Global and Regional Trends in Corporate Governance for 2016

Russell Reynolds Associates

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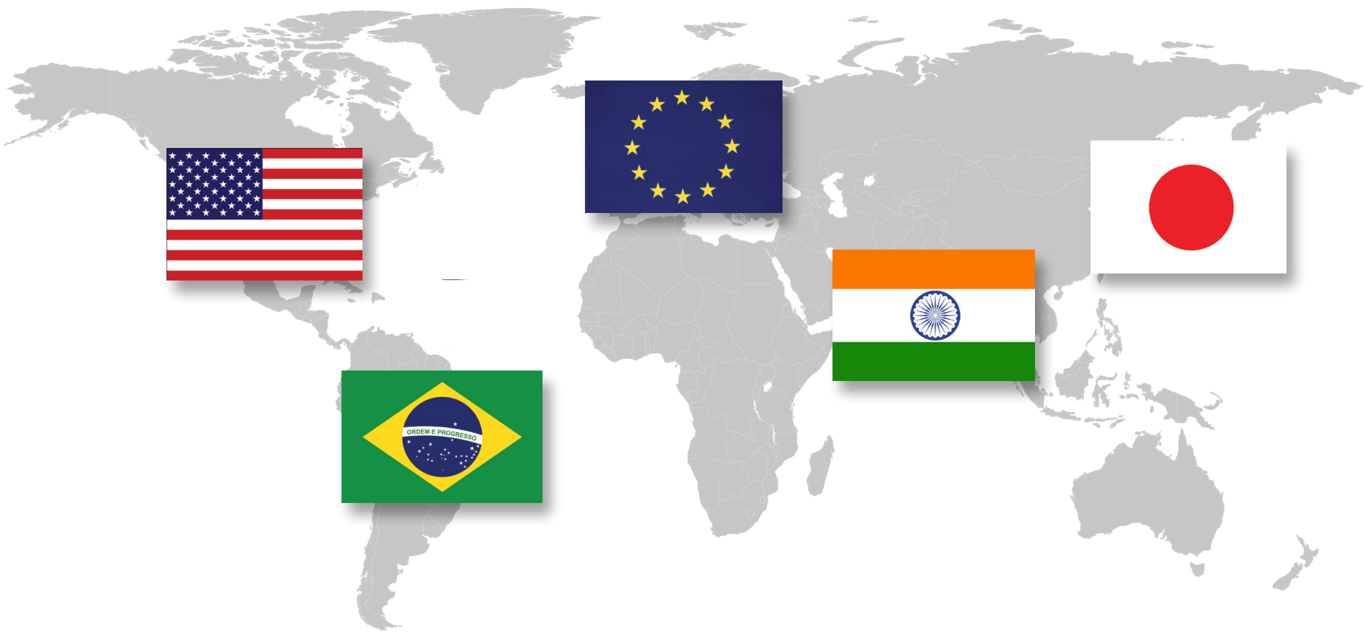
INTRODUCTION

Over the past few years, institutional investors have held boards increasingly accountable for company performance and have demanded greater transparency and engagement with directors. Investors' interest in more disclosure and interaction arises from their desire for improved performance, both on the part of boards and in terms of overall corporate governance.

The real question investors are asking is **How can we be sure we have a high-performing board in place?** Most of the governance reforms currently under discussion globally attempt to address that question. As investors drive change in governance and raise the bar for board quality, the role and job description of public company board directors is evolving—in many cases, rapidly.

During autumn 2015, Russell Reynolds Associates interviewed numerous governance executives and experts at some of the world's largest asset managers, pension funds, shareholder organizations, proxy advisory firms, and activist investors to learn what trends they see emerging for 2016. Additionally, we talked with our colleagues around the world who regularly advise on governance and effectiveness issues in their work in boardrooms.

The drivers of global and regional trends are myriad: scandals, the globalization of companies' investor bases, and stewardship issues are all factors. The institutional investors we spoke with want to "trust, but verify" the work of boards on behalf of the owners.



SCANDALS CREATE THE MOMENTUM FOR CHANGE IN COMPANIES

Successive waves of corporate scandal have reshaped the landscape of corporate governance around the world and continued to do so in 2015. Most observers believe that the Petrobras scandal in Brazil, Satyam and more recent incidents in India, Toshiba in Japan, and perhaps Volkswagen in Germany will have a substantial impact on corporate governance in those countries as legislators, regulators, and institutional shareholders demand more tools to promote accountability and transparency from companies and their boards of directors.

Around the world, large institutional investors continue to push hard for reforms that will enable them to elect independent non-executive directors who will constructively challenge management on strategy and hold executives accountable for performance (and pay them accordingly). When trust breaks down, activist investors (often hedge funds) move in to drive for change, often with institutional support.

GLOBALIZATION AND STEWARDSHIP PUT PRESSURE ON INVESTORS

Institutional investors are becoming more global in their operations and outlook as their international investment holdings and commensurate governance staffs have expanded. They want to see a core set of shareholder rights and responsibilities applied across all the markets in which they invest. Why, they ask, do they have proxy access, say on pay, and majority voting in some countries and not others? The 2015 corporate governance reforms in Japan were in part driven by US and other international asset managers who demanded higher levels of transparency and director independence.

Investors may be increasing their scrutiny of boards, but they are also under pressure themselves. In the United Kingdom, the financial crisis gave rise to a new investor stewardship code, and similar codes are being implemented in many other countries, including Japan and Malaysia. These codes attempt to ensure that investors fulfill their responsibilities to manage their investments and vote their shares transparently.

Additionally, over 1,300 institutional investors globally, representing US$59 trillion assets under management, have chosen to sign on to the UN Principals of Responsible Investing (UNPRI), which seek to integrate environment, social, and governance (ESG) concerns into investing objectives. Therefore we expect to see greater shareholder focus on environmental and social factors in 2016.

"TRUST, BUT VERIFY" IS A COMMON DEMAND

The wisdom conveyed by the old Russian proverb "trust, but verify" underlies the actions of institutional investors as they seek to monitor their investments in many thousands of public companies globally. Not even the largest investor has the resources to get to know the directors they are electing to oversee management on the investors' (or other stakeholders') behalf. Given the scale of their holdings, many investors will continue to rely on proxy advisory and research firms to identify companies with poor performance and governance red flags.

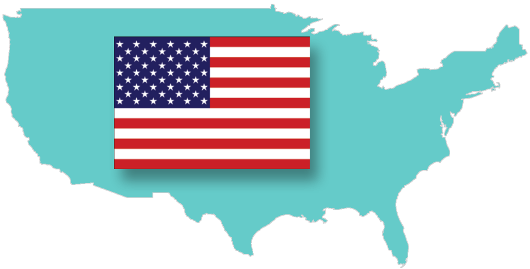
We expect investors will increase their demands that trust be accompanied by verification. Among the services that will be launched in 2016 to educate institutional investors on the skills and appropriateness of sitting public company directors is a database, established by one proxy advisory firm, that will provide investors with directors' backgrounds, expertise, and governance histories (such as votes against them at all their companies).

GLOBAL AND REGIONAL TRENDS IN CORPORATE GOVERNANCE IN 2016

Based on our interviews in each market and our collective insights, we believe in 2016 public companies globally will likely face the following trends:

- More focus on what makes a highly-effective board, with attention particularly being paid to independence, composition, diversity, and board leaders' roles
- More scrutiny of individual directors by investors, or their advisors, and increasing demand in many markets for internal and/or external board and director assessments to drive board performance
- More regulations, more revisions to corporate governance codes, and more rules on disclosure to drive increased transparency
- More shareholder engagement, particularly around ESG concerns, and more activist investor interventions when shareholder engagement is absent or trust breaks down

On the following pages, we explore in more detail the corporate governance trends in five key markets: the United States, Brazil, the European Union, Japan, and India.



UNITED STATES

In 2016, we expect boards will face an increasing call for accountability and disclosure from all classes of investors. Companies can expect demands from institutional investors to say more about strategy, environmental risk factors, board leadership roles, the process used to assess the board, and the details of board and CEO succession plans.

- There will be a focus on improving the quality of engagement between investors and boards, including through individual meetings between investors and board leaders. Some institutional investors have been disappointed by their encounters with directors, describing conversations as formulaic and scripted. The less authentic and more scripted the conversations, the more institutional investors questioned the quality and effectiveness of the board.
- Investors are pushing to have boards designate one or two directors as point people who will engage with investors meaningfully and appropriately about the board's role in strategy development, executive compensation, and CEO succession planning.
- Boards will start to look for more investor-savvy directors, whether from the investment community or from the ranks of current and former CEOs and CFOs who have dealt with investors regularly.
- At the same time, investors will be under pressure to improve the quality of their own engagement with boards—for example, by limiting "gotcha" questions.
- Some very large institutional investors will push harder for regular (every third year) external board assessments, following the British and French models.
- Board leaders, whether chairmen or lead directors, will see a new focus on their precise roles and responsibilities for board oversight of management (with requests that this be publically disclosed).
- Since the Department of Labor has clarified fiduciaries' ability to consider ESG factors, we expect to see more interest from all types of investors in disclosure of environmental and social risks.
- Proxy access will continue its march through company bylaws and shareholder proposals—even though it will prove very hard to utilize.
- Institutional Shareholder Services (ISS) and Glass Lewis have further restricted the number of boards on which directors can sit to stop "overboarding."
- The Securities and Exchange Commission will need to decide what it is going to do about the audit committee report and reveal outcomes from its disclosure effectiveness review, particularly for the 10-k, 10-q, and 8-k.

BRAZIL

The Petrobras scandal has led to a flurry of activity in corporate governance, much of which may bear fruit in 2016. That being said, many institutional investors are skeptical that proposed governance reforms will bring real changes in attitude and behavior and not mere check-the-box compliance activity.

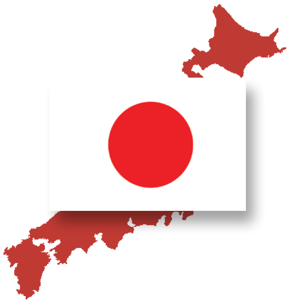
- As the recession continues, there will be additional focus on the effectiveness of boards and individual directors. Some observers predict an increase in activist investor interest in underperforming Brazilian companies.
- The country will likely have new laws governing state-owned enterprises (SOEs). Proposals include mandating more independent directors, a ban on ministers being directors, and requiring audit committees.
- In 2016, a new national governance code incorporating a comply-or-explain approach for listed companies may take effect. It is being developed by 11 capital markets organizations and is based on the Brazilian Institute of Corporate Governance (IBGC) code. If the code is endorsed by Brazil's Securities and Exchange Commission (CVM) as expected, listed companies will be subject to oversight and enforcement under it.
- The BM&FBOVESPA stock exchange has announced, and CVM has supported, a review of the "Novo Mercado" rules that will be updated in the first half of 2016.
- 2016 will also see more enforcement of existing rules and laws for directors of non-SOEs and the impact of already agreed-upon changes to proxy voting for all listed entities, including streamlined voting for international investors for the April 2016 proxy season.

EUROPEAN UNION

The response to the Volkswagen scandal is not yet clear. Questions have been raised regarding the independence and quality of nonexecutive board directors in Germany, which applies a dual board structure. However, we expect the trend toward more active (and activist) shareholders across Europe will continue.

- Gender and minority diversity for boards will remain a major focus of governmental and voluntary action across the EU, and we expect to see many more women named to boards across Europe in 2016 as national laws take full effect.
- The EU is already set to introduce a revised Shareholder Rights Directive in 2016 that will standardize practices such as advisory say-on-pay votes and the handling of related-party transactions. It will also require transparency of the voting and engagement policies of institutional investors.
- However, many institutional investors are more concerned about differential shareholder rights and protection for minority shareholders (for instance, in the double voting rights in France's Florange Law[1]).
- ESG disclosures and engagement with shareholders on ESG issues will likely increase across the EU in 2016. The 2014 EU directive on disclosure of nonfinancial and diversity information requires 6,000 large European companies to publish information on ESG factors.
- National regulators will continue to scrutinize audit committees and are required to issue a report on the performance of audit committees at least every three years. Member states have to implement the EU Audit Directive and Regulation by June 17, 2016.
- In France, there will be continued focus on board composition, particularly on requirements for employee representation (for certain large public companies) and gender diversity. Risk management will continue to be an important area of focus in 2016. France will also continue to see an increase in external board assessment, which the code recommends take place every three years.
- In Spain, there is a recommendation to increase the number of independent directors on boards and a continued focus on gender diversity. We expect to see a continued increase in external board evaluations to meet code requirements. The number of lead directors will also increase to comply with new regulations.

1. The Florange Law (2014) introduces an automatic attribution of double voting rights for shares held for at least two years, and companies now have to opt out if they wish to keep to one share, one vote.



JAPAN

The Olympus and Toshiba scandals, along with years of low economic growth, have led to the development of both corporate governance and stewardship codes and an amended Company Law that took effect in June 2015. Japan's Financial Service Agency made the code mandatory for listed companies, hoping to see a shift in attitudes and behaviors as well. All the changes are part of Prime Minister Shinzo Abe's efforts to stimulate economic growth and foreign investment. Foreign investment in Japan has increased from 5% of total market value in the 1970s to 32% in 2015.[2]

- Japan will start to feel the full impact of the governance changes in 2016. The initial focus in 2016 is likely to be on gender diversity, to be achieved through the appointment of independent directors. The government has set a gender diversity target of 30% by 2020 for all layers of management.
- The concept of board effectiveness itself is new to Japan. In a sign of change, boards are conducting self-evaluations, and a handful have begun to conduct external evaluations both to comply with requirements and to improve governance.
- Engagement is another new concept in Japan. The stewardship code may not lead to an increase in effective engagement between investors and companies, however, because of a cultural reluctance on the part of domestic and some international shareholders' corporate governance teams to challenge management over matters such as corporate strategy and shareholder returns.
- Observers do not predict any increase in activist investing in Japan given the continued prominence of cross-shareholdings.
- In a significant decision, Japan's Government Pension Investment Fund became a signatory of UNPRI in 2015, heralding a new interest in ESG matters.
- Ironically, there is a concern among shareholders that Japanese companies will spend more time and effort on cosmetic governance reforms and disclosures and less on financial returns to shareholders and growth. The government is reviewing progress, and the codes could be amended as early as the end of 2016.

2. Sumitomo Mitsui Trust Bank, "Corporate Governance Developments in Japan in 2015 and Beyond," October–November 2015.

INDIA

The 2013 Companies Act introduced major changes to corporate governance practices in India, including clearer definitions of director independence and related-party transactions, promotion of gender diversity on boards, and enhanced disclosure of the performance evaluations of the board, committees, and individual directors. The Securities Exchange Board of India (SEBI) also increased shareholder rights and responsibilities by introducing compulsory e-voting and requiring investors to disclose and explain their voting decisions.

- Boards are finding it difficult to deal with the numerous changes brought in by the Companies Act and the SEBI regulations. Companies and governance experts have been placing compliance steps into two categories: what must be done and what can be loosely followed. Director evaluation, for example, falls into the second category. Since neither the act nor SEBI prescribe a process, companies are developing their own, creating great inconsistency.
- The Companies Act also mandated corporate social responsibility for Indian companies, and there is likely to be increased focus on CSR strategies and spending.
- In 2015, the government set up panels to review the act and remove what it sees as undue burden on Indian businesses in areas such as intercompany loans, related-party transactions, and consolidated financial statements. The reviews are likely to lead to new legislation being proposed in 2016.
- Minority shareholders are taking advantage of the changes to defeat management proposals on compensation and other matters. New proxy advisory services have emerged to assist investors.
- Additionally in 2016, India intends to shift to International Financial Reporting Standards (IFRS), which may lead to volatility in company earnings and new tax demands. The switch will also mean that board directors and investors must study company and auditor accounting judgments more carefully.

AUTHORS

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