
Corporate Governance: Flattening the curve - what can the City and its advisers do to help avoid boom and bust in the future?

How businesses operate – strategically and ethically – has never been of greater importance to the City, or the UK as a whole. However, despite the financial crisis whirlwind, British companies still lead the world in effective governance structures.

But how did we get to where we are today? What does corporate governance in a post ‘Great Recession’ world mean? How do businesses define it? And most importantly, how crucially do the concept and execution of corporate governance principles affect what matters most to the City of London: its wider reputation in the global economic marketplace and its profitability?

As a major global law firm and close adviser to many of the City’s biggest names, we wanted to play our part in further sparking the debate and in particular, help uncover how businesses and their advisers can ensure they avoid repeating the economic and governance cycles of boom and bust.

Rather than put together a report based purely on our own opinions, we wanted to do something different. We wanted to reflect the views of some of the City’s key individuals from right

across the spectrum, in order to get a wider conglomeration of ideas about the ever-developing concept of governance principles for British business.

That’s why we decided to commission a report from two highly respected independent journalists, to explore these questions in greater detail. I was delighted to put my own thoughts on record and I was fascinated to read the opinions of some of the most respected names in the City. I hope you enjoy the report that Jonathan Ames and Robert Verkaik have written, and I’d welcome your views too.

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How did we get here?

It's been a long and bumpy road, but the UK's economy is now far healthier than at any time since the trauma of the worst global financial crisis in 80 years. And while the spectre of independence for Scotland had threatened to throw the recovery off course, the recent 'no' vote north of the border has calmed nerves. Forecasters have returned to predictions that the UK will see 3 per cent growth this year, a figure likely to be the envy of most of Britain's industrialised competitors.

But recent memories are still raw. The global financial crisis nearly spiralled out of control, western economies nosedived into recession faster than an albatross off the formerly booming Silicon Valley coast, and commentators were seriously contemplating the prospect of a depression that would rival the 1930s.

Much blame was heaped on corporate governance systems, with bosses across all business sectors coming under heightened and at times deeply uncomfortable scrutiny.

To be fair, however, it wasn't just the global economic crisis of 2008 that trained a harsh spotlight on business processes and ethics. Concerns over corporate governance regimes had been in the air some 16 years earlier in the UK when the scandal following the death of newspaper tycoon Robert Maxwell triggered the Cadbury Report in 1992.

Nearly a decade later Enron's catastrophic demise in the US spawned America's Sarbanes-Oxley Act 2002 and a fresh round of media and public attention on corporate governance. The global financial crisis some six years later only turned up the heat further.

Where are we today? What does corporate governance in a post-'Great Recession' world mean? How do businesses define it and most importantly, how vital does the City of London view the concept in relation to what matters most: its wider reputation in the global economic marketplace and the continuing growth and success of the British economy?

'Good corporate governance is fundamental to the success of the City,' says Sir Gerry Grimstone, chairman of Edinburgh-based insurance multi-national Standard Life as well as chairman of TheCityUK. 'Why would people come to the City as a market unless they felt they were getting top quality governance? Everyone's livelihood in the City depends on reputation. And the reputation of the City is driven fundamentally by behaviours, and what influences behaviours most is governance. So you can't separate good governance from the future fortunes of the City.'

And there are strong signs that lessons have been learnt. Last year's corporate governance review by London-based accountancy practice Grant Thornton found that 57 per cent of FTSE companies comply with the UK's corporate governance code, an increase of 6 per cent since 2010.

Building boards – experience v independence

High-profile corporate scandals have shaken the foundations of Wall Street and the City of London over the last 15 years, prompting governments and regulators to issue thousands of pages of guidance instructing companies on how they can best avoid history repeating itself.

But if the banking crisis has taught us anything, it is that written rules alone will never solve the shortcomings of business management.

A plethora of financial reporting and corporate governance codes has not stopped some highly complex City institutions from coming close to financial disaster. Explains Lord Green of Hurstpierpoint, a former UK government trade and investment minister and former group chairman of HSBC Holdings, who is also a Church of England minister: 'You can't run a business just on rules and regulations – while they are absolutely necessary, we all know that they are not sufficient. One of the lessons of the crisis is that it doesn't matter how many regulations you put in place, it doesn't matter how much detailed supervision both boards and the regulators bring to bear on the trading activity within the City – at the end of the day, unless the culture is right, those things aren't going to work.'

What we now know is that the levers of corporate governance are pulled from inside the company or financial organisation and it is at the boardroom level where the guidance must be translated into action.

Stewards of the business

Sean Connolly, senior partner at global law firm Mayer Brown, sums up the task facing companies just six years after the banking crisis: 'The board members are effectively the stewards of the business on behalf of the shareholders. They are responsible not just for driving the business forward in the short-term but ensuring its long-term sustainability.'

At the heart of this challenge, says Connolly, is the principle of independence: 'To achieve long-term sustainability, the board must be sufficiently independent to challenge the thinking of the executives and to offer constructive guidance as to the best way forward.'

The theme is taken up by Simon Lowe, chairman of Grant Thornton's governance institute. He says the UK's corporate governance code has identified independence as the key component of corporate accountability. 'The hard and fast rule is that in a FTSE 350 company, the code requires at least an equal balance or a majority of independent non-executives excluding the chairman. And that is a very good practice for a listed company.'

Experience shows

But not everybody agrees that independence is a panacea for bad corporate governance or that it will protect businesses from corporate disaster. Hans-Christoph Hirt, a qualified lawyer and executive director at the Equity Ownership Services section of Hermes Fund Managers, says: 'The financial crisis has shown that more independence doesn't always work very well. In advance of the crisis, there were a lot of independent directors on the boards of British banks, and look what happened.'

Hirt adds: 'The vogue has been that you need increasingly independent directors – people who are almost independent of everything in terms of the business. But you can never have a completely independent board. Arguably, businesses should strive to have half of their boards composed of independent directors.'

Hirt also says there is now a 'very healthy' focus on having directors on boards who properly understand the business. 'You don't want to have ignorant independence. It is safe to say that there was too much of a focus on independence immediately prior to the financial crisis, and too little focus on whether the directors actually understood what was going on.'

Sir Gerry brings recent and direct personal experience to the issue. 'In my boardrooms,' he says, 'I expect every single director to contribute on pretty much every topic under discussion. That doesn't mean they have to think in the same way – group-think can be very destructive to a board – but these people have to know what they are doing.'

'That doesn't mean in a financial services company they all have to be accountants or bankers – but they have to have the skill set to be able to unpick the sometimes very complex issues in front of them and make a useful contribution to the discussion.'

Likewise, Lowe points to first-hand experience to illustrate the dangers of having too much 'independence' at the top, recalling: 'We were involved with an oil company and we noticed that all the non-execs on the board were investment bankers. There wasn't a non-exec with apparent oil industry experience, which was a bit odd.'

But neither should companies appoint all their independent directors from the same sector. 'You have to strike a balance,' advises Lowe. 'In that oil company example, you wouldn't want all the non-execs to have an oil background because they won't know what is happening in the wider world of industry and they won't bring different experience. You'd hope that the execs would have deep experience, but if the non-execs are there to hold the execs to account and to provide a relevant challenge, then they need either to bring experience from a different sector so they can cross-refer, or they need to have the experience of having been in that sector.'

Shareholder input

In 2009, following the financial crisis, Lowe was asked to conduct a review that would feed into a report to the government on the banking crisis. 'In relation to the financial services industry and its boards, we looked at direct experience, indirect experience and other relevant experience between 2004 and 2009. The relevant experience among the non-execs available to the banks was probably the lowest of any sector. It went from 11 per cent to 23 per cent over that period, but it was still the lowest.'

And Lowe says that today the right relevant experience is still an issue for many boards. In addition, our expert commentators agree that one of the most important and often most neglected influences on corporate governance comes from outside the boardroom. Connolly maintains the role of the shareholders and institutional investors is 'absolutely critical.'

He explains: 'You've got a balance now between the obligation of the company, in particular the board of directors, adequately to communicate with its shareholder base, and the shareholder base properly to hold to account those responsible for conducting the affairs of the company. And they can only do that if they've got access to the appropriate information and they're able to properly interrogate it and to seek a dialogue with the board of directors.'

But Connolly stresses: 'The most important thing is for institutional investors to take a long-term view on sustainability of the business and to make sure they hold the directors to account. It's easy to be focused on quarterly returns, whereas what is needed is to ensure sustainability, to ensure the business model is robust and able to meet the challenges of the changing market place.'

Investors have clearly paid heed to the lessons of the financial crisis. But is there a danger that this enthusiasm to get on top of corporate governance can end in meddling with a company's sound business plan?

Hans-Christoph Hirt comments: 'There is currently a tendency for investors to go too deep inside a company and to have too many ideas about strategic issues or actually to try to get involved in the management of companies.' Instead he suggests: 'The principle focus should be on getting the directors right, getting the auditors in and ensuring there is a dialogue and then holding the directors to account for how they perform.'

Outside objectivity

At the same time chief executives and their teams should be confident that in-house experts will flag up corporate governance issues. Traditionally this has been the role of the auditor but more and more companies expect the legal department to take the lead – after all it is lawyers who drew up the original corporate governance codes.

'Perhaps historically there might have been a perception, though it perhaps wasn't a reality, that the audit department took the prime role,' says Connolly. 'Systemic risk occupies the minds of both

lawyer and auditor and it's important that they work together. Indeed if you take something like reputational risk, which so many businesses are now fully focusing on, it is often the case that it is the legal function that people approach first. But the most important thing is that those two groupings work closely together with the leadership team so that they're in a position properly to assess the risks to the overall enterprise.'

Pay day moans

Many of Britain's best known corporate brands have faced intense media scrutiny following revelations of apparently excessive director salaries.

Five years ago, Sir Fred Goodwin's infamous pension package at the now majority-government-owned Royal Bank of Scotland sparked national outrage. And since then there have been many other notable examples of bosses at top companies receiving what many critics describe as excessive pay packages.

More recent examples include Barclays, where the bonus pool was found to be three times as large as the total sum of dividends paid to shareholders, and at Sports Direct, where the board has repeatedly attempted to push through an enormous remuneration package for founder Mike Ashley despite shareholder opposition (Ashley eventually won shareholder approval in July 2014, but was forced to withdraw his participation in the company's bonus scheme in the face of pressure from the City).

So it is little surprise to learn that the Financial Reporting Council (FRC) has decided to focus the 2014 revisions of the UK corporate governance code on pay, with amendments applying to reporting years beginning or after 1 October 2014.

The revised code recognises the need for companies to attract and retain top quality directors with lucrative remuneration packages, but it stresses that 'a company should avoid paying [a director] more than is necessary' to 'run the company successfully.'

Mayer Brown's Sean Connolly maintains that the 'best remuneration structures seek not only to reward and capture the very best talent, but to make sure that their goals are linked to the long-term performance and sustainability of the business.'

Yet some commentators have accused remuneration committees of rewarding directors for bringing about short-term success at the expense of long-term performance. The 2014 revisions of

the code seek to redress this by placing ‘greater emphasis ... on ensuring that remuneration policies are designed with the long-term success of the company in mind.’

One way in which it hopes to do this is by including a controversial claw-back arrangement. The FRC proposes to add the following to provision D.1.1 of the code: ‘[Remuneration] schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which the committee considers it would be appropriate to do so.’ Such an arrangement will help align personal gain with the company’s long-term sustainability, and this certainly seems like a healthy step.

Simon Lowe, of Grant Thornton, says the FRC is taking the right steps to address excessive executive pay: ‘I am pretty confident and comfortable that they [the FRC] are doing what should be done. The current [code] review is focused on remuneration, but in the much longer term, and also risk management and control – those are positive steps because they are the areas that needed tightening. Not with rafts of guidance, but just with emphasis. And that’s where the FRC has been doing a good job.’

From the perspective of the Institute of Business Ethics, Philippa Foster Back points to the growth of more creative use of incentive packages. ‘Many more companies, as part of remuneration, particularly in at board level, have 20-25 per cent of the bonus calculation related to how the individuals have done their jobs. That is very judgemental and can be difficult to assess, but many companies are putting in performance measurement systems that articulate what is expected in terms of competencies in various categories and those are being monitored carefully. It is a new field, but it is certainly happening.’

Hans-Christoph Hirt at Hermes Fund Managers adopts a slightly different view, suggesting that while much attention is given to the issue of remuneration, not enough is allocated ‘to the main task of ensuring that the right people are sitting on the board.’

The majority of larger companies now have a remuneration committee. Nevertheless, studies have shown that companies with remuneration committees actually pay their directors more than those that don’t have them. Further concerns have been voiced over the true independence of non-executive directors.

Many are in fact executives themselves for other companies and as a result, they tend to share the same perspective as the executives

that they are tasked with monitoring. Since non-executive directors usually only work a couple of days in any given month, they are unlikely to be fully conversant with the company’s business. The revised FRC code is directed at tackling this problem head on.

One size doesn’t fit all – global models and monitoring mechanisms

There isn’t a modern executive worth a bonus payment who doesn’t weave into a conversation or a presentation the word ‘globalisation’ at least every other sentence. But regardless of the shrinking world of international commerce, there are still regional and national differences to corporate governance.

The one-tier board model involving executive directors and non-executive directors sitting together on the same level is the classic construction found in the UK and North America. But in continental Europe, most notably Germany but also in other smaller jurisdictions, various incarnations of a two-tier model exists. This structure involves an additional layer that separates the executive function.

Hans-Christoph Hirt of Hermes EOS maintains there is no perfect design to corporate governance. A German himself, he sees both strengths and weaknesses in the two-tier model. A key disadvantage, he says, is that the two boards do not operate closely enough. Looking at other jurisdictions, Hirt points out that in Sweden the common practice is for the biggest investors – usually a group of no more than five – to form the nomination committee for a board. On the other hand, in many parts of Asia there is no discussion whatsoever with investors. Board selection is left to those in the business, who generally select from an in-crowd of their friends and other acquaintances.

The UK sits somewhere in the middle, while most companies stick to the one-tier board model. ‘Some companies have fairly well developed outreach programmes,’ says Hirt, ‘that speak to their big institutional investors. And they would at least invite feedback.’

Regardless of the model, corporate governance systems are only as good as their monitoring mechanisms. Philippa Foster Back maintains the core equation is not complicated: ‘Make sure the values structure is simple and not over-complicated. Make sure the right checks and balances are in place. Make sure that certain things are consistent throughout the organisation, such as the speak-up policies, so anyone in the organisation can speak up if they think something is not right.’

And Mayer Brown's Sean Connolly suggests companies should employ both internal and external systems of checks. The in-house functions, says Connolly, is based on an intimate understanding of the business and the issues it faces. On the other hand, external advisors such as legal and accountancy practices provide a more objective assessment of corporate governance. 'The skill of the external professional adviser,' says Connolly, 'is to quickly master that situation and bring to bear not only an understanding of that business, but of other businesses of which it has advised in the same sector.'

And the increasing importance of technology presents both benefits and dangers, with Connolly maintaining that modern businesses are facing a 'perfect storm' of challenges. 'We're seeing an increasing reliance on technology and its evolution at a faster and faster pace,' he says.

'While at the same time, if you look at the make-up of senior leadership within FTSE 350 companies, their age profile and their experience profile is such that they're not always best equipped to be able to meet the challenges that are represented by technology. So the challenge for them is how do they provide adequate leadership to their business?'

As an example, Connolly points to the retail sector with its issues around data privacy and supply chain management. Likewise, the financial services field has experienced an array of issues emanating from the way in which technology has revolutionised that sector.

But Sir Gerry Grimstone counsels that a core element of good corporate governance is that it is 'rooted inside the company.' He warns: 'If it is done by outsiders coming in, it is less likely to be effective.'

Nonetheless, he acknowledges that for effective systems to take root, a company may need assistance from external advisers, not least because they bring experience of models used across business and industry.

In addition, external advice can be crucial at times of specific governance crisis. 'Sometimes you face a situation in which something has gone egregiously wrong requiring an extra level of scrutiny or governance that has to be brought in,' he explains. 'External advisers have an extremely important role to play in that process, not as policemen, but as very constructive challengers of the status quo.'

But, reiterates Sir Gerry: 'should corporate governance be handed over on a day-to-day basis to external advisers? Probably not.' A point supported by Lord Green, who is adamant that 'what we must not do is get into a position where boards are contracting out their basic decisions to external advisers. When that has happened you know something is wrong.'

Smaller fries – same issues

It would be easy to assume that only the chairmen and boards of multi-national household name businesses have sleepless nights over corporate governance issues. But, say the experts, good governance, applies equally farther down the business food chain, not least because private smaller and medium-sized enterprises harbour desires to grow and in some cases list publicly.

And, as Grant Thornton's Simon Lowe points out, corporate governance is of vital importance to all British public companies. 'The issues are hugely relevant,' he argues. 'The [UK] code applies to all listed companies. It softens a bit when you get below the FTSE 350, but the fundamentals of what the code is trying to do are as relevant to medium-sized companies as to big companies.'

Hans-Christoph Hirt from Hermes EOS agrees, stating simply: 'Smaller private companies need to look at corporate governance issues if they are considering listing. They need to signal good intentions to investors.' Indeed, so important is the issue at that level that Britain's Quoted Companies Alliance produces an annual 'Corporate Governance Code for Small and Mid-Size Quoted Companies.'

But, while in principle the issues apply across the board regardless of size, businesses have to retain a degree of realism about what can be achieved. According to Mayer Brown's Sean Connolly, there are three core differences between a major multinational and smaller and medium-sized enterprises when assessing governance needs.

'Firstly,' he says, 'is the issue of resources - they are more limited for the SMEs. Secondly access to the best talent to enable them to meet obligations surrounding corporate governance is a further issue. And finally, the ability to surround themselves with the best possible professional advisers remains an issue for a number of smaller businesses.'

Ultimately, maintains Simon Lowe, it is for companies to choose what they think is appropriate. 'You can understand in a smaller company - where the share-holder is the chairman or the chief executive -

that the separation of those to roles might not be appropriate. Whereas in bigger companies, where the share-holders are very independent from those running the business, you need that separation.'

Even so, some smaller companies might take the view that separating those roles would be beneficial as doing so is likely to bring an alternative point of view to issues around strategy and risk. 'It's not an issue of compliance,' comments Lowe, 'it's actually commercially beneficial to the business.'

He points out that some companies in the £150 million to £200 million turnover bracket have constituted audit committees. And while those bodies might be slimmed down versions of committees at larger companies – for example, not having three independent non-executives, but instead just an independent chairman – the rigour of having an independent audit committee brings about greater control and oversight. Says Lowe: 'It forces them to think about the issues that they should be thinking about.'

Playing by the code

Much of the corporate governance debate in the UK revolves around the evolution of a 24-year-old code. Currently overseen by the Financial Reporting Council – a hybrid independent body that covers both the UK and the Republic of Ireland – the corporate governance code had its genius in the Cadbury Report of 1992. Four years ago, the council issued a revamped version of the governance code along with a new stewardship code, with the latter aimed at institutional investors with UK voting rights.

Views of the original code are generally positive, with recent moves to simplify it being welcomed.

'Of course,' says Mayer Brown's Sean Connolly, 'the devil is always in the detail, and how you implement it and tailor it to meet your particular situation.' And Connolly describes the stewardship code as 'a step in the right direction,' with his key point regarding both documents is that businesses must not ignore them.

'It is absolutely critical to understand what your obligations are and the way in which you propose to address them,' he advises. 'It's important that all enterprises are on top of their obligations to the code. It is often indicative of problems within an enterprise if their ability to explain why they departed from the code doesn't bear scrutiny.'

Grant Thornton's Simon Lowe recalls that the immediate aftermath of the financial crisis saw a knee-jerk reaction from politicians around the world. However, now the dust is beginning to settle, he claims the most recent revisions to the UK code have been effective. 'They have tried to focus on greater accountability,' says Lowe, 'looking at the longer-term impact and the connection between strategy and output and reward.'

In the 2012 review, he says, energy was devoted to studying audit committees and the concept of greater disclosure to allow shareholders a better appreciation of business risks. But, importantly says Lowe, that review did not involve wholesale change, but more of a polishing and tightening of the code.

What remains to be done to the code? Nothing much, according to Lowe, who advises a relatively quiet period of reflection and digestion.

Future focus

When asked to reflect on what has been learnt about corporate governance and its implementation over the last 15 years, commentators suggest there are three clear messages.

The first is that the demands on directors – especially on non-executive directors – have been increasing and are not likely to abate. Second is the importance of culture. 'No amount of strategy and business modelling is sufficient if your corporate culture is not what it should be,' argues Lord Green. 'It is the responsibility of the board to ensure that good culture is consistently nurtured. There is no greater priority.'

Lastly is a growing recognition of the importance of diversity on boards. Time was when boards were dominated by middle-aged white males, many of whom had probably been at school and university together.

But, says Lord Green, gender and other diversity are now viewed as not being crucial simply because they are ethically right, but because they make sound business sense. 'It makes for a much better board,' he comments, continuing: 'It is surprising how much better the discussion is when you have a good gender mix.'

The ultimate question around corporate governance is: does business ethics pay? In other words, is good governance a cost that must be borne because it is ethically right to do so? Or does implementing good governance and ethical standards – and efficiently monitoring them – actually boost the bottom line?

The Institute of Business Ethics has researched the point, first at the beginning of the last boom in 2003, when it surveyed the FTSE 100, some of which at that stage had codes of ethics, while others did not. ‘We showed that better-managed companies were able to prove across four financial factors that they out-performed their peers,’ explains Philippa Foster Back.

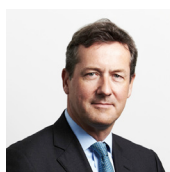
She goes on to say that a troubling issue for the wider public is whether business is simply paying lip service to corporate governance ideals. It’s easy to plaster office walls with ethical messages and ‘value-statements’, but doesn’t the experience of the consumer – and indeed, employees – often tell a different tale?

‘We suggest to companies that it is very important that they test that point through their employee questionnaires. We have a charter mark called investing in integrity, which asks those types of questions. If you ask the question: do you believe your

manager will take a shortcut to retain or win business? And you get back an answer that 25 per cent of your employees have said “yes” – that is telling a very powerful message.’

This is not fluffy feel-good psychology, but a crucial bottom-line issue. ‘The reputation of the City of London has been knocked around,’ says Foster Back of recent negative episodes and poor executive performance. ‘So these measures are very important. In today’s global environment, scandal can have a much bigger effect than it ever did before because of the scale, interconnectivity and complexity of the markets. The effort the City is taking to address these issues and maintain its reputation is very important.’

Jonathan Ames and Robert Veraik
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