped to continue generating growth and increasing value for the shareholders and stakeholders. The board is playing an essential role in this succession process, ensuring that competent professionals are involved in the selection process and that the decision criteria fit with the company's vision, mission, values, and strategic choices. The board also can exercise its full powers to resolve any internal conflicts that might arise during the process.

Non-family professionals take the helm at Marcopolo

Non-family professionals took the management helm for the first time at **Marcopolo** in 1995, with the appointment of a team of executive directors who were not shareholders. Ten years later, although this executive team was still young, it became apparent that the company needed a succession plan. Since 2005, the company has focused on managing succession.

Currently, Marcopolo's senior executive succession plan looks like this:

- Retirement policy: At age 60, with possibility of a five-year extension period in special cases
- Retirement preparation plan: Policies for potential continued relations between the company and the retired executives, such as consultancy, or appointment as a board member in controlled companies

- Board role: Regular follow-up on the succession plan, mainly through the company's human resources committee

In addition to the succession of business leadership positions, family businesses should pay close attention to ownership succession and preparing future generations of owners.

For Marcopolo this meant developing a formal ownership succession plan. Currently, the two potential candidates for succession attend in-house and external training programs. The main theme of these courses is the enhancement of knowledge, skills and technical know-how to become competent company shareholders—the successors at Marcopolo decided that they would only assume the role of shareholders, with seats on the board. They leave the role of managing company operations to external management professionals.

Elements of Marcopolo's Training for Family Ownership Succession Candidates

- In-house training: Lectures on specific characteristics of industrial, engineering and manufacturing areas
  - commercial knowledge-building emphasizes sales and marketing strategies
  - administrative and financial knowledge-building focuses on strategic planning, budgets, accounting, cash management and company finance
- External training: Courses and seminars given by institutions that are highly regarded in the academic world and the corporate community

"This was an outstanding process, brilliantly planned and executed accordingly. Succession was successful and created room for new executives to join our group."

Ana Maria Igel, wife of Pery Igel, son of Ultrapar's founder

Succession process for Ultrapar

At **Ultrapar**, Pery Igel, the son of the company's founder, viewed some of his hired executives as allies who could help protect the company from the uncertainties that a business dependent on family management and capital could face. In the 1980s, Igel drew up a process for his succession based on two key elements:

- Professionalization of Ultra Group's management
- Shared control of the company between heirs and key executives

To carry out this plan, Igel distributed beneficiary shares to his heirs and transferred shares to executives. A shareholders agreement, formalized in the mid-1980s provided for reciprocal rights of first refusal in the event of sale of controlling shares. It established two separate holding companies with a defined life span of twenty years and control over the umbrella firm, Ultra S.A:

- Igel Participações: held by the heirs of the family
- Avaré Participações: held by Ultrapar executives

During this period, new management leaders were trained to prepare them to lead the company's growth. These executives who were now also owners had their interests aligned with those of the family. In the transition stage, a new group of executives received shares, but with a shorter time horizon in which to dispose of the shares.

In late 2004, the two holding companies were dissolved, and the corresponding shares were passed on directly to Ultrapar's heirs and executives.

Two years later, in 2006, a new succession process took place. This time the CEO—one of the executives who received shares from Igel as part of the original 1980s share transfer—was replaced by a professional groomed internally by the company. The former CEO retained his position as chairman of the board of directors—yet another step in the company's evolution towards better governance.

Suzano Restructuring

In 2002, as the Feffer family's third generation began to assume more leadership, the company initiated a thorough restructuring process. The goal: to ensure that the businesses in which the Group had decided to invest—pulp and paper and petrochemicals—would be sufficiently capitalized for long term sustainability, able to grow, with competitive costs of capital through its partnerships with the capital markets. Efforts also were designed so that the businesses did not depend excessively on the controlling shareholder's capital.

Case Study: Suzano and 83 Years in a Family-Controlled Company

The path to good governance requires a tailor-made approach that addresses the particular challenges, vision and purpose of each company. It also must be understood in the context of the level of maturity of the controlling family, its shareholders and the controlled companies.

Working with strangers who are managing your company and sitting in your boardroom for the first time might be an uncomfortable experience at first, especially when you are not sure of its value. This challenge was experienced thirty years ago at Suzano by Max Feffer, son of founder Leon Feffer and father of current board chairman David Feffer. The different stages experienced through the years helped make it possible for the organization to react in a fast and effective way when Max Feffer died, creating a model to survive family uncertainties.

The Suzano Group designed a structure based on family control and on maintaining a close relationship with capital markets. The arrangement allows heirs of the founders to exercise control through the board of directors, while management is comprised of non-family executives. The family acknowledges that this move has enabled more potential development and expansion of the company, and protects the business from possible intra-family conflicts.

Of course, the extent of governance processes and structures that the company follows depends on the development stage of the company and the controlling family. It requires careful and gradual introduction and implementation of governance measures, which can be improved and enhanced over time.

A big picture of the phases of Suzano's company development as shareholders' involvement in the company evolved is shown in Table 5.7.

Table 5.7 Suzano´s Development Phases

Phase	Benchmarking Process
First phase (1920s-1970s)	› Founded by Leon Feffer at the age of 20. He maintains leadership until his death in 1999. › Management highlighted by his entrepreneurial style and centralization
Second phase (1970s-2001)	› Max Feffer joins executive management in the 1970s › Development of executive managers and heirs › First executive president and first non-family board director
Third phase (2001-present)	› Max Feffer dies › New model of governance and management › David Feffer presides over the board with executives in management

The timeline in Figure 5.8 shows the milestones in each phase of company development, the impact and next steps. On the right-hand side one can see the most recent phases of the process, culminating in the installation of a new governance structure and the sale of one of the units, generating significant value for the shareholders

Details of the Restructuring. In 2002, as the Feffer family's third generation began to assume more leadership, the company initiated a thorough restructuring process. The goal: to ensure that the businesses in which the Group had decided to invest—pulp and paper and petrochemicals—would be sufficiently capitalized for long-term sustainability, able to grow with competitive costs of capital through its partnerships with the capital markets. Efforts also were designed so that the businesses did not depend excessively on the controlling shareholder's capital.

For this to happen, the two companies, Suzano Papel e Celulose and Suzano Petroquímica, had to comply with corporate governance standards consistent with best market practices.

In 2003, the Group implemented a new business model based on three pillars:

- Family control: For the Group's long-term vision, reputation and values

- Professional management: For capital discipline and a fast decision-making process
- Partnership with the capital markets: To assess company performance on a permanent basis, promote the continuous practice and enhancement of corporate governance standards and ensure business growth and development

A first step in the Group's restructuring process: Suzano Holding began to run Suzano Papel e Celulose and Suzano Petroquímica subsidiaries through a professional management team, recruited in a search that considered internal and external candidates from the marketplace.

The new professional management team, comprised of highly-qualified executives, streamlined corporate operations spread among the subsidiaries. Their efforts have resulted in 30 percent cost reduction, improved management performance, implementation of appropriate subsidiary control mechanisms, and management accountability for results. The team also implemented a new monitoring model allowing for improved monitoring of and reporting for subsidiaries.

These successes have enabled members of the controlling family to step aside from their executive role in these subsidiaries and assume a more strategic position, minimizing succession-associated risks to the continuity of the Group's businesses. Some members of the family began to participate in the strategic management of Suzano Papel e Celulose and Suzano Petroquímica through appointments to the boards and related management and strategy committees, along with other Suzano Holding executives. So, the Group created processes to ensure a better balance between greater management independence for the subsidiaries and long-term strategy for the controlling shareholders.

These improvements have marked an important change in the behavior of the controlling shareholders. After decades of a hands-on approach to the businesses, the controlling family withdrew from day-to-day management, delegating to professionals and assuming a more strategic role. For members of the family who had truly grown up in and with the company, this represented a huge paradigm shift.

In the Words of the Entrepreneur: David Feffer Tells the Suzano Story [79]

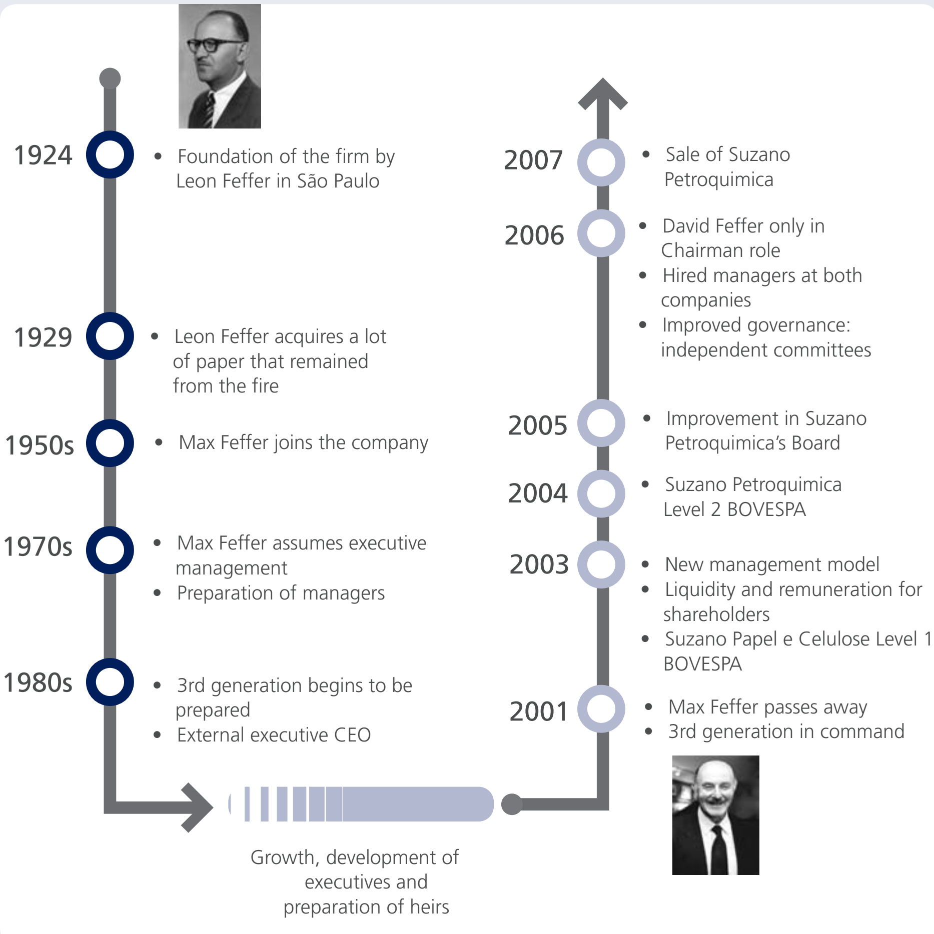
Understanding the enhancement of corporate governance practices in Suzano Group demands, at first, the rebuilding of the path since its foundation in 1924 by my grandfather, Leon Feffer.

The implementation of the Brazilian industry in the early 1950's, more concentrated in the state of São Paulo, was the scenario of the beginning of our industrial activities. This movement was led by important entrepreneurs, who set up family-owned conglomerates strongly responsible for the development of Brazilian industry.

The beginning of our activities was in the pulp and paper industry. In the 1950's, we developed the technology for the production of pulp from eucalyptus and became the first company in the world to produce it on an industrial scale. For that,

[79] Written for UPsides, FMO quarterly magazine, Number 2, Netherlands, April 2007.

Figure 5.8 **Progression of Suzano´s Leadership Succession and New Governance Model**



Source: Better Governance with Suzano data

my father, Max Feffer, and a group of Brazilian scientists spent some months at the University of Gainesville, Florida (USA), studying alternatives for pulp production using native Brazilian trees, since all the pulp produced at that time was based on pine trees, common in European countries.

In the 1970's we diversified our activities towards the petrochemical industry since we identified an important growth trend in the use of plastic in the packaging segment, an important market for the paper industry, thus seeking to keep our presence in that segment.

My grandfather's management ended with his death in 1999, at the age of 96, leaving behind entrepreneurship as his legacy, which enabled the substantial growth of our business.

Then, my father, Max Feffer, assumed command and marked his management by preparing the Group for the strategy towards the capital market. Under his command, the Suzano Group defined its growth platform, divested from non-core assets and focused investment on our main businesses, which were separated into two different companies, Suzano Papel e Celulose and Suzano Petroquímica.

With my father's unexpected death in 2001, after little more than two years leading the group, the controlling shareholders—my brothers, my aunt and my mother —unanimously invited me to assume command of the Group. I accepted and we discussed how we would face the future. I said: "We have two options; there is no right or wrong decision, nor one that is better than the other. But whatever is to be done will be definitive. There is no turning back."

We could continue being a family business, like in my grandfather's and father's days, or become a professional company with a strong and clear capital market strategy. In the first case, I explained, Suzano could perfectly serve the current generation of our family, but the future would be uncertain because it would probably be difficult to access the necessary resources for modernization and growth of the businesses. We need to always keep in mind that we participate in two capital intensive companies. Therefore, we could begin to face serious difficulties to invest, reinvest and compete in the marketplace.

On the other hand, professionalizing the companies and reinforcing the partnership with the capital market, would allow us to leave the 21st century better than how we started it, also having access to competitive funding to successfully face future investment challenges.

Both options were correct. The second one, however, presented another advantage: the perspective of solid value generation, business sustainability and the maintenance of the values and beliefs of the founders, who did not just think about the present, but also the generations to come. Everybody was conscious that taking the capital market route would entail having to live from the results of the businesses rather than directly from them. Between the two options, the second one prevailed.

Despite all the changes this process has brought, the transitional phase was very smooth and, in fact, represented an enhancement of our way of doing business. We had very sincere and realistic conversations. We closed the door to the past and opened the gates to the future. The basic foundation was that Suzano should belong to all shareholders, including the Feffer family. When we made that decision, the difficulties started to be felt. First, we requested to be dismissed from our positions. We needed to create a meritocracy criteria in the Group, paving the way to promote *stronger development, to reformulate assessment parameters and, particularly, to treat all shareholders equally.*

All these changes were very challenging. I had grown up getting ready to be the president of the Group one day. Suddenly, I was forced to commit a kind of hara-kiri. I left management's front line to take over as chairman of the board of directors of both companies, which are responsible for defining business policies, long-term global strategy and for the supervision and management of executive directors. It was not easy. The process progressed. We hired executives from the marketplace. We began to define and align strategic actions for the pulp and paper and petro-chemical businesses counting on the support of a professional senior management.

In 2003, we implemented the new management model with the adoption of high standards of corporate governance practices, based on three pillars: family control, professional management and partnership with the capital market.

Independent members are also part of the board of directors of both companies, transforming them into an important place for debates focused on adding value for the businesses. Suzano Papel e Celulose and Suzano Petroquímica are listed in BOVESPA's special of corporate governance segments, which ensure a fair, transparent and reliable relationship with the shareholders and the capital market. We created the Audit, Sustainability and Strategy, and Management committees, which are responsible for discussing these subjects in depth, with the goal of better support for the board of directors in its decision making. The boards of directors at the Suzano companies have internal rules defining their operating procedures and guidelines for performance, qualification and assessment of their members.

We launched our code of conduct based on the ethical principles that always guided our activities: integrity, equality, transparency, professional recognition, corporate governance and sustainable development.

The benefits of better corporate governance and the capital market strategy became evident when we realized that the access to capital was bigger and easier, coupled with lower sensitivity to market volatility. The capital market has an additional important role of permanently evaluating the performance of the company and its management. If the results do not meet expectations, they are criticized by analysts, and investors tend to step back. It is a matter of coherence between what is promised and what is done. If there is good management, what was promised is delivered and the capital flows. Otherwise, the market penalizes the company. There is no way to hide this reality. Management is either positive or negative. The capital market, naturally, is practical, very clear and pragmatic.

When a company adopts high standards of corporate governance, it should have greater responsibility for results. The balance between right and wrong has a higher importance since the control systems acquire a wider perspective, with respect to detailed and clear rules. For Suzano Group, corporate governance is a guarantee of the sustainability of what the founders created. It is the evolution of a dream. We may face difficulties along the way, which are natural. But good corporate governance practices contribute to the continuity of the Suzano companies, and make its foundations resistant to this irreversible movement called globalization. And, thanks to these good governance principles and the good performance of our businesses, the capital markets have learned to value and respect our controlling position.

—**David Feffer,** *Suzano, Chairman of the Board*

Suzano Group sold its petrochemical operation to Petrobrás in 2007, creating value for its shareholders. This would have not been possible without key improvements in corporate governance.

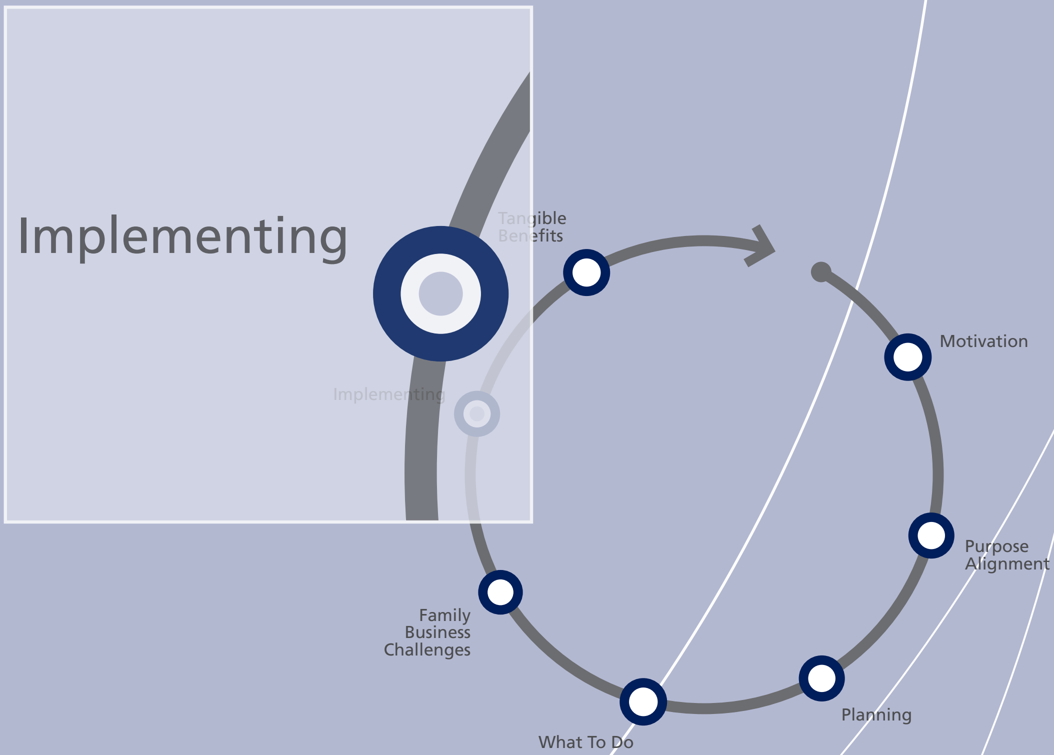
This chapter addressed the unique corporate governance challenges facing family businesses.

For Further Thought and Discussion

- Are you a member of a family that owns a company? If so, identify some of the main challenges facing your company and your family.
- Are you a non-family senior executive in a family-owned company? List some of the main challenges facing the firm.
- Based on the discussions in this chapter, name some specific steps towards resolving these challenges, using suggested corporate governance practices. Remember to first identify the company's ownership stage—still led by the original founder? Are direct heirs in control? Effective actions will depend on pegging them to the right phase in the company's lifecycle.

6

IMPLEMENTING GOVERNANCE



Chapter 6
Implementing Governance

KEY MESSAGES

Company leaders are responsible for implementation of changes. Success in improving corporate governance policies and practices requires the company's leadership to take responsibility for ensuring that governance changes are implemented. Such oversight and support for implementation sets the proper tone at the top which, when combined with effective mechanisms for monitoring and following up, can help to ensure successful implementation.

Communicate the changes. Once initial governance improvements are underway, communicate the changes internally and externally. The feedback received from all stakeholders will help the company's leadership to modify the governance improvement plans to fit current needs, demands and reality.

Good governance requires continuous improvement. All interested parties must realize that good governance requires constant improvement as internal and external circumstances change. Companies should stay on top of advances in corporate governance worldwide and in the region. They should implement the best practices possible for the benefit of the company, its shareholders and all stakeholders.

This chapter covers tactics and techniques that should be used to manage the impact of changes in the organization, how they are perceived, and what can be learned from reactions, both internally and externally. Section 1 provides examples of real cases with timelines for implementation of critical governance improvements. The next sections elaborate on how the governance improvement process should be governed, with examples of structures and processes that can help with implementation and provide some examples of ways that Circle members have monitored the governance implementation process to ensure that it stays on track. Section 4 deals with companies in transition. The following section discusses the key role that communications play in the change process. Finally, the chapter concludes by emphasizing the continuous nature of the corporate governance improvement process.

1 Implementation Takes Time

Regardless of the strengths or weaknesses of current company practices, corporate governance improvement is a matter of constant process. Chapter 3 noted the importance of including specific timelines for attaining specific milestones in overall governance policies and practices. Indeed, it takes time for all measures to be implemented. It also takes time for them to become rooted in the company as part of the corporate culture.

Resistance is not always evident in advance, and this can lead to slower than expected results. In developing timelines for action plan implementation, remember to build in time for internal consultations as a way to manage expectations of all stakeholders: it is easier to address known concerns than to move forward with below-the-surface concerns unresolved. Lack of opportunity to express these concerns and have them addressed can cause passive resistance, resulting in project delays that reflect a lack of enthusiasm, belief or commitment to the process of improvements.

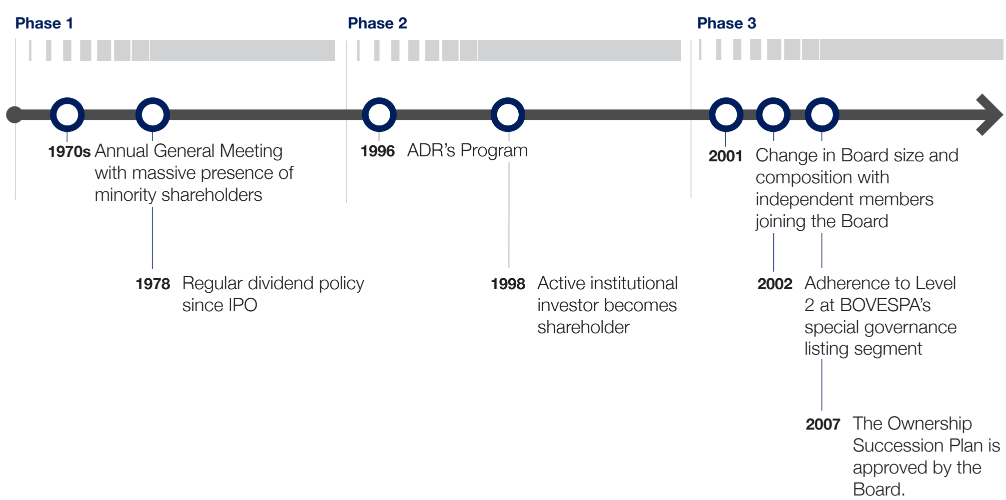
For Your Consideration

Of course, many internal and external factors will affect the planning of deadlines and achievement of milestones. Each situation is unique. So develop a good plan, but anticipate that there will be adjustments to the original timelines along the way.

Setting deadlines for achieving your milestones is critical. When doing that be flexible, because you will need to make adjustments to the original timeline along the way.

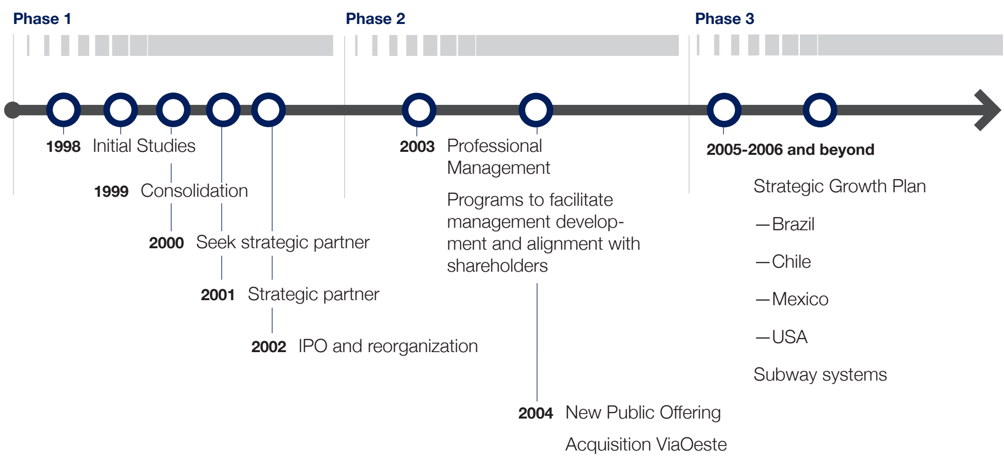
Figures 6.1 and 6.2 illustrate the experiences of two Companies Circle members and the timeline of their governance improvements. These depictions show that some actions are time-dependent—they should be implemented in a specific progression, either before or after other actions have been initiated.

Figure 6.1 Marcopolo's Corporate Governance Implementation Process
This timeline of Marcopolo's governance reforms illustrates the maturing of governance improvements over time. Some steps may only be achievable once previous actions are settled and a new horizon is in place favoring a new set of improvements—for example, changing the size and composition of the board to include independent members.



Source: Marcopolo, September 2007

Figure 6.2 CCR governance implementation steps
This graphic demonstrates the importance of planning and leaving time for initiatives to take hold within the company and with its relevant stakeholders. For CCR several years passed after the initial assessment before finding the strategic partner who could add value to the shareholder base and to introduce the company to the capital markets. Still more time was needed to implement additional steps to improve the company's governance



Source: CCR, March 2007

2 Governing Governance

Creating an internal structure will ensure the effectiveness of your corporate governance system. There are various alternatives for such internal structures to governing the governance improvements. Rather than creating a separate entity, the approach might involve expanding the scope of responsibility for an existing body or a company official who is tasked with this function.

Regardless of approach, it is important to involve the company's senior leaders—the board, senior management and—perhaps—controlling shareholders. Assign clear responsibilities for monitoring governance-related actions as a way to ensure that company leaders receive relevant and timely information on progress and have sufficient opportunity to intervene and make course corrections, if needed.

Natura faces new governance reality following 2004 IPO

When **Natura** went public in 2004, the company had to review its governance system and adjust accordingly. In addition, company leaders were faced with deploying an international expansion strategy. The board's solution: creation of a corporate governance committee and a new position—the corporate governance secretary.

The board charged the corporate governance committee with a five-fold mission:

- Monitor the company's entire corporate governance system
- Follow up on the evolution of the best international corporate governance practices
- Propose adjustments and improvements to the company's corporate governance system wherever necessary

- Follow up on the corporate governance metrics approved by the board
- Report to the board on the status and progress of corporate governance

When the secretary's position was created two years later, the board's intent was to provide the organization with a full-time professional who could ensure proper operation of the corporate governance system, and seek and propose improvements on an ongoing basis. The secretary serves as the interface between company executives and company directors on corporate governance issues, facilitating dialogue among these corporate entities.

Two years after completing the upgrade of governance practices, the company made another change, expanding the scope of responsibility for the executive in charge of strategic planning and moving the corporate governance supervision role to this executive's portfolio.

Evolutionary corporate governance process for CPFL Energia

CPFL Energia's experience in oversight of corporate governance has evolved over time, as circumstances changed. When the initial set of governance changes was implemented, the company appointed an executive whose sole task was to advise and support the management on corporate governance practices.

Over the years, things changed—the company reached its first governance goals and there were shifts in both the internal and external environment. For instance, compliance with the Sarbanes-Oxley Act and international stock market regulations expanded the scope of activities performed by the corporate governance professionals, increasing their responsibilities.

So, company leaders realized that it was time to re-evaluate its governance structure. The original governance area was divided into two functions:

- The compliance role was transformed into a risk management function to support the CEO, the CFO and the fiscal council in monitoring internal control processes, among others.
- Work related to the board and its committees, shareholders and governance practices was assigned to another executive who handled legal work related to the decision-making process. Some of the functions of the legal department were transferred to this newly formed governance area as well. This group reports to the chair of the board, rather than to the CEO—another change from the initial structure.

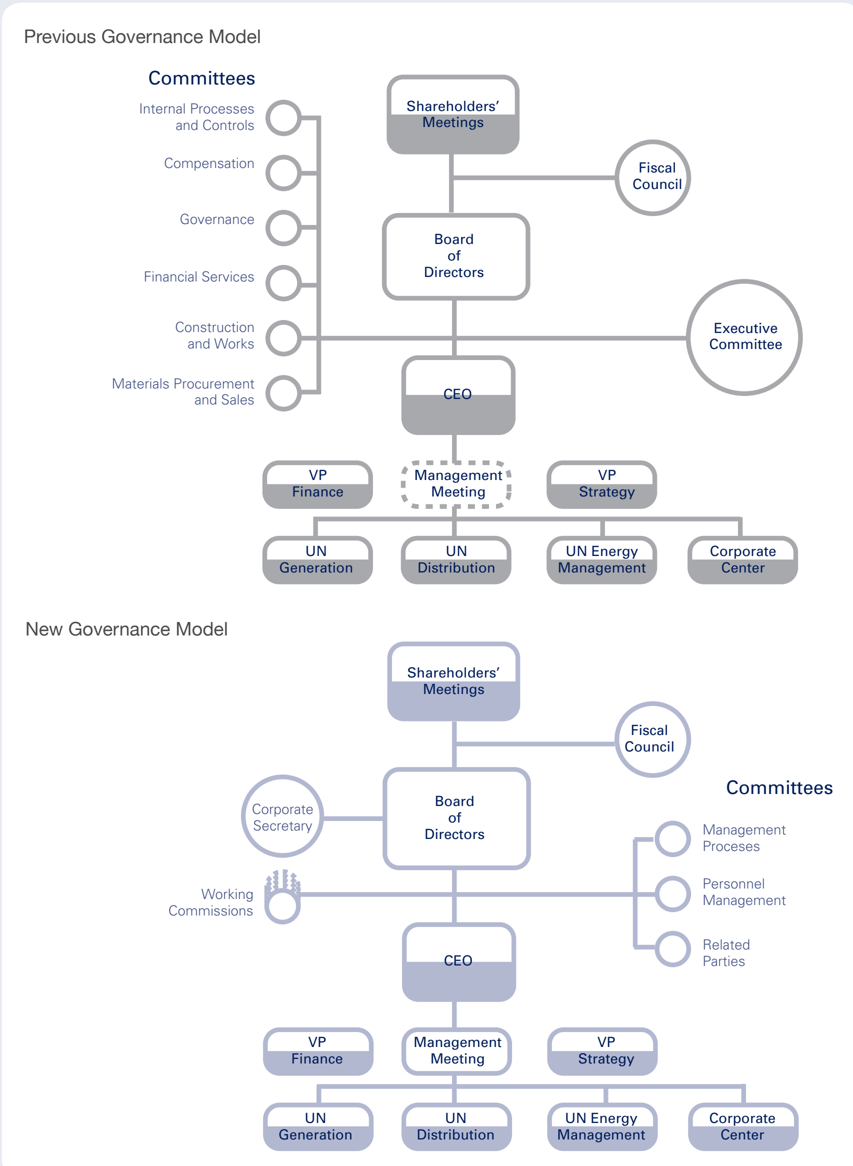
The introduction of the new governance model has been an essential part of the process of monitoring and ensuring that the company's governance improvements stay on track. In addition to the new streamlined governance structure, CPFL Energia created a set of tools to manage the governance process. The tool created for tracking and reporting on decisions is known internally as the "pipeline."

Introduced in 2006, the pipeline has played an important role in informing the board and enhancing the efficiency of its decision-making. By making use of the pipeline to monitor relevant issues in advance, directors and officers can make sure that all relevant information for the decision process is provided on a timely basis. The pipeline also sets context for board members as they consider future decisions for approval.

The pipeline is actually a simple list of topics to be discussed by the board over the next three months, presented by the assessor at each board meeting. The document includes terms and deadlines and is used by directors to request information beforehand, or to highlight issues regarding certain topics, such as potential conflicts. Besides streamlining the agenda, the pipeline provides a broader scope and time horizon for matters the company will face.

Case Study: Understanding CPFL Energia's Governance Improvements

CPFL Energia's original governance model featured seven permanent board committees involving 37 different people, including directors, managers, and shareholder representatives. The sheer numbers dramatically increased the interactions required. Board and management were caught up in meetings all the time. Plus, committees included shareholder representatives who were not members of the board and this was causing excess noise and inefficiency.



Source: CPFL. December 2008

Implementing

The company also realized that it needs to re-evaluate the amount of time spent reviewing documentation during board meetings. For instance, reviewing the progress of engineering works across the country used to involve listening to lengthy presentations, complete with photographs at meetings, taking up to an hour.

As part of the governance restructuring, this process was streamlined: now, photos are uploaded to the directors' private Web site before the meeting. Directors can review the photos and reports on the site beforehand and use board time to ask questions. The result: the same topic is covered in 15 minutes, compared to the hour it used to take.

Management Supporting Functions

The corporate governance functions were also reviewed to ensure that they were in line with the complexity of the corporate structure. The company created a compliance function, reporting to the CEO, with a focus on internal controls to meet all requirements of BM&FBOVESPA and NYSE. Company leaders set up a second entity—an advisory office—for monitoring and improving corporate governance processes and reports to the chairman of the board.

The head of the new advisory office is responsible for:

- Maintaining the link between the chairman, different committees and commissions, and the executive officers, and for ensuring that corporate governance guidelines are followed in the decision-making process
- Coordinating the preparation of legal documents for both shareholders and board meetings, and for the information supplied by management to the board and its committees

The company's pipeline also supports management, providing a broad overview of future issues, improving planning and the organizing process.

3 Monitoring the Progress of Implementation

Having the right set of policies, practices and structures is not enough to ensure that changes in governance will really take place. The implementation and maintenance processes are also key to making things work properly. The governance system has to be monitored along the way so that it can be adapted to new situations, and to ensure that knowledge and information related to earlier governance efforts is captured.

Special attention has to be given to creating and maintaining an efficient decision-making process and ensuring good information flow. This includes the new practices, and the mechanisms to facilitate their implementation and continuous improvement.

Throughout their journeys of improving governance practices, the companies from the Circle needed to develop mechanisms to ensure the reforms were implemented. The companies also sought process efficiency. The examples that follow demonstrate the various ways in which companies can organize themselves to ensure information flow and adherence to effective practices and processes.

ISA's automatic workflow helps monitor compliance

ISA implemented an automatic workflow system in 2004. The system enables monitoring of compliance with every aspect of the corporate governance code. Here is how the system works:

- One month prior to the deadline for the implementation of a given commitment or task, the system sends a message to the employees responsible for a specific activity, reminding them that they must report on the current status of their task.
- Upon task completion, employees must document the accomplishment in the system.
- If for any reason the activity was not completed, the responsible officer must explain why the result was not obtained.

Company leaders responsible for governance implementation say that the system is critical to the company's adherence to corporate governance principles and practices. It helps create a sense of real commitment and a common vision throughout the company. It is also an indication of changes in attitude from employees about better corporate governance practices.

The system helps management and the general public measure and monitor the efforts that the company and its employees are making to bring ISA's corporate governance code to life. It also provides valuable input for the corporate governance code compliance report that is presented on an annual basis to shareholders.

Communication and interaction between the different governance bodies in a company calls for establishing specific procedures. Certain mechanisms can facilitate adherence to the desired practices.

CPFL Energia sets up structure for interaction

CPFL Energia has used a variety of dynamics and processes to develop effective relationships between the executive board, the board of directors and its committees.

Company leaders understood the importance of solid structure with appropriate flow and systems so that the right information gets to the right people. This would enable an optimal decision-making process.

In 2003, the company developed and implemented corporate governance guidelines consistent with existing and most advanced practices in the market. This effort was part of the preparation for the company's IPO, planned for September 2004.

International consultants identified main issues needing improvement and outlined the initial documents to be adopted by the company. The most important corporate governance documents were printed and made available to all interested parties—the board of directors, board committees, fiscal council, senior executive officers of the holding company, and all subsidiaries.

Both the board and the fiscal council approved their own charters defining their functions, duties and obligations. A self-evaluation for the board and fiscal council was created to help their members identify opportunities for improvement and to reveal areas they wish to address.

To ensure the proper flow of information the company codified all important governance rules to be followed and made them available through the company Web site. This proved a major benefit—it engaged all internal stakeholders on the proposed changes as the company moved towards practices required of a company listed on the NYSE and on the highest corporate governance segment of BM&FBOVESPA.

The directors also asked the management processes committee to analyze all information provided to the board. They wanted to evaluate the various forms of information and channels for disclosure, with a goal of eliminating what is not necessary and identifying information that is critical to decision-making.

> *"We have organized a basic calendar of events to be approved by the board of directors and its advisory committees during the course of the year and related to corporate strategic planning and budget events which we know that we have to undertake. In addition, we have established a Web site for the board of directors where all the information, minutes and presentations can be accessed. This has increased substantially the predictability on what has to be decided. The Web site has also considerably reduced the need for sending documentation and clarification of doubts on the part of the Directors and Committee Members."*

—Marco da Camino Soligo, *CPFL Energia, former Manager of the Corporate Governance Department*

4 Interim Procedures and Situations in Transition

Sometimes, companies will need to create interim procedures as they advance through different stages of development. There will be practices that are applicable only during this period, with the goal of ensuring a smooth transition.

Transitional solution at Embraer

Embraer provides a good example of this interim course, which was well-planned and communicated to the market.

The company's board of directors, elected on March 31, 2006, included 11 members and their respective alternates. To ensure the stability of corporate actions and continuity of management guidelines during the period immediately following the approval of capital restructuring, the first term of the board of directors was set for three years.

Meanwhile, subsequent maximum board terms were set at two years.

The rationale for this approach: to build continuity in already planned short- and medium-term strategies and provide for the company's transition to the new structure without jeopardizing its businesses.

During this transition period, the company's chairman of the board also served as CEO. The board elected a new CEO in April 2007. As of this date, the company. expressly prohibited concurrent service as a member of the board and as a senior manager.

The Embraer board includes a representative from the Brazilian government, two Embraer employee representatives, and five independent directors.[80]

Suzano Petroquímica's temporary management team guides transition phase

Suzano Petroquímica used to be a holding company with co-controlling positions in several Brazilian petrochemical companies. After reviewing the company's position in the national petrochemical sector during the 2004 strategic planning meeting, Suzano Petroquímica's leaders realized that the company had the potential to become an industry leader in Latin America. This leadership potential was due to several factors:

- Quality of assets
- Opportunities for consolidation and growth
- Sound capital structure
- Promising medium- and long-term outlook for Brazil's petrochemical industry

In fact, the company was already an important player in the Brazilian's petrochemical industry. But to become a true industry leader, the company needed to abandon its holding company structure and assume direct control of its own operations with a structure that would successfully support an anticipated future consolidation process.

With the September 2005 acquisition of Polibrasil and its subsequent merger, Suzano Petroquímica became the Latin American leader in the production and trading of polypropylene and the second largest producer of thermoplastic resins in Brazil. To transition following the merger, the company installed a temporary senior management team comprised of executives from Suzano Petroquímica and from Polibrasil. The company created an oversight structure to ensure a harmonious merger of cultures. In addition, the chairman of the board position was combined with the CEO position.

This transitional structure remained until September 2006, when the new senior management was nominated and the positions of chairman of the board and CEO were separated.

This new senior management team included four executives. The team was headed by two co-CEOs, who had successfully led teams to strong results during the post-merger phase as leading executives at the two merged companies. Because of this strong post-merger performance, the board and controlling shareholders determined that these executives had the right combination of skills, styles and leadership to help the company face future challenges as the industry continued to consolidate.

5 Communicating Changes

Once initial improvements in governance practices have been implemented, what's next? How can the changes your company is undergoing best be communicated?

80 See Appendix 4 for the indicative definition of independent director, International Finance Corporation, 2009.

Going public with the changes comes with internal and external benefits. As the market becomes aware of changes and recognizes their value, it will further reinforce internal commitment to the changes. Plus, awareness of a pending public announcement of a governance initiative can stimulate additional internal commitment.

Still, it is important to realize that not all corporate governance improvements will be immediately recognized and valued by the market. At the time, when many Companies Circle members began to disclose their governance progress, the Latin American market had very little knowledge of the concept of governance.

In fact, the market gave these companies very little credit for their efforts.

In such an environment, strong internal communication of changes and their value is especially important. An overall communications strategy can provide mutually reinforcing benefits that support employee commitment to changes and recognition and understanding by external stakeholders, shareholders and the market.

Argos goes public with governance improvements

Argos publicly announced the adoption of a new corporate governance code in 2004—a pioneering event in the country. Here are the highlights:

- Company develops its governance code in 2004, following a process of internal communication, discussion and documenting of the company's corporate governance policies and practices.
- Board reviews and approves new code, demonstrating further commitment from the top to this process.
- Company embarks on first communications initiative, to share results on improving governance with approval of new code.
- Company meets some initial resistance and unawareness of the importance of corporate governance: market initially views good governance as a passing trend that would not last.
- Attitude changes after Argos educates marketplace: Argos insists on demonstrating the value of the code being implemented and assumes the role of educator, for recognition of governance's value by the market. Today, the target audience is aware of the important role corporate governance values and principles have played in the company's development.

Argos' code itself helps in this continuous communication process. Consistent with its requirements, the management meets frequently with market participants and regulatory agencies to communicate the company's action plans and demonstrate how the company is moving forward. The external auditor is required to inform the shareholders' meeting and the market in general about the company's compliance with its code.

A structured system gives shareholders full access to clear and relevant information on a timely basis. The company believes that it is critical for the market, shareholders and stakeholders to remain up-to-date and familiar with the relevant information from the organization.

At Ferreyros, communication effort is mission-critical

Ferreyros has never been shy about telling its story and showing its progress in corporate governance. This has helped to transform the subject from an academic concept to an action plan in its business environment. The company firmly believes that other companies will follow along if Ferreyros proves to be a success story. For this reason, the company participates in many seminars organized by different governance institutions in Peru, including academic conferences such as those held at the University of Lima and University of Pacífico. The company also attends corporate seminars sponsored by leading international audit and accounting firms and capital markets organizations, including Procapitales, Asociación de Empresas Promotoras del Mercado de Capitales, and the Bolsa de Valores de Lima. Today, Ferreyros' leaders spend a considerable part of their time communicating the company's results and successes to the market.

5.1 Convincing the Skeptics

Not everyone is going to give you a standing ovation when you implement governance improvements. Sometimes it can take a while before the market understands what the company is doing as the experience of Argos, detailed in the previous section, shows.

> *"Corporate governance is only possible if you truly believe in it. It is tough to precisely measure its results, especially in the short term. But every time that you look back, you know that a long way has been walked and it becomes harder and harder to step back.*

—João Elek, *NET, CFO*

But company leaders say that belief in the value of the improvements will help ensure eventual acceptance and understanding.

Despite challenges, NET complies with Brazilian and US standards

NET's decision to compile and release its financial statements in accordance with Brazilian accounting standards and US GAAP simultaneously marked the first time that this had been done in Brazil's corporate history.

This was not an easy task: it meant several sleepless nights every quarter, especially in the early stages.

Part of the challenge was getting staff, executives and directors who were involved to review the results before they were disclosed. Some questioned whether the marathon was truly necessary.

And despite all the work, it initially seemed that no one in the market noticed or cared. Gradually, though, as the process moved forward, market participants began to realize the importance of what the company was doing.

The real payback came later, as this type of reporting became an actual legal requirement. When most other companies were only just beginning to adjust to the simultaneous publication of the two sets of financial statements, NET was already in the process improvement phase.

Of note, NET has earned Exemplary Disclosure Certification, which attests that all of its communication to the market is only done when the stock market is closed and all markets receive the information within a period of one hour. This process is audited, so investors can have confidence that everyone will receive all announcements from the company at the same time, regardless of their geographic location or time zone.

Case Study: CCR's Early Example: Persistence of Governance Pioneers Pays Dividends

Here, CCR's director and chairman of the Corporate Governance Committee, Eduardo Andrade talks frankly about the early struggles to implement good governance practices in Latin America. Clearly, leaders must be persistent and hold firm to the conviction that what they are doing is truly the right thing.

"The IPO took place at a time when the market was stagnant. There had only been two or three IPOs in Brazil in previous years. Besides that, we did not have any experience in the market. So we decided to bring in an American consultant, a bank, and then we discovered the Novo Mercado. The company felt it was a good match; however, there were many doubts and questions. Many people asked why have only common shares? They thought the Novo Mercado thing was a bit utopian. Others said that money provided by the Novo Mercado was expensive, and that it was the place for naive businesspeople. But we felt that the Novo Mercado would either be a success or the stock exchange in Brazil would have no future. So we decided to place our bet. CCR was the first company to enter the Novo Mercado and we remained there all by ourselves for almost one year.

Then we were joined by Sabesp and just the two of us remained there for quite awhile. At the time of the IPO, distrust began to come to the surface because of the construction companies who were CCR controlling shareholders. Some felt we were like the fox in the henhouse.

We decided we had to change that concept and so we went after some opinion leaders to expose our true intentions. One of the most respectable private equity firms was one of these and it received me very well. We talked for nearly three hours but this private equity firm did not buy a single share. The IPO was not successful and demand was less than the quantity of shares offered. The partners had to buy part of the shares, which opened at R$ 18.00, with the company's value set at R$ 1.5 billion.

I believe that the share price at the IPO should be the least of a company's worries when it goes for an IPO. It is what occurs after that that really matters. CCR launched its shares at R$ 18.00. Six months later, they were at R$ 5.40. That was absolutely ridiculous to us. After all, at that price the company's market capitalization was less than R$ 500 million.

That is when the criticism began. Some wanted the company to buy back the shares. However, good sense prevailed, and with persistence we showed everyone what we were really trying to do and we began to work on the external aspects of good governance: investor relations, transparency and total respect for minority shareholder rights.

One year later, the market woke up from its deep sleep and CCR issued more shares when it purchased ViaOeste.[81] *And this time it was a completely different story. The market has an excellent sixth sense and it correctly values the companies. This time the shares were sold at R$ 23.50, which represents a company value of R$ 2.3 billion, and the demand was six times greater than supply. That demonstrates the market's perception capacity.*

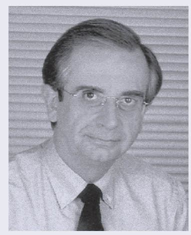
One of the biggest changes in the country over recent years has been the maturation of the capital market, its growth and its sophistication. Society has yet to take notice of the importance of this.

Implementing

[81] Another Brazilian toll-road operator.

Over time, we have improved our relationship with the market. In 2005, we won the IBGC award for best Corporate Governance, and the past three years we have been included among the 10 best publicly held companies in the Agência Estado[82] ranking. That shows we have done our homework and have been recognized for it. Today,[83] after each share has been split into four, share price is around R$ 30.00, which would be R$ 120.00 before the split, and CCR's market value would exceed R$ 12 billion."

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



5.2 Learning from Outsiders' Reactions

It is natural for a company that is going through the process of implementing improvements of any kind to expect praise from the outside world, but critical feedback often can prove even more valuable. This is why the eyes of the company must stay open, its ears attuned to external reactions, as Companies Circle members can attest.

NET confronts marketplace rumors

In 2008, there were rumblings in the market that **NET**'s new strategic shareholder would give unfair treatment to minority shareholders in the event of a change in control. NET faced the challenge head-on, sending its management on a road-show and listening tour. The team listened to the main concerns and different views from investors and presented the feedback to its controlling shareholders.

As a result, the strategic shareholders went public and clarified their position to the market. This helped shed light on the issue. The approach is consistent with the active listening attitude developed at the company through its years of enhancing good governance practices. Once again, this open approach demonstrated its value.

Suzano Group learns from market reaction

Suzano Group companies Suzano Papel e Celulose and Suzano Petroquímica decided to issue follow-on offerings as a way to increase share liquidity, an important step in governance strategy as described in Chapter 4.

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82 Brazilian New Agency, related to the newspaper "O Estado de São Paulo".

83 This statement was written in July 2008.

But the effort hit some bumps in the road: Suzano Papel e Celulose's offering in 2003 attracted important new shareholders, many of whom had common long-term investment horizons. This initially frustrated the goal to increase liquidity. Still, other benefits emerged, because investors with this kind of profile, together with the vision of controlling shareholders, are vital for the company's long-term plans.

To avoid a similar re-concentration of liquidity, Suzano Petroquímica introduced a temporary mechanism into its by-laws in preparation for its 2004 follow-on offering. The language limited the holdings of a single preferred shareholder to 8 percent of its preferred shares.

By making the mechanism temporary, the company considered the long-term interests expressed by some of its new shareholders—they wanted the flexibility to purchase more shares. A follow-on offer provided this flexibility, as a small secondary offering. Some important shareholders were prepared to sell part of their position to enhance share trading liquidity and create an initial platform that would allow for new fundraising in the near future. Re-concentration would have defeated the purpose to increase liquidity.

Ultrapar grants tag-along rights

Ultrapar faced a challenging situation in 1999, when its shares were floated on the BM&FBOVESPA exchange in Brazil. At the same time, the company issued Level III American Depositary Receipts on the NYSE. In addition to the rigorous US Securities and Exchange Commission requirements, Ultrapar granted tag-along rights for all of its shares six months after the company's IPO. The market strongly influenced this decision—it viewed the granting of tag-along rights as a way to protect the interests of minority shareholders in case the control of the company is transferred.

At the end of 2001, with the approval of the new Brazilian Corporate Law, tag-along rights became mandatory, providing minority shareholders with the right to receive 80 percent of the price offered to the controlling shareholder and only for the transfer of voting shares. As mentioned in Chapter 4, Ultrapar determined that it would go above and beyond the requirements of the law, guaranteeing tag-along rights for all shares and at 100 percent of the offer price.

"The adoption of tag-along rights for all shareholders at 100 percent of the offer price brought forward changes in the Brazilian Corporate Law and it is still today broader than what is required by the legislation. The tag-along rights were aimed at strengthening the alignment of economic interests of all shareholders. This decision brought trust to shareholders and was instrumental in our follow-on offer in 2005."

—André Covre, *Ultrapar, CFO*

Implementing

6 Pursuing Best Practices Is a Continuous Learning Process

One cannot overstate the fact that corporate governance is a continuous process. At each stage of governance improvements, a company must continue to reflect on what its new needs are and what new opportunities can be derived from its governance model. This is particularly true as the business landscape and developments in the concept of good corporate governance continue to evolve.

Following the series of scandals in the U.S. and elsewhere involving big corporations, the market has become increasingly demanding regarding improvements in corporate governance practices and internal controls to increase investor confidence. The awareness that followed the scandals created an environment conducive to better governance. This was seen in Latin America, in countries like Brazil: after the initial period when investors were pushing for basic governance measures, they now are refining their requests by seeking improvements in quality of disclosure, composition of boards and more. Lessons learned from the benchmarking process described in Chapter 3 can be used as the starting point and as a continuous learning process, as the path of Circle members illustrates.

CPFL Energia:

As noted earlier in this chapter, **CPFL Energia** carried out a major review of its mechanisms and governance practices in 2006. It brought back the international consulting firm that had supported the company in outlining its corporate governance structure to review it and propose any modifications that might be required. This resulted in a new design of the governance structure that gained much in flexibility and efficiency.

Why did the company make changes in its board and committees? The company felt a strong need to increase efficiency and effectiveness as well as improve the decision-making process. The company had undergone huge growth since the initial governance improvements were implemented—in 2001, the group had only two companies. Today, CPFL Energia has more than 20 companies that share the same corporate governance guidelines. The company had used the governance structure, processes and practices for five years and realized that management and directors were spending too much time in governing the company.

Since September 2006, when the board approved the new governance structure and processes, the company has seen strong results:

- Important savings in time and in efforts spent by management and the board
- More fluid process of decision-making
- Considerable reduction in miscommunication

The company also understands that the more flexible and streamlined structure is part of a continuing journey towards improvement and that this too will one day require revision and enhancements.

Homex:

Homex shares with other Circle members the understanding that maintaining sound governance is a continuous process. Even today, observing practices around the world, Homex knows that the market requires constant improvement. Homex is continuously evaluating new sources of benchmarking and, looking for new trends in order to update its model. The company believes that keeping up with international higher corporate governance standards helps the company to ensure dynamic policies and good governance practices that provide great confidence to investors.

The Suzano Group:

The company has substantially improved its practices since 2003, carefully evaluating each measure prior to implementation in a continuous manner. But governance transformation is a dynamic process. The company must be prepared to meet ever more demanding requirements of the market over time so governance must be structured appropriately. Recently, the company has put great effort into mapping out and anticipating tendencies so that the market will view the group as a corporate governance leader.

Ferreyros finds opportunities for continuous improvements outside the company

At **Ferreyros**, company leaders realized that continuous change is best implemented when a company's current status has been assessed internally and benchmarked both domestically and abroad. In 2001, the firm joined a group of companies responding to a questionnaire that assessed ownership and financial transparency, board structure and procedures, and shareholder relations. The company scored well in the assessment, but what they did with the information was even more important. Ferreyros decided to use the questionnaire as a starting point to implement improvements based on areas in which their responses were less satisfactory.

The company has updated this assessment annually, in an on-going effort to identify areas for improvement. The effort enabled compliance when in 2004 Conasev published a list of 26 disclosure requirements for listed companies, taken from the Peruvian Code of Corporate Governance.

In late 2006, the company's assessments were enhanced further, making use of a program prepared by the Andean Development Corporation (CAF, for its acronym in Spanish). Now, Ferreyros can set priorities and appropriately plan what needs to be done.

During this same year, the company participated in a corporate governance contest organized by Procapitales and Universidad Peruana de Ciencias Aplicadas. This contest required the presentation of information related to shareholder treatment, board practices including the presence of independent directors, board committees, information transparency, executive management structure, risk management, and finally relations with internal and external stakeholders. The effort was valuable because it:

- Helped the company assess its current status and identify more changes to be implemented in the future
- Singled out the company for recognition
- Enabled continuous improvements: the company believes that investors will pay more for good corporate governance practices
- Allowed for feedback from the organizers on areas for improvement

The result: Ferreyros has received numerous awards: in 2006, it won a shareholders' rights prize. In 2007, the company received an award for best annual progress in corporate governance.

The process continues to the present. In 2006 the company implemented the board members' self-evaluation and planned to adopt additional changes. This continuous assessment is vital when companies deal with the ever-changing business and corporate governance landscape. Companies must remain agile and flexible, always ready to adapt the course if so needed.

NET's long and winding road

A final good example of the corporate governance journey can be seen at **NET**. Its controlling shareholders and management have been working together at enhancing corporate governance for many years now. A long, and sometimes winding, road has been traveled ever since Multicanal went public in 1996 and Globocabo joined BM&FBOVESPA's Level 1 in 2001 and then Level 2 in 2002.

Looking back, there were hurdles that had to be overcome by the management and the board together, such as initial concerns about committing to resolve disputes through BM&F BOVESPA's Arbitration Chamber and the impact this could have on the company moving forward. However, it is now widely acknowledged that sound corporate governance practices enhanced outsiders' perception of value creation.

Despite the good results that follow a well-implemented governance reform, there will be new battles to win. New market circumstances, legislation or company initiatives may provoke new waves of resistance. Here is how one of the governance leaders from the Circle sums up the company's journey:

> *"The corporate governance journey will never end. There will be new discussions and ideas that will come up. Some corporate governance activists will want to lead and implement new measures faster than others; this will trigger new waves of resistance; some ideas may be good but they will require time to be understood. This process will need resilience and persistence. It will need time for people to really understand the benefits of better governance; it will also need people who will have the skills to build compromises at different levels inside the companies and with different groups of shareholders. But I am sure that five years from now, when we look back, we will see a much more mature equity markets in Latin America and we will have good laughs and stories that we will only be able to tell ten years from now."*

—Leonardo Pereira, NET, former CFO

This chapter covered ways to implement corporate governance best practices. Companies Circle members provided examples of facing the challenges using the various tools at their disposal and taking organized steps to ensure buy-in and compliance. The chapter demonstrated ways that companies can learn from listening to market clues and highlighted the importance of a transformative process that involves continuous learning.

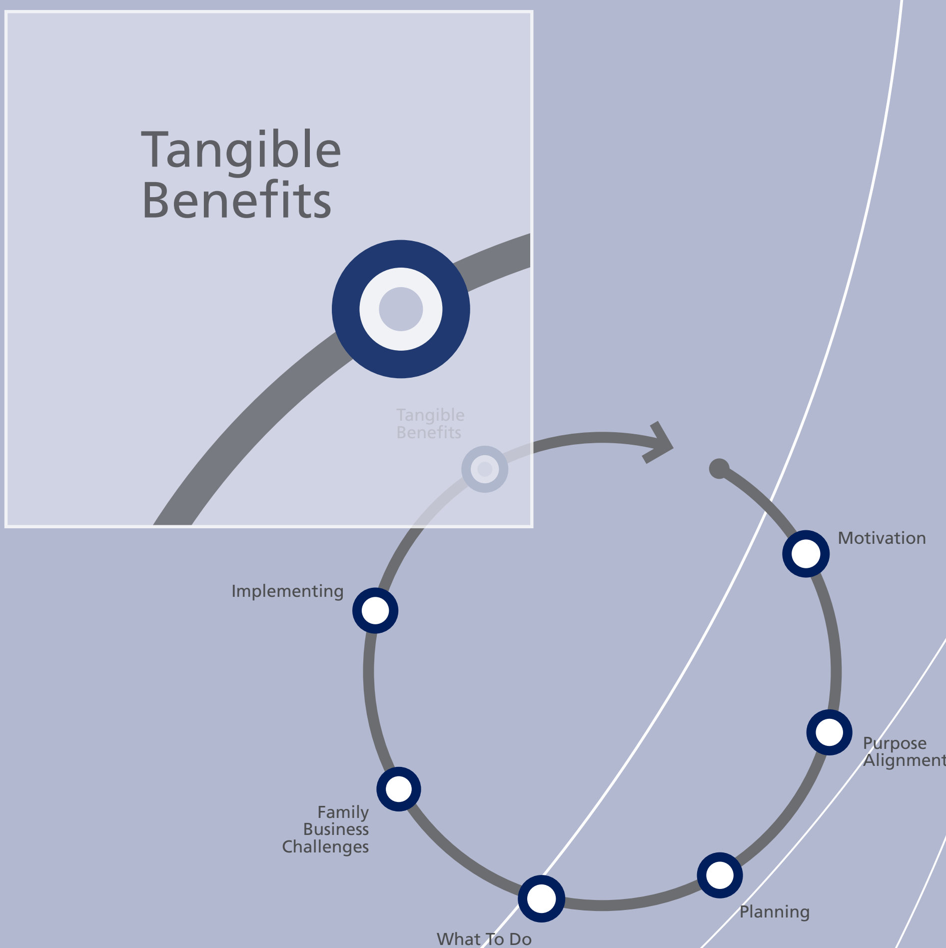
Now that corporate governance improvements are in place, it is time to assess the benefits of implementing such practices.

For Further Thought and Discussion

- What elements would you include as part of your company's governance implementation process?
- Are there skeptics who would have to be convinced of the value? How would you overcome their hesitations?
- Is your company set up to communicate changes taking place? Where would you need to supplement so that key messages are communicated in a timely manner, both internally and outside?
- Where can your company find feedback on the substance and progress of governance improvements? Identify some of your key constituencies and stakeholder groups.
- What governance mechanisms your company could create to ensure that improvements are made in a continuing basis?

7

THE TANGIBLE BENEFITS OF GOOD GOVERNANCE



Chapter 7
The Tangible Benefits of Good Governance

KEY MESSAGES

Companies believe in the value of good corporate governance. The Companies Circle members, as leaders in corporate governance in Latin America, strongly believe that good governance contributed substantially to the success of their companies and is essential for good business prospects in the long term.

Empirical data support the companies' belief in the benefits of improving governance. Empirical analysis carried out for this chapter found that Companies Circle member-firms, which have invested more in corporate governance policies and practices, have produced substantially better operational and market results than their Latin American peers. This is reflected in higher levels of profitability, relative share prices and liquidity, and reduced cost of capital.

Good governance helps in good and bad economic times. The tangible positive results of good governance are clear when the economy and the market are growing. Good governance also helps companies to weather the severe consequences of an economic downturn with more equilibrium, as the results during the current global financial crisis show.

Efforts to measure company performance and the impact of corporate governance improvements on results have gained momentum since the issue first started attracting increased attention in the early 1990s.

The entire corporate governance discussion is based on the premise that adopting good governance practices has a positive influence on company performance. As noted in Chapter 1, several benefits result from good governance practices. Among them:

- Improved top level decision-making processes
- Better control environments
- Reduction in firms' cost of capital

For companies listed on a stock exchange, the most commonly discussed benefit of good governance is the effect on share value, liquidity and investor portfolio composition. Such benefits were the main motivating factors for Companies Circle members as they embarked on the path of governance policy and practice improvements.

This chapter lays out evidence from a quantitative analysis to identify tangible gains achieved by the group of Companies Circle members as a whole,[84] compared to the broader community of listed Latin American companies.

[84] Not all Companies Circle members were used in all of the analyses. The Suzano Group is treated as two separate com-

Section 1 describes the overall approach taken in these analyses, followed by Sections 2 and 3, which detail the results with indicators of operational and market performance, including the cost of capital, during sustained periods of growth.

Section 4 compares the performance of Circle members to other Latin American firms, following the emergence of the 2008 global financial crisis, including their stock reaction. It addresses the impact of an economic downturn on firms with leading corporate governance practices.

The chapter concludes with first-hand testimony from leaders of Companies Circle firms on the value of their governance best practices journey.

1 Overall Approach to the Comparative Analysis

Academics and corporate governance experts have long tried to identify and empirically prove that there is a link between good corporate governance practices and the success of the firms. Several studies focused on examining how separate governance characteristics of a company affect its profitability, share price fluctuations, firm valuation, and other results.[85] With all this evidence, many academics and practitioners, international organizations and advocacy groups, investors and company leaders, including those of the Companies Circle, strongly believe that good governance leads to tangible benefits and affects the company's performance and results.

At the same time, it is not easy to fully and unequivocally quantify the relationship between good corporate governance practices and the firm's specific performance results. There are those who dispute the direct link between governance and performance claiming that there is no fully-accepted framework to determine the ways in which corporate governance structures and processes influence corporate performance. Among the issues: the complexities involved in defining and measuring corporate governance improvements and how to attribute success, since improved corporate governance may not be the only reason for better performance by a particular firm.

Despite these difficulties in measurement, it is important to emphasize that there is global acknowledgment of the benefits of good governance for firms—and for markets.

This said, the analysis undertaken here finds that Companies Circle members demonstrate better operational and market performance than their Latin American peers in recent years, as they have improved the quality of their corporate governance. The comparative evidence shows that a group of companies identified as Latin American leaders in corporate governance, with strong commitments to improving their governance as a key part of their business strategy, also have enjoyed strong financial and operational performance success across a number of indicators compared to the typical Latin American company.

The analysis takes a detailed look at a group of Companies Circle members that have invested more than average resources and attention to improving corporate governance struc-

panies, Suzano Papel Celulose and Suzano Petroquímica, since the two firms were listed separately on the stock exchange, although they participated in the Circle as a single company and both entities belonged to the same controlling group. Suzano Petroquímica was excluded from the 2008 data, following its 2007 acquisition by Petrobras. The analysis does not include Atlas, which was listed in Costa Rica before its 2008 acquisition by Mabe of Mexico, since the Economatica® database does not cover companies listed on the Costa Rica stock market.

85 See Chapter 1 (page 14) for references to some of the studies that have found benefits of corporate governance improvements in terms of firm value.

tures and processes, as described in the previous six chapters of the guide, and whether they display better performance indicators than a broad group of their Latin American peers.

While the data do not necessarily prove causality between improved governance and performance, it nevertheless provides strong support for the 14 Companies Circle members' belief, based on their own analysis, that improving governance standards has led to better results and impressive benefits—financial and otherwise.[86]

1.1 Analysis Features Five Approaches

To demonstrate tangible, financial and economic gains from better governance practices, a pragmatic and quantitative analysis of Companies Circle members was conducted, making use of five different approaches.[87] The approaches are divided into two broad groups, looking at the impact of good governance on operational indicators and cost of capital.

GROUP 1: Operational indicators

› First approach: Comparison of traditional accounting indicators
› Second approach: Economic profit analysis

GROUP 2: Cost of capital

› Third approach: Comparison of traditional stock market indicators
› Fourth approach: Analysis of the impact of governance improvements announcements
› Fifth approach: Analysis of total stock returns

The rationale behind employing several approaches is clear—to confirm Companies Circle members' perceptions that they achieved better results after improving their corporate governance standards, across multiple methodologies. The diverse nature of the group—in nationality, size, industry, and ownership structure—reduces the possibility that performance improvements were due to a specific characteristic, such as industry, size, or location.[88]

Tangible Benefits

86 It is not the intention of this chapter to prove causality between Circle members' governance improvements and their impressive financial, share price and operational results. The analysis is not based on random sample selection, and it has not fully controlled for other factors that may also have contributed to Companies Circle members' performance. However, some of these factors are reviewed and taken into account later in this chapter in a review of the robustness of the results, such as differences in countries and sectors represented, size, and risk. Different time periods related to both market growth and market downturns are also examined to further test the applicability of the results.

87 The methodology behind each approach is presented in Appendix 5

88 Diversity is an interesting aspect of studying a group of companies such as the ones in the Circle. The intention of the multilateral institutions that support the Companies Circle initiative in seeking this diversity was to offer a set of experiences shaped by different contexts and conditions, thus permitting the Circle to serve as a reference for a larger number of Latin American companies. This condition is appropriate for an analysis of the relationship between good governance and results.

2 Impact of Corporate Governance on Operational Indicators

Many studies argue that better corporate governance practices translate into better access to both equity and debt financing, resulting in lower cost of capital.[89] However, since a better governance model can help companies make better business and strategic decisions, it is also reasonable to argue that better-governed firms will achieve better operational results as well, as described below. This potential benefit is important, since it is applicable to both listed and non-listed companies, whereas higher stock value applies only to listed companies.

2.1 Comparison of Traditional Accounting Indicators

In this first group of analyses, the results of a comparison of Companies Circle members against their Latin American peers are presented. Initially, the comparison is made using traditional accounting indicators. This analysis compares selected operational indicators of the Companies Circle members against the mean indicators of all Latin American listed firms. To prevent short-term distortions, the average indicator of each firm was calculated for three years (2005–2007).[90]

The idea here is to look at whether firms with better corporate governance standards, as represented by Companies Circle members consistently achieve better operational results than the average firm in the market. Six usual and relevant indicators were chosen:

- Two measures of profitability:
    - ROE—Return on Equity (net income / book value of equity)
    - EBITDA[91] margin (EBITDA / operational revenues)
- One measure of dividends' distribution: Payout Index (dividends per share / earnings per share)
- Two measures of business solvency in the short term:
    - Current ratio (current assets / current liabilities)
    - Solvency ratio (EBIT[92] / Interest Expense)
- One measure of financial leverage:
    - Debt ratio (current + long term financial debt / total assets)

After collecting data for all Companies Circle members and for 1,078 Latin American listed companies, the results are presented in Chart 1 below:[93]

89 See Chapter 1 (page 14) for references to some of the studies that have found benefits of corporate governance improvements in terms of capital costs as well as firm value.

90 A relatively recent time period was chosen for this analysis, corresponding to the period during which the Companies Circle was established and many corporate governance improvements were undertaken by Circle members. However, other time periods were chosen for other analyses later in this chapter to consider how performance may have varied over a longer period of time

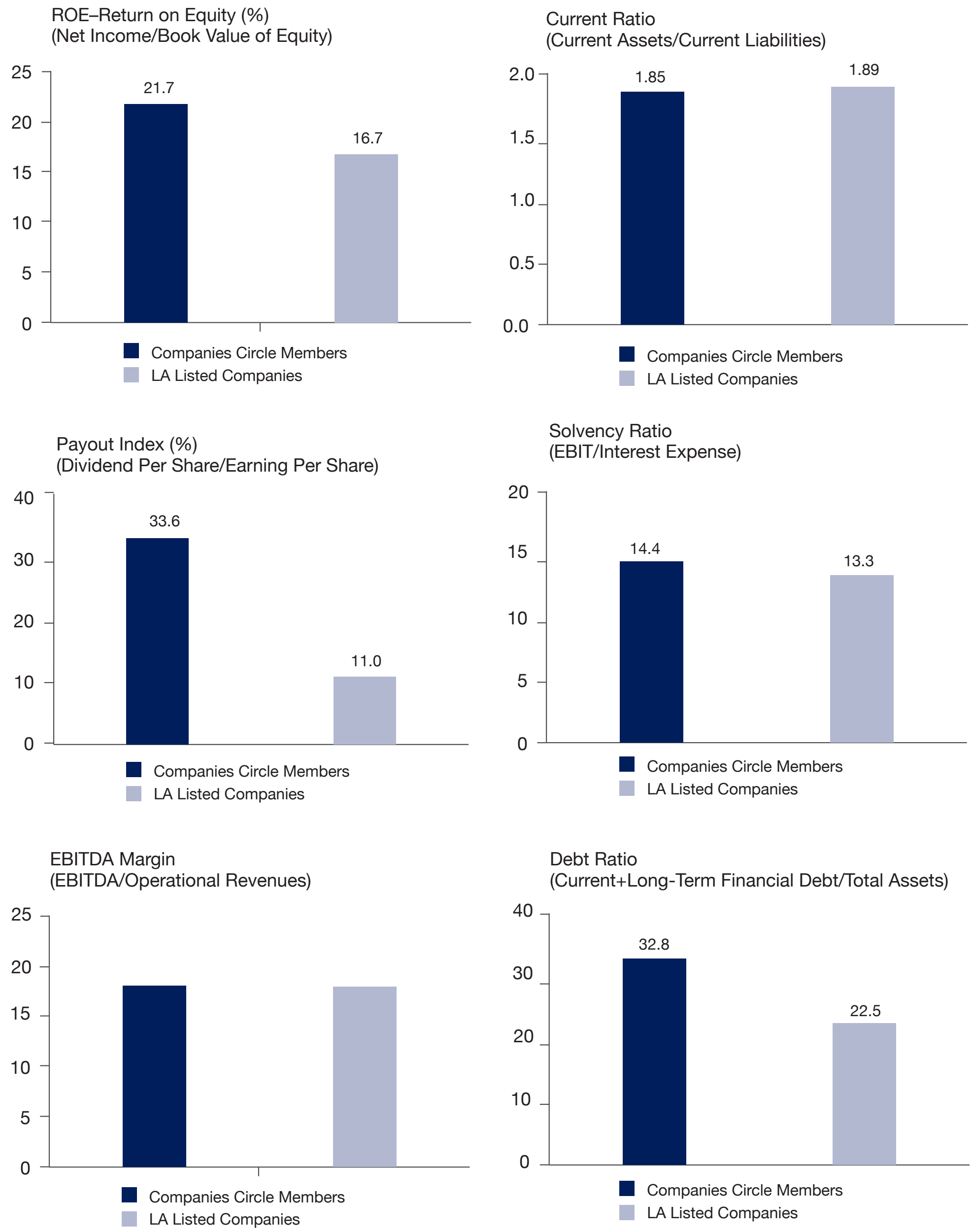
91 EBITDA is the Earnings Before Interest, Tax, Depreciation and Amortization. It is a commonly used way of measuring the profitability of a company. Some analysts also use it as a proxy measure for the cash-flow generated by a firm.

92 EBIT is the Earnings Before Interest and Taxes. It is a commonly used measure of the earning power of a company from ongoing operations.

93 The peer group consists of all Latin American companies with stocks traded from 2005 to 2007. The data was collected from Economatica®, an electronic database focused on Latin American companies. Further details on the methodology are contained in Appendix 5.

Chart 1 Comparison of Selected Operational Indicators

Companies Circle members compared to 1,078 Latin American listed firms, using mean results from both groups for the period of 2005–2007.



In line with the hypothesis that good governance pays off, Chart 1 shows that the group of Companies Circle members produced better operational results in terms of profitability, as noted by ROE, than their Latin American peers. Specifically, they displayed an average ROE of 21.7 percent in the three years from 2005 to 2007, against an average ROE of 16.7 percent by the broad group of Latin American firms in the same period.

Two additional results stand out:[94]

- Companies Circle members paid more dividends in relative terms, as shown by the payout index chart. They distributed about 34 percent of profits per share, compared to only 11 percent by all Latin American companies. Although it is not clear that higher dividend payouts are necessarily better for investors, since higher dividend returns are sometimes linked to preferred shares with restricted shareholder rights, many investors prefer larger cash flows from dividends. This, in turn, may increase the company shares' appeal in attracting additional investors.
- Companies Circle members are financially leveraged higher than the group of Latin American companies, as shown by their debt ratio of 32.8 percent, compared to 22.5 percent with the broad comparison group. Likewise, the dividend payout index results, this also may be seen as a positive indicator: Latin American companies historically have been poorly leveraged especially in the long term, due to lack of access to long-term credit at reasonable costs. Thus, one could argue that higher long-term debt ratios indicate that these companies are better able to access long-term debt markets or bank financing at reasonable costs. Still, firms with more leverage might incur higher solvency risks, especially in moments of great credit market distress, since they depend on the ability to issue new debt or generate constant cash flows to repay the debt service.[95]

2.2 The Second Approach: Economic Profit Analysis Reveals Positive Results

Since the adoption of better corporate governance practices can improve the top level decision-making processes and reduce the cost of capital, there is a good probability that better-governed companies can create more shareholder value through better operational results. Bottom line: long-term investors want to know how much economic value their investee companies are creating or destroying.

A specially-designed measure of the economic profit of all firms from 1995 to 2008[96] identifies the economic value created or destroyed by Companies Circle members and their Latin American peers over a longer period of time. The analysis compares the evolution of the annual economic profit—a simplified version of EVA®[97]—of Companies Circle members against mean indicators for Latin American listed firms from 1995 to 2008. Since Companies Circle members substantially improved their corporate governance practices during the period, it is possible to see whether firms also increased their wealth creation during the period in which they improved their corporate governance practices.[98] The results are presented in Chart 2 below.

[94] For the three other indicators, on the EBITDA margin and short-term solvency (current and solvency ratios), only a slightly higher but statistically insignificant difference for Companies Circle members compared to their Latin American peers was observed, which does not allow for a clear-cut conclusion that this group displayed better results on these indicators.

[95] This result may be due to better access to bond markets and/or to banks by Companies Circle members, rather than more financial difficulties.

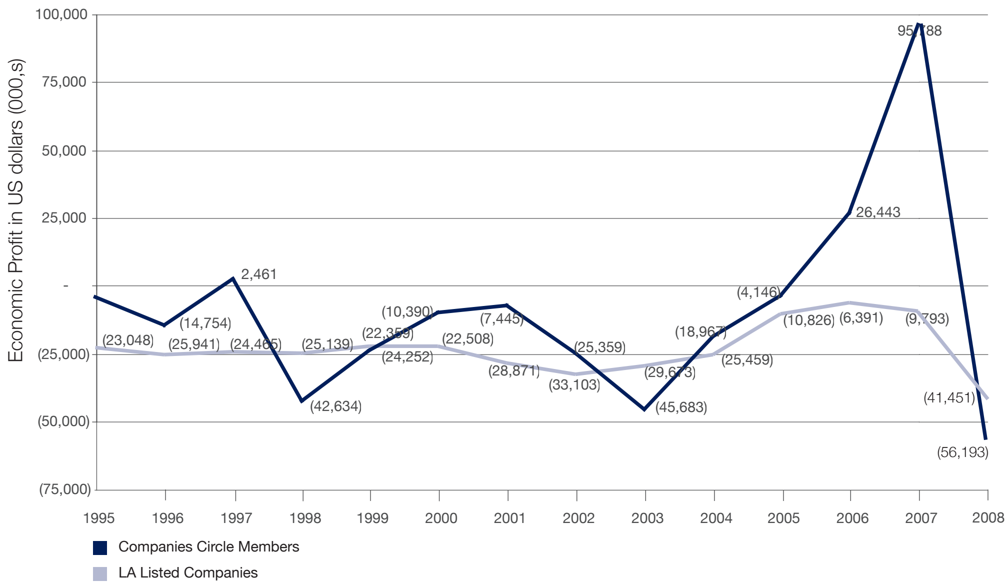
[96] This period was chosen for two main reasons: during this period the corporate governance improvements of Companies Circle members took place and reduced inflation allowed more realistic analyses, especially for the Brazilian data.

[97] See Glossary for a more complete definition of EVA®, the Economic Value Added.

[98] It should be noted that the indicator of economic profit has an advantage over traditional accounting ratios (used in the first approach) by taking into account both the opportunity cost of capital and the amount allocated in a firm by investors.

Chart 2 Economic Profits, 1998–2007

Evolution of the yearly economic profit (a simplified version of EVA®) of Companies Circle members against 1,078 Latin American listed firms, using mean results from both groups for the period of 1995–2008.



Cost of capital can influence results. Chart 2 shows that firms from the region—including Companies Circle members—presented an overall negative result on value-creation during the ten year period from 1995 to 2004. This likely was caused by the higher cost of capital in Latin America. However, the reduction of the cost of capital in subsequent years because of the region's relative financial stability seems to have contributed to a changed picture. A look at the period between 2006–2007 reveals that Companies Circle members appear better prepared, with an aggregate value-creation of approximately US$ 122 million in 2006–2007, compared to overall value destruction of approximately US$ 16 million for the group representing all Latin American companies during the same period. The 2008 global financial crisis seems to have impacted all companies from the region, with an average economic value destruction of around US$ 41 million to the group with Latin American companies, against an average value destruction of US$ 56 million for Circle members.

The apparent higher economic profit volatility for the Companies Circle group, with larger extremes for both positive and negative results, may be the result of two factors: the exclusion of outliers (extreme values) from the group of all Latin American firms, and the fact that Companies Circle members are a significantly smaller group.

Overall, the second analysis shows that Companies Circle members destroyed less value when macroeconomic conditions in Latin America were more turbulent until 2004, created more value when the region became a more stable economic and business environment during the boom period of 2005 to 2007, and suffered an economic value destruction of the same magnitude of their Latin American peers after the emergence of the global financial crisis in 2008.

3 Impact of Corporate Governance on Cost of Capital

In this second broad group of analyses, the focus is on the crucial component of the competitiveness of any firm: the cost of capital. The access to a lower cost of capital immediately generates two benefits: an increase in the market value of the company—and on the shareholders' wealth position—and an increase in the number of viable projects to be carried out by firms, since the company's required rate of return is diminished.

3.1 Comparison of Traditional Stock Market Indicators

This section presents a comparison between Companies Circle members and all Latin American firms, using traditional stock market indicators—the third analytical approach used. Here, select market indicators from the 14 Companies Circle members are compared to mean indicators from all Latin American listed firms. Similar to the first approach presented in Section 2, the average indicator of each firm is calculated for three years, 2005–2007, to prevent short-term distortions.

The idea here is to see whether firms with better corporate governance standards, as represented by Companies Circle members, display better stock market indicators than the average Latin American firm in the market. Six commonly used and relevant market indicators were chosen:

- One measure of absolute value:
  - Market capitalization (number of outstanding shares x share price)
- Two measures of relative value:
  - PE ratio (share price / projected earnings per share)
  - PBV (share price / book value of shares)
- Two measures of stock liquidity:
  - Daily volume of shares traded
  - Liquidity index (calculated by the respective stock exchange)
- One measure of stock return solely due to dividends received in the year:
  - Dividend yield (dividend per share during the year / share price in the beginning of the period)

The results are presented in Chart 3.

Chart 3 Comparison of Selected Market Indicators

Comparison of selected market indicators of Companies Circle members and 1,078 Latin American listed firms, using mean results from both groups for the period of 2005–2007. Numbers reference the three-year average for each group.

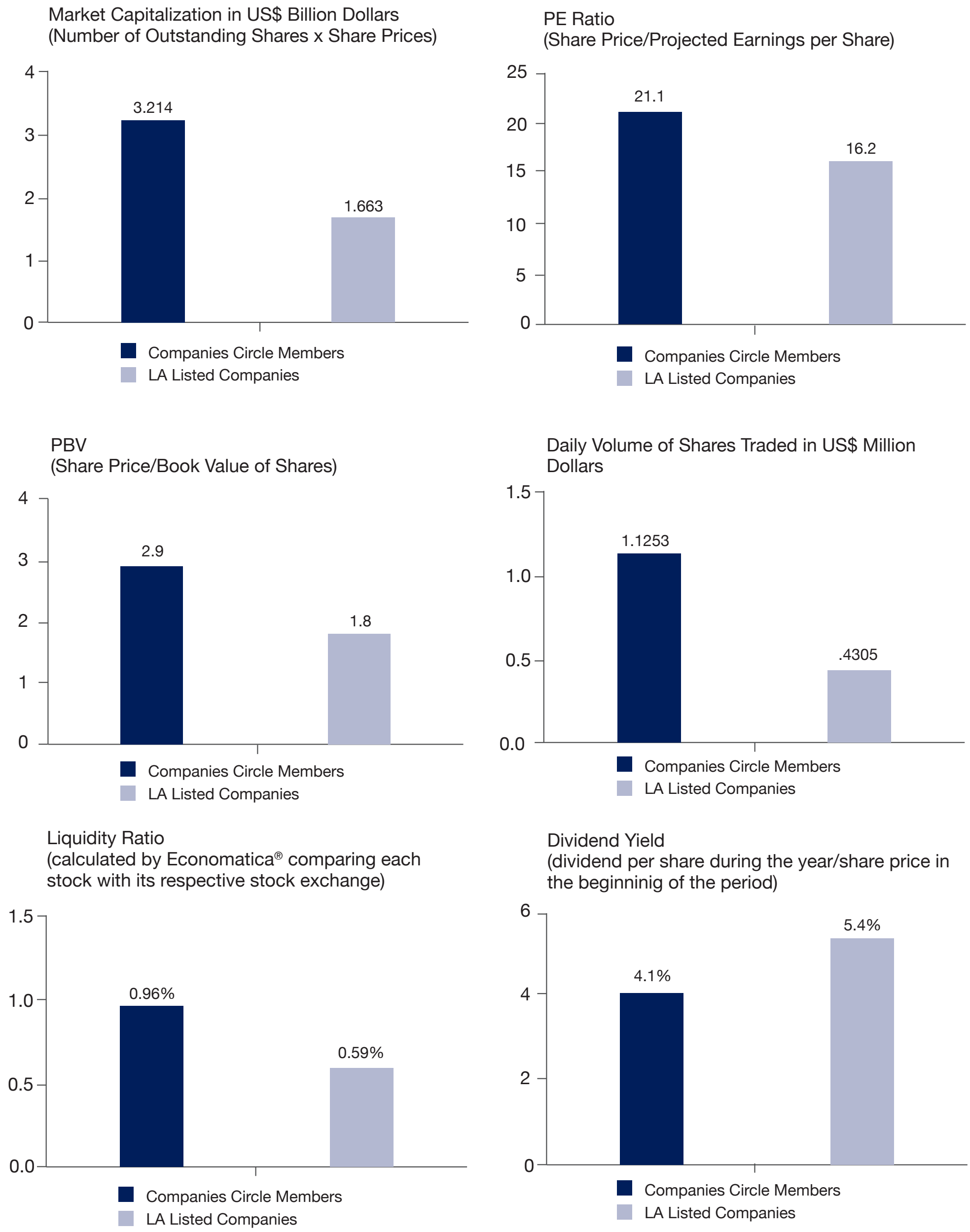


Chart 3 results underscore the value of good governance: the group of Companies Circle members produced substantially better market indicators than the group of all Latin American listed firms in terms of relative value and stock liquidity. Two results stand out:

On average, Companies Circle firms trade at higher stock multiples than Latin American companies, indicating a better "value perception" by investors. On average, their stocks are traded at 21 times earnings per share, compared to approximately 16 times for other Latin American companies. In addition, their shares are worth about 2.9 times the book value, compared to 1.8 times for their Latin American peers. The results clearly show that investors value Circle member stocks more than the stocks of average firms.

The Companies Circle members also have higher liquidity for their shares, another fundamental that investors consider. Their share liquidity ratio is about double the ratio for their Latin American peers.

Interpretation of dividend yield results. The final indicator on dividend yields requires more analysis: The stocks of Companies Circle members present a lower return, solely due to dividends paid in the period as a percentage of the share price.

It is important to note that, since the total return on a share also depends on the share's appreciation (the price increase), and keeping in mind that Circle members' share prices were rising at faster than average rates during this period, the overall return to investors may still have been higher for Circle members. In addition, some companies offer higher dividend returns for non-voting shares as compensation for the weaker shareholder rights that are attached to them. So higher dividends in some cases may be inversely correlated to some aspects of governance quality.

3.2 Analyzing the Impact of Governance Improvement Announcements

When firms announce that they have or will improve their corporate governance standards—cross-listing on stock exchanges with stricter requirements, hiring independent directors and professional (non-family) managers, undertaking large-scale corporate governance improvement measures and the like—it is reasonable to expect that their businesses will run better in the long run. The result: an immediate and positive stock price reaction after the announcement of the good news.

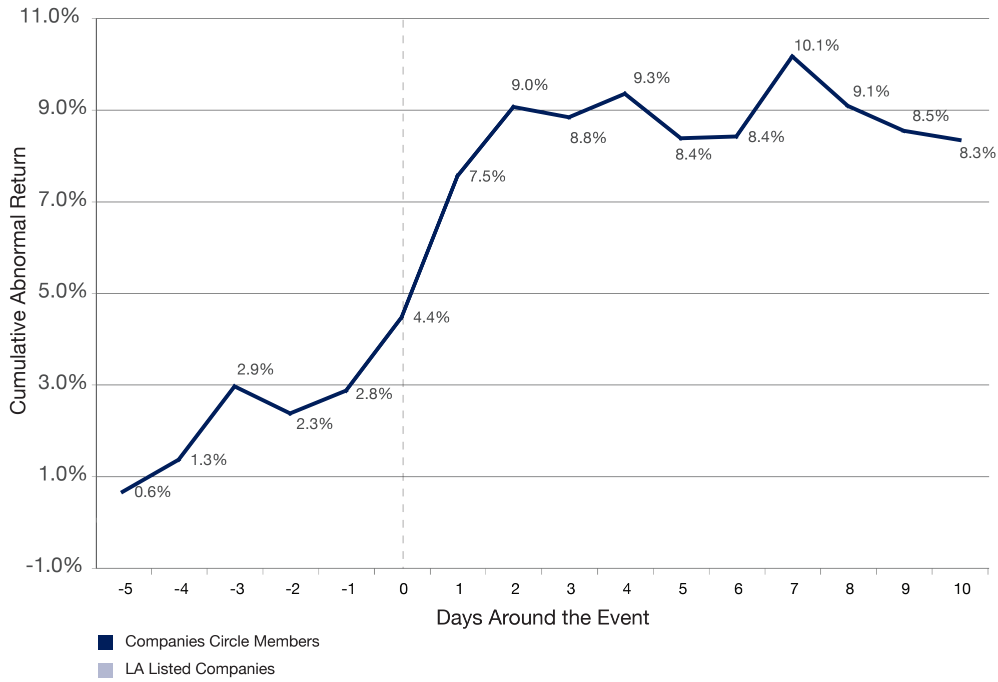
This fourth approach, analyzing the impact of good governance looks at the effect of unexpected announcements of corporate governance practices' improvements on stock prices. When firms announce that they have or will improve their corporate governance standards (such as cross-listing on stock exchanges with stricter requirements, hiring independent and external (non-family) directors, and undertaking large scale corporate governance improvement measures). It is an event study analysis, using relevant of corporate governance improvements announcements from Companies Circle firms.

The idea here is to see whether firms achieved substantial positive returns during the period around the announcement of corporate governance improvements, called an "event window."[99] This is probably the strongest measure of confidence in the real impact of corporate governance on firm value.

For this analysis, 12 separate announcements of changes that qualify as substantial corporate governance improvements were collected and reviewed for impact. Chart 4 displays the aggregate results. For additional information on the individual releases, including actual wording of announcements, dates and companies issuing the releases, see Appendix 5.

99 The event study methodology elaborated by Campbell et al (1997) was applied. This methodology is well known and accepted in the academic field.

Chart 4 Cumulative Average Abnormal Return
Event study analyzing the impact of 12 unexpected announcements of corporate governance practices' improvements on stock prices of Companies Circle members.



Positive market reaction. A look at Chart 4 reveals that the market reaction after the announcement of corporate governance improvements is extremely positive: on average, Companies Circle members experience an abnormal[100] positive return of about 8 percent after the announcement of such news in the media. This clearly demonstrates that the market welcomes and values improvements in corporate governance practices—with an immediate willingness to pay a higher price for shares.

For Your Consideration

Companies Circle firms added approximately 8 percent to their market value by communicating improvements in their corporate governance structures and processes to the market.

3.3 The Bottom Line: Analyzing Total Stock Returns

This final approach covers the bottom line for stock market investors: total stock returns. Specifically, it investigates whether Companies Circle members produce a higher return on their shares in the long term than two different benchmarks: all listed Latin American companies and

[100] The term "abnormal" means the share appreciation during the period discounted by the marker return and the expected stock return in the same days.

the group of Latin American companies with ADRs issued in the US market.

From the investors' point of view, it is important to determine whether investments in a portfolio of firms with better governance practices would have produced higher returns in the long term than investments in different portfolios. The hypothesis is that firms with better corporate governance practices will be a better investment option for shareholders, yielding higher annual stock returns. To explore this hypothesis, two charts, analyzing the evolution of compound annual returns of a hypothetical Companies Circle portfolio—equally weighted among the firms—were created against the two benchmarks specified above. The results are presented in Charts 5a and 5b.

Striking results. The results presented in Charts 5a and 5b are striking: an individual investing US$ 1 in a portfolio with shares of all Companies Circles members on December 31, 1997 would have reaped exceptionally higher returns eleven years later, even after the emergence of the current global financial crisis in 2008, compared with an investment in any other portfolio.

Specifically, US$ 1 invested in the hypothetical "Companies Circle Portfolio" would have resulted in US$ 15.45 at the end of 2008—an accumulated return of 1,445 percent. Compare this return the US$ 3.41 earned in a portfolio with all Latin American companies, and US$ 2.32 in a portfolio composed of Latin American ADR issuers.[101]

For Your Consideration

Overall, investors buying Companies Circle member stocks on December 31, 1997, on December 31, 2008 would have an equity position worth:

- Five times more than a similar investment in all Latin American companies
- Six times more than a similar investment in Latin American companies with ADRs in US markets

The slower growth in share values of ADR issuers, a group of companies that is required to follow stricter disclosure and governance requirements than the average listed Latin American company, may be explained by the fact that Latin American ADR issuers are among the largest and longest established Latin American companies. In many cases, they were required to adopt stricter practices prior to cross-listing their stocks, so they may have earned improvement-related gains early on, leaving less room for additional gains during the period under analysis.

By contrast, Companies Circle members improved their corporate governance standards during the period under analysis, including many improvements that go beyond the corporate governance-related requirements of ADR issuers. This may be a reason for their superior stock returns compared to ADR issuers. Another possibility is that ADR issuers were companies with a lower ex-ante expected return, since they were viewed as less risky companies. If this were the case, then a lower total absolute return would not necessarily mean a lower risk-adjusted return. This possibility is examined later in this chapter.

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101 Since some Companies Circle members presented extreme (both high and low) stock returns in specific years, two additional tests were made: one excluding Companies Circle stocks with highest and lowest returns in each year, and another excluding Companies Circle members with highest and lowest compound returns during the whole period. In both cases, the portfolio with Circle members still provided substantially superior stock returns. Finally, an analysis from 2002–2008 was done, excluding the period from 1998–2001 when several extreme stock returns from both Circle members and their Latin American peers were identified. Again, the results remained essentially the same

Chart 5a Compound Annual Returns, 1998–2008

Compound annual stock returns of Companies Circle members compared to an equally-weighted portfolio of 1,073 Latin American listed companies from 1998 to 2008.

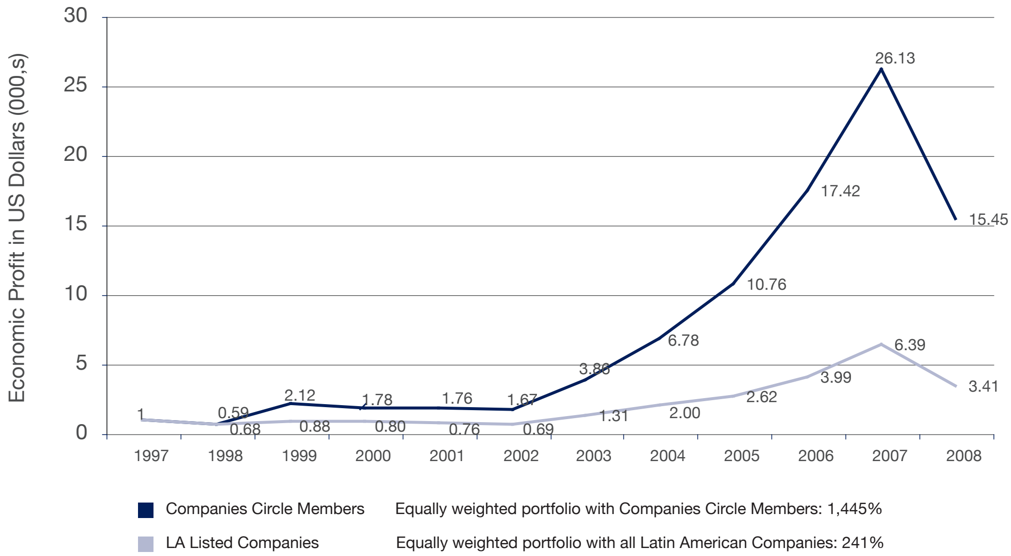
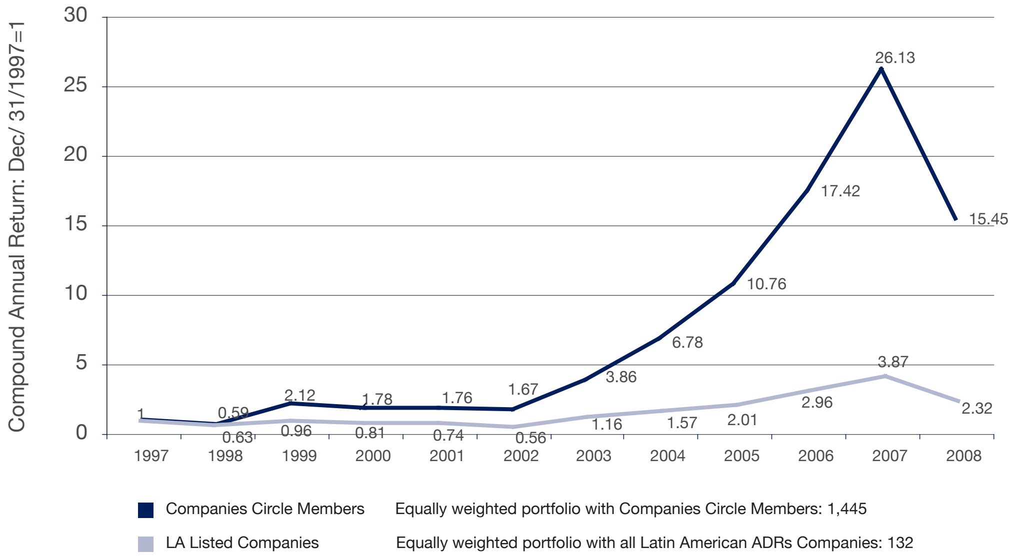


Chart 5b Compound Annual Return: 1998–2008 Companies Circle Members vs. Latin American ADRs Companies

Compound annual stock returns of Companies Circle members compared to an equally-weighted portfolio of all 113 Latin American Companies with ADRs from 1997 to 2008.



Tangible Benefits

3.4 How Robust Are the Results?

As noted in the first section of this chapter, some may question the robustness and applicability of the results—are Companies Circle members sufficiently representative of Latin American companies? Are they comparable to the broader set of Latin American listed companies?

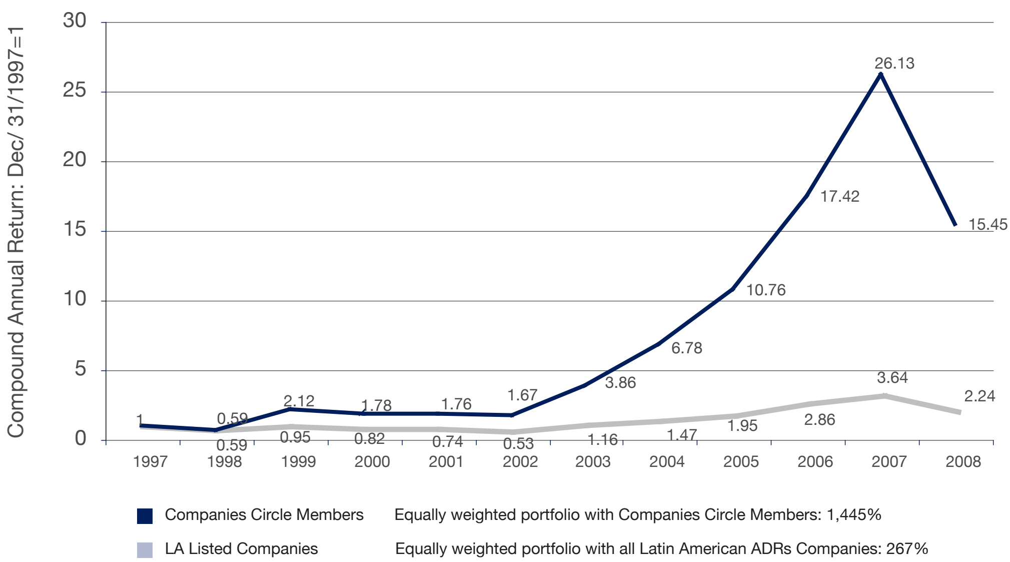
For example, with eight of the Circle's fourteen members based in Brazil, there are other factors, such as economic trends and risks unique to a particular sector and this particular country that can contribute to returns and operational results. To account for such factors an additional review of the robustness of the results was undertaken. The review considered two potential points of bias:

- The weighting of the countries in the different portfolios
- Failure to consider the different risks associated with the portfolios

Accounting for country weighting. In the robustness analysis, a country represented in the Companies Circle portfolio was assigned the same weight in the portfolio of all Latin American companies for each year. For instance, in 2005, Brazilian companies represented 64.3 percent of the total number of Circle members with data available. The same 64.3 percent weight was assigned to Brazilian companies in both comparison portfolios for the 2005 data analysis. Chart 5c shows the comparative results following these adjustments.

Chart 5c Compound Annual Return: 1998–2008 Country-Weighted Analysis of Companies Circle Members vs. All Latin American Companies

Compound annual stock returns of Companies Circle members compared to an equivalent country-weighted portfolio with 1,073 Latin American listed companies from 1998 to 2008



Based on the data provided in Chart 5c, it is clear that the superior results of the Companies Circle member portfolio remain unchanged after adjusting the broad portfolio with all Latin American companies for equal country weight. The results against ADR issuers reveal a similar outcome. This leads to the conclusion that, the higher returns from the Companies Circle portfolio are not caused by variations in country weighting.

Adjusting for risk. The other potential bias deals with the potential for different risks in each portfolio. For investors, evaluating the investment's return based on the risks they are taking is crucial. To do so, the financial literature has developed the so-called "risk-adjusted" measures of stock returns, which are performance measures that allow the comparison between volatile stocks and steadier, lower-risk ones. Three risk-adjusted measures stand out in the literature and are widely used by market practitioners.[102]

The results of this analysis indicate that the portfolio of Companies Circle members displayed higher overall mean risk-adjusted measures of return than the portfolio with their Latin American peers in the period 1998–2008. The results against the portfolio with ADR issuers were qualitatively the same. Again, this reinforces the view that the Companies Circle member portfolio has delivered superior returns over the eleven-year period under analysis than the competing portfolios.

A look at the Jensen's Alpha, a measure of the "extra" return that an investor would have earned by investing in a given asset or portfolio, provides an interesting perspective on this. The mean value of 17.1 percent for the Circle portfolio indicates that it has provided an annual "extra" return of about 17 percent, after discounting the expected "fair" return that an investor should have gained from running the risks of investing in such portfolio. By contrast, for the broad portfolio with all Latin American companies, this "extra" return averages close to zero, meaning an effective return similar to the expected and fair return.

4 Benefits of Good Governance During the Recent Financial Crisis

Good corporate governance practices are just as relevant to differentiating companies; performance during market downturns as they are in boom periods. To evaluate this proposition, this section reviews the performance of Companies Circle members against Latin American peers during the emergence of the current financial crisis in 2008.

4.1 Comparing Operational and Market Indicators

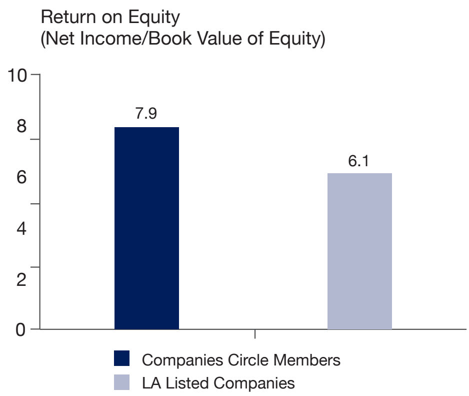
Testing the benefits of good governance during the downturn begins by comparing the operational results of Circle members with their Latin American peers at the end of 2008. Similar to the comparisons made in the first and third approaches, shown in Charts 1 and 3, the focus is on whether the results for the years 2005–2007 years are able to hold up consistently during a more turbulent period.

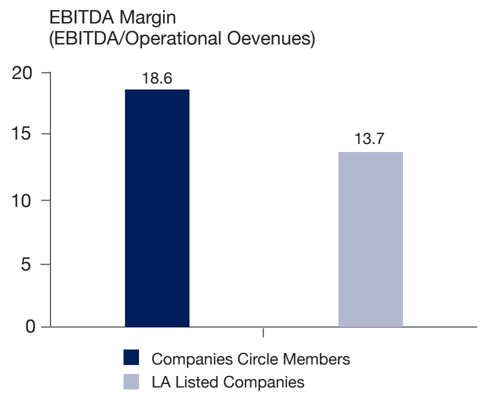
In Charts 6a and 6b, six operational and market indicators are analyzed, revealing stronger performance, and increased immunity to the market shocks. Chart 6a shows the results for five selected operational indicators.[103]

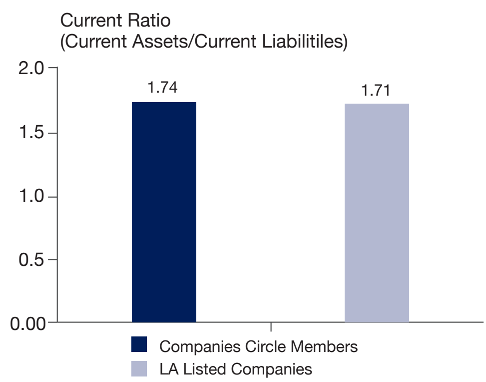
102 The three ratios used are the Sharpe Ratio, the Treynor Ratio and Jensen's Alpha.

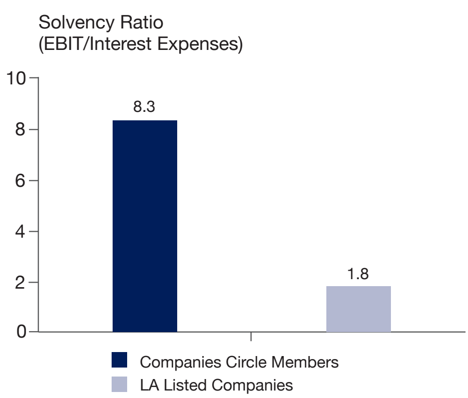
103 It was not possible to calculate the payout index for the 2008 year, since companies have not released their dividends per share until late April, 2009.

Chart 6a Comparison of Companies Circle Portfolio Market Performance to Latin American Company Performance, 2008









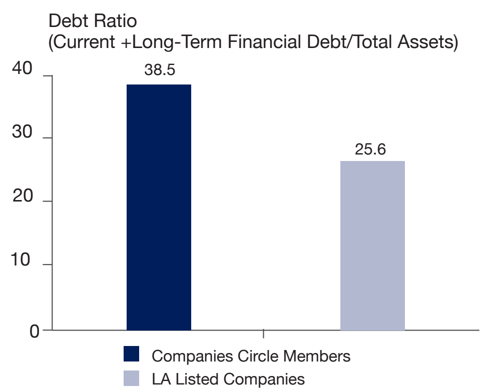
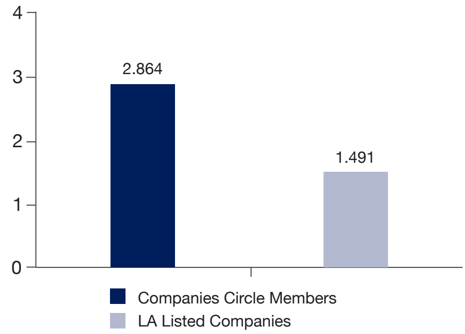


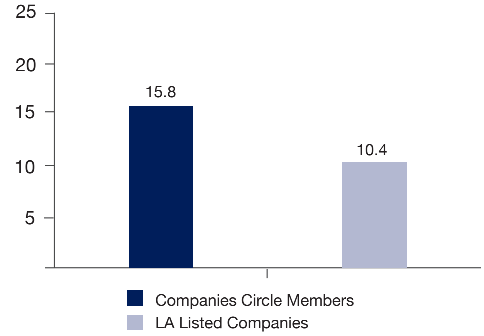
Chart 6b Comparison of Companies Circle Portfolio Operational Performance to Latin American Company Performance, 2008

Comparison of selected market indicators for Companies Circle members and for 1,073 Latin American listed firms, using mean results from both groups at the end of 2008.

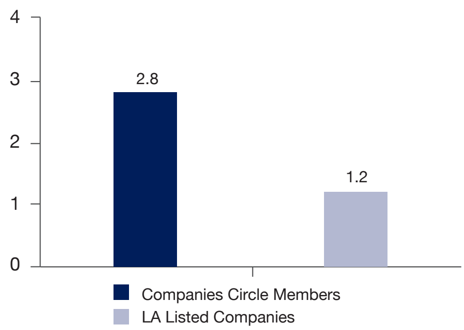
Market Capitalization in US$ Billion Dollars
(Number of Outstanding Shares x Share Prices)



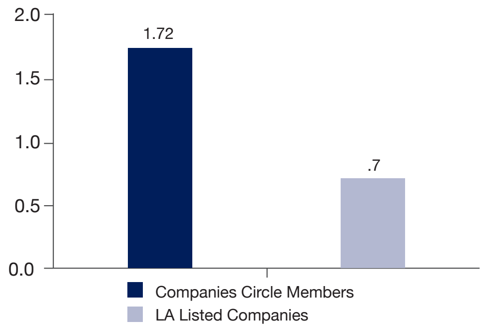
PE Ratio
(Share Price/Projected Earnings per Share)



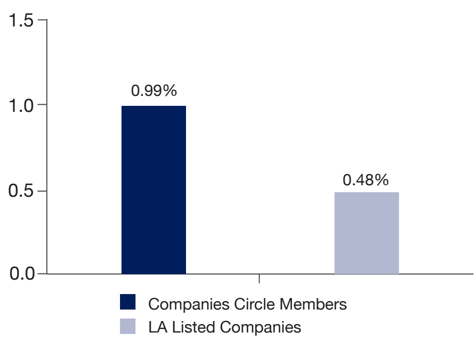
PBV
(Share Price/Book Value of Shares)



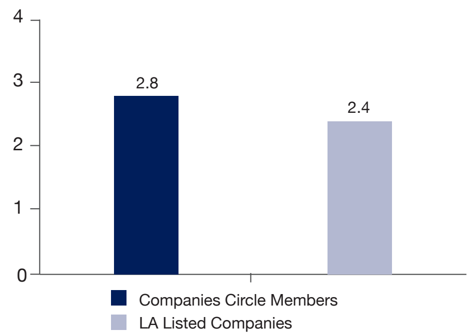
Daily Volume of Shares Traded in US$ Million Dollars



Liquidity Ratio
(calculated by Economatica® comparing each stock with its respective stock exchange)



Dividend Yield
(dividend per share during the year/share price in the beginninig of the period)



The information in Chart 6a highlights the fact that despite the emergence of the global financial crisis in the second half of 2008, the overall picture of the indicators in favor of Circle members remained the same as in Chart 1 for the 2005–2007 years. Again, Circle members displayed a higher return on equity than their Latin American counterparts (7.9 percent compared to 5.1 percent). They also have displayed a superior EBITDA margin (18.6 percent compared to 13.7 percent) and a better solvency ratio (8.3 versus 1.8)—of particular importance during turbulent times like 2008. Similar to the Chart 1 results, both groups have displayed about the same current ratio and Circle members demonstrate a higher debt ratio.

Chart 6b reinforces the view that the global financial crisis did not alter substantially the overall picture—the indicators continue to favor of Circle members. In addition, the Circle group expanded its lead for price/earnings ratios and share price/book value ratios compared to Chart 3 results for 2005–2007. Such results indicate that investors perceive that Circle companies offer better value than the broad comparison group in a time of market distress. The dividend yield comparison is interesting as well: Companies Circle members demonstrated a significantly smaller reduction in dividend yield than the broader group.

4.2 Analyzing the Stock Market Reaction of Circle Members in 2008

A number of researchers have investigated the link between sustaining better stock performance during a downturn and good governance practices. The vast majority have confirmed this link, that good governance practices are a determining factor in explaining better stock behavior during financial crises.[104]

This research also compares the performance of Circle members with the performance of all Latin American companies after an external economic shock. The analysis reviews the performance of Circle members' stocks against two broad benchmarks:

- Portfolio of all listed Latin American companies
- Country-weighted portfolio of all Latin American companies

These portfolios are constructed similar to the portfolios built for Chart 5c.[105] In Chart 6c the results from the three portfolios are shown during four different time windows: third quarter 2008, fourth quarter 2008, second half of 2008, and all of 2008.

Chart 6c shows that the portfolio of Circle member stocks suffered slightly less than the broad portfolios with all Latin American companies. For example, the portfolio with Circle member shares lost 41.3 percent of its value in US dollars through 2008, compared to a loss of 49.3 percent for the country-weighted portfolio of all Latin American companies.[106]

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104 BAEK, J-S; KANG, J-K; PARK, K. S. (2004), Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis. Journal of Financial Economics, 71, pp. 265–313.

CLAESSENS, S,; DJANKOV, S.; KLAPPER, L. F. (1999, revised 2004), Resolution of Corporate Distress: Evidence from East Asia's Financial Crisis (June 1999). *World Bank Policy Research Working paper No. 2133. Available at SSRN: http://ssrn.com/abstract=168530.*

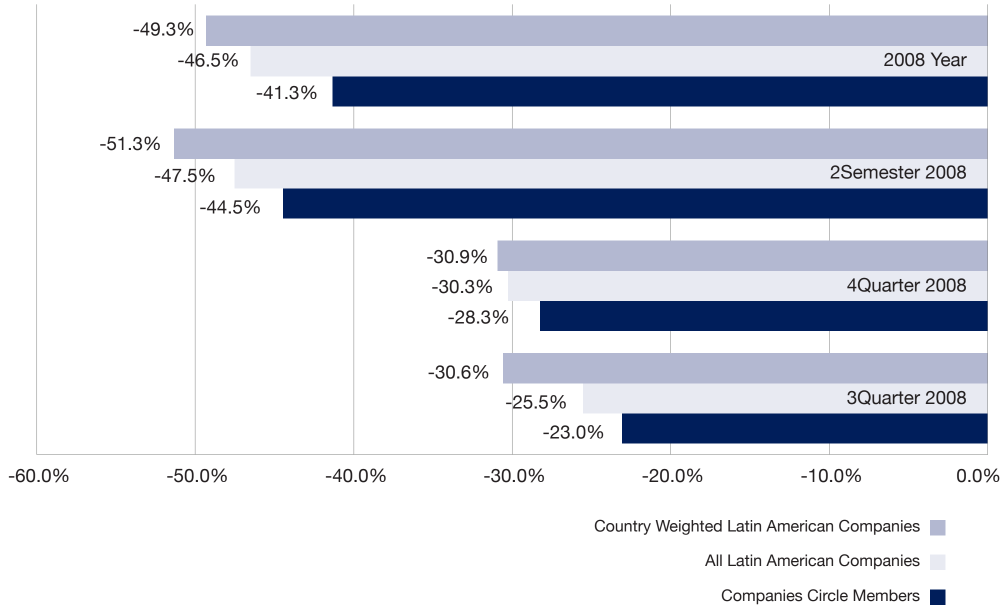
MITTON, T. (2002), A cross-firm analysis of the impact of corporate governance on the East Asian financial crisis. *Journal of Financial Economics*, pp. 64, 2, 215–241.

105 The analysis of the equally country-weighted portfolio is particularly important, since exchange rates fluctuated differently among Latin American companies and, since all results are presented in US dollars, the stocks of some Latin American companies may have struggled less in US dollar terms. For instance, the Chilean peso has struggled less than the Brazilian real, which tends to favor Chilean companies when evaluating their US dollar return. Since there is not yet a Circle member from Chile, this country is not represented in the country-weighted portfolio, avoiding the potential bias from different exchange rate reactions to the 2008 financial crisis.

106 However, since all portfolios display a high standard deviation of returns, these results were not statistically significant and do not allow for a clear-cut conclusion based exclusively on this analysis.

Chart 6c Stock Price Reaction to the Emergence of 2008 Global Financial Crisis

Stock market reaction after the emergence 2008 global financial crisis: comparison of stock returns against equally-weighed and country-weighted portfolios of 1,073 Latin American companies.



A second analysis redefined the comparison group and the time window, to provide a more accurate comparison.

- A matching control group consisting of 13 companies,[107] relatively similar to Circle members was created. For each Circle member, a peer company from the same country and industry was chosen. Firms were selected for their market capitalization and operational profitability similarities to the Circle member firms.[108] See Appendix 5 for the list of firms in this matching control group.
- The time window called "critical period" was redefined to cover the period from September 1, 2008, shortly before the collapse of Lehman Brothers and the announcement of problems with U.S. mortgage lenders Fannie Mae and Freddie Mac, to December 1, 2008, when National Bureau of Economic Research officially announced that the US was in recession.

The rationale here is that a comparison between a more equivalent peer group and within a more precise time window can distinguish more clearly the reactions to these external events. Chart 6d provides the mean and median results of both groups during this critical period. For comparison purposes, it also displays the mean and median returns of the official stock market indexes from the countries in which the firms are listed.[109]

[107] This portfolio of the Circle companies does not include Atlas (see Footnote 1) and Suzano Petroquímica since it was acquired in August 2007 by Petrobras (the Brazilian national oil company).

[108] Due to restrictions on the number of listed firms in some countries, it was not always possible to find a comparable listed company from the same industry of a Circle member. In such cases, similarly sized companies, from similar industry environments were selected.

[109] The stock market indexes used are: IBOVESPA in Brazil, IGVBL in Peru, IGBC in Colombia, and IPyC in Mexico. The results are weighted based on the number of companies from each country comprising the portfolio of Circle members.

Chart 6d Stock Price Reaction to the Emergence of Current Global Financial Crisis: Analysis of Critical Period, September 1, 2008–December 1, 2008

Stock market reaction after the emergence 2008 global financial crisis: comparison of stock returns against selected matched control group and average official stock market indexes from September 1 to December 1, 2008.

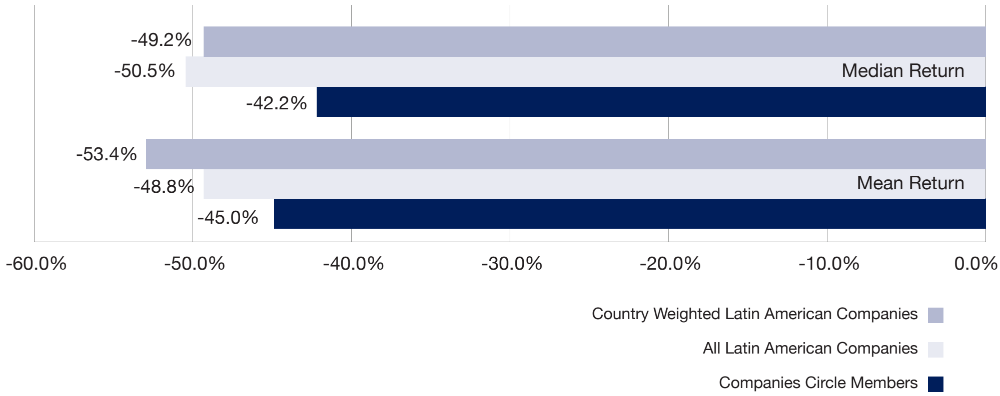


Chart 6d shows that the portfolio of Circle members declined slightly less than the matching control group and the average returns of the official stock market indexes. For instance, the median return for the Circle member portfolio was -42.2 percent during the period studied, compared to median drop of -50.5 percent from the matched control group portfolio.[110]

4.3 Corporate Attributes Affecting Better Stock Performance During an Economic Shock

The third analysis replicates the more complex methodology employed by previous academic research, particularly the study carried out by Baek, Kang and Park (2004) on the East Asian financial crisis of the 1990s. It uses a multiple statistical regression to evaluate the corporate attributes that may be associated with relatively better stock performance during an economic shock,[111] such as firms' size, profitability and debt ratio. In this analysis two variables related to corporate governance were included:

- Membership in the Companies Circle group
- The issuance of Level II or III ADRs[112]

Why look at these variables?

If there are positive and statistically significant results, this would be a clear sign that being part of the Circle group and/or cross-listing in a stricter market are factors that mitigate stock market deterioration during a period of sharp market distress, after filtering for other specific corporate attributes.

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[110] Since all portfolios display a high standard deviation of returns, these results were not statistically significant and do not allow for a clear-cut conclusion based exclusively on this analysis.

[111] The authors argue that the advantage of focusing on the crisis period is that it allows the unambiguous examination of the effect of corporate governance on firm value. The use of a given set of measures for corporate governance immediately before an external shock to explain changes in firm value can avoid any spurious causality caused by the endogeneity problem.

[112] Issuers of Level II and III ADRs are subject to the requirements of Sarbanes-Oxley Act, thus subject to stricter disclosure and internal control rules.

This analysis provides clear—and quite interesting—results.[113] In all model specifications and time windows employed, being a member of the Companies Circle group is associated with better stock performance, after filtering for other possible explanatory factors. The results are statistically significant, reinforcing the connection even more. The results remain consistent with the inclusion of the ADR variable, which also had a positive influence on stock price reaction.

Companies Circle members' stocks declined less than the stock of other firms in the region during this recent period of dramatic market stress.

5 Companies Circle Members Acknowledge Gains

While numbers and results provide bottom-line support for the benefits of better governance, Companies Circle members say that their efforts have produced a combination of hard, numbers-based gains, and soft, harder-to-quantify gains. Some of these benefits are detailed in Chapter 1. Here, members provide further insight on the advantages.

- An institutionalization process, with less dependence on specific people to run the business
- Higher investor community confidence
- Better access to credit terms, including long-term capital from development banks
- More recognition from stakeholders, including national and international institutions
- Greater confidence in carrying out mergers and acquisitions because of increased standards of transparency
- Substantial improvement of business processes, including internal controls and supervision of the decision-making process

Circle members point to significant, qualitative results from their corporate governance journeys.

Homex

For **Homex**, the early stages of the company's life included the same struggles that most family businesses face when starting a business. Today, the leader of this company, now Mexico's largest and most diversified homebuilder with operations in 33 cities and 21 states, points to specific gains from adopting better corporate governance practices. Here is how Eustaquio de Nicolás, Homex's Chairman of the Board, puts it:

> *"Ten years ago we began our institutionalization process. Our efforts and good governance practices have brought us numerous benefits internally at Homex and to our operations, and it has also helped us gain the investment community's confidence, along with that of our share-*

[113] Appendix 5 has the complete results, including the methodological details on the data and variables construction.

holders and suppliers, and the recognition of several national and international institutions."[114]

—Eustaquio de Nicolás, *Homex, Chairman of the Board*

Suzano

For the **Suzano Group**, corporate governance improvements have been elevated to a strategic level, and the efforts have paid off, with an impressive display of share appreciation.

"…The story of Suzano Group since 2003 is impressive in terms of value creation. It is obviously impossible to link it exclusively to corporate governance, but one can unquestionably say that it has been an essential element of the strategy.

Suzano Papel e Celulose shares traded by the end of 2007 at the level of R$ 29.00, compared to roughly R$ 4.24 in early 2003, reaching more than 580 percent appreciation, with a daily trading liquidity more than 100 times bigger. It financed a long-term expansion plan which doubled its pulp production capacity and has placed it as a relevant world player in the industry.

Suzano Petroquimica followed a similar path and evolved from an irrelevant holding position to a leadership position in its business segment, through a series of acquisitions, divestment of assets and a consistent capital markets plan. As a direct result of its recognized standards of corporate governance, market position and relevance of its assets, the company was sold to Petrobras in late 2007 for an equity value of R$ 2.7 billion. This translates into a share appreciation of about 600 percent

[114] DIRECTORSHIP (October 10, 2007), *http://www.directorship.com/homex-joins-governance-group.*

when compared to the value of the stock—R$ 1.53—in the beginning of 2002. Minority shareholders were protected with tag-along rights.

The implementation of the sale was extremely simplified and accelerated due to transparency and well known practices of the company. Due diligence was only performed after announcement. These issues have a hidden value which can only be correctly perceived as part of the overall successful transaction."

— **João Pinheiro Nogueira Batista,** former co-CEO, Suzano Petroquímica.

Last words. Companies Circle members' experience has taught them that the companies most successful in facing complex business challenges are the ones that have adopted a constant learning attitude, pursuing shareholder value creation, and taking into account the perspectives of all stakeholders.

The Companies Circle members invite you to embark on the governance journey. They hope that this book will serve as your travel guide as your company moves forward toward better corporate governance practices.

APPENDICES

Appendix 1: IFC Corporate Governance Progression Matrix [Listed Companies]

Attributes	LEVEL 1 Acceptable CG Practices	LEVEL 2 Extra Steps to Ensure Good CG	LEVEL 3 Major Contribution to Improving CG Nationally	LEVEL 4 Leadership
A. Commitment to Corporate Governance	› The basic formalities of corporate governance are in place. › The company has a written articulated set of policies or corporate governance code addressing, at a minimum, the rights and treatment of shareholders, the role of the board, and transparency and disclosure. › The company has a written code of ethics, approved by the board.	› The company has a designated officer responsible for ensuring compliance with the company's corporate governance policies and code and also a compliance officer for its code of ethics. › The company periodically discloses to shareholders its corporate governance code and practices, and the extent to which such practices conform to the country's voluntary code of best practices.	› The company meets all applicable recommendations of the country's voluntary code of best practices. › The board has a corporate governance committee.	› The company is publicly recognized as a national leader and among the global leaders in corporate governance.
B. Structure and Functioning of the Board Of Directors	› The board meets regularly, and deliberates independently of executive management. › Board members are given sufficient time and information for analysis and deliberation so they can exercise their duties of oversight and developing company direction and strategy. › The board includes directors who are neither executives of the company and its affiliates, nor a controlling shareholder.	› Two or more board members are independent of management and controlling shareholders. › The board has an audit committee with a majority of independent directors. › Board composition (competencies/skill mix) adequate for its oversight duties. Annual board and director evaluation conducted.	› The audit committee is composed entirely of independent directors. › A board committee composed entirely of independent directors is required to approve all material transactions with affiliates of the controlling shareholders, directors or management. › Other board specialized committees address special technical topics or potential conflicts of interest (e.g., nominations, compensation, risk). › The board is fully elected on an annual basis.	› The company's board is composed of a majority of independent directors.
C. Control Environment and Processes	› The company has in place an appropriate system of internal controls and internal audit that regularly interfaces with the external auditors and is accountable to the board.	› The company's financial statements are audited in accordance with International Standards on Auditing. › The board monitors the company's risk management and compliance policies and procedures.	› The company has a comprehensive compliance program that is annually reviewed.	› Internal controls, internal audit and external audit practices are in accordance with highest international standards.
D. Transparency and Disclosures	› Financial statements are prepared in accordance with an internationally recognized system of accounting, and audited by a recognized independent external auditing firm. › The company complies with all disclosure requirements under applicable laws, regulations and listing rules (fair disclosure). Investors and financial analysts are treated equally regarding information disclosure.	› The company publishes meaningful quarterly reports, containing segment reporting as well as results per share. Its practices go beyond local listing requirements. › The company prepares and presents all financial statements and reporting in accordance with IFRS or U.S. GAAP.	› The company discloses its code of ethics, the main provisions of its implementation program and the degree of compliance experienced in its annual report. › All disclosure and communications with shareholders are made available on the Internet in a timely fashion.	› Financial and non-financial disclosure practices are in accordance with highest international standards.
E. Treatment of Minority Shareholders	› Minority shareholders are provided with adequate notice and an agenda of all shareholders' meetings; and are permitted to participate and vote at shareholders' meetings. › All shareholders of the same class are treated equally with respect to voting rights, subscription rights and transfer rights. › Holders of all securities of the same type and class are treated equally with respect to information disclosure (fair disclosure). › Shareholders are provided with accurate and timely information regarding the number of shares of all classes held by controlling shareholders and their affiliates (ownership concentration).	› Effective representation of minority shareholders is provided by cumulative voting or similar mechanisms. › The company has clearly articulated and enforceable policies with respect to treatment of minority shareholders in changes of control. › The company has a well understood policy and practice of full and timely disclosure to shareholders of all material transactions with affiliates of the controlling shareholders, directors or management (conflicts of interest); and complete, timely and accurate disclosure is made of all material shareholder agreements. › The annual report discloses the principal risks to minority shareholders associated with the identity of the company's controlling shareholders; the degree of ownership concentration; cross-holdings among company affiliates; and any imbalances between the controlling shareholders' voting power and	› The company has effective shareholder voting mechanisms in place to protect minority shareholders against unfairly prejudiced actions of controlling shareholders when ownership is especially concentrated or controlling shareholders may have strong conflicts of interest (e.g., super-majority or "majority of minority" provisions).	› The company's history of equitable treatment of shareholders demonstrates consistent conformance with international market expectations.

Appendix 2: Organizations Involved In Corporate Governance[1]

ARGENTINA

Bolsa de Comercio de Buenos Aires
www.bcba.sba.com.ar

Cámara de Sociedades Anónimas
www.camsocanon.com

Centro para la Estabilidad Económica
www.cefargentina.org

Comisión Nacional de Valores Buenos Aires
www.cnv.gov.ar

Fondos Argentina
www.fondosargentina.org.ar

Fundación Empresarial para la Calidad y la Excelencia
www.fundece.org.ar

Instituto Argentino de Responsabilidad Social Empresarial
www.iarse.org

Instituto Argentino para el Gobierno de las Organizaciones
www.iago.org.ar

Mercado de valores de Buenos Aires
www.merval.sba.com.ar

BOLIVIA

Bolsa de Valores de Bolivia
www.bbv.com.bo

Superintendencia de Bancos y Entidades Financieras de Bolivia
www.sbef.gov.bo

BRAZIL

Associação de Investidores no Mercado de Capitais
www.amecbrasil.org.br

BM&FBOVESPA Bolsa de Valores, Mercadorias e Futuros
www.bmfbovespa.com.b

Centro de Estudos em Governança Corporativa
www.ceg.org.br

Comissão de Valores Mobiliários
www.cvm.gov.br

Instituto Brasileiro de Governança Corporativa
www.ibgc.org.br

CHILE

Centro de Gobierno Corporativo y Mercado de Capitales
www.cgcuchile.cl

Centro para el Gobierno de la Empresa
www.gobiernodelaempresa.cl

Superintendencia de Pensiones
www.spensiones.cl

Superintendencia Valores y Seguros
www.svs.cl

COLOMBIA

Asociación Colombiana de Administradoras de Fondos de Pensiones y Cesantías
www.asofondos.org.co

Asociación Nacional de Empresarios de Colombia
www.andi.com.co

[1] Note that this list is not intended to be exhaustive, it reflects organisations active in the area of corporate governance in the region.

Asociación Nacional de Fiduciarias
www.asofiduciarias.org.co

Asociación Nacional de Instituciones Financieras
www.anif.com.co

Auto-regulador del Mercado de Valores
www.amvcolombia.org.co

Bolsa de Valores de Colombia
www.bvc.com.co

Cámara de Comercio de Medellín
www.camaramedellin.com.co

Confederación Colombiana de Cámaras de Comercio
www.confecamaras.org.co

Superintendencia Financiera de Colombia
www.superfinanciera.gov.co

Superintendencia de Sociedades
www.supersociedades.gov.co

COSTA RICA

Bolsa de Valores de Costa Rica
www.bolsacr.com

Superintendencia General de Valores
www.sugeval.fi.cr

DOMINICAN REPUBLIC

Superintendencia de Valores de la República Dominicana
www.siv.gov.do

ECUADOR

Bolsa de valores de Quito
www.bolsadequito.com

Buen Gobierno Corporativo
www.gobiernocorporativo.com.ec

Superintendencia de Compañías
www.supercias.gov.ec

EL SALVADOR

Bolsa de Valores de El Salvador
www.bves.com.sv

Superintendencia de Valores
www.superval.gob.sv

MEXICO

Asociación de Bancos de México
www.abm.org.mx

Asociación Mexicana de Intermediarios Bursátiles
www.amib.com.mx

Bolsa Mexicana de Valores
www.bmv.com.mx

Centro de Excelencia en Gobierno Corporativo
www.uas.mx/cegc

Comisión Nacional Bancaria y de Valores
www.cnbv.gob.mx

Consejo Coordinador Empresarial
www.cce.org.mx

NICARAGUA

Bolsa de Valores de Nicaragua
www.bolsanic.com

Superintendencia de Bancos y Otras Instituciones Financieras
www.siboif.gob.ni

PANAMA

Asociación de Administradoras de Fondos de Pensión
www.asociacionafp.com.pe

Bolsa de valores de Panamá
www.panabolsa.com

Comisión Nacional de Valores
www.conaval.gob.pa

Instituto de Gobierno Coporativo Panamá
www.igc-panama.org

PERU

Bolsa de valores de Lima
www.bvl.com.pe

Comisión Nacional Supervisora Empresas y Valores
www.conasev.gob.pe

Procapitales
www.invertir.org.pe/procapitales.asp

USA

Center for International Private Enterprise
www.cipe.org

Council of the Americas
www.counciloftheamericas.org

Council of Institutional Investors
www.cii.org

Latin American Venture Capital Association
www.lavca.org

EStandards Forum (Financial Standards Foundation)
www.estandardsforum.org

VENEZUELA

Asociación Venezolana de Ejecutivos
www.ave.org.ve

Comisión Nacional de Valores
www.cnv.gov.ve

INTERNATIONAL

Corporación Andina de Fomento
www.caf.com

Global Corporate Governance Forum
www.gcgf.org

Ibero-American Federation of Exchanges
www.fiabnet.org

Instituto Iberoamericano de Mercados de Valores
www.iimv.org

InterAmerican Development Bank
www.iadb.org

International Corporate Governance Network
www.icgn.org

International Finance Corporation
www.ifc.org/corporategovernance

International Monetary Fund
www.imf.org

Organisation for Economic Co-operation and Development (OECD) Companies Circle
www.oecd.org/daf/companiescircle

OECD Latin American Roundtable on Corporate Governance
www.oecd.org/daf/corporate-affairs/roundtables

World Bank
www.worldbank.org

World Federation of Exchanges
www.world-exchanges.org

Appendix 3: Corporate Governance Benchmark Questionnaire[1]

Also available at: *www.oecd.org/daf/companiescircle*

1 The Benchmark Questionnaire was developed by Better Governance Consulting Services—a Brazilian-based company—with the support of IFC, OECD and GCGF.

Appendix 3: Corporate Governance Benchmark Questionnaire

Main Topic	Theme	#
Commitment to Corporate Governance	"One Share=One Vote"	1
		2
	Shareholders' Agreement	3
		4
	Internal Regulations	5
	Succession Planning	6
		7
	Annual General Meeting	8
		9
		10

This 100-point benchmarking questionnaire was designed to serve as a reference for self-evaluating corporate governance practices in listed companies. This Guide starts from the idea that an individual company's approach depends on its own unique set of circumstances but considers that there are similarities across companies perceived as valuable by the market agents. In this context, this self-assessment tool may facilitate identifying gaps and help improve decision-making. It can certainly serve to orient the discussion among companies' leaders.

Question	Yes	No	NA	Comments
Does the company only have common shares*?	O	O	O	
If the company has preferred shares*, are there voting rights on relevant questions, such as merger, split-up, purchase of relevant assets, approval of relevant contracts between companies in the same group and the like?	O	O	O	
In case the company has a shareholders' agreement, is it disclosed to all other shareholders?	O	O	O	
Does the shareholders' agreement bind or restrict any of the directors' voting rights?	O	O	O	
Does the company have a corporate governance code, policy, charter or guidelines that outline the governance practices of the company and, in particular, the role of the board?	O	O	O	
Does the company have a written policy on succession planning approved by the board —for, at minimum, the CEO position?	O	O	O	
Does the board have an updated and formal succession plan for the CEO?	O	O	O	
Are public notices posted for annual general meetings within the 30-day minimum time period?	O	O	O	
Are reports and other documents related to the agenda available to all shareholders on the date that the agenda is first posted?	O	O	O	
Does the company send a detailed proxy statement to its investors in advance of the shareholders' meeting?	O	O	O	

* See Glossary.

Main Topic	Theme	#
Commitment to Corporate Governance (continued)	Annual General Meeting (continued)	11
		12
		13
	Code of Conduct	14
		15
		16
Structure and Functioning of the Board of Directors and interface with management*	Chairman and CEO	17
		18
	Number of Members	19

Question	Yes	No	NA	Comments
Can shareholders vote by proxy* or other methods instead of personal attendance at shareholders' meetings?	O	O	O	
Is there a mechanism to permit nominations to the board by minority shareholders, such as cumulative voting*, block voting and the like?	O	O	O	
Is there a mechanism allowing minority shareholders to introduce proposals for discussion and vote at shareholders' meetings?	O	O	O	
Does the company have a code of conduct/ethics prepared by management and approved by its board of directors*?	O	O	O	
In the annual report, does the company disclose its code of ethics, the main provisions of its implementation program and its degree of compliance?	O	O	O	
Does the company have a designated officer or specific committee responsible for ensuring compliance with the company's corporate governance policies and code and with its code of ethics / conduct, reporting to its board of directors?	O	O	O	
Are the positions of chairman of the board and CEO occupied by different people?	O	O	O	
If the CEO is a formal member of the board, does the board hold regular executive sessions without the presence of executives?	O	O	O	
How many members sit on the company's board of directors?				

Main Topic	Theme	#
Structure and Functioning of the Board of Directors and interface with management* (continued)	Independent Directors	20
		21
		22
		23
		24

Question	Yes	No	NA	Comments
Does the board of directors have at least two board members who are independent of management and controlling shareholders?	O	O	O	
Is the board of directors comprised of a majority of independent members?	O	O	O	
Using the next column to insert numbers, detail the composition of the board of directors by type of director:				
a. independent directors				
b. outside directors representing controlling shareholders				
c. inside directors (executives of the company)				
Using the next column to insert numbers, describe the composition of the board of directors by type of director:				
a. directors appointed by controlling shareholders				
b. directors appointed by other shareholder groups				
c. directors appointed by employees				
d. other				
For family-controlled firms, describe the composition of the board of directors, Using the next column to insert numbers:				

Main Topic	Theme	#
Structure and Functioning of the Board of Directors and interface with management* (continued)	Independent (continued)	Directors
		25
	Term of Office	26
		27
		28
	Compensation	29
		30

Question	Yes	No	NA	Comments
a. directors from the controlling family				
b. directors representing the controlling family but not family members				
c. independent directors				
d. others				
If applicable, does any minority shareholder (such as an institutional investor) or block of them actually appoint any director in the board?				
Is the board fully elected on an annual or bi-annual basis?				
Is re-election permitted only after a formal performance evaluation of the directors?				
Is there a formal procedure for selection of new directors that prevents, or at least limits, the intervention of executives in this process?				
Does the company disclose the compensation and benefits of the management team (money, shares, total package and the like)?				
Does the company disclose the compensation and benefits of directors (money, shares, total package and the like)?				

Main Topic	Theme	#
Structure and Functioning of the Board of Directors and interface with management* (continued)	Compensation (continued)	31
	Budget of the Board and External Consultants	32
		33
	Committees	34
		35
		36
		37
		38
	Corporate Secretary	39

Question	Yes	No	NA	Comments
Does the company have a formal and transparent procedure in place to develop compensation policies and set compensation packages for management?	O	O	O	
Does the board of directors have its own budget approved by the shareholders?	O	O	O	
Are directors entitled to consult with outside professionals (lawyers, auditors, specialists, among others) paid by the company, to get specific advice on relevant matters?	O	O	O	
Does the board have committees comprised solely of directors, such as audit committees, compensation committees and governance committees?	O	O	O	
Do the committees have bylaws*/statutes that define their make-up and methods of operation?	O	O	O	
Are the committees chaired by independent directors?	O	O	O	
Do the bylaws prohibit executive/ senior manager membership on board committees?	O	O	O	
Is there a provision that a board committee comprised entirely of independent directors is required to approve all material transactions with affiliates of the controlling shareholders, directors or management?	O	O	O	
Does the company have a corporate secretary, whose responsibilities include the organization and functioning of the board of directors?	O	O	O	

Benchmark Questionnaire Appendix 3

Main Topic	Theme	#
Structure and Functioning of the Board of Directors and interface with management* (continued)	Corporate Secretary (continued)	40
	Conflict of Interest	41
		42
		43
		44
	Board Meetings	45
		46
		47
		48
	Evaluation of the Board and of Directors	49

Question	Yes	No	NA	Comments
Is acting/serving as corporate secretary the exclusive role of this employee?	O	O	O	
Do the bylaws prohibit loans to the controlling shareholder and related parties?	O	O	O	
In the last five years, has the company been investigated by a regulator or a stock exchange for treatment of shareholders?	O	O	O	
Are there formal rules on dealing with conflicts of interest within the board of directors and among members of the management team?	O	O	O	
Is there a written policy on negotiation and approval of related parties' transactions (RPTs)?	O	O	O	
Does the board meet with frequency: a maximum of once a month or a minimum of six times per year?	O	O	O	
Does the board have an annual meetings agenda?	O	O	O	
Is there an annual calendar of board meetings, detailing board topics for each meeting? Example: human resources will be reviewed at the February meeting; risk management will be reviewed at the May meeting.	O	O	O	
Do directors receive all documentation at least seven days in advance of the meeting?	O	O	O	
Does the board of directors formally evaluate its performance or formally review its effectiveness?	O	O	O	

Main Topic	Theme	#
Structure and Functioning of the Board of Directors and interface with management* (continued)	Evaluation of the Board and of Directors (continued)	50
		51
	Evaluation of Officers	52
		53
		54
		55
	Officer Nominations	56
Control Environment and Processes: Internal Control (IC), Internal Audit (IA) and External Audit (EA)	Internal Controls	57
		58
	Audit Committee	59
		60

Question	Yes	No	NA	Comments
Does the board of directors formally evaluate the individual performance of the directors?	○	○	○	
Does an independent third party conduct board and director evaluations?	○	○	○	
Does the board of directors conduct an annual formal evaluation of the CEO?	○	○	○	
Does an independent third party conduct the CEO evaluation?	○	○	○	
Do officers participate in self-evaluations and evaluate the effectiveness of their peers?	○	○	○	
Does the company use economic value added metrics in order to evaluate performance (ex. EVA, GVA, etc)	○	○	○	
Does the board approve the slate of officers nominated by the CEO?	○	○	○	
Does the company have an appropriate system of internal controls and internal audit that regularly interfaces with the external auditors and is accountable to the board?	○	○	○	
Does the board systematically monitor the company's risk management and compliance policies and procedures?	○	○	○	
Does the company have an audit committee?	○	○	○	
Is the audit committee made up of non-executive directors?	○	○	○	

Main Topic	Theme	#
Control Environment and Processes: Internal Control (IC), Internal Audit (IA) and External Audit (EA) (continued)	Audit Committee (continued)	61
		62
		63
		64
	Independent Auditing	65
		66
		67
		68
		69

Question	Yes	No	NA	Comments
Is the audit committee made up solely of independent directors?	○	○	○	
Does the audit committee regularly meet with the CEO, other officers, and auditors?	○	○	○	
Does the audit committee meet jointly and separately with the internal and external auditors?	○	○	○	
Does the audit committee evaluate the quality of information from subsidiaries, associated companies and third parties, which may impact on the consolidated financial statements?	○	○	○	
Does the board of directors/audit committee select the independent auditors and periodically formally evaluate its work?	○	○	○	
Are the auditors hired for a pre-established period, with the possibility of contract renewal following a formal and documented evaluation by the audit committee and/or board of directors?	○	○	○	
Does the company require rotation of audit firms?	○	○	○	
If the company doesn't require rotation of audit firms, does it require rotation of audit partner?	○	○	○	
Have the independent auditors reported any disagreement with the firm's financial statements in the past five years?	○	○	○	

Main Topic	Theme	#
Control Environment and Processes: Internal Control (IC), Internal Audit (IA) and External Audit (EA) (continued)	Independent Auditing (continued)	70
	Internal Auditing	71
		72
		73
	Other Fiscal Body	74
	Risk Management	75
		76
		77
Transparency and Disclosure	Disclosure	78

Question	Yes	No	NA	Comments
In case the independent auditor provides other professional services, are the audit committee and/or board of directors aware of all the services and fees?	O	O	O	
Does the internal audit unit report directly to the audit committee or to the board of directors?	O	O	O	
Does the internal audit unit have an audit charter that is approved by the audit committee or by the board?	O	O	O	
Are work plans and programs consistent with relevant local or international internal control frameworks and internal auditing standards?	O	O	O	
If the company does not have an audit committee, has it established a permanent and independent body with a similar function?	O	O	O	
Does the board periodically review the company's risk management systems?	O	O	O	
Do the board and management appropriately assess risks when planning new strategies, activities and products?	O	O	O	
In the annual report, does the company disclose the main risk factors that can impact the firms' cash flow?	O	O	O	
Does the annual report* set aside a specific chapter/section for the company's corporate governance practices that are in place or that will be implemented soon?	O	O	O	

Main Topic	Theme	#
Transparency and Disclosure (continued)	Disclosure **(continued)**	79
		80
		81
		82
		83
		84
		85
		86

Question	Yes	No	NA	Comments
Do the bylaws, annual report or other corporate document explain the company's corporate governance model?	O	O	O	
Does the company periodically disclose to shareholders its corporate governance code and practices, and the extent to which such practices conform to the country's voluntary code of best practices?	O	O	O	
Does the company disclose its code of ethics, the main provisions of its implementation program and the degree of compliance experienced in its annual report?	O	O	O	
Does the annual report provide information about the compensation of the directors and officers on an individual or aggregate basis?	O	O	O	
Does the company publish meaningful quarterly reports, containing segment reporting (reports by business units) as well as results per share?	O	O	O	
Are all disclosure and communications with shareholders made available on the Internet in a timely fashion?	O	O	O	
Does the company have a well-understood policy and practice of full and timely disclosure to shareholders of all material transactions with affiliates of the controlling shareholders, directors or management?	O	O	O	
Are shareholders provided with accurate and timely information on the Web site regarding the number of shares held by controlling shareholders and their affiliates (ownership concentration)?	O	O	O	

Main Topic	Theme	#
Transparency and Disclosure (continued)	Disclosure (continued)	87
		88
		89
	Use of insider information	90
		91
Treatment of Minority Shareholders	Corporate Control Acquisition	92
		93
		94
	Family Issues (if company is controlled by or founder or family)	95
		96

Question	Yes	No	NA	Comments
Does the annual report disclose the principal risks to minority shareholders associated with the identity of the company's controlling shareholders?	O	O	O	
Does the company prepare and present all financial statements and reporting in accordance with IFRS or U.S. GAAP?	O	O	O	
Is the audit committee briefed on the major off-balance sheet items and their potential impact if taken into account on the financial statements?	O	O	O	
Does the company have a policy for disclosure of relevant information to the market?	O	O	O	
Is there a policy for the securities negotiation, including periods when share trading by managers or any other people with privileged information is forbidden?	O	O	O	
Does the company grant tag-along rights (a mandatory bid rule in case of control transfer) for minority shareholders* beyond what is legally required?	O	O	O	
Does the company grant 100 percent tag-along to non-voted shares?	O	O	O	
Is there a policy that demands shareholders' approval before adopting a poison pill*?	O	O	O	
Do shareholders have a family board?	O	O	O	
Are the activities of the family board formalized in any document?	O	O	O	

Main Topic	Theme	#
Treatment of Minority Shareholders (continued)	Family Issues (continued)	97
		98
		99
		100

Question	Yes	No	NA	Comments
Are there clear rules for family members who work in the company?	○	○	○	
Is there a clear separation of roles between the family board and the board of directors?	○	○	○	
Is there a family office in place to manage family businesses, wealth and other issues?	○	○	○	
If there is no family office, are personal expenses, investments or any other personal services handled outside of the company?	○	○	○	

Appendix 4: Indicative Independent Director Definition [International Finance Corporation]

The purpose of identifying and appointing independent directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the Company, judgment that is not clouded by real or perceived conflicts of interest. IFC expects that in each case where a director is identified as "independent" the board of directors will affirmatively determine that such director meets the requirements established by the board and is otherwise free of material relations with the Company's management, controllers, or others that might reasonably be expected to interfere with the independent exercise of his/her best judgment for the exclusive interest of the Company. An indicative definition follows. In each case, the Company and IFC should consider changes tailored to those sorts of relationships that would impair a director's independence, taking into account the circumstances of the particular Company.

"Independent Director" means a Director who has no direct or indirect, material relationship with the Company other than membership on the Board and who:

a. is not, and has not been in the past five (5) years, employed by the Company or its Affiliates;
b. does not have, and has not had in the past five (5) years, a business relationship with the Company or its Affiliates (either directly or as a partner, shareholder (other than to the extent to which shares are held by such director pursuant to a requirement of Applicable Law in the Country relating to directors generally), director, officer or senior employee of a Person that has or had such a relationship);
c. is not affiliated with any non-profit organization that receives significant funding from the Company or its Affiliates;
d. does not receive and has not received any additional remuneration from the Company or its Affiliates other than his director's fee and such director's fee does not constitute a significant portion of his annual income;
e. does not participate in any share option [scheme]/[plan] or pension [scheme]/[plan] of the Company or any of its Affiliates;
f. is not employed as an executive officer of another company where any of the Company's executives serve on that company's board of directors;
g. is not, nor has been at any time during the past five (5) years, affiliated with or employed by a present or former auditor of the Company or any of its Affiliates;
h. does not hold a material interest in the Company or its Affiliates (either directly or as a partner, shareholder, director, officer or senior employee of a person that holds such an interest);
i. is not a member of the immediate family (and is not the executor, administrator or personal representative of any such Person who is deceased or legally incompetent) of any individual who would not meet any of the tests set out in (a) to (i) above (were he a director of the Company); and
j. has not served on the Board for more than [ten (10)] years.

For purposes of this definition "material interest" shall mean a direct or indirect ownership of voting shares representing at least [two percent (2%)] of the outstanding voting power or equity of the Company or any of its Affiliates.

Appendix 5: Methodology for Chapter 7 Analysis

This appendix details the methodology followed for all quantitative analyses presented in Chapter 7, which evaluates the general hypothesis that the adoption of good governance practices by Companies Circle members has positively influenced their overall performance. This is investigated by applying five different approaches. The data were collected from the Economatica® database, a system focused on Latin American companies widely used by market practitioners and academic researchers from the region. The system collects stock price and other corporate data directly from stock exchanges from the region, thus avoiding potential errors from data gathering. The peer group of Latin American companies represents all listed companies from the region covered by Economatica® and with active stocks as of March 2009.[1] To facilitate the comparisons, all data were collected in US dollars, converted by the official exchange rate as of the respective dates to which the data refer.[2] The methodological details are presented separately for each of the five approaches used in the chapter.

Approach 1 Comparison of selected operational indicators of the Companies Circle members against Latin American listed firms.

Related chart: Chart 1

Methodological details:

- Chart 1 compares mean results from the group of 14 Companies Circle members against the group of 1,078 Latin American listed companies.
- Data refer to the years 2005-2007.
- The numbers displayed in the chart refer to the three-year average of each group.
- To avoid any bias from extreme data, outliers from the Latin American group were excluded (2.5 percent highest and 2.5 percent lowest results).[3]

Approach 2 Evolution of the yearly economic profit (a simplified version of EVA®) of Companies Circle members against Latin American listed firms.

Related chart: Chart 2

Methodological details:

1 Not all Companies Circle members were used in all of the analyses. The Suzano Group is treated as two separate companies, Suzano Papel e Celulose and Suzano Petroquímica, since the two firms were listed separately on the stock exchange, although they participated in the Circle as a single company and both entities belonged to the same controlling group. Suzano Petroquímica was excluded from the 2008 data, following its 2007 acquisition by Petrobras. The analysis does not include Atlas, which was listed in Costa Rica before its 2008 acquisition by Mabe of Mexico, since the Economatica® database does not cover companies listed on the Costa Rican stock market.

2 For instance, when the market capitalization data of a Brazilian company are provided in relation to December 31, 1997, market capitalization is calculated in Brazilian Reals (BRL) at that time divided by the official BRL / USD exchange rate of December 31, 1997.

3 Outliers for Companies Circle members were not excluded because of the small sample size, which would potentially lead to greater distortions in the data. As a robustness test, all analyses were re-run excluding the highest and lowest performing members of the Companies Circle, obtaining similar overall results and conclusions. To further investigate the possible effect of outliers, median values for both groups were compared, in addition to mean values. In this case, the results even more clearly favored Companies Circle members.

- Chart 2 analyzes the evolution of the economic profit (through a proxy of EVA®) of the group of 14 Companies Circle members against the group of 1,078 Latin American listed companies from 1995 to 2007.
- Economatica® database supplied the financial data.
- Discount rates (cost of equity and cost of debt) were provided by Damodaran Online (www.stern.nyu.edu/~adamodar/).
- Emerging Market Bond Index (EMBI+)[4] data were provided by http://www.cbonds.info/.
- Tax rates for each country were provided by the KPMG Tax Rate Survey.
- The numbers in the chart refer to the average of all Companies Circle members and the average of all 1,078 Latin American companies provided by Economatica®.
- EVA® proxy was calculated as Net Income + Interest Expense * (1-Corporate Tax Rate)-WACC[5] * Invested Capital.
- Invested Capital was calculated as: Total Assets – Deferred Asset – Investments / holdings in affiliates / controlled firms – Long Term Liabilities + Short and Long Term Financial Debt + Short and Long Term Bonds Payable + Payable Debts with affiliates/controlled firms.
- WACC was estimated using book value of equity and book value of debt (short and long term, including bonds).
- Cost of debt and cost of equity were estimated as the industry's cost of equity and debt in the US (directly provided by Damodaran Online) plus country risk for the respective year (measured by the spread between each country's EMBI+ and US Treasury bonds).
- To avoid any bias from extreme data, outliers from the Latin American group were excluded (2.5 percent highest and lowest results).[6]

Approach 3 Comparison of selected market indicators of the Companies Circle members against Latin American listed firms.

Related chart: Chart 3

Methodological details:

- Chart 3 compares mean results from the group of 14 Companies Circle members against the group of 1,078 Latin American listed companies.
- Data refer to the years 2005-2007.
- The numbers presented on the chart refer to the three-year average of each group.
- To avoid any bias from extreme data, outliers from the Latin American group were excluded (2.5 percent highest and lowest results).[7]

Approach 4 Analysis of the impact of unexpected announcements of improvements in corporate governance practices on stock prices.

Related chart: Chart 4

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4 EMBI+ is a benchmark bond market index produced by investment bank J.P. Morgan. It tracks total returns for traded external debt instruments in the emerging markets. Since it indicates the interest rates paid by emerging countries on their external bonds, it is widely viewed as a proxy for measuring country risk.

5 WACC is the Weighted Average Cost of Capital. It is the overall cost of capital of a firm, based on both the costs of equity and debt capital. It is also understood as the rate, which a company is expected to pay to finance its assets, or the minimum return that a company must earn on existing asset-base to satisfy its creditors, owners, and other providers of capital. It is calculated using the following equation: $WACC = (E/(E+D) * ke) + (D/(E+D) * kd)(1 - Tc)$, where: E = Market value of the firm's equity; D = Market value of the firm's debt; ke = Cost of equity capital; kd = Cost of debt capital; and, Tc = corporate tax rate.

6 Similar to the explanation in Footnote 1, all analyses were re-run without excluding outliers, with overall results remaining qualitatively similar.

7 Similar to the explanation in Footnote 1, all analyses were re-run excluding the highest and lowest performing members of the Companies Circle as a robustness test, obtaining the same overall conclusions. We also have compared the median values for both groups, in addition to mean values, with results remaining similar.

Methodological details:

- Chart 4 presents aggregate results from the announcement of corporate governance improvements on Companies Circle members from 1998 to 2007.
- After exclusions due to lack of share liquidity or share trading during the event period, 12 different events from eight Companies Circle members were identified.
- Clear events were not identified for Atlas, Cemento Argos, Ferreyros, ISA, Marcopolo, NET and Ultrapar.
- A 16-day event window was established, between five days before publication (D-5) and ten days after publication (D+10).
- Abnormal returns were measured by the market model used in the calculation of expected returns.
- The estimation window included 50 trading days before the event window (from -55 to -6).
- The table below presents a summary of all events analyzed. The events were selected based on their potential for improvements in the corporate governance practices of Companies Circle members:

Table 1 Summary Table with All Events Analyzed

# News	Company	Country	Event Date	News Headline	Corporate Governance Rationale
1	Buenaventura	Peru	12/18/95	Buenaventura will Launch ADRs on NYSE	A cross-listing in an environment with higher corporate governance requirements indicates a clear commitment to more disclosure and better governance practices
2			4/1/02	Buenaventura Combines A and B Share Classes into One Type Only	A consolidation of share classes into a single class adopting the one-share one-vote rule is in line with the recommendations of most corporate governance codes
3	CCR Rodovias	Brazil	4/3/07	CCR Elects an Independent Director to its Board	An election of an independent director signals a move towards a board structure with independent oversight of management
4	CPFL Energia	Brazil	3/15/07	CPFL Simplifies Ownership Structure	A simplification of the ownership structure makes it easier for outside investors to understand the financial flows inside and outside the company
5	Embraer	Brazil	7/21/00	Embraer will have ADRs Issued on NYSE	See rationale for Event 1
6			1/13/06	Embraer Prepares for Ownership Restructuring and Conversion of Non-Voting Shares	See rationale for Event 2
7	Homex	Mexico	10/10/06	Homex Elects an Independent Director to its Board.	See rationale for Event 3
8	Natura	Brazil	2/28/05	Natura Announces a New Professional CEO Consistent with Its Succession Plan.	The planned succession of a CEO, especially one with no family ties with the controlling shareholders, can be seen as a signal of a merit-based and well-governed environment
9			12/2/05	Natura Joins the New BOVESPA Index—ISE	The selection for an index comprising companies with commitments to higher standards of governance and sustainability demonstrates a concrete effort of the company in this direction

# News	Company	Country	Event Date	News Headline	Corporate Governance Rationale
10	Suzano Papel e Celulose	Brazil	5/9/03	Suzano Announces a New Corporate Governance Model	The announcement of improvements to the composition and functioning of the board signals the company's strong efforts towards better governance practices
11			6/2/06	Suzano Announces a New CEO from Outside the Controlling Family	See rationale for Event 8
12	Suzano Petroquímica	Brazil	10/25/04	Suzano Petroquímica Joins BOVESPA's Corporate Governance Level 2	The migration to a listing segment with stricter corporate governance requirements demonstrates movement towards better governance practices

Approach 5 Analysis of annual stock returns of Companies Circle members against different benchmarks.

Related charts: Chart 5a, 5b, 5c, and 5d

Methodological details:

- Chart 5a presents the compound annual stock returns of the Companies Circle members against an equally-weighted portfolio with 1,073 Latin American companies.
- Chart 5b presents the compound annual stock returns of the Companies Circle members against an equally-weighted portfolio with all 113 Latin American companies with ADRs.
- Chart 5c presents the compound annual stock returns of the Companies Circle members against an equally-weighted portfolio with 1,073 Latin American companies, after adjusting for country weights.
- The annual return of each stock was computed by dividing the stock price on the last trading day of the year by the stock price on the first trading day of the given year. Stock prices are adjusted by the Economatica® system for all corporate actions (such as stock splits, capital adjustments, capital reductions, reversed splits) including cash dividends. This adjustment is made to avoid accounting for corporate actions that trigger abrupt changes in the stock price series and do not truly represent stock appreciation or depreciation.
- The portfolio return was computed as the average return of all firms with shares traded in each year.
- For the country0-weighted analysis (Chart 5c), the weight of each country in the Companies Circle portfolio of a given year was replicated in relation to two portfolios: all Latin American companies, and all companies with ADRs. For instance, for 2007, the return of the portfolio with all Latin American companies is calculated as follows: mean return of all Brazilian listed companies * weight of Brazilian companies (in this case 9/14, the weight of Brazilian companies in the Circle portfolio in 2007) + mean return of all Peruvian listed companies * weight of Peruvian companies (in this case 2/14) + mean return of all Colombian listed companies * weight of Colombian companies (in this case 2/14) + mean return of all Mexican listed companies * weight of Mexican companies (in this case 1/14).

Details on the risk-adjusted analysis:

Related charts: Chart 5d, 5e, and 5f

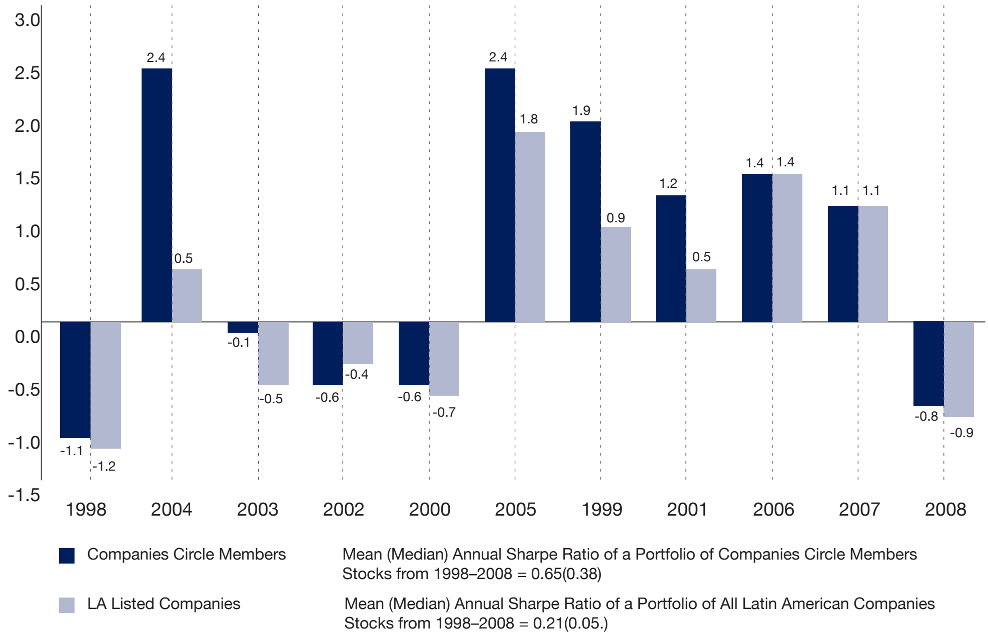
Methodological details:

- Charts 5d, 5e, and 5f present the results of risk-adjusted analysis, by comparing Sharpe Ratio, Treynor Ratio, and Jensen's alpha of Companies Circle members against a broad portfolio of 1,073 Latin American listed companies from 1998 to 2008.
- Three risk-adjusted measures that stand out in the literature and are widely used by market practitioners were employed: Sharpe Ratio, Treynor Ratio, and Jensen's Alpha.
- Sharpe Ratio (SR) is calculated by the following equation:
  SR = (portfolio return-risk-free rate) / portfolio volatility
  or,
  SR = (asset return-risk-free rate) / asset volatility

  Sharpe Ratio compares the asset return by discounting the risk-free rate where the asset is held (the systemic risk) and its volatility (the idiosyncratic risk). According to Investopedia[8]:

  Sharpe Ratio tells us whether a portfolio's returns are due to smart investment decisions or a result of excess risk. This measurement is very useful because although one portfolio or fund can reap higher returns than its peers, it is only a good investment if those higher returns do not come with too much additional risk. The greater a portfolio's SR, the better its risk-adjusted performance has been. A negative SR indicates that a risk-less asset would perform better than the security being analyzed.

Chart 5d Risk-adjusted analysis: Sharpe Ratio of Companies Circle members against a broad portfolio with 1,073 Latin American listed Companies from 1998 to 2008.



8 www.investopedia.com.

Treynor Ratio (TR) is calculated by the following equation:

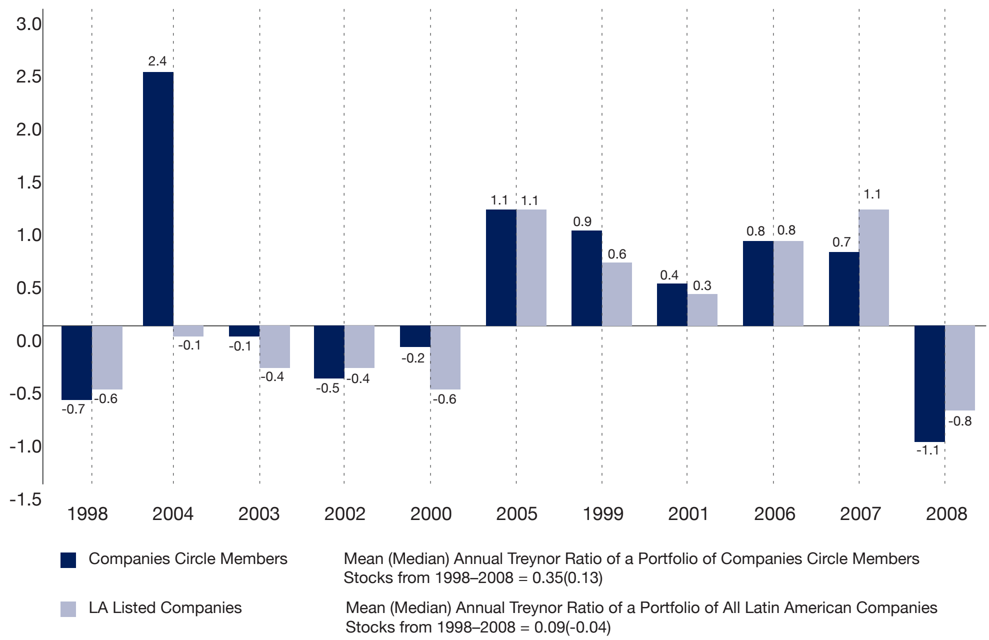
$$TR = \frac{portfolio\ return - risk\_free\ rate}{portfolio\ beta} = \frac{asset\ return - risk\_free\ rate}{asset\ beta}$$

TR = (portfolio return-risk-free rate) / portfolio beta

or,
TR = (asset return-risk-free rate) / asset beta

Treynor Ratio is similar to Sharpe Ratio. The difference is in the measure of the specific or idiosyncratic risk. Where Sharpe Ratio uses the annual stock volatility (standard deviation of returns), the Treynor Ratio uses the asset's beta, a measure of the correlation between asset and market returns.

Chart 5e Risk-adjusted analysis: Treynor Ratio of Companies Circle members against a broad portfolio with 1,073 Latin American listed Companies from 1998 to 2008.



Jensen's Alpha (J) is calculated by the following equation:

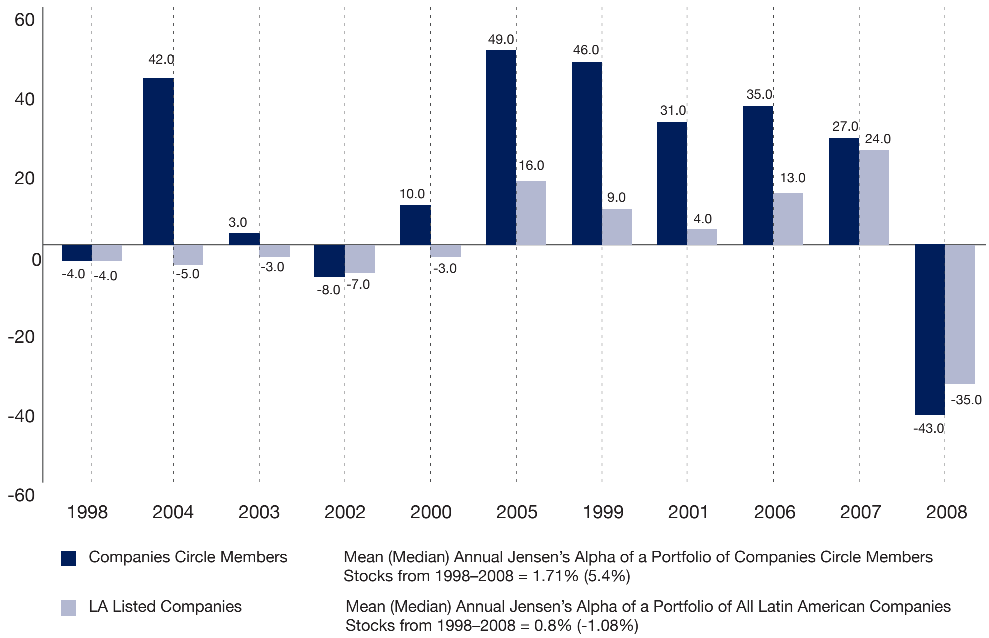
$$TR = \frac{portfolio\ return - risk\_free\ rate}{portfolio\ beta} = \frac{asset\ return - risk\_free\ rate}{asset\ beta}$$

J = asset return-[risk-free rate + asset beta * (benchmark return-risk-free rate)]

Jensen's Alpha tries to measure the "extra" return that an investor would earn by investing in a given asset. It is the difference between the asset return and the asset's expected return. The expected return is given by CAPM (Capital Asset Pricing Model), a widely-used asset-pricing method. According to Investopedia:

The basic idea is that to analyze the performance of an investment manager you must look not only at the overall return of a portfolio, but also at the risk of that portfolio. For example, if there are two mutual funds that both have a 12% return, a rational investor will want the fund that is less risky. Jensen's measure is one of the ways to help determine if a portfolio is earning the proper return for its level of risk. If the value is positive, then the portfolio is earning excess returns. In other words, a positive value for Jensen's alpha means a fund manager has "beat the market" with his or her stock picking skills.

Chart 5f Risk-adjusted analysis: Jensen's Alpha of Companies Circle members against a broad portfolio with 1,073 Latin American listed companies from 1998 to 2008.



To calculate the three risk-adjusted indicators, the following premises were adopted:

- Asset return: annual stock return, dividing stock prices at the end of a given year by their prices at the end of the previous year
- Risk-free rates: ten-year US Treasury bond average annual yield + average annual EMBI+ of the country where the firm is located (for instance, risk-free rate for a Brazilian company in 2005 is calculated by the average country risk during that year, proxied by EMBI+) plus the average annual yield of ten-year US Treasury bonds in 2005
- Asset volatility: standard deviation of annual asset returns
- Asset beta: based on the previous 36 months against the local stock market's overall index. For instance, the asset beta of a Brazilian company in 2005 is calculated by using stock returns from the last 36 months against IBOVESPA
- Market return: annual market return of the market index of the local stock exchange where the firm operates. For instance, for a Brazilian company in 2005 market return was calculated by IBOVESPA's annual return throughout 2005.

Section 4: Stock market reaction after the emergence of 2008 global financial crisis.

Related charts: Charts 6a, 6b, 6c, 6d, and Table 6e

Methodological details:

- Charts 6a and 6b compare mean results from the Companies Circle member group against a group of 1,073 Latin American listed companies.
- Data refer to the mean result of both groups at the end of 2008.
- The charts are constructed based on the same procedure as for Charts 1 and 3, which compare operational and market indicators for the 2005-2007 period. Similar to these charts, outliers from the Latin American group were excluded (2.5 percent highest and lowest results) to avoid any bias from extreme data.
- Charts 6c and 6d present the stock market reaction of Companies Circle members after the emergence of the 2008 global financial crisis, compared with three portfolios: 1,073 Latin American companies, a matched control group consisting of 13 companies relatively similar to Circle members,[9] and the official stock indices from the countries to which Circle members belong.
- Table 6e presents the results from several multiple Ordinary Least Squares (OLS) performed to explore the potential determinants of a low stock return during the 2008 financial crisis.
- To create the matched control group used as the benchmark group for Chart 6d: for each Circle member, a peer with the most market capitalization and operational profitability similarities from the same country and industry was selected. But because of restrictions on the number of listed firms in some countries, it was not always possible to find a comparable listed company from the same industry and/or size as the Circle member. In these cases, a company with comparable total revenues, operating in market environments similar to the Circle member was chosen. The table below shows the company matched with each Circle member:

Country	Circle Member	Matched Company
Peru	Buenaventura	Soc. Min. Cerro Verde
Brazil	CCR Rodovias	OHL
Colombia	Cementos Argos	Paz del Rio
Brazil	CPFL Energia	Cemig
Brazil	Embraer	TAM
Peru	Ferreyros S.A.A.	Alicorp SA
Mexico	Homex Desarr	Urbi Desarollos
Colombia	ISA Interconex Elec	Isagen SA
Brazil	Marcopolo	Randon Participações
Brazil	Natura	P. de Açucar - CBD
Brazil	NET	UOL
Brazil	Suzano Papel	VCP
Brazil	Ultrapar	Braskem

[9] Since Suzano Petroquímica was acquired in August 2007 by Petrobras (the Brazilian national oil company), it was not included in the Circle portfolio for the 2008 analysis.

- In Chart 6d, Companies Circle results are compared to the results from the official stock market indices of Circle members' home countries. The analysis used IBOVESPA of Brazil, IGVBL of Peru, IGBC of Colombia, and IPyC of Mexico.
- Table 6e replicates the more complex methodology used in prior academic research, particularly the study carried out by Baek, Kang and Park (2004) on the East Asia financial crisis of the 1990s. It involves a multiple statistical regression to identify the corporate attributes that are associated with comparatively better stock performance during an economic shock. Besides affiliation to Circle's group and issuance of level II or III ADRs,[10] the following attributes were collected and taken into consideration:

  - Firm size, measured by total operating revenues and by total assets
  - Firm profitability, measured by return on assets (ROA-earnings before interest and taxes divided by total assets) and return on equity (ROE-net income divided by equity book value)
  - Firm value, measured by price-to-book-value ratio (PBV-market price of the stock divided by its book value) and by total firm value (debt plus equity) divided by EBITDA (EVEBITDA)
  - Financial leverage, measured by the debt ratio (net financial debt of the company divided by the book value of its equity)
  - Firm short-term solvency, measured by cash ratio (ratio between all cash and cash equivalent assets and all current liabilities) and current ratio (current assets divided by current liabilities)
  - Industry, measured by 18 industry dummies based on the classification given by Economatica® database
  - Stock risk, measured by beta coefficient (covariance of the stock returns and the official stock market index returns, divided by the variance of the stock) and by stock volatility (annual standard deviation of stock returns)
  - Stock liquidity, measured by the liquidity ratio provided by Economatica® and by the company's free float
  - Ownership structure, measured by the concentration of voting rights held by the three main shareholders

- The sample for running the regressions presented in Chart 6c is comprised of 471 listed companies from Brazil, Peru, Colombia and Mexico, the countries with firms in the Companies Circle group.
- The table below shows the output from different regressions:

[10] These companies were chosen because issuers of ADRs 2 and 3 are subject to the requirements of Sarbanes-Oxley Act, thus subject to stricter disclosure and internal controls' rules.

Table 6e Multiple Ordinary Least Squares (OLS) Regression

OLS regression of stocks returns during the emergence of 2008 global financial crisis and corporate attributes, including affiliation to Companies Circle group.

	HPR Critical Period (9/1/ 08-12/1/08)			HPR Second Half, 2008 (7/1/08-12/31-08)		
Explanatory Variables	(1)	(2)	(3)	(1)	(2)	(3)
Circle Member	0.057** (2.02)	0.074** (2.31)	0.060* (1.77)	0.116*** (3.23)	0.105*** (2.64)	0.083** (2.07)
ADR23	-	-	0.051** (2.02)	-	-	0.083*** (2.83)
lnREV	-	-0.009** (-2.22)	-0.009** (-2.13)	-	-0.006** (-1.30)	-0.008** (-1.57)
ROA	-	0.215*** (2.73)	0.238*** (2.85)	-	0.260*** (2.76)	0.278*** (2.95)
PBV	-	-	-0.000 (-0.19)	-	-	-0.000 (-0.24)
Debt Ratio	-	-0.001 (0.31)	0.001 (0.26)	-	-0.003 (1.12)	-0.001 (0.18)
Cash Ratio	-	-0.007 (-1.61)	-0.005 (-1.06)	-	-0.004 (-0.69)	-0.001 (-0.29)
Dummies Industry	YES	YES	YES	YES	YES	YES
Intercept	-0.417*** (-5.47)	-0.373*** (-4.64)	-0.306*** (-3.07)	-0.503*** (-8.47)	-0.484*** (-4.95)	-0.477*** (-4.54)
R2	18.45%	25.41%	27.67%	18.31%	21.64%	23.87%
Sample (n)	444	354	338	453	366	350

› This table shows the results of multiple OLS regressions estimating the effects of selected corporate attributes (including affiliation to the Circle group) on stock returns throughout the emergence of the 2008 global financial crisis. The dependent variables are the holding period return (HPR, the total return of an investor holding the stocks) during two different time windows:

a. The so-called "Critical Period", from September 1, 2008, just before the collapse of Lehman Brothers and mortgage lenders Fannie Mae and Freddie Mac in the US, to December 1, 2008, when the National Bureau of Economic Research formally announced that the US was in recession
b. The entire second half of 2008

The explanatory variables include:

- Circle member is a dummy variable that takes the value of 1 if the company is a Companies Circle member, and zero otherwise
- ADR23 is a dummy variable that takes the value of 1 if the company trades levels II or III ADRs in the US markets, and zero otherwise
- lnREV is the natural logarithm of total operating revenues for 2007
- ROA is the return on assets for 2007 year, measured by earnings before interest and taxes divided by total assets
- PBV is the price-to-book value ratio at the end of 2007, measured by market price of the stock divided by its book value

- Debt ratio is the net financial debt of the company divided by the book value of its equity at the end of 2007
- Cash ratio is a measure of short term liquidity. It is calculated by the ratio between all cash and cash equivalent assets and all current liabilities at the end of 2007

Of note, 18 additional industry dummies were used in the regressions (classification given by Economatica® database) but were not included in the table due to space constraints. The sample is comprised of 471 listed companies from Brazil, Peru, Colombia and Mexico, the countries with companies represented in the Companies Circle group.

- The numbers (1), (2), and (3) refer to three different econometric models employed for analysis.
- p-values[11] are presented in parentheses.
- ***, **, and * denote statistical significance at the 1 percent, 5 percent, and 10 percent levels, respectively.
- All models were estimated with heteroscedasticity-robust standard errors, meaning that the methodology accounts for changes in the dispersion of the stocks returns of the sample companies along the period under analysis.[12]

- Overall, Chart 6e indicates that being a member of the Companies Circle group is a positive factor during periods of market distress, after filtering for other corporate attributes that may impact stock performance, such as industry, size, profitability, market value, debt, and solvency ratios. The results are always statistically significant, mostly at the 5 percent level. The economic significance of the coefficients indicate, for instance, that being a member of the Circle group is associated with a stock decrease that is 6 percent less than other company declines during the critical period from September 1 to December 1, 2008 (based on coefficient of Model 3, regressions against Holding Period Return[13] HPR Critical Period).
- In addition to the results from Chart 6e, several other model specifications were also tested for robustness, including:

  - Three other time windows: third quarter 2008, fourth quarter 2008, and all of 2008
  - 2006 data for all explanatory variables instead of data at the end of 2007
  - Other operational definitions for the explanatory variables, such as: enterprise value divided by EBITDA as a proxy of relative value instead of PBV, natural logarithm of total assets as a proxy of firm's size instead of total revenues; and, current ratio (current assets divided by current liabilities) as a proxy of short-term solvency instead of cash ratio. In all specifications, the results remained qualitatively the same. Finally, other potential explanatory variables were added, such as risk (beta and stock volatility), stock liquidity and ownership structure measures. Since these variables were not available for several firms, they significantly reduce the sample, thus weakening the statistical significance of some coefficients.

The results remain qualitatively the same, with no signs of changes in the overall conclusions.

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11 The p-value is associated with a statistic test, providing a convenient basis for drawing conclusions in hypothesis-testing applications. The smaller the p-value, the more strongly the test rejects the null hypothesis, that is, the hypothesis being tested. In the case analyzed in table 6e, a p-value of .05 or less rejects the null hypothesis "at the 5 percent level" that the explanatory variable is statistically different of zero. Usually, a p-value below 10 percent or 5 percent (to be more conservative) corroborates the view that a given explanatory variable (for instance, "membership in Circle group") is relevant for the outcome of the dependant variable (for instance, total stock return on the "critical period").

12 Heteroscedasticity is a situation in which the variance of the dependent variable varies across the data. It complicates the analysis, since OLS regressions are based on an assumption of equal variance.

13 The Holding Period Return (HPR) is the total return on a stock over the period during which it was held. It is calculated as the sum of income and capital gains of a given stock divided by the stock's price at the beginning of the period.

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Glossary

Accountability: The liability of a board of directors to shareholders and stakeholders for corporate performance and actions of the corporation. It is the concept of being responsible for all actions performed by the company's management and reporting this information to stakeholders.

Accounting Standards (also see Generally Accepted Accounting Principles, GAAP): A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by accounting standard-setters.

Acquisition: Gaining control of another corporation by stock purchase or exchange. An acquisition can be either hostile or friendly.

Agency Conflicts: Problems that can arise when a principal hires an agent to act on his behalf, giving the agent decision-making power.

Agency Costs: Costs incurred by an organization due to problems related to divergent management-shareholder objectives. The costs consist of two main sources: costs inherently associated with using an agent (e.g., the risk that agents will use organizational resources for their own benefit) and costs of techniques used to mitigate the problems associated with using an agent (e.g., the costs of producing financial statements or the use of stock options to align executive interests to shareholder interests).

Agency Theory: A theoretical framework used to describe the relationship of power and interest between someone—the principal—who hires a second party—the agent —to act on his behalf.

American Depositary Receipt (ADR): A security issued by a US bank in place of the foreign shares held in trust by that bank, thereby facilitating the trading of foreign shares in US markets.

Annual General Meeting (AGM) (Shareholders Meeting): A shareholders' gathering, usually held at the end of each fiscal year, at which shareholders and management discuss the previous year and the outlook for the future, directors are elected and other shareholder concerns are addressed. The AGM is the main opportunity for shareholders to put questions directly to the directors of the company and to exercise their voting and decision-making power.

Annual Report: A document issued annually by companies to their shareholders and stakeholders. Contains information on financial results and overall performance during the previous fiscal year and comments on future outlook.

Audit: An examination and verification of a company's financial and accounting records and supporting documents by a professional and independent external auditor.

Audit Committee: A committee constituted by the board of directors, typically charged with oversight of financial reporting and disclosure of both financial and non-financial information to stakeholders. The committee usually is responsible for selecting the company's audit firm to be approved by the board/shareholders.

Board of Directors: The collective group of individuals elected by the shareholders of a company to define vision and mission, set the strategy and oversee the management of the company. The board is charged with selecting the chief executive officer (CEO), defining the compensation package of officers and setting the long-term objectives of the firm.

Board Statutes (or board charter): Document that details the roles, responsibilities, and functioning of the board of directors and its committees.

By-Laws: A written document stating the rules of internal governance for a company as adopted by its board of directors or shareholders. They include topics such as election of directors, duties of officers, and how share transfers should be conducted.

Cash Flow Rights: The right to receive a specified portion of the company's profits. Cash flow rights for shareholders are determined by the company, based on the amount invested and the ownership of the specific class of shares.

Chairman/Chairperson of the Board: Highest-ranking director in a board of directors. The chairman is responsible for the elaboration of the board agenda and ensuring that the business is conducted in the interest of all shareholders.

Charter: An official document filed with the relevant Government agency in the country where the firm is incorporated. The charter outlines the corporation's purpose, powers under law, authorized classes of securities to be issued and the rights and liabilities of shareholders and directors.

Chief Executive Officer (CEO): The highest ranking officer of the company who reports to the board of directors. The CEO is tasked with short-term decisions, while the board of directors sets the company's long-term objectives.

Codes of Conduct/Ethics: Developed and adopted by organizations to define appropriate course of action on relevant and potentially delicate subjects.

Comisión Nacional Bancária y de Valores (CNBV): Mexico's Securities and Exchange Commission.

Comisión Nacional de Rescate de Valores (CNFV, or Conasev): Peru's Securities and Exchange Commission.

Comissão de Valores Mobiliários (CVM): Brazil's Securities and Exchange Commission.

Committees of the Board: Comprised by board members and established to assist the board in the analysis of specific subjects outside of regular board meetings.

Common Shares: Equity securities representing ownership in a corporation and providing the holders with voting rights and the right to a share in the company's residual earnings through dividends and/or capital appreciation.

Compliance: Agreeing to and abiding by rules and regulations. In general, compliance means conforming to a specification or policy (internal or external), standard or law that has been clearly defined.

Concentrated Ownership: A form of ownership in which a single shareholder (or a small group of shareholders, united by agreement) holds the majority of the company's voting shares.

Conflict of Interest: When a person or group is not independent regarding the topic under discussion and can influence or make decisions motivated by interests that may be different from those of the organization. Source: Código das Melhores Práticas de Governança Corporativa, IBGC, São Paulo, 2004. (Best Corporate Governance Practices' Code, published by IBGC – www.ibgc.org.br).

Control Block: The combined group of shares that represent the majority of a company's voting shares.

Controlled Companies: Firms in which an individual or a legal entity holds the majority of the voting rights.

Controlling Shareholders: Shareholders who own enough of the company's voting capital to control the composition of the board of directors—typically, this is 30 percent or more.

Cost of Capital: The expected rate of return the market requires to attract funding for a particular investment.

Cost of Debt: The cost of funds borrowed at current market rates.

Cost of Equity: The minimum rate of return a firm must offer the owners—as compensation for a delay in the return on the investment and for taking on the risk.

Cumulative Voting: A voting system that gives minority shareholders more power, by allowing them to cast all of their board of director votes for a single candidate, as opposed to regular or statutory voting, in which shareholders must vote for a different candidate for each available seat, or distribute their votes between a number of candidates.

Current Ratio (current assets / current liabilities): A measure of the short-term solvency of the firm—the ability to pay its short-term liabilities.

Daily Volume of Shares Traded: Volume of a given stock traded on the financial exchange each day.

Debt Ratio (current + long term financial debt / total assets): A measure of the long-term financial leverage of the firm.

Dividend Yield: The ratio of annualized dividends to the price of a share. Dividend yields are used widely to measure the income return of a share.

Disclosure: The public dissemination of material, market-influencing information in accordance with the requirements of a regulatory authority or in accordance with self-regulatory contracts. It is one of the main corporate governance principles.

Dispersed Ownership: An ownership structure in which there is no controlling block of shareholders—the stocks are pulverized and held by many shareholders, each of whom owns only a small percentage of shares, and none of whom can make decisions on corporate matters alone.

EBITDA Margin (EBITDA / operational revenues): A measure of profitability, indicating the margin of return for a company's Earnings Before Interest, Depreciation, and Amortization.

Economic Profit (Residual Profit): The profit earned after deductions for the cost of all capital invested. Economic profit equals operating profit after income tax minus cost of capital invested.

Economic Value Added (EVA)®: A financial measure that estimates the true economic profit after accounting corrections to deduct the opportunity cost of equity capital. The measure gets at the value created, above the required return, for the company's shareholders.

Executive Session: The portion of a board of directors' meeting that excludes the chief executive or any other executive.

Family Constitution: Guidelines for the rights and duties of family members who will share in the family's resources, mainly those associated with invested companies.

Family Council: Organized forum for family members to meet and discuss the current and future state of the family business. Members may, or may not, be directly involved in the day-to-day business operations. The family council is a way of building family unity and cohesiveness through a shared vision of the family's guiding principles and to separate the professional management of the firm from the personal family issues.

Family Office: A group of financial services designed for families with very large and complex sets of assets. The office protects constituents' interests on the basis of absolute independence through optimal management and comprehensive coordination of individual wealth components. The family office can be a tool to implement broader succession, leadership, and governance plans.

Family-Owned Businesses: Companies and projects, in which the controlling shareholders belong to the same family or group of families.

Fairness: Respect for the rights of all stakeholders. One of the corporate governance principles.

Fiscal Council: A corporate entity defined by Brazilian regulations. The council is charged with analyzing, reviewing, and approving the financial statements of the firm and comprised of members elected by the AGM. Regulations in other Latin America countries call for the establishment of similar entities as part of the governance system.

Free-Float: The portion of shares negotiated in the market, giving liquidity to shares. These shares are not held by large owners and are not stock held in the company's treasury.

Generally Accepted Accounting Principles (GAAP): Accounting rules, conventions and standards for US companies, established by the Financial Accounting Standards Board (FASB).

Hostile Takeover: The continued pursuit of a company acquisition after the target company's board rejects the offer; or a situation, in which the bidder makes an offer without prior notification of the target company's board.

Independent Auditors: Professionals from an external audit firm charged with overseeing the financial reports. They must have no personal interest in the financial statements, to render an unbiased judgment about the financial position of the firm.

Independent Director: Someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. See Appendix 4 for IFC Independent Director Definition.

Internal Audit: An appraisal of the financial health of company's operations by its own employees. The employees who carry out this function are called internal auditors.

Investor Relations: The corporate communications department of a company. This department specializes in information and disclosure management for public and private companies as they communicate with the investment community at large.

Lead Director: Independent director who should provide counterbalance to the power of the CEO, and who ensures that the supervisory responsibilities of the board are being accomplished. This position is generally assigned when one person holds both the CEO and chairman of the board positions.

Levels 1 and 2 – Special Corporate Governance Listing Segments of BOVESPA: Stock listing segments designed for shares issued by companies that voluntarily undertake better corporate governance practices and transparency requirements in additional to those already requested by Brazilian Law and CVM.

Liquidity Index: Created by stock markets to provide a broad indication of the traded volume percentage of volume for a given stock over the total volume traded by all stocks in the period.

Market Capitalization: The market value of the firm, defined by the number of outstanding stock multiplied by the market price of the stock.

Minority Shareholders: Those shareholders with minority stakes in a company controlled by a majority shareholder—usually less than a 5 percent stake.

Non-Voting Shares: Owners holding this share class do not commonly have voting rights at the AGM, except on some matters of highest importance. Usually, non-voting shareowners have preferential rights for receiving dividends.

Novo Mercado: A Brazilian listing segment designed for shares issued by companies that voluntarily abide by corporate governance practices and transparency requirements above what is required by Brazilian Law and CVM. To be listed on Novo Mercado, a company's capital stock must be represented only by common, voting shares.

OECD Principles of Corporate Governance: Corporate governance principles as defined by the Organisation for Economic Co-operation and Development.

Ownership Structure: The way in which company shares are distributed among shareholders.

Payout Index (dividend per share / earnings per share): A measure of the dividends paid by the firm based on its net earnings.

Price/Earnings (PE) Ratio: A measure of relative valuation of a firm, determined by the current share price divided by the projected earnings per share.

PBV: A measure of relative valuation of a firm, given by the current share price divided by the book value of shares.

Poison Pill: A device designed to prevent a hostile takeover by increasing the takeover cost, usually through the issuance of new preferred shares that carry severe redemption provisions.

Preferred Shares: Equity securities representing ownership in a corporation with preferential rights over others in regard to the payment of dividends and distribution of assets upon liquidation. Preferred stock usually does not carry voting rights.

Pulverized Ownership: An ownership structure in which there are no controlling shareholders.

Proxy: A ballot by which shareholders can submit their votes on proposed corporate actions without physically attending the annual meeting.

Related Parties: A subsidiary, a joint venture partner, a family member, or a company owned by or affiliated with, any of the related individuals.

Return on Equity (ROE): Net income / book value of equity. A measure of profitability, indicating the percentage return on capital invested by shareholders.

Risk Management: The process of analyzing a corporation's exposure to risk and determining optimal approaches to handling such exposure.

Sarbanes-Oxley Act: US legislation that tightened up corporate financial reporting, introduced a federal accounting supervision board and criminal liability for executives who are shown to have falsified accounts.

Securities Exchange Commission (SEC): The US agency empowered to regulate US financial markets to protect investors. All companies listed in US stock exchanges must comply with SEC rules and regulations.

Shareholders: Holders of stock issued by companies.

Shareholders Agreement: A written document governing the relations among shareholders and defining how the company will be managed and controlled. The agreement helps to align the objectives of controlling shareholders to safeguard common interests.

Shareholders Rights: The rights resulting from ownership of shares. There are two types: voting rights and cash flow rights.

Standard & Poors 500 Index (S&P500): An index of the 500 largest US companies, accounting for 85 percent of the dollar value of all stocks listed on the New York Stock Exchange (NYSE). The index provides a general measure of the overall performance of the US stock market.

Solvency Ratio (EBIT / Interest Expense): A measure of a firm's ability to pay its interest expenses in a given period.

Stakeholder: A person or organization that has a legitimate interest in a project or company. In a more general sense, it refers to suppliers, creditors, clients, employees, and the local community—all who are affected by the actions of the company.

Stock Multiple (stock ratios): Ratios designed to measure the claims of stockholders relative to earnings (cash flow per share) and equity (book value per share) of a firm.

Stock Option: An agreement, or privilege, which conveys the right to buy or sell a specific security or property at a specified price, by a specific date. The most common stock options are calls—the right to buy a specified quantity of a security at a set strike price at a time on or before expiration—and puts—the right to sell a specified quantity of a security at a set strike price at a time on or before expiration.

Stock Trading Policy: Terms and conditions that specify the conditions under which insiders—typically directors and officers of a company—can trade company shares.

Superintendencia Financiera de Colombia (Superfinanciera): Colombia's Securities and Exchange Commission.

Tag-Along Rights: If a majority shareholder sells his/her stake, minority holders have the right to participate and sell their stake under the same terms and conditions as the majority shareholder. This right protects minority shareholders and is a standard aspect of shareholders agreements.

Takeover: The purchase of a public company (the target) by another company (the acquirer or bidder).

Tobins' Q: A proxy for corporate market value commonly used in the academic literature. It is calculated as the market value of a firm's assets divided by the replacement value of the firm's assets. The indicator is named for James Tobin, the Yale University, Nobel Laureate economist who created it.

Transparency: The corporate governance principle of publishing and disclosing information relevant to stakeholders' interests.

VBM: 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.—

Voting Rights: The right to vote at shareholders meetings on issues of importance for the company.

Voting Shares: Shares that give the stockholder the right to vote on matters of corporate policy, including elections to the board of directors.

Weighted Average Cost of Capital (WACC): A measure of return on a potential investment. The measure includes cost of debt and equity, weighted by their relative contribution to overall costs in proportion to total funding and the cost of the related interest or dividend payments.

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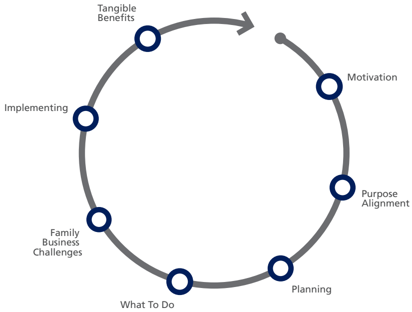

The Companies Circle is an elite group of Latin American firms that have demonstrated leadership in advocating governance improvements for companies throughout the region.This *Practical Guide to Corporate Governance: Experiences from the Latin American Companies Circle* sets out both the benefits of good governance and the different paths that these companies have taken in the Latin American context. It provides step-by-step guidance on different aspects of implementing governance improvements, as well as empirical data on how those who have adopted such practices have benefited. With evidence presented here that the benefits of good governance accrue not only in times of economic growth, but also during the most recent economic downturn, this book could not be more timely. At a time of increasing competition for financing and investor attention, this Guide will serve as a useful reminder that governance is of vital important for sustainable growth and the creation of value for all stakeholders.

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