EXPERIENCES FROM THE

REGIONAL CORPORATE GOVERNANCE ROUNDTABLES

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Experiences from the Regional Corporate Governance Roundtables

Foreword

The OECD issued its *Principles of Corporate Governance* in 1999, following a series of major financial crises. That same year, the OECD organised the first meetings of what were to become the Asian and Russian Corporate Governance Roundtables as a way of using the *Principles* as an instrument to assist not only OECD countries but also developing and emerging economies. By 2001, Corporate Governance Roundtables had also been established for Latin America, Eurasia and South East Europe. These Roundtables were developed in close co-operation with the World Bank Group.

The Roundtables have evolved over time into effective regional coalitions for promoting corporate governance reform. The Roundtables have involved participants from 38 non-OECD economies, as well as many OECD countries. They have supported national and regional reform initiatives, produced White Papers that serve as action plans for continuing reform, raised the visibility of corporate governance as a policy issue and, critically, provided a forum where experiences are exchanged and new ideas developed. The work of the Roundtables, carried out under the auspices of the OECD's Centre for Co-operation with Non-Members, is continuing through helping economies to develop policies to implement the recommendations of the White Papers. The Roundtables have also provided an essential input into the current assessment of the *OECD Principles*, which are now a globally-recognised reference point for efforts to strengthen corporate governance.

This report draws upon the experiences of the 25 meetings of the Roundtables, and identifies the major corporate governance problems faced by developing and emerging economies, as well as potential solutions.

The five Regional Roundtables would not have been possible without the hard work and generosity of many partners and co-hosts, including the Global Corporate Governance Forum (GCGF), which has provided essential financial support to all of the Roundtables, as well as for this report. Ultimately however it is the members of the Roundtables who deserve the greatest credit, and whose continuing involvement will be essential in the Roundtables' efforts to improve corporate governance in the years to come.

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SUMMARY AND MAIN CONCLUSIONS

1. The experiences of economic transition and all too frequent financial crises in developing and emerging market economies have confirmed that a weak institutional framework for corporate governance is incompatible with sustainable financial market development. Good corporate governance helps to bridge the gap between the interest of those that run a company and the shareholders that own it, increasing investor confidence and making it easier for companies to raise equity capital and finance investment. Good corporate governance also helps ensure that a company honours its legal commitments, and forms value-creating relations with stakeholders including employees and creditors.

2. To support corporate governance reform worldwide, the Organisation for Economic Co-operation and Development (OECD), in co-operation with the World Bank Group, established the Regional Corporate Governance Roundtables in five regions: Asia, Russia, Latin America, Eurasia and South East Europe. Over the last four years, the OECD has organised 25 meetings of the Regional Corporate Governance Roundtables in 18 countries. Thirty-eight non-member countries participate in the Roundtables, as do a majority of OECD member countries. The Roundtables also receive support from national and multilateral donors and the Global Corporate Governance Forum (GCGF).

3. The Roundtables have revealed a wide range of corporate governance challenges across the five regions. Many of the participating countries have taken the lead in proposing and implementing reforms to respond to these challenges. Nonetheless, substantial work remains. The regional Roundtables have produced regional corporate governance White Papers identifying priority areas for reform; the Roundtables will continue to assist in developing and implementing these reform priorities. Some of the main findings of the Roundtables are summarised below. One of the critical findings of the Roundtables is the usefulness of the *Principles* as a guide for multilateral policy dialogue. The meetings of the Roundtables confirmed the adaptability of the *Principles* as a reference for varying legal, economic, and cultural contexts.

4. **Main findings of the Regional Roundtables for Corporate Governance:** This report provides a broad overview of corporate governance across the participating countries based on the discussions and materials from the 25 Roundtable meetings, as well as additional sources. The experiences from the Roundtables are certainly diverse, with important differences across regions, across countries, and in many cases across companies in the same country. However, there are important commonalties as well.

5. ***Ownership and control:*** Across the five regions there is a high degree of concentrated ownership and control in individual companies or groups of companies. While concentrated ownership is seen as the solution to the fundamental principal agent problem of corporate governance, in the absence of a credible legal and regulatory framework, the expected gains may not be realised. This is especially true when control is also kept through control pyramids[1] and cross-holdings, which lead to a separation of ownership and control. This is often aggravated by insufficient information about ultimate ownership and the use of opaque control structures. The potential problems that arise from this combination of concentrated ownership, weak shareholder protection and insufficient disclosure has been highlighted in all the Regional

[1] See glossary, beginning page 88, for definitions of specialised terms.

Roundtables. The White Papers take a broad approach to these problems, emphasising improved transparency and disclosure and more effective boards as well as the protection of the rights and equitable treatment of shareholders.

6. When minority shareholder protection is inadequate, control shareholders may extract *private benefits* from the company at the cost of minority shareholders and other stakeholders. This potential conflict not only harms the minority shareholders, but also retards equity market development and limits companies' access to capital. A poor corporate governance environment will cost the controlling shareholder in other ways, making it difficult to manage succession and limiting the use of professional management.

7. While most controlling shareholders are individuals or families, in many cases the state remains a major owner of commercial assets in spite of extensive privatisation over the last ten years. Both continuing state ownership and the legacy of privatisation present significant corporate governance challenges, especially improving the governance of still state owned firms, and protecting shareholders in privatised ones. The latter is particularly relevant for Eurasia and South East Europe, where voucher privatisation has led to widespread ownership of thousands of privatised companies.

8. ***Enforcement:*** Perhaps the most widespread sentiment expressed in the Roundtables was the importance of improving the enforcement of existing law and regulations. While legal traditions vary across countries, there is a broad consensus that the structure, vigilance, and capacity of the regulatory and judicial framework forms an integral part of the corporate governance environment. All Roundtables have emphasised the need to "close the gap" between formal provisions and actual implementation.

9. Proper implementation and effective enforcement create an obvious challenge in countries where the required human and financial resources are in short supply. Overall, shareholder suits are rare or non-existent, and actions taken by regulators, stock exchanges and other relevant bodies not common or effective enough. Improved enforcement will require broad reform to improve the performance of the judiciary, empower securities regulators while preserving accountability, and increase the effectiveness of self-regulatory bodies. Enforcement and implementation will also be enhanced by a clear and functional apportion of powers among authorities and greater consistency, clarity and predictability in the legal and regulatory framework.

10. Some countries are also considering greater use private actions, such as derivative and class action lawsuits, to make it easier for shareholders to receive redress for violation of their rights. The Asian White Paper discusses ways to introduce responsible class actions. More generally, each White Paper discusses mechanisms that encourage market discipline and "self-enforcement" that can provide alternative options within a weak judicial and regulatory framework.

11. ***Shareholder rights and equitable treatment:*** Controlling shareholders can extract private benefits using a variety of techniques, ranging from excessive compensation and complex intra-group transactions to more direct forms of asset stripping and other kinds of tunnelling. While these methods may sometimes be legal under a narrow interpretation of the law, in most cases they involve subverting the rights of shareholders. In some countries, improving shareholder protection requires better protection for basic rights, like the right to secure share ownership, or to attend and participate in the general shareholders meeting. In other countries, these basic rights are protected, but full shareholder participation still faces various barriers. These barriers are particularly high for shareholders, including foreign ones, who would like to vote by proxy.

12. Perhaps the most important problem that follows directly from the combination of concentrated ownership, opaque control structures, weak minority protection, and insufficient disclosure is the frequent

abuse of related party transactions. Curbing such transactions is one of the top priorities for corporate governance reform across the five Roundtables and a prerequisite for attracting minority investors on a long-term basis.

13. The Roundtables discussed in some depth the appropriate regime for related party and major transactions, including changes in capital structure, changes in corporate control, and de-listing. The White Papers call for significant improvements in disclosure of related party transactions--particularly the identity of related parties and their material interests in the transaction--and recommend direct shareholder approval of major transactions, expanded appraisal rights, pre-emptive rights with respect to capital increases, and other mechanisms that can deter abusive transactions. Similarly, the Roundtables also discussed the board's role in these transactions, and the importance of having independent directors in a position where they can evaluate, and when necessary block, related party transactions.

14. In many cases, shareholders could do more to improve the governance of the companies they own. Some controlling shareholders have experienced large increases in valuation, and personal wealth, after taking voluntary steps to improve corporate governance. Institutions that allow controlling shareholders to credibly signal improved governance, such as special stock market tiers, can facilitate this process. As pension funds, foreign funds, and other institutional investors gain prominence in many markets, they should also take a more prominent role in the governance of the companies they invest in.

15. ***The role of the board:*** Roundtable participants described most company boards as either passive "rubber stamps" or as active participants in furthering the interest of the controlling shareholder. While countries have established the legal duties of board members to exercise care and act in the interest of the company and *all* shareholders in each region--though the origin and exact nature of board members' duties vary across countries--these legal requirements often have limited influence on actual board practices. This reflects both concentrated ownership and the limitations of the judicial system: many countries participating in the Roundtables have never had a successful suit filed by minority shareholders against a board member.

16. One widespread response is mandating greater use of "independent" board members. The definition of "independence" varies, but increasingly includes independence from the controlling shareholder. For these mandates to be truly effective however the pool of potential independent directors capable of exercising informed and objective judgment needs to expand substantially in a number of countries. In some countries, institutions offering board member training and "chartering" have emerged to facilitate this process.

17. Beyond requiring that certain board members be independent, there has been great interest in having a certain portion of the board chosen more directly by minority shareholders. The main method suggested for doing this is cumulative voting. While some Roundtable participants supported the possibility for cumulative voting, others were concerned that it reinforced the notion that board members should act as "delegates" of certain groups. Board members that represent all shareholders, not just some, will better serve minority shareholders. As the role of independent board members increases, greater attention will also have to be paid to their nomination, remuneration, and replacement.

18. Board structures vary across countries, with some countries having unitary board, others having supervisory boards, and many having complementary company organs, such as boards of "statutory auditors". Outside of committees of executive board members, specialised committees are only widely used in some of the countries that participated in the Roundtables. However, the Roundtables supported much greater use of committees, especially audit committees, that can allow independent board members to oversee the company's disclosure practices and evaluate the fairness of related party transactions.

Experiences from the Regional Corporate Governance Roundtables

19. ***The role of stakeholders:*** Employees in many countries have various mechanisms to participate in the governance of the company, including works councils and in some cases direct share ownership. These mechanisms do not always work as hoped, however, and employees may face abusive actions by corporate insiders that impede their ability to communicate illegal operations or seek effective redress for violations of their rights. It has been pointed out that these abuses are not only in breach of existing laws, but may also deprive shareholders of important information about corporate operations and possible future liabilities. On the other hand, some participants noted that employees do not always use the powers they have as constructively as they could.

20. Debt is frequently the principal source of external finance for companies, but poor protection of creditors' rights and an aversion to exercise bankruptcy procedures limit access to "hard" loans in many countries. Effectively restricting abusive transactions and enforcing loan agreements would enhance creditor protection and facilitate access to commercial loans, with the overall goal to not only protect creditor rights after insolvency but also to facilitate risk management and ensure fair treatment of creditors before insolvency.

21. In many of the Roundtable countries, banks have ownership structures and other features that may create conflicts of interest and undermine their own governance, as well as their role as monitors; for example the same owner may control both the lending bank and the borrowing company. This can lead to related lending that harms the banks' minority shareholders, in many cases its depositors, and ultimately the government, which usually offers explicit or implicit deposit insurance. When borrowing companies do not own banks, the state frequently does, which presents its own challenges in terms of soft lending. Fortunately, banking reform is advanced in many countries. As emphasised in the Asian White Paper, better corporate governance will require continuing this reform, and improving both monitoring by banks and the governance of banks.

22. Some Roundtable participants emphasised that companies need to improve their relations with a range of stakeholders, not just employees and creditors. This is not just an issue of legal compliance. In the face of increased concern for human rights and environmental conditions in developing and emerging market economies, companies in these markets have increasingly found that responsible behaviour is a prerequisite for attracting foreign investment and contracts.

23. ***Transparency and disclosure:*** International Accounting Standards now influence disclosure requirements in all regions covered by the Roundtables. Regulators and exchanges are also introducing improved standards for auditing and non-financial disclosure based on international standards. These standards offer the promise of improved transparency, and all Roundtables have pointed to the need to close the sometimes-substantial gap between these accepted standards and actual practices. Closing this gap will require both better oversight of and self-regulation by the accounting and auditing professions, increased training efforts for accountants, auditors and regulators, and more involvement of stock exchanges in ensuring listed companies meet minimum disclosure requirements. Most importantly, it will require companies to take the steps needed to implement these standards.

24. As a direct consequence of the efforts to curb abusive related party transactions, the Roundtables have called for improvements in the disclosure of ownership to encompass beneficial owners. This is a complex matter, which raises the question of where the responsibility for such disclosure should rest. It has nevertheless been seen as essential, since abusive related party transactions can only be identified if the disclosure of the transaction can be matched with information about the ultimate ownership of the involved parties. In some of the Roundtables, the OECD template on *Options for Obtaining Beneficial Ownership and Control Information* has been used as a reference for improving the availability of such information.

Experiences from the Regional Corporate Governance Roundtables

BACKGROUND

25. Over the last decade, corporate governance has risen in prominence as the role of the private sector has increased around the world and greater international financial integration has led to greater competition for, and risk from, internationally mobile capital flows. In developing and emerging market economies, the experiences of economic transition and all too frequent financial crises have confirmed that a weak institutional framework for corporate governance is incompatible with sustainable financial market development. Significant academic work has also confirmed strong links between financial development, economic performance, and corporate governance[2].

26. By bridging the gap between the interest of those that run a company and the shareholders that own it, good corporate governance increases investor confidence and makes it easier for companies to raise equity capital and finance investment[3]. Corporate governance also involves the company's relationship to the wider community. Good corporate governance helps ensure that a company honours its legal commitments, and forms value-creating relations with stakeholders like employees and creditors.

27. The Organisation for Economic Co-operation and Development (OECD) established the Regional Corporate Governance Roundtables to support corporate governance reform worldwide, especially in non-OECD member countries. The Roundtables are organised in co-operation with the World Bank and regional partners, and guided by the *OECD Principles of Corporate Governance* (*Principles*). The Roundtables also receive support from national and multilateral donors and the Global Corporate Governance Forum (GCGF)--founded by the OECD and the World Bank in 2001. The role of the OECD throughout has been to facilitate participants' access to the global policy dialogue to strengthen corporate governance and to set a framework for the sharing of experiences across and within countries.

28. The first meeting of the Asian Corporate Governance Roundtable was held in March 1999, shortly before the release of the *Principles*. Roundtables for Russia, Latin America, Eurasia and South East Europe followed[4]. Over the last four years, the OECD has organised 25 meetings of the Regional Corporate Governance Roundtables in 18 countries. Thirty eight non-member countries participate in the Roundtables, as do most OECD member countries. There are large differences in economic and financial development across these countries (Table 1). Underlying institutional differences are also substantial, with participant countries having diverse histories, legal traditions, and until relatively recently very different economic systems.

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[2] For an overview of the literature on financial development and growth, see Levine (1997). For a discussion and evidence on the links between corporate governance, finance and growth, see La Porta et al (1997), Pistor (2000), and Boxes 2 and 10 of this paper.

[3] The danger posed by the separation of ownership from control has been known since at least the time of Adam Smith. Standard references include Adolf Berle and Gardnier Means (1932) and Michael Jensen and William Meckling (1976).

[4] The Global Corporate Governance Forum has supported informal Corporate Governance meetings in the Middle East, Africa and the Caribbean. See www.gcgf.org for more information.

Table 1. Non-member countries participating in the Roundtables

	Population *Millions*	Per Capita Income *Purchasing power parity gross national income per person in US dollars*	Market Capitalisation of Listed Companies *%GDP*	Credit to Commercial Sector *%GDP*
ASIAN ROUNDTABLE				
Bangladesh	133.3	1,700	2.5	24.7
China	1,271.9	4,400	53.8	124.6
Chinese Taipei	22.6	18,000	NA	NA
Hong Kong, China	6.7	26,000	383.5	158.8
India	1,032.3	2,540	32.4	29.0
Indonesia	209	3,100	17.6	21.6
Malaysia	23.8	9,300	129.9	140.6
Pakistan	141.4	2,100	10.8	29.8
Philippines	77.0	4,200	69.0	44.5
Singapore	4.1	24,000	164.8	109.4
Sri Lanka	18.7	3,700	6.6	28.9
Thailand	61.1	6,900	24.4	108.7
Vietnam	79.5	2,250	NA	35.3
EURASIAN ROUNDTABLE				
Armenia	3.0	3,800	1.4	10.6
Azerbijan	8.1	3,500	0.1	5.9
Georgia	5.2	3,100	NA	8.8
Kazakhstan	14.8	6,300	7.3	11.2
Kyrgyz Republic	4.9	2,800	NA	4.2
Moldova	4.2	2,500	3.2	12.7
Mongolia	2.4	1,840	3.5	8.1
Ukraine	49.1	4,500	6.0	11.2
Uzbekistan	25.0	2,500	0.4	NA
LATIN AMERICAN ROUNDTABLE				
Argentina	37.4	10,200	58.4	23.9
Bolivia				
Brazil	172.6	7,600	38.1	35.1
Chile	15.4	10,000	80.0	63.5
Colombia	43.0	6,500	11.5	26.9
El Salvador	6.4	4,700	15.5	41.6
Peru	26.1	4,800	25.9	19.8
Uruguay	3.3	7,800	0.8	51.2
Venezuela	24.6	5,500	6.7	12.0
RUSSIAN ROUNDTABLE				
Russia	144.7	9,300	15.0	11.9
SOUTH EAST EUROPE ROUNDTABLE				
Albania	3.1	4,500	NA	4.5
Bosnia-Herzegovina	4.0	1,900	NA	NA
Bulgaria	7.9	6,600	4.9	11.9
Croatia	4.3	8,800	14.4	36.2
FYR of Macedonia	2.0	5,000	0.2	17.8
Romania	22.4	7,400	2.8	7.2
Serbia and Montenegro	10.6	2,370	NA	0.1

Per capita income 2002 estimate, all other figures for 2001.
Source: World Bank, CIA World Fact Book, Chinese Taipei National Statistics.

29. Roundtable participants have included ministers and deputy ministers, the chairs of over a dozen securities commissions, members of parliament and other policy makers and regulators; as well as the leaders of stock exchanges, trade unions, professional bodies of accountants and auditors, investor

associations and institutes of directors. Importantly, chief executive officers, board members, company secretaries, and other representatives of publicly held companies also participated in the meetings, as did prominent academics and experts on corporate governance. These included participants from both member and non-member countries. Also joining officials from the World Bank and the OECD Secretariat were officials from a number of other multilateral organisations (Table 2).

Table 2. Examples of regional and international bodies participating in the Roundtables

Asian Development Bank (ADB),
European Bank for Reconstruction and Development (EBRD)
European Commission
Global Corporate Governance Forum (GCGF)
Inter-American Development Bank (IADB)
International Accounting Standards Committee (IASC)
International Federation of Accountants (IFAC)
International Finance Corporation (IFC),
International Organisation of Securities Commissions (IOSCO)
United Nations Conference on Trade and Development (UNCTAD)
World Bank
OECD Business and Industry Advisory Committee (BIAC)
OECD Secretariat
OECD Steering Group for Corporate Governance.
OECD Trade Union Advisory Committee (TUAC)

30. The meetings of the Roundtables have helped to establish and sustain regional coalitions for improved corporate governance. Since their creation, awareness of the importance and the substance of corporate governance have advanced significantly in each region. The reforms originating in many participating countries reflect this. The Roundtables have contributed to a number of these local reform initiatives, ranging from investor protection legislation in Romania to the establishment of the Novo Mercado in Brazil.

31. During the course of their meetings, the Regional Roundtables have produced regional corporate governance White Papers. The conclusions and recommendations in the White Papers have been developed and agreed by the participants on a consensus basis. Guided by the *Principles*, these White Papers have identified common policy objectives and concrete recommendations for reform. The White Papers will, together with other regional and national initiatives, serve as a blueprint for reform and the Roundtables' future work. The Russian Roundtable completed its White Paper in April of 2002 and the South East Europe and Asian White Papers where completed in the first half of this year. The Latin American Roundtable will complete its White Paper by the end of 2003[5].

32. The Roundtables have generated a wealth of background information and identified aspects of corporate governance that are of particular importance to developing and emerging economies. In addition to the White Papers themselves, this material is available on the Corporate Affairs Website at www.oecd.org/daf/corporate-affairs, which features agendas, summary records, background papers and other documents relating to the five Regional Roundtables.

33. The work of the Roundtables continues. With the completion of the White Papers, the Roundtables have begun to develop focused programmes to monitor and assist in implementing and effective enforcement of their recommendations. The Roundtables will also continue to act as the leading regional fora for corporate governance policy design. Roundtable participants have been clear in their desire to preserve the networks and the "brands" that have developed over the last four years.

[5] The Eurasian Roundtable will produce a comparative paper on corporate governance in the region, to be released in 2004.

Experiences from the Regional Corporate Governance Roundtables

34. The following chapters provide a broad overview of corporate governance across the participating countries based on the discussions and materials from the 25 Roundtable meetings, as well as the relevant Reviews of Standards and Codes (ROSC) prepared and made publicly available by the World Bank, and the discussions of the International Meeting on Corporate Governance, which included participants from all the Roundtables[6]. Where appropriate, this material has been supplemented by additional sources.

35. The experiences from the Roundtables are certainly diverse, with important differences across regions, across countries, and in many cases across companies in the same country. However, there are important commonalties as well. This paper cites a number of examples, in most cases taken directly from the meetings of the Roundtables, to discuss issues that are in many cases relevant for a wide range of developing and emerging market economies, not just the ones cited. One of the critical findings of the Roundtables is the usefulness of the *Principles* as a guide for multilateral policy-dialogue. The meetings of the Roundtables confirmed the adaptability of the *Principles* as a reference for varying legal, economic, and cultural contexts.

[6] This meeting was organised by the Global Corporate Governance Forum in Paris, November 2003. The agenda can be found at www.gcgf.org/Int%20Mtg%20Nov%202003/Agenda.pdf

I. OWNERSHIP AND CONTROL

36. In the developing and emerging market economies that participate in the Roundtables, major shareholders control most companies. In Asia, Latin America, and increasingly the other regions, most of these *controlling shareholders* are individuals or families. In many cases, a single family will have controlling stakes in a number of companies. Historically state control has also been important in all the Roundtable regions, and while privatisation has reduced the role of the state, it remains an important controlling shareholder in many countries. In a number of countries in Eurasia and South-East Europe, the public sector still produces 30%-40% of output. Finally, the controlling shareholder may be company with dispersed ownership, like a foreign multinational or major bank, but this is the least common controlling shareholder.

37. Controlling shareholders have strong incentives to closely monitor the company and its management, and can have a positive impact on the governance of the company. However, their interests may also conflict with the interest of other shareholders—minority shareholders. This conflict is most destructive when the controlling shareholders extract *private benefits* at the expense of minority shareholders. One of the principal goals of the Roundtables has been to deter abusive behaviour on the part of controlling shareholders.

38. Minority shareholders are not the only victims of poor corporate governance. Controlling shareholders themselves pay the costs of poor corporate governance in the form of lower valuations, restricted access to equity finance, and difficulties with respect to succession planning and accessing outside talent. To reduce these costs some controlling shareholders do take voluntary measures to improve their own corporate governance and improve their reputations with other shareholders. The creation of institutions like special stock market tiers and voluntary corporate governance codes can facilitate these voluntary measures by allowing companies to credibly signal markets that they have high standards of corporate governance. However, the Roundtables have also acknowledged the limits of voluntary action. In the long run controlling shareholders may actually benefit from legally binding measures to improve investor protection.

39. In Eurasia and South East Europe, mass privatisation has created thousands of open joint stock companies. Only a small fraction of these companies meets the requirements for listing on local stock exchanges and protecting their shareholders remains a substantial challenge. In other regions, governments have sold equity in a number of major companies. However, in spite of this widespread privatisation, state control remains high due to the state retaining significant ownership stakes and the use of "golden shares". Although the state can use its continuing influence to improve corporate governance, in practice continuing state control can be a source of serious conflicts of interest that undermine effective governance.

The prevalence of controlling shareholders

40. The great majority of open and publicly listed companies in the Roundtable regions have a controlling shareholder. Table 3 presents evidence from 10 of the countries that have participated in the Roundtables, including some with the largest equity markets. For most of these countries, over 90% of listed companies have a controlling shareholder. The average across countries is 87%. In other developing and emerging markets, controlling shareholders are probably as or more dominant. For example, in Russia

eight business groups control over 60 of the largest companies[7]. Roundtable participants confirmed that companies in the other participating countries also normally had controlling shareholders. One important exception involves companies privatised to employees or the public at large as part of a mass privatisation program. These may have very dispersed ownership structures leading to greater management power, though for potentially valuable companies a controlling shareholder has usually emerged.

41. Table 3 also breaks down controlling shareholder by type. These results are also consistent with the wider observations of the Roundtables. The great majority of controlling shareholders are families, or individuals. In some cases, it is the state. Another widely held company--in many cases a foreign multinational or bank, may also hold control . However, banks are not major owners, or are not owners at all, in many countries, and when they are, it is often the outcome of borrower insolvency. In some countries there are other major owners, such as official privatisation funds. In China, major universities control some large business groups[8].

Table 3.Ultimate control of publicly traded companies in selected countries

Country	Widely Held	Controlling Shareholder			
		Family	State	Widely Held Financial	Widely Held Corporation
Argentina[1]	0.0	65.0	15.0	5.0	15.0
Mexico[1]	0.0	100.0	0	0	0
Chinese Taipei	26.2	48.2	2.8	5.3	17.4
Hong Kong, China	7.0	66.7	1.4	5.2	19.8
Indonesia	5.1	71.5	8.2	2.0	13.2
Korea	43.2	48.4	1.6	0.7	6.1
Malaysia	10.3	67.2	13.4	2.3	6.7
Philippines	19.2	44.6	2.1	7.5	26.7
Singapore	5.4	55.4	23.5	4.1	11.5
Thailand	6.6	61.6	8.0	8.6	15.3
Average	12.3	62.8	7.6	4.1	13.2

Note: Percentage of firms that are widely held or with a particular kind of controlling shareholder, where control is defined as having 20% or more of the voting rights.
1: Data for Argentina and Mexico limited to the twenty largest firms by market capitalisation.
Source: Claessens et al (2000) and La Porta et al (1999)

Control versus ownership

42. Companies with controlling shareholders have a single individual, family, or institution that has enough voting rights to prevent an unwanted takeover, to select a majority of board members, and to determine the outcome of a normal vote in the general shareholders' meeting. This does not mean that controlling shareholders always have more than 50% of a company's voting rights. In most cases a combination of "allied" shareholders who vote with the controlling shareholder, and passive shareholders who do not vote at all, allow a company to be controlled with 30% or less of the company's voting rights[9].

[7] New York Times (2002)

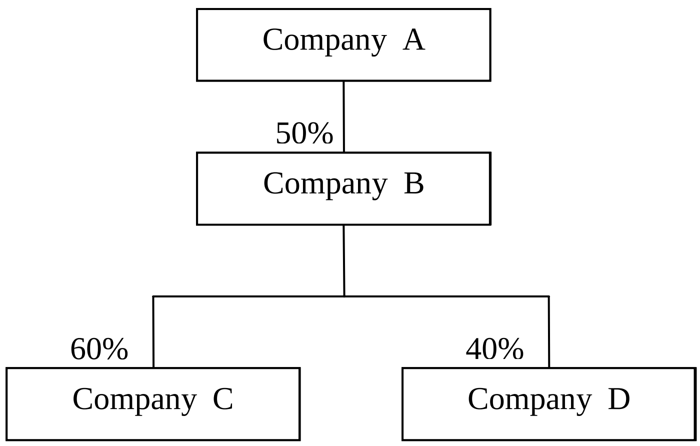
[8] Lang (2002)

[9] Table 3, following the literature in this area, assigns 20% or higher as the point at which a shareholder has a controlling stake.

43. Controlling shareholders also frequently use devices that give them greater voting rights than their underlying ownership. One way to do this is using stock with special voting rights, e.g. the controlling shareholder may have only 10% of the company's stock, but the stock they have has ten votes per share, and the other 90% has one vote per share. In this case, the controlling shareholder would have just over half the voting rights for the company, but receive only 10% of the company's dividends or capital gains.

44. Many countries, including Chile, Malaysia, Romania, Russia, Singapore, Ukraine, and recently Brazil, limit all common stock to one vote per share, and restrict the amount of non-voting preferred stock that can be issued. However, controlling shareholders may also use "control pyramids" to retain control with a limited amount of ownership. For example, figure one shows a hypothetical group of companies. The controlling shareholder owns 100% of Company A, which in turn effectively owns 50% of Company B. Company B owns 60% of C and 40% of D, which implies that the controlling shareholder *effectively* own 30% (.5 X .6) of company C and only 20% (.5 X .4) of company D. Yet the controlling shareholder is in a position to control all of them.

Figure 1. A hypothetical group of companies



45. These sorts of control pyramids are widespread. In Malaysia, the Philippines, and Chinese Taipei over 35% of listed companies are controlled with a pyramid structure, in Indonesia and Singapore well over 50%. In most cases, these pyramids are not nearly as simple as the hypothetical case presented here. They make use of cross-shareholdings and may contain a large number of companies (see Box 1). This will result in a ratio of *cash-flow rights*--direct or indirect ownership of equity--and *control rights*--the share of the vote--for controlling shareholders that is significantly less than one (see Table 4). This separation of ownership and control has important implications for the companies other, minority shareholders.

Box 1. Separation of ownership and control: an example from Hong Kong, China

The largest business group in Hong Kong, China is the conglomerate controlled by Li Ka-Shing and his relatives. Centred on Cheung Kong and Hutchinson Wampoa, it has 25 companies, including some of the largest in mainland Asia in terms of market capitalisation. These companies are linked together by a web of vertical and cross shareholdings, and include closed as well as widely held companies. The Li family has 34% of the vote in Hong Kong Electric, but due to an elaborate ownership structure, only effectively owns 2.5% of the company. Hence the Li family have enough votes to control the company under most circumstances, but only receive 2.5% of the dividends or capital gains (Taken from a paper by Stijn Claessens, Simeon Djankov and Larry Lang (Claessens et al 2000).

Table 4. Differences between ownership and control for controlling shareholders in selected countries

Country	Cash Flow Rights	Control Rights	Ratio of Cash Flow To Control Rights
Argentina[1]	38.0	48.0	0.79
Mexico[1]	36.0	52.0	0.69
Chinese Taipei	16.0	18.9	0.83
Hong Kong, China	24.3	28.1	0.88
Indonesia	25.6	33.7	0.78
Korea	13.9	17.8	0.85
Malaysia	23.9	28.3	0.85
Philippines	21.3	24.3	0.90
Singapore	20.2	27.5	0.79
Thailand	32.8	35.2	0.94
Average	25.2	31.3	0.83

Note: Percentage of cash flow rights--ownership-- versus percentage of control, or voting, rights for the largest shareholder in companies where one shareholder holds at least 5% of the control rights.
1: Data for Argentina and Mexico limited to the twenty largest firms by market capitalisation.
Source: Claessens et al (2000) and La Porta et al (1999)

Controlling shareholders, management and minority shareholders

46. One advantage of controlling shareholders is their ability to monitor and discipline management. Either management reports directly to the controlling shareholder, often bypassing the board, or the controlling shareholder runs the company directly. This would seem to solve the core corporate governance problem of an entrenched manager unaccountable to dispersed owners. From the Roundtables, there is reason to believe that in fact this solution has largely been effective: any difficulty that controlling shareholders have in overseeing and disciplining managers is generally considered a secondary issue.

47. What clearly is an issue is the relationship between controlling shareholders and minority shareholders. Controlling shareholders are normally in a position to take actions that benefit themselves at the expense of other shareholders. The separation of ownership and control increases the incentives of controlling shareholders to extract these *private benefits of control* (see Box 2).The Roundtables have discussed a number of cases of shareholder abuse along these lines, and there is a consensus that the treatment of minority shareholders needs to be improved in all five regions[10].

48. In theory, particular kinds of control may hinder the extraction of private benefits, or may facilitate them. For example, a company based in a country with relatively good corporate governance may ‘export’ these corporate governance standards when it becomes a controlling shareholder in another country. On the other hand, it may use its position as a multinational to engage in inter-company transactions to transfer resources away from the company at the expense of minority shareholders. The Roundtables discussed cases of good, but also bad, governance by non-family controlling shareholders like multinationals or large banks. One kind of control that participants considered systemically different was state control, which is still common in many developing and emerging market economies. The state can use its controlling position to ensure better treatment of minority shareholders. In practice, continuing state control often coincides with abusive behaviour by the company’s management, the political appointees that may serve on its board, and other company insiders.

[10] Chapter III discusses the problem of private benefits, and the protection of minority shareholders, in more detail.

Box 2. Quantitative evidence on the benefits of control

One indicator of the advantage that controlling shareholders have vis-à-vis minority shareholders is the *control premium*. This is the difference between the market value of a block of shares, and how much someone is willing to pay for those shares if they confer (or maintain) control over the company. One reason why such a premium might exist is that it reflects the gains that a controlling shareholder can acquire at the expense of other shareholders. In some markets, this premium is quite large. One study by Alexander Dyck and Luigi Zingales (2002) that looked at control transactions in a range of countries found that the average value of control is fourteen percent of the company's equity. For the twenty emerging market economies in their sample, the average was over eighteen percent. In the case of Brazil, control is worth sixty-five percent of the company's equity[11]. These figures suggest that in many countries a significant portion of a firm's value goes to those who control the firm, not those who own it. They also find that this control premium is correlated with measures of investor legal protection (including enforcement) and other indicators of the ease with which controlling shareholders may be able to gain benefits at the expense of outside shareholders[12].

If controlling shareholders are diverting resources from the company, then this should be reflected in a lower valuation for that company. Two recent studies, one by Stinj Claessens, Simeon Djankov, Joseph P.H. Fan and Larry H.P. Lang (2003), the other by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (2002), look at the relationship between ownership structure and valuation in a wide range of countries, including a number of OECD countries and ten of the countries that participated in the Asian and Latin American Roundtables. These studies examine the impact of greater control rights (voting) versus greater cash-flow rights (ownership) on firm value, based on the hypothesis that the lower the cash flow rights of controlling shareholders, than the greater is their incentive to divert funds from the firm. This research finds that there is a positive correlation between the cash-flow rights held by the controlling shareholder and firm value. It also finds that greater control rights relative to cash-flow rights are correlated with lower firm valuations. In other words, the greater the difference between ownership and control, the less valuable the firm. This implies that shareholders who have control with less ownership are taking actions that lower the value of the firm, but presumably are of benefit to themselves[13].

The costs for the controlling shareholder

49. The costs of insufficient investor protection are not only borne by minority shareholders, but also by controlling shareholders who are interested in making profit in a legitimate manner. In markets where investor protection is low, both foreign and domestic investor participation in equity markets will be correspondingly reduced and valuations, the overall ability to issue equity, and the supply of outside finance more generally, will all suffer[14]. This creates an *adverse selection* problem for company owners. Those with good companies, or who do not plan on extracting private benefits, may resist listing at low valuations, whereas those with poorer companies, or who plan to transfer funds to related parties, may be less reluctant.

50. A solution is to credibly signal to potential shareholders that their rights will be respected. A company can signal improved governance by listing in New York or London, upgrading their domestic listing to the top tier of the domestic stock market, or complying with a voluntary "comply or disclose" code that is credibly audited[15]. However, these actions generally require a certain level of institutional development to be fully effective. The opinion of the Roundtables was that these measures were most effective when backed up by strong legal protection for the basic rights of shareholders. Recent research is

[11] Oman (2003), chapter 3, provides examples of control transactions with large control premia in Brazil.

[12] Dyck and Zingales (2002)

[13] Claessens et al (2003), La Porta et al (2002b)

[14] *ibid,* La Porta et al (1997)

[15] Unfortunately, even in most OECD countries these codes are not monitored effectively, OECD (2003a).

consistent with this: a company from a country that protects basic investors' will receive better terms listing abroad than a similar company from a country with little investor protection[16].

51. A poor environment for corporate governance not only reduces valuations. In limiting the use of equity, it makes controlling shareholders more dependent on their own funds and increases the relative amount of debt that companies will use. Both increase the risk faced by the controlling shareholder, which may encourage the heavy use of "soft lending" or push companies away from higher risk, but also higher returning investments. Limited access to equity may also be one reason why heavily diversified conglomerates are so common in developing and emerging market economies: diversification allows the controlling shareholder to spread their risk over a wider range of activities. However heavy diversification prevents the company or group from focusing on its competitive advantages, and may tax the capabilities of the often small number of family members who must oversee such a wide range of activities.

52. A poor corporate governance environment may also complicate succession and other aspects of company management. Without access to a well-developed capital market, a family founder may have a difficult time selling out at a reasonable price. This may lead to continued family control even when the interests and attributes of the relevant family members would normally dictate otherwise. Similarly, a poor corporate governance environment may make it very difficult to bring professional management to run the business group. With a poor environment for corporate governance, it may be foolish to have an outsider in charge of the family company[17].

State control and privatisation

53. Less then a decade ago the economies of Russia, Eurasia, and South East Europe were dominated by state ownership. Today, the role of the state has been substantially reduced (Table 5). In each, the share of output produced by the private sector is over 50%, versus 5% to 20% in the early 1990s. However the role of the state is still large; many countries have 40% of GDP produced by the state controlled sector. In contrast, the private sector share of GDP is 80% in Hungary and the Czech Republic. For other Roundtable participants, including Bosnia-Herzegovina, Serbia and Montenegro, and Kazakhstan, the state share of output is almost certainly greater still.

Table 5. The impact of privatisation in selected transition economies

Country	Private Sector Share of GDP	Listed Companies	Companies with dispersed owners (Estimate)
Armenia	NA	18	1,156
Azerbaijan	60	48	3,400
Bulgaria	70	27	600+
Croatia	60	63	3,000
FYR Macedonia	60	22	1,400+
Georgia	60	2	1,500
Kyrgyz Republic	60	63	1,212
Mongolia	NA	20	400
Romania	65	60	5,700
Ukraine	60	9	9,000+

Note: "Listed companies" are listed on the main exchange, meet minimum listing requirements, and have had some trading in their shares, generally at least once a month.
Source: EBRD (2001), exchange websites, OECD estimates

[16] Reese and Weisbach (2002).

[17] Burkart et al (2002)

54. There has been another consequence of privatisation in these countries: the creation of a very large number of open joint stock companies. This is due to *mass privatisation,* where enterprises were converted to joint stock companies, then distributed to the employees and managers of these companies, to the public at large through a voucher scheme, or some combination or variation thereof. The result is that large fractions of the adult populations in these countries are shareholders, and that each of these companies may have thousands of dispersed owners. While authorities only privatised the largest 2% or so of enterprises in this way, the resulting number of companies with relatively high numbers of shareholders is large by any standard. In the very early stages of transition, there may be few other equitable ways to privatise large companies then through some kind of mass privatisation. Eventually however countries that try mass privatisation almost universally stop using it and switch to other methods that lead to less dispersed ownership[18].

Box 3. Privatisation in China and India

Like the transition economies of Europe and Central Asia, India and China have both embarked on ambitious privatisation programs. In China over the last ten years hundreds of state owned, and still state controlled, companies floated shares on the Shanghai and Shenzhen stock exchanges. Today these exchanges have 1200 listed companies, with a market capitalisation of over $500 billion, second only to Japan in Asia. It is estimated that 30-60 million Chinese own shares. Some of the largest Chinese state owned enterprises have also listed on the Hong Kong stock exchange, and now make up 35% of its market capitalisation[19].

The initial goal of floatation was to facilitate enterprise restructuring and to provide alternative sources of funding to state controlled banks, which have very large portfolios of non-performing loans. However, over the last few years the focus has shifted to more wholesale privatisation and capital market development. In 2001, authorities also allowed private companies to list on the Shanghai and Shezhen exchanges. This process is still in its early stages. Experts estimate that the state still holds over two thirds of the shares in listed companies and only 35 of the listed companies have been classified as private (vs. state) owned. Recent plans to sell more state shares through the two stock exchanges have been put on hold, for fear of diluting the quality of listed companies[20].

"Disinvestment," as privatisation is called in India, began in 1991 with the sale of minority stakes in dozens of companies. In 1999 a Ministry of Disinvestment was established, and the strategy shifted from selling only minority positions to selling controlling stakes and transferring control to private management. Overall, controlling stakes worth $2.3 billion have been sold in 14 major companies and equity sold in another 36 companies. Another 34 companies, some of the largest in India, are slated to be privatised, and with one of the largest state owned sectors in Asia, others could follow[21]. The main goal of the policy to date has been to improve the public finances; however, the shift to sales of control also reflects the increasing priority given to firm performance.

In China and India both valuations--and hence privatisation revenues--and the performance of privatised firms, depends on the effective rights of new shareholders. Policy makers in both countries have recognised this, and have given corporate governance reform increased priority. Supporting India and China in this essential transformation will remain a priority as both countries continue to participate in the Roundtable process

55. Shareholders in the great majority of these unlisted, open companies are essentially stranded, with no way out of their shares, and in many cases no real rights as owners. One response has been to create active secondary markets to facilitate the consolidation of shareholdings. In Mongolia, privatisation was conducted through the stock exchange, and nearly five hundred companies became "listed" (the number given on the table are for those companies that meet minimum listing requirements for the A level of the exchange). The Mongolian Stock Exchange has allowed dozens of companies to be taken private

[18] This includes both OECD member countries as well as the non-member countries participating in the Roundtables. One early example is the Czech Republic, where the phrase "tunnelling" was first used to describe abusive self-dealing. See Coffee (1999) for more on corporate governance in the Czech Republic during transition.

[19] *The Economist* (2003)

[20] *Ibid*

[21] Ministry of Disinvestment website: http://divest.nic.in/.

successfully. Even more ambitious was the creation of the RASDAQ in Romania. Modelled on the US NASDAQ and using comparable technology thanks to generous donor assistance, the RASDAQ had well over five thousand companies. Hundreds of those have since been taken private. Overall, active over the counter markets have generated liquidity and allowed ownership consolidation in many companies.

56. Yet in most of these countries, no more than 200-300 stocks will make up the active over the counter market. The great majority of these companies remain widely held, and their stocks are not traded on or off the stock market. It is recognised that these companies need to be taken private, but in a way that does not harm their minority shareholders, who normally own most of these companies' equity. In addition, Roundtable participants also pointed out that many of these companies are effectively insolvent--whether due to insider machinations or the great changes in the economy during the transition--and that this is an issue of creditor rights, not shareholder rights. However, some of these companies do retain value, and taking them private while providing minority shareholders with some compensation remains a significant challenge.

Continuing state control

57. States are controlling shareholder in hundreds of publicly listed companies in China, dozens in India, many of the largest companies in Singapore, a very large number of companies in South East Europe and Eurasia, as well as a smaller share of companies in a number of other countries (see Table 3). These are often some of the largest companies by revenue, assets, and employment, and usually have a strategic function in the economy: air travel, telecommunications, banking, electricity, water, oil, etc.

58. Lingering state control may reflect the ongoing nature of a particular country's privatisation process; however, in many cases it is a strategic decision by the government. Many governments have maintained "golden shares" to influence major decisions in companies deemed to be natural monopolies or that have other special properties. In theory, privatisation with a golden share can allow for continuing state oversight to compensate for a incomplete regulatory framework, while giving the company financial independence and putting it on a sounder commercial basis. For example, a country wishing to bring private investment into electrical power generation, but lacking the regulatory framework to closely monitor the pricing of a wholly private company, could privatise the company while retaining a control stake or golden share.

59. This logic also applies to corporate governance. In theory, the state could use its continuing influence to oversee the board and management of a privatised company and in the process prevent any serious abuses against the company's minority shareholder or other stakeholders. In practice, state controlled companies do sometimes have corporate governance as good, or better, than their privately controlled peers. However, in many other cases insiders in state controlled companies have been involved in serious abuses of minority shareholders. It has also been regularly pointed out in the Roundtables that the state as both owner and regulator, sometimes the rationale for retaining an ownership stake or golden share, can in practice also lead to conflicts of interest. Determining the proper role for the state in strategic companies, and the governance of those companies, remains an ongoing challenge for policy makers. Chapter III, under "effective shareholder involvement, controlling shareholders", discusses some of the ways that major shareholders, including the state, can improve the governance of the companies that they control.

II. ENFORCEMENT

60. The great majority of countries that participate in the Roundtables now have laws and regulations that seem to offer strong protection to shareholders and other stakeholders. Yet these stakeholders still have their rights violated, in large part because of ineffective enforcement of these laws and regulations. Each of the five Roundtables concluded that the greatest corporate governance improvements would come from implementing and enforcing existing laws and regulations.

61. Ironically, problems in enforcement and implementation reflect in part the efforts made to improve corporate governance. To paraphrase one Roundtable participant: “Laws have been transplanted, but not practices.”[22] Without the appropriate institutional framework, new laws, whether they are transplanted or domestically developed, may simply be ignored, or in a few cases create new difficulties.

62. It is ultimately the responsibility of the judiciary to uphold the law, and it has been with the judiciaries of various countries that Roundtables have expressed great disappointment. One response is to strengthen the judicial system directly. Another is to develop alternative sources of redress, and in particular to strengthen the national securities regulator. A third is to empower shareholders by developing a framework that makes market discipline more effective. Nonetheless, while various measures can compensate for a weak judiciary, *all* redress ultimately depends to one degree or another on the judicial system. The White Papers emphasise the importance of improving enforcement through each of these three channels.

The legal system

63. Across the countries that participate in the Roundtables, courts are seen as costly to use and as providing limited protection to minority shareholders, creditors, and other stakeholders. For example, in some countries there are no known cases where courts had made a ruling in favour of minority shareholders. Even in countries with more advanced institutional frameworks, going to the courts is perceived as time-consuming, uncertain and only to be used as a last resort.

64. In some cases, the problem may lie with particular judges. The nature of cases that courts must consider can also create difficulties: controlling shareholders and other corporate insiders are skilled at making abusive transactions appear, at least superficially, to be legitimate business transactions. Legal ambiguity compounds this problem. Even when there is strong evidence of some kind of impropriety, the liability of particular board members, executives, or significant shareholders may not be clear.

65. When faced with cases of potential abuse by controlling shareholders and other corporate insiders, courts frequently take a narrow view of what actually constitutes harm to minority shareholders. In a case discussed in the Asian Roundtable[23], in 1998 a Chinese court ruled that the disclosure of false information did not necessarily cause a loss to shareholders. Later, the Supreme People’s Court in China temporarily suspended cases seeking civil compensation for insider trading, fraud and market manipulation. In general,

[22] Galogaza (2001)

[23] Hu (2002)

courts in many countries prefer to leave maximum discretion to those who control the company as the expense of minority shareholders[24].

66. Narrowness in ruling frequently reflects narrowness in the law. Company law normally does provide lists of liabilities for board members or other executives, but these are liabilities to *the company*. For this reason shareholders may face significant hurdles in seeking redress against particular board members[25]. Sometimes the law does not specify a particular abuse, or may note the abuse, but not prescribe a penalty. In addition, statutes may also contradict one another.

67. In this area common law countries may have an advantage. Under common law, courts have more discretion and may be willing to make broader legal interpretations that provide greater protection to shareholders. India, Malaysia, Singapore and Hong Kong, China can also build on (either explicitly or implicitly) extensive English case law on shareholder protection and the duties of board members and other company officials. Broader interpretation also allows for more *flexible* interpretation that can evolve through time without explicit changes in company law or other regulation[26].

68. However, the difference between particular common law and civil law countries should not be exaggerated. For example, in Malaysia, a common law country, shareholders could not file suits against particular board members until 2001[27]. On the other hand, many civil law countries have countered narrow interpretation by taking steps to spell out more clearly the rights of shareholders and what sorts of transactions are potentially abusive. In China, the Supreme Peoples Court has recently allowed for shareholder suits in the case of fraud. Whatever the legal origin, a successful regime will be one that can continually adapt to maintain the confidence of shareholders and other resource providers to companies.

69. In some countries, there may be more serious problems than narrow legal interpretation. Controlling shareholders and other corporate insiders will normally have significant financial and political resources. Judges, on the other hand, may be poorly paid and not entirely free of political influence. In some countries, judges may have less status than lawyers in private practice. The resulting potential for corruption and political meddling has implications that reach far beyond corporate governance. The Roundtables strongly support programs to fight corruption in the judiciary and increase the political independence of judges, both to improve corporate governance and for the wider benefits that such measures would bring.

70. Even when corruption is not a central issue, increasing the compensation and tenure for judges may attract people more capable and willing to deal with potentially complex commercial cases. Training is another way to increase the capacity of the judiciary, and the Roundtables widely supported training programmes for judges. In transition economies this could include extensive training on commercial law generally, as well as issues specifically related to corporate governance. In other countries, effective training might include more focused workshops and other specialised programs on abusive transactions, the liabilities of board members and executives, and similar topics.

71. Other suggestions in the Roundtables to improve the performance of the judiciary included allowing for greater specialisation, and encouraging the publication of written court opinions and

[24] For some well known examples, see Johnson et al (2000).

[25] See Chapter IV, "Legal duties of board members".

[26] La Porta et al (1997) and others argue that common law countries on average have higher levels of financial development and better corporate governance than civil countries. Levine et al (2002) attributes this to the greater flexibility of common law systems.

[27] Nathan (2001)

decisions. Judicial reform is a long-term process, but also a process with far-reaching implications. In many countries, it should be a national priority, strongly supported by multilateral and bilateral assistance.

Shareholder law suits

72. Beyond narrow rulings and potential corruption, many shareholders face perhaps an even greater barrier to seeking redress through the court system: the time and cost involved. While direct court costs may not always be high, plaintiffs must pay lawyers fees (many jurisdictions do not have contingency based fees) and can spend many months or years in court. Finally, shareholders may face additional hurdles: e.g. in China a shareholder suit cannot be filed unless the Securities Commission has already found wrongdoing[28].

73. In a typical shareholder lawsuit, courts treat shareholders as individuals. This does not prevent joint filings, but the court must consider the case of each shareholder separately: hence the example presented in the Roundtables, of a filing by 679 investors weighing *3 tons*[29]. The Roundtables expressed great interest in mechanisms that would reduce the administrative burden of these suits and pool costs across shareholders.

74. One alternative to individual suits is derivative lawsuits. In a derivative suit, some shareholders sue board members or other company officers on behalf of the company. Damages reflect the liability of the officer to the company as a whole, and can be used to cover legal fees, but otherwise must go to the company. Derivative suits are consistent with a legal framework where company officers are liable to the company, but accountable to shareholders. In a few countries, they are the only kinds of suits that shareholders may file. However, derivative suits are not as widely used as they could be. For example, shareholders have not filed derivative suits in Bulgaria and Romania even though the legal framework allows for them[30]. Some Roundtable participants also indicated that these sorts of suits had their limitations [Box 4].

75. One alternative being introduced in China and Chinese Taipei, considered in Korea, and recommended in the Asian White Paper for other countries in the region, is class action law suits. Nonetheless, they remain controversial. The principal advantage is direct payment of the award to shareholders. However, there have been concerns that these sorts of suits could be easily abused and lead big companies to face "green mail," where lawyers, not shareholders, seeking fees demand large payments to settle cases of dubious merit.

76. The Korean proposal places a number of limitations on these suits to prevent potential abuse. For example, plaintiffs must include at least 50 shareholders, the case and any settlement must be approved by the court and, to prevent "professional plaintiffs," the lead plaintiff and participating attorney are limited to three cases in three years.

77. The introduction of class action law suits in Korea and China will be a significant "natural experiment" that can provide important lessons to other countries, especially those with civil law systems. These suits may provide a more cost effective alternative for some shareholders. But there is little reason to believe that they will make the court system work faster, or lead to better rulings in and of themselves.

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[28] Hu (2002), also see Chapter IV, "Legal duties of board members".

29 *Ibid*.

[30] David (2001)

Box 4. Derivative suits in Korea

In Korea, there were no derivative suits by shareholders before 1997, in part because of the requirement that plaintiffs have at least 3% of the company's shares. Since the 1997 crisis, the ownership requirement has been reduced to 0.01% and three suits have been filed. The first suit was filed in 1998 against two former presidents and two former board members of the Korea First Bank for illegal loans and receiving bribes to make loans. The case went to the Supreme Court of Korea, and was not finalised until 2002. The courts ruled in favour of the shareholders, however a great proportion of the settlement went to legal fees, and the remainder was not enough to prevent the Bank from failing.

The second derivative suit was filed in 1999 against a former president and ten board members of Samsung Electronics for a series of abuses including an illegal political contribution. In 2001, the district court ruled in favour of the plaintiffs, and awarded $72 million out of $282 million in damages claimed, though the case was appealed. The third case was also filed in 1999 against the former chairman of the Daewoo Corporation for illegal subsidies to private companies owned by the controlling family. As of November 2002, a hearing was still pending due to the absence of the defendant.

Each case lasted years. When courts awarded damages, management resisted collecting the award for the company. In addition, plaintiffs had to file a separate lawsuit to collect legal fees, which were not contingent: initially shareholders paid the fees and were reimbursed later from the award to the company, which retained any remaining funds. It is perhaps not surprising that these were the only cases filed[31].

The securities regulator and self regulatory organisations

78. Investor protection is a central part of the mandate for securities regulators. In meeting this mandate, regulators have important advantages over the judiciary. Securities regulators, who normally have the power to interpret securities law and issue regulation, are potentially more flexible than judges in making decisions based on what may be long-established company law, allowing the regulator to respond to new market conditions and new challenges created by controlling shareholders and corporate insiders. Regulators, whose career prospects may depend on their ability to penalise corporate misbehaviour, may also have stronger incentives to confront complex cases than judges, whose desire to appear impartial may not be consistent with an activist agenda[32].

79. Securities regulators can normally bring both criminal and civil action against companies, their board members and their executives. Regulators can also use administrative measures that do not depend on lengthy court proceedings. They may be able to impose fines and, importantly, issue binding compliance orders that prevent or reverse potentially abusive actions. While the party being penalised will and should have the right of appeal, the administrative sanction will remain in effect during the potentially lengthy appeals process. Regulators will also generally have investigative powers and be in a position to demand information from companies and their officers.

80. Securities regulators frequently focus their efforts on overseeing market intermediaries such as broker-dealers, stock exchanges, depositories and registries, custodian banks, and professional associations of accountants and auditors[33]. An important administrative tool is the licensing of these intermediaries. This allows the regulator to effectively delegate certain market oversight functions and prevent intermediaries from facilitating abusive actions: e.g. self-dealing in the company's stock, or temporarily "misplacing" share ownership records. As with other administrative powers, it also provides the regulator with a "stick"-- the suspension of the license --that may not be directly dependent on the court system.

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[31] Jang (2002)

[32] Glaeser (2001)

[33] *Ibid*.

81. A powerful securities regulator can be an effective deterrent against shareholder abuse. However, an unaccountable regulator can be the source of other abuses. The securities regulator should not only ensure transparency in financial markets, but its own transparency as well. The regulator should explain and publish their rulings, and develop new regulation in an open manner.

82. Generally, the staff of the regulator must be independent of ties to the companies or individuals they may be investigating, e.g. they cannot own shares in companies they may investigate. Beyond these basic requirements, Roundtable participants emphasised the importance of a merit-based system for choosing commissioners and other securities regulators that is free of unwarranted political interference. While there may be some trade-off between political independence and accountability, participants emphasised the importance of keeping regulation as professional, and de-politicised, as possible.

83. Like judges, securities regulators can be undermined by legal ambiguities and gaps. They may also be severely restricted in terms of resources. While the threatened eviction of the Romanian Securities Commission was an extreme case, securities regulators from a number of countries will require substantial increases in resources if they are to oversee more than a handful of large companies and market intermediaries.

84. In many countries the securities regulator is not alone in overseeing financial markets and investor protection. Ministries of finance, industry, and justice, and the central bank or a banking regulator may also be involved, and there can be overlaps and sometimes outright confusion about relative powers and responsibilities. Many Roundtable participants emphasised the importance of clarifying the relative powers of the various bodies that oversee financial markets. Bulgaria has addressed this problem by introducing a single Financial Services Authority modelled on the British FSA, and other countries are considering this option.

85. Increasing the capabilities of securities regulators is clearly a priority for the Roundtables, and each White Paper provides further guidance in this area. IOSCO has also begun to develop principles for securities regulation. The securities regulators from a number of the countries that participated in the Roundtables are IOSCO members and these principles should also provide a useful framework for regulators around the world.

The stock exchange

86. Delegating powers to self-regulatory organisations is one way that the securities regulator can conserve scarce resources. However, there are limits to delegation: the securities regulator must also be able to oversee and monitor these bodies. For listed companies, a critical self-regulatory body will be the stock exchange[34]. Through listing requirements, the stock exchange may have a substantial influence on the corporate governance of the listed company. Listing may require that the company disclose additional information, and disclose certain critical information to the exchange in a timely and ongoing manner. Listing may require setting up certain special committees, and or complying with a particular corporate governance code.

87. The exchange must be able to enforce these requirements, and normally relies on suspension of trading or listing, or permanent de-listing to do so. This can create a dilemma. Suspension or de-listing can harm minority shareholders. Setting high standards for listing will also limit the number of listed companies. While this may reduce *adverse selection* by guaranteeing a certain minimum quality for listed companies, it will also increase the number of largely unregulated unlisted companies. This is particularly

[34] Historically, self-regulation has been important with respect to transparency and disclosure. Chapter VI discusses the roles of securities regulators and self-regulatory bodies in ensuring transparency.

problematic when only a small number of companies are listed. One solution that some stock markets are beginning to employ is multiple tiers or markets, some with stricter requirements than others.

88. Some stock exchanges, notably Brazil's Novo Mercado, allow for binding professional arbitration between companies, their officers, and shareholders. Roundtable participants have enthusiastically greeted this sort of *alternative dispute resolution*, in large part because it presents an alternative to the court system. Traditionally these sorts of resolution mechanisms have been reserved for disputes between companies and between investors in closed companies. Much of the existing legal framework in this area, has also focused on resolving international, not domestic, disputes[35].

89. Alternative dispute resolution has also only seen limited use in developing and emerging market economies. One reason is that many countries, including Russia, Romania, Bulgaria, and Croatia, have been reluctant to allow for private binding arbitration. In these countries, only the courts have the final authority to issue binding judgements. The effectiveness of alternative dispute resolution rests on the courts willingness to enforce it.

90. However, the Novo Mercado is an indication that binding arbitration for open companies and their investors is a real possibility. To build on this, the White Papers call for greater use of alternative dispute resolution and the OECD and the United Nations Commission on International Trade Law (UNCITRL) have initiated a series of meetings focused on expanding the use and effectiveness of alternative dispute resolution specifically to improve corporate governance in developing and emerging market economies. Some of the White Papers also recommend third party mediation and arbitration to facilitate redress for employees and other stakeholders—as with shareholders, these must somehow be binding to ultimately be effective.

Market discipline and self enforcement

91. Market forces can be one of the most effective restraints on corporate malfeasance. A controlling shareholder that develops a reputation for expropriation will not be able to sell securities. If poor governance leads to deteriorating performance, then product market competition can drive badly governed companies out of the market entirely.

92. By empowering shareholders and enhancing these market forces, some have argued that the corporate governance framework can largely be "self-enforcing," with only a limited role for courts and regulators[36]. The Roundtables and White Papers discussed a number of mechanisms that may give shareholders the ability to stop or challenge actions by corporate insiders, increase board member independence and enhance transparency in ways that are potentially self-enforcing. This kind of self-enforcement depends on mandatory procedures designed to protect investors. It is quite distinct from private contracting, for example through the company's charter. Courts enforce private contracts, with all that that implies.

93. However, enhancing market discipline through "self-enforcing" mechanisms also requires the possibility of judicial enforcement. A typical self-enforcing mechanism is the requirement that the general meeting approve major transactions, in some cases with a super-majority. For this to be meaningful, the meeting must take place, shareholders must know about it, and they must be in a position to make an informed decision about the transaction, i.e. they must know something about the transaction before hand.

[35] The New York Convention specifically requires the recognition of international arbitration, but not domestic arbitration.

[36] A standard reference on "self-enforcing" systems of corporate governance is Black and Kraakman (1996).

One of the basic lessons of the Roundtables is that these cannot be taken for granted, and shareholders must have some sort of redress mechanism for the violation of seemingly very basic rights.

94. Deciding whether or not a meeting took place is more straightforward than determining if a particular transaction was in the interest of the company. Nonetheless, these mechanisms require some kind of legal backing. Each White Paper provides an "action plan" for introducing and enhancing a range of mechanism that can increase market discipline and facilitate self-enforcement while at the same time boosting the capabilities of judges and regulators.

III. SHAREHOLDERS RIGHTS AND EQUITABLE TREATMENT

95. Investors will only purchase shares if they expect to get a positive return on their investment. However, common stock normally does not come with a schedule of guaranteed dividend payments, instead the company has significant discretion about what dividends will be paid[37]. This flexibility, and the risk sharing that it facilitates, is the great advantage that equity has over debt. Nonetheless, if investors are to participate in this system, they have to know that their rights as owners will be respected. They will also not participate if they believe that they will be discriminated against in favour of other shareholders.

96. The regions covered by the Roundtables have witnessed extreme violations of shareholder rights, especially the rights of minority shareholders. Controlling shareholders will extract ”private benefits” from the companies they control, violating the basic rights of other shareholders in the process. For example, minority shareholders may be prevented from attending a general shareholder meeting at which a major acquisition that will benefit the controlling shareholder will be voted on. More generally, minority shareholders are not treated equally. They are not given the same information, or the same opportunities to share in the profits of the company, as controlling shareholders.

97. Across the Roundtables, three areas are of particular importance for protecting the rights and equitable treatment of shareholders in developing and emerging market economies: shareholders should have secure rights to hold and transfer their shares; they should be able to fully participate in the general meeting; and major and related party transactions must be carried out in a transparent manner that treats shareholders fairly. In addition, the Roundtables discussed constructive ways to enhance shareholder involvement in the companies they own[38].

98. As the Roundtables have progressed, a number of participating countries have adopted new legislation to further protect shareholders, including Argentina, Bulgaria, Chile, Romania, and Russia. A number of countries have also introduced voluntary initiatives designed to improve the treatment of shareholders, including special stock market tiers and corporate governance codes.

The problem of “private benefits” of control

99. The Roundtables have confirmed one primary problem with corporate governance in developing and emerging market economies: “tunnelling”. Tunnelling describes when insiders take a company’s assets for themselves, as if the assets are disappearing down an underground tunnel. This tunnelling comes at the expense of other shareholders and stakeholders. In the process it erodes investor confidence and retards capital market development, leading to lower valuations, less equity finance, and ultimately slower growing and less stable economies.

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[37] Company law in some countries does require minimum dividend payments, and in many countries shareholders approve dividend payments in the general meeting. Nonetheless, significant *de facto* discretion remains.

[38] Protecting shareholders, and in particular stopping the transfer of resources out of the company, goes beyond the material in chapter III. Chapter VI discuses one of the best deterrents to this sort of abuse: improved transparency and disclosure. The board, especially in dealing with conflicts of interest, can also be a deterrent, or facilitator, of abusive related party transactions. The board is discussed in chapter IV. Finally, the enforcement and implementation of the law may be the most important determinant of shareholder protection and is covered in chapter II.

100. There are many kinds of transactions that can transfer money from the company to controlling shareholders or other corporate insiders (Box 5). In general, insiders have shown great ingenuity in devising new ways extract resources from companies they control. These transfers and other private benefits do not only hurt other shareholders. All of these activities may make the company more prone to bankruptcy, and there are cases where controlling shareholders have intentionally "hollowed out" the company, leaving workers and creditors with back wages and debts unpaid.

Box 5. Forms of tunnelling

Acting on privileged information: Using confidential information for personal gain. Often combined with some other transaction. For example, one company transfers resources to another company, the controlling shareholder buys stock in the recipient company, then the "investment" into the second company is announced (or signalled in some way), increasing its share price. Sometimes transferring the information itself can be a kind of tunnelling, e.g. transferring information about a business opportunity from a listed company with a controlling shareholder to another company wholly owned by that shareholder.

Asset transfers: Selling the company's assets on very favourable terms to a related party, in many cases another company wholly owned by the controlling shareholder. A typical form of tunnelling.

Capital increases: One of the most common abuses noted in the Roundtables is when a controlling shareholder will, either directly or through a related party, acquire new shares issued by the company on very favourable terms. The Roundtables have described a number ways in which capital increases have been designed to benefit the controlling shareholder.

Changes in control and sales of the company: Sale of control blocks (enough shares to take control of the company), or the company outright, can often be used to facilitate tunnelling. A would-be controller may be in a better position to transfer resources from the company than the current owner, e.g. through abusive transfer pricing. This may also occur through the terms of the sale itself. For example, a related party control transaction may involve swapping stock in the existing company for stock in a new holding company--where the controlling shareholder will now effectively hold a much higher portion of the equity.

Coinvestment: Similar to the asset and liability transfer, this an investment made on favourable terms by the company into another company (wholly) owned by the controlling shareholder. Coinvestments may also involve the exchange of securities, and hence raise the same valuation issues as other in-kind contributions.

In-kind contributions: A variation on the capital increase, where a physical asset of some kind, like land or machinery, is exchanged for shares instead of cash. In many cases this allows the restrictions on normal capital increases, like pre-emptive rights, to be bypassed. Assets or items with low values may also be exchanged for large amounts of stock.

Liability transfers: Instead of assets being transferred out of a company, liabilities are transferred into it, on poor terms for the receiving company. This sort of transfer may serve a double purpose, expropriating both shareholders and creditors. This is the mirror of the abusive asset transfer, and either (or in many cases both) can be used to create a company whose liabilities greatly exceed its assets.

Transfer pricing: Instead of a single, perhaps large, transaction, involving an asset sale, abusive transfer pricing involves ongoing transactions between companies, frequently involving intermediate inputs (steel, coal, oil, parts, etc.) or services. If the goal is to transfer funds to the supplier, the price is set higher than normal. If the goal is to transfer funds to the buyer, then the price is set lower than normal. Abusive transfer pricing can sometimes be used to bypass legal restrictions on major transactions.

101. In jurisdictions with better investor protection, private benefits may be acquired in less blatant ways. The controlling shareholder, and her friends and relatives, may have management positions for which they are over compensated. The investment decisions of the company may reflect personal interests, not the best opportunities for the company, e.g. low profit subsidiaries created to satisfy the interest of the children and siblings of the founder. However even in jurisdictions with relatively good investor protection, "soft" personal benefits may coexist with "hard" tunnelling, albeit of a more sophisticated sort.

102. A number of institutional elements facilitate tunnelling. Companies that are related parties usually carry out tunnelling transactions. For example, using the hypothetical business group from Figure 1, a controlling shareholder could use transactions between company D and company A to transfer resources to themselves. In some cases, the related party may not even be known to be a related party. Offshore companies with obscure beneficial ownership are frequently used for these sorts of transactions. In many cases the transaction itself may technically be legal. However, a great deal of tunnelling is facilitated by subverting shareholder rights, often through indirect means: a transaction with an offshore company may be legal, but the concealment of owner of that company probably is not. Tunnelling presents great challenges for regulators and the judiciary, both in the resources required to investigate seemingly normal corporate transactions and also in dealing with the often legally ambiguous nature of the transaction.

Secure rights to hold and transfer shares

103. The *Principles* identify the rights to hold and transfer shares as a basic right of shareholders. In some companies, this right is reflected in a bearer share: a document that confirms that the holder is a shareholder, and which the shareholder has the right to transfer at will. In most cases however, share certificates held by shareholders are essentially nominal, a kind of receipt of share purchase. A registry or central depository holds the actual shares, which are often fully “dematerialised”. There are no paper “shares”, only records in a computer system.

104. Many developing and emerging market economies have developed secure, and increasingly sophisticated, share registration for listed companies. Advanced systems for registration can speed the settlement of share transactions and can facilitate the tracing of beneficial ownership and control. On the other hand, some countries have not yet developed sophisticated and always secure systems for share registration. This does not just delay settlement, or make it more difficult to determine the ultimate owner of a company. Un-secure registration may prevent shareholders from confirming ownership at critical points, or may even lead to the *de facto* theft of shares.

105. The Russian, Eurasian, and South East Europe Roundtables have identified the insecurity of share registration as a serious problem. For example, in Armenia companies may simply refuse to register minority shareholders[39]. In Russia, registries have refused to register changes in ownership, and changed the status of shares from voting common stock to non-voting preferred stock. Other countries have reported similar abuses. They have also experienced the occasional “loss of record,” and hence outright loss of ownership rights, by registrars.

106. Many of these abuses have been associated with very light regulation of registrars. Sometimes the law allows companies to act as their own registrar. In others, shares have had to be registered with a third party, but these registrars are in turn unregulated, and may be easily swayed by the companies giving them business. In either case management, the controlling shareholder, or other interested parties may be able to manipulate share records relatively easily. Sometimes regulation focuses only on listed companies. However, the privatisation process has produced thousands of widely held, but not listed, companies in these countries.

107. After a number of scandals, in 2001 Russia changed its law so that companies with more than fifty shareholders have to use a professional registrar licensed by the national securities commission. Many countries have introduced a carefully regulated central depository for all shares--including shares in non-listed companies. There are in fact a number of different methods of registration that may be effective, but to be effective they must ensure that share records cannot be manipulated. This depends not only on who

[39] Karapetyan (2002)

the registrars are and the rules they have to follow. Individuals who have manipulated share records must also face some punishment.

108. A country's law can limit shareholders' rights to transfer their shares. In some countries shareholders cannot trade shares immediately before the general meeting. In Croatia, the management of joint stock companies can block the transfer of shares by shareholders. In other countries, other shareholders may be able to block share transfers. While such rules may be appropriate for closed companies, where the founding owners may want a say in who their effective partners are, they are not appropriate for companies with a large number of shareholders. The presence of so many open, but not listed companies in some of these countries may be a reason why such provisions are in place. In Croatia, the courts have now placed limits on the ability of management to abuse this provision. In any case countries must be very careful to clarify their company law to limit restrictions like these to companies with a small number of shareholders.

Effective participation in the general shareholder meeting

109. At its best, the general shareholder meeting allows shareholders to exercise their fundamental rights in an informed way, participating as owners in the company. Unfortunately, the general shareholder meeting often does not live up to this promise. At worst, shareholders are actively kept away from the meeting through a variety of methods. Even in countries with relatively good corporate governance, the meeting is often seen as a non-event, acting as a "rubber stamp" for management and the controlling shareholder. Each Roundtable made clear that the effectiveness of the general shareholder meeting could be improved significantly.

110. Does the general shareholder meeting matter when a company has a controlling shareholder? Almost by definition, the controlling shareholder owns enough stock to dominate the general meeting. However, other shareholders can also have an impact. Controlling shareholders often have less than 50% of the company's vote. If enough other shareholders come to the meeting, or are able to vote by proxy, then the meeting's outcome is not a forgone conclusion. Another is the use of super majority requirements for certain major transactions or other important company decisions, to change the company's charter in many countries requires 75% of the vote. A third reason is that a growing number of countries have provisions, such as cumulative voting, that allow minority shareholders to elect some board members at the meeting. The shareholders meeting is also not just about voting, but also allows for interaction between the company's owners that can contribute to better informed decisions.

111. If the controlling shareholder can control the outcome of the general meeting, they can not only block initiatives by other shareholders or select the board, they may be able to change the company's charter, or approve major transactions that are detrimental to other shareholders. In some cases, the most brazen means are used to keep minority shareholders out of the meeting. The meeting may not be announced, and held in secret. The meeting may be held in another city, or even another country, than where the company is headquartered. Or the meeting may never be held, with whoever is running the company completely ignoring the outside shareholders, or voting their shares for them.

112. Only slightly less brazen is the use of administrative procedures to keep certain shareholders out of the meeting. Registries can be manipulated to temporarily "lose" the records of a particular shareholder. If shares are purchased before the meeting, the record of the purchase may not be updated until after the meeting. At the meeting itself, arduous identification requirements can be imposed for the shareholder to "prove" that he is who he says he is. In many countries domestic shareholders do not face such barriers if they come to the meeting in person, but foreign shareholders, or proxies for other shareholders, may be barred on similar grounds.

113. In many cases, a meeting will take place, the time and location will be communicated to shareholders, and they will be able to attend. This does not mean the meeting will be effective. Before the meeting little information on issues to be decided, e.g. the approval of a major transaction, may be distributed. Shareholders may have no practical way to place items on the agenda. They may not be able to nominate board members. At the meeting there may be no, or very little, opportunity for questions. Voting may not be transparent, or fair: a proposal may be passed by an uncounted show of hands, or there may be no way for shareholders to verify the results of a secret ballot. Finally, once the meeting is over, proposals passed at the meeting may be "delayed"--in some cases indefinitely. To take one widely cited abuse, many countries allow for shareholders to call for dividends during the general meeting. Once a dividend is approved however, it may not be paid for several months--in the presence of high inflation the real value of the dividend will fall substantially--or it may be delayed until the next annual general meeting, when shareholders will presumably call for it again.

114. The Roundtables have emphasised that to be effective, meetings should be announced so that shareholders can easily know that they will take place. They should be announced well in advance, at least 30 days, preferably 45-60. In addition, shareholders should have easy access to supporting information, such as a draft agenda specifying issues to be decided at the meeting and the nominees for board member, and relevant supporting information.

115. The Roundtables have also noted that before the meeting shareholders having a minimum stake in the company--individually or collectively--should be able to place items on the agenda, and have some influence on the nomination of board members. Identification requirements for the meeting should be reasonable and applied equally. At the meeting, shareholders should be able to question board members and top management, or be able to submit written questions in advance. Voting at the meeting must be transparent and accurate. The voting rights of the shareholders should be honoured. After the meeting, there should be no "ambiguity" about the need to act on binding proposals passed by the shareholders, and shareholders should be able to go to court, or regulators, if they are not acted on.

116. There has been ongoing reform to improve the effectiveness of the meeting in a number of countries. Minimum notification requirements have been strengthened. Many countries have quorum requirements mandating that a minimum fraction of share capital be represented at the meeting, this gives a strong incentive to facilitate shareholder participation. In some cases, rules on voting procedures have been clarified. Another common reform is to allow a shareholder via the courts to annul the results of the meeting if legal requirements have not been met. Specific mandates for acting on the decisions of the meeting have also been imposed. Many countries have introduced explicit deadlines, often 60 days or less, for dividends to be paid. Unfortunately, in many countries legal gaps remain, and enforcement is still spotty. Each White Papers details how to extend these reforms across and within countries.

Proxy voting and foreign shareholders

117. The advantage of an open company over a closed one is that it can sell equity to a wider class of investors. This can include shareholders with relatively small stakes, and it can include foreign shareholders, both of which may need to vote in abstentia, if they are to vote at all in a cost-effective way. The extent to which a shareholder can actually vote by proxy varies by country. Most jurisdictions allow proxy voting by another shareholder, though these proxies sometimes face serious administrative hurdles such as requiring formal power of attorney for the shareholder being represented. Many countries restrict voting by nominees, only allowing shareholders to vote. In the case of Singapore, nominees are only given two proxy cards, forcing them to aggregate the votes of their clients, an issue if different clients would like to vote differently. More generally, it is normal for banks and brokers acting as nominees to "aggregate votes" by automatically voting with management. The *Principles* explicitly discourage this. Many

countries require a "physical presence" to vote, preventing voting by mail or some other long distance means. Examples include China, Chinese Taipei, India, Korea, Philippines, and Thailand.

118. Foreign shareholders face even greater barriers to voting than domestic shareholders. They are certainly more likely to vote by proxy. Cross-border voting by proxy remains practically impossible in many developing and emerging markets (or in many developed ones for that matter). For example, shareholders who have shares of companies listed in the US via American Depository Receipts (ADR) fall in between US law and the law of the country where the company is based. The company does not have to follow standard US procedures for releasing information about the meeting and often does not. At the same time, the ADR agreement often provides leeway with respect to the home countries own law. The result is information that may be late, incomplete, and frequently not in English[40].

119. The *Principles* note that "shareholders should be able to vote in person or in absentia, and equal effect should be given to votes cast…in absentia…voting by proxy [should] be generally accepted". The Roundtables have expressed strong support for making proxy voting easier, especially for foreign investors. While current use of information technology is minimal, interest was also expressed in introducing electronic voting, or using information technology in other ways, in spite of concerns over security, and access to the internet for shareholders in some participant countries. However, neither was seen as an insurmountable barrier. As the Roundtables move onto the next stage of their work, reform in this area should begin to move forward at a faster pace.

Major and related party transactions

120. The *Principles* state that "shareholders have the right to participate in, and to be sufficiently informed on…fundamental corporate changes" and "abusive self-dealing should be prohibited…abusive self-dealing occurs when persons having close relations to the company exploit those relationships to the detriment of the company and investors". Given the problem of tunnelling, fundamental corporate changes, and "abusive self-dealing" are of great relevance for developing and emerging market economies. A central issue for the Roundtables has been how to prohibit abusive self-dealing, and in that context, how shareholders should participate in fundamental corporate changes.

121. It is widely accepted that certain major transactions deserve special treatment: those that could have a large impact on the company and shareholders, and related party transactions--transactions where members of the board, management, or the controlling shareholder may have a personal interest. Company law and, with respect to disclosure, securities regulation normally has additional requirements for these sorts of transactions. These requirements are often further reinforced by listing standards and voluntary corporate governance codes.

122. The *Principles* include the authorisation of additional shares (capital increases) and extraordinary transactions that in effect result in the sale of the company as being among the fundamental corporate changes that shareholders should be informed about and participate in. Other major transactions identified in company law and securities regulation will usually also include major sales and acquisitions, with major being defined as meeting or exceeding a certain fraction of the company's book value or similar thresholds.

123. The board is generally required to approve any significant transaction the company engages in. Law or regulation also normally calls for disclosure of such transactions in a timely manner, which should mean when the transaction is planned and not as a *fait accompli*. Other requirements for major transactions vary across countries. Some countries may require direct shareholder approval for a relatively wide range of transactions, while such approval may only be required for a much smaller set of

[40] The International Corporate Governance Network (2002)

transactions in other countries, e.g. only for the sale or merger of the company. If shareholder approval is required, providing shareholders with timely and accurate information about the planned transaction is essential. Super majority approval by the board or shareholders may also be required to approve certain transactions in some countries.

Appraisal rights and dissenters rights

124. Shareholders, at least formally, often have *appraisal rights* for certain transactions. Through a fair and accurate appraisal, shareholders can confirm if the terms of a transaction are good for the company, or biased in favour of the other party. In some cases, an independent appraisal is automatically required, in others shareholders may have to go to court, or petition regulators, to initiate one. In many countries, access to appraisal rights has been broadened over the last few years. However actually ensuring a fair and accurate appraisal remains a challenge. Often the company chooses who will conduct the appraisal, and in practice, this may compromise its independence and objectivity. The Roundtables have discussed methods to improve third party appraisals, including government licensing and increased liability for misleading appraisals, and this remains an important area for ongoing reform.

125. Some countries, including Korea, also provide shareholders with *dissenters' rights*. When some shareholders vote against certain major transactions approved by the general meeting, those shareholders may have dissenters' rights. Typical transactions under which this would apply include mergers and sales of the company. Under dissenters' rights, the dissenting shareholders can demand to sale their shares back to the company. The price the company pays may depend on an appraisal price, or may simply be the price of the shares before the announcement or approval of the transaction. In any case, the valuation should reflect the worth of the shares as if the transaction had not taken place.

Related party transactions

126. Related party transactions can be any transaction, major or otherwise, that involves the company and another entity to which the company is related via a board member, other employee, significant shareholder, etc. In practice, the definition of related party, and related party transaction, that have special status under the law, listing requirements, or in accounting standards, varies from country to country (as does the term itself, some countries use "interested" or "connected" party). Some countries focus only on board members: a transaction with another company in which a board member is an employee, significant owner, or has some other significant connection, would be a related party transaction. In many cases, the definition is broadened to include senior executives, and entities that they may be connected to. In a smaller subset of countries, a controlling or significant shareholder who is not also a board member or manager is considered to be a related party. For example in Eurasia, shareholders owning 5-10% of shares in Kazakhstan, 20% in Armenia and 25% in Moldova are considered to be interested parties. In some common law countries, the concept of the "shadow director"--an individual who is not on the board but who exercises influence over it--may be used to identify controlling shareholders as related parties. This treatment of the controlling shareholder is crucial, given the potential for transactions that benefit the controlling shareholder at the cost of other shareholders and stakeholders.

127. While many related party transactions are legitimate, their clear potential for abuse generally means that controls on these transactions are commonplace. Controls on related party transactions are often similar to those on major transactions, and include reporting requirements, special kinds of board approval, appraisal rights, and direct approval by shareholders in some cases.

128. As with major transactions, the specific regime for related party transactions varies widely across countries, and may depend on company law, accounting standards, and listing requirements. In Singapore accounting standards require the disclosure of related party relationships and related party transactions with

financial statements. In addition listing requirements on the Singapore Exchange require *immediate* reporting of transactions exceeding 3% of the company's book value (last net audited assets), and details on parties that may have an interest in the transaction, the transaction itself, the rational for the transaction, and an opinion of the company's audit committee regarding the fairness of the transaction. For related party transactions that individually or collectively exceed 5% of the issuer's book value, shareholder approval is required. However there are some exceptions to both the disclosure and approval rules.[41]

129. The regime in Singapore is a relatively sophisticated one, including the requirement of an opinion from the audit committee, which are not widely used in many countries. Other countries have some of the same features, including shareholder approval for larger transactions, and prompter reporting requirements for listed companies. Another requirement found in many countries is that a board member who has an interest in a particular transaction must, after declaring their interest, abstain from voting on that transaction. In Hong Kong, China, this principle is extended to shareholders. If shareholder approval is required for a transaction, a shareholder that has a personal interest in that transaction must abstain from voting on it.

130. One important element across regimes is disclosure. The *Principles* note that "Members of the board and management should be required to disclose any material interest in transactions or matters affecting the corporation." In cases where a controlling shareholder can guarantee the approval of the transaction, via the board or the shareholders meeting, it may in fact be the only safeguard available to current or potential shareholders. The effectiveness of other controls also depends on the disclosure regime. For example, Russian company law has extensive requirements governing cases where board members may have an interest in a particular transaction. All these requirements however depend on a board member disclosing their interest to the rest of the board, and the rest of the board taking this disclosure into account. There is *no external* reporting requirement. Without such a requirement, it is not clear that the relevant mandatory procedures, which can include shareholder approval if enough of the board is conflicted, are in fact being followed.

131. In Russia, changes in the company law, securities regulation, and the recent voluntary *Corporate Governance Code* aim to improve disclosure by Russian companies. However, the responsibility of individuals to disclose their interests is still unclear, as are the sanctions for not doing so. Like Russia, many other countries have also strengthened disclosure requirements for the related party transactions, often through listing requirements or Codes. However, many of the countries that participated in the Roundtables also have similar weaknesses with respect to individual board members, managers, or significant shareholders reporting their interest in a transaction.

132. Each White Paper has recommendations on how to improve the reporting of related party transactions, and in some cases specify other controls on these transactions as appropriate. The Asian White Paper calls for banning certain transactions, such as loans to board members and in some cases asset sales to corporate insiders and their relatives that fall outside the normal course of business[42]. In any case, this will almost certainly remain an area of active reform over the years to come.

[41] The treatment of related party transactions in Singapore, as well as US, UK, Australia and Hong Kong China are described in Mak et al (2002).

[42] Clark (1986), Chapter 5, discusses the limits of shareholder and disinterested board member approval, and advocates banning a wide range of related party transactions, though allows for administrative waiver (by a securities regulator for example) if an expected benefit for shareholders can be shown from the transaction.

Capital increases

133. The company can use capital increases to finance profitable investment opportunities. Unfortunately, the controlling shareholder may use changes in share capital to dilute the equity of minority shareholders. To dilute other shareholders, the controlling shareholder (or another corporate insider) will arrange for the new shares to be sold at a substantial discount to themselves, or to a related party. Various tactics are used to prevent outsiders, including other shareholders, from participating in the offering. In-kind contributions, where equity is issued in return for equipment or other assets, are frequently used as a means of diluting shareholders [Box 6]. In the most extreme case, the controlling shareholder will not bother to resort to subterfuge, but will just give themselves the shares.

Box 6. Improving corporate governance: in-kind contributions in Romania

In kind contributions, where a controlling shareholder receives stock from the company not for cash but for a piece of equipment or other kinds of assets, have been widely used to dilute the holdings of minority shareholders. In Romania minority shareholders were confronted with three forms of abuse: 1) for in-kind contributions, shareholders did not have the same pre-emption rights as they would with normal capital increases; 2) the in-kind contribution was usually over-valued and sometimes had nothing to do with the activity of the company; and 3) the in-kind contribution was performed without prior revaluation of the existing capital--often overstating the value in shares of the contribution. At Comet Bucuresti, a retail trading company having a registered share capital of less than USD 300,000, the majority shareholder decided to increase the capital with the contribution of a non-functioning helicopter evaluated at USD 550,000--reducing the value of outstanding shares to almost one third of their previous value. At Condem Bucuresti, the share capital was doubled by including as in-kind contribution six patents held by the majority shareholder. Chimcom SA Bucuresti, the majority shareholder in Romaqua Group, increased the capital by transferring the intellectual property rights on a patent it was holding and which was evaluated at more than the existing share capital. Afterwards, an increase of capital through revaluation of the existing assets was performed.

In 2002 Romania passed comprehensive legislation to restrict in kind contributions, as part of broader reform to improve investor protection. Through the South East Europe Roundtable and a country specific program, the Romanian government was able to draw on a wide body of expertise to inform its legislative efforts. For example, the above cases were cited in a 2001 OECD report on corporate governance in Romania that recommended severely restricting in kind contributions, and suggested other changes that were later incorporated in the 2002 legislation.

134. The special nature of capital increases, and their potential for abuse, is widely recognised, and restrictions on their use are widespread. Shareholder approval is frequently required, and shareholders may also have appraisal rights. Appraisal rights are especially important in in-kind contributions when shares are not being exchanged for cash, but for assets of some kind. In-kind contributions involving physical assets are so prone to abuse as to warrant specific restrictions on their use; in the case of share swaps, or debt equity swaps, proper valuations are essential.

135. Many countries now have *pre-emptive rights* that give all shareholders the right to participate in a capital increase on equal terms. However, pre-emptive rights have limits. In-kind contributions may be used to bypass them. A more general problem is that shareholders may not have sufficient liquidity to fully participate in the increase. One solution to this problem, suggested in the South East Europe Roundtable based on proposed changes in Bulgarian Law, is for *tradable* pre-emptive rights, i.e. a shareholder that could not exercise their rights could sell them to a third party that can.

Changes in control and delisting

136. The transactions that can have the biggest impact on shareholders are *control transactions*. There are three basic kinds of control transactions: a "sale of control" when enough shares to control the company--a control block--are sold from the current controlling shareholder to a new controlling shareholder; a "sale of the company", when the company in its entirety is sold to another party and all of its shares are bought in the process; and a "tender offer", where a third party buys enough dispersed shares to become the controlling shareholder. The prevalence of controlling shareholders ensures that sales of

control and sales of the company are the most common control transactions in developing and emerging market economies.

137. Control transactions can be an important source of value creation, bringing in new owners with superior skills and resources that can benefit minority shareholders and other stakeholders. Many of the countries that participate in the Roundtables are in the midst of widespread industrial restructuring driven by transition from central planning and increasing integration into the global economy. In these countries control transactions are essential if restructuring is to be successful. On the other hand, control transactions can also bring in new owners whose main goal is to extract private benefits at the cost of other shareholders or other stakeholders. The transactions themselves can be designed to extract resources from other shareholders. Control transactions may not even involve actual changes in control; instead the controlling shareholder may essentially sell the company to themselves.

138. In a number of countries, including Argentina, Brazil, Chile, and Russia, changes in control have emerged as one of the most controversial issues for shareholders. Part of the controversy stems from the perceived unfairness of these transactions: the existence of private benefits of control and the resulting control premiums (Box 2) implies that to take control, the new owner may have to pay substantially more to the current controlling shareholder than to other shareholders, even though the transaction does not necessarily make other shareholders worse off. However these transactions can make other shareholders worse off, and many countries have now sought to improve the protection of minority shareholders during control transactions.

139. There are important differences in the legal regime for sales of control across countries. Some countries have relatively laissez-faire approaches where the sale of the control block must be disclosed, but otherwise the sale is treated as a private transaction between the old and new controlling shareholder. Other countries have stricter regimes, with mandatory tenders, or bids, for other shareholders when a control block is purchased. In some cases, board or shareholder approval may also be required for a would-be controlling shareholder to exceed a certain control threshold or be able to vote their shares if they do.

140. Countries with mandatory offers often follow the *City Code on Takeovers and Mergers* from the United Kingdom, where a would-be controlling shareholder has to offer to buy shares from minority shareholders at the same price offered to the current controlling shareholder. This gives minority shareholders an exit option, and treats shareholders equally. However, it also makes changes in control extremely expensive when the current controlling shareholder is already receiving large private benefits, and requires a large control premium to sell their control block. Having to share this premium with all shareholders may require the bidder to pay more than the company is worth-even assuming a large increase in value after the change in control. Hence this regime, while it guarantees equal treatment, may prevent value enhancing takeovers from ever taking place[43].

141. Alternative approaches are available. In Brazil, a new controlling shareholder must offer to buy out other shareholders at 80% of the price per share offered for the control block. In Russia, bidders are required to offer minority shareholders a buy out at the six-month average of the stock price. Under certain circumstances, countries may require buy-outs or compensation using appraised values for the company's stock. Each of these approaches gives minority shareholders an exit, while not placing the same burden on bidders when existing private benefits are large.

[43] The cost and benefits of different tender regimes for companies with a controlling shareholder are examined in Bebchuk (1994).

142. A "sale of the company", once finalised, will generally require that shareholders turn over their shares for cash or shares from the acquiring company, or for shares in a new company created by the sale, on the terms negotiated by the two companies. The obligatory nature of the transaction, as well as its magnitude, warrant special protection for shareholders. Transactions of this magnitude almost always require shareholder approval, and some countries require super majority approval, i.e. approval by 66% or 75% of shareholders. Shareholders also frequently have appraisal rights of some kind with respect to the terms of the bid. Bidders are also sometimes required to make *prorated payments*, offering one sum for the company, and dividing it equally amongst all shareholders. In practice, this is similar to the mandatory offer regime and while it can also prevent certain beneficial transactions from taking place, the mandatory nature of the sale may warrant the additional protection.

143. Investor protection is particularly important when the company is sold to an entity controlled by the controlling shareholder, management or other corporate insiders. In Argentina there were two high profile cases where controlling shareholders used this sort of control transactions to essentially dilute the holding of minority shareholders. In each case they were required to turn over their existing shares for shares in new holding companies where they had reduced voting rights.[44]

144. One reason that controlling shareholder or management would sell the company to themselves is to de-list it and take it private. Many countries that have experienced large-scale privatisation, including not only transition economies but some Latin American ones as well, have had extensive post privatisation consolidation where listed companies have been de-listed. This process can be efficiency enhancing, especially for small and medium sized companies. However, it can also be problematic when the company still has outside shareholders who hold only a small fraction of the voting rights, and who may be left with un-tradable shares if the company de-lists. One solution are so called "squeeze-out" procedures under which the controlling shareholder buys out other shareholders if a certain ownership threshold is crossed, like 75% or 90%. Once initiated, squeeze-outs are normally mandatory for both the buyer and the sellers. Squeeze-outs may be required after the threshold is crossed, or they may be initiated by the controlling shareholder, minority shareholders, or either. In spite of their potentially misleading name, squeeze-outs can be beneficial to minority shareholders, but this depends on how the terms for the buy out are set: squeeze-outs almost always involve appraisal rights.

145. While the particular regime for control transactions may vary, one essential element emphasised by the *Principles* is transparency. Unfortunately, in too many cases the rules governing control transactions are not clear, and not well known. The transactions themselves, especially the sale of control blocks, often occur under terms that are opaque to outsiders. In addition, major control transactions have too often been presented to shareholders after the transaction was completed. Some countries have responded to the controversy surrounding these transactions by clarifying their laws and regulations, and spelling out more clearly the regime for control transactions, and the rights of shareholders during those transactions. However the regime for control transactions remains very much a work in progress given the recent nature of this reform. Corporate control transactions will be a priority area for follow up work in a number of the Roundtables.

Insider trading

146. Controlling shareholders and other corporate insiders can use their privileged position to profit at the expense of other shareholders by trading shares based on privileged information. This can be combined with other abuses, e.g. selling shares in a company from which resources are being diverted using concealed transactions, or can be an isolated event. The *Principles* note that insider trading should

[44] These two cases involved Pérez Companc S.A. and Banco de Galacia y Buenos Aires S.A. Grondona et al (2001).

be prohibited and the general feeling in the Roundtables was that such transactions significantly undermined confidence in capital markets and discouraged outsiders from purchasing shares.

Table 6. Introduction of insider trading laws

Country	IT Law Introduced	First Prosecution
Germany	1994	1995
Italy	1991	1996
Japan	1988	1990
Spain	1994	1998
United Kingdom	1980	1981
United States	1934	1961
Bangladesh	1995	1998
China	1993	No
Chinese Taipei	1988	1989
Hong Kong, China	1991	1994
India	1992	1998
Indonesia	1991	1996
Malaysia	1973	1996
Pakistan	1995	No
Philippines	1982	No
Singapore	1973	1978
Sri Lanka	1987	1996
Thailand	1984	1993
Argentina	1991	1995
Brazil	1976	1978
Bolivia	No	No
Chile	1981	1996
Colombia	1990	No
Mexico	1975	No
Peru	1991	1994
Paraguay	1999	No
Armenia	1993	No
Kazakhstan	1996	No
Moldova	1995	No
Mongolia	1994	No
Ukraine	No	No
Bosnia-Herzegovina	No	No
Bulgaria	No	No
Croatia	1995	No
Macedonia	1997	No
Romania	1995	No
Serbia and Mont.	1997	No
Russia	1996	No

"No" indicates no law or prosecution on or before 1999

Source: Bhattacharya and Daouk (2002)

147. The US has had laws against insider trading since the 1930's. However many other countries have only introduced these laws recently, and some still have not done so (Table 6). Germany, Italy and Spain did not have laws against insider trading before 1991, and did not have any prosecutions for insider trading before 1995. Only 9 of the 32 Roundtable participants for which data is available had laws against insider trading before 1990, and 14 did not have laws before 1995. Even after laws are introduced, there are long

lags before prosecution takes place: Overall, only six countries had prosecutions for insider trading before 1995, and the majority still had no prosecutions by 1999.

148. The late introduction of insider trader laws is not a reflection of their importance for capital markets. A recent study finds that the introduction of insider trading laws, and even more significantly their enforcement, lowers the cost of equity for firms, and increases various measures of market turnover and liquidity[45]. This underscores the observations of the Roundtables on the costs of insider trading, and the potential gains from combating it.

149. As indicated by the long delays between the introduction of insider trading laws and actual prosecution, enforcing these laws can be challenging for securities regulators. Effectively enforcing insider-trading laws requires disclosure of share trading by parties that may have access to privileged information, including not only corporate insiders but in some cases their family members as well. This sort of reporting is not only needed to enforce insider trading laws, but if disclosed widely can also provide critical information to shareholders, who would certainly like to know if insiders are buying or selling shares in the companies they control.

150. Related to concerns about insider trading are other abuses of privileged information. Insiders can “tunnel” information out of a company that could be of benefit to themselves, e.g. a controlling shareholder could transfer the business opportunity developed at one company to another company in which he had a larger stake. Insider trading and other abuses of privileged information make clear the importance of defining what information should remain privileged, i.e. potentially significant information that is not disclosed to shareholders and the public, and what the duties are of those who have information. A general principle is that parties who do have access to privileged information should not to use it for their personal benefit.

Effective shareholder involvement

151. One of the strongest messages from the Roundtables was that improved corporate governance required more effective involvement by shareholders. This includes both controlling shareholders, who may benefit from taking a longer-term point of view, and making greater use of voluntary measures to improve corporate governance; and institutional investors, who can influence corporate governance both through their choice of investments, and in monitoring and voting after they invest. It also includes individual portfolio investors, who collectively can have a major impact on the behaviour of companies they invest in.

Controlling shareholders

152. The shareholders who are in the best position to improve governance of the companies they own, and who in many cases have the most to gain from doing so, are controlling shareholders. In all five regions, there are companies that have taken the lead to improve transparency and the treatment of minority shareholders and other stakeholders. In many cases, the controlling shareholders in these companies have been rewarded with higher share prices and easier access to capital. Voluntary actions in these cases made both the controlling shareholder and other shareholders and stakeholders better off. However, controlling shareholders often feel that they will be put at a disadvantage if they take actions to improve corporate governance while rivals do not. For example, increasing transparency unilaterally, and reporting bad news more consistently than other companies, may lower the company's stock price, not increase it. Controlling shareholders may also feel that their efforts on behalf of the company warrant special “compensation”--this is especially true when valuations are low.

[45] Utpal Bhattacharya and Hazem Daouk (2002)

153. By *credibly* indicating improved transparency and better treatment of other shareholders, the controlling shareholder is in a position to reap the benefits in terms of higher valuations and easier access to equity finance. Hence, mechanisms that allow controlling shareholders to send credible signals to investors can facilitate voluntary action to improve corporate governance. These include foreign listing, special stock market tiers, and voluntary corporate governance codes. The effectiveness of these mechanisms clearly depends on the faith that other shareholders have in them: a voluntary code whose compliance is effectively monitored will have more of an impact then one that depends solely on the honesty of the controlling shareholder.

The state as shareholder

154. The widespread privatisation that has taken place in so many of the Roundtable countries has transferred many companies once wholly owned by the state into companies with significant private ownership. However, the state remains a significant shareholder in a number of these companies. Like other controlling shareholders, the state is in a strong position to improve the governance of companies that it still controls or influences, and some OECD countries have taken significant steps to improve the governance of state owned enterprises.

155. Improving the governance of these companies generally requires a clear separation of the state's role as owner and regulator. Control should be transferred from ministries to professional boards with commercial objectives. The management culture of the company should also be transformed into that of a private commercial enterprise. Introducing performance-enhancing compensation combined with high standards for management can facilitate this. Most of the White Papers give more detailed recommendation on improving the governance of state controlled companies, and the OECD has also initiated work on *Principles* for the governance of state owned assets.

Foreign companies

156. While families or the state controls most companies, multinational corporations are also significant owners in a number of countries. A multinational based in a country with relatively good corporate governance is normally in the position to apply the same high standards of governance in other countries where it is a controlling shareholder. However, cases were presented in the Roundtables where multinationals treated shareholders and stakeholders in developing and emerging market subsidiaries quite differently than shareholders and stakeholders in the company's home market. These companies should respect the laws and standards of the countries they invest in, and behave in a responsible manner consistent with the OECD Guidelines for Multinational Enterprises. Beyond that, multinationals often introduce new technology and expertise to a market they invest in and they should also introduce superior corporate governance when possible. This is particularly true for governance practices that go beyond legal minimums.

Institutional investors

157. Historically, the role of institutional investors in developing and emerging markets has been limited. However, in recent years their presence has increased significantly and looks likely to continue to grow in the years to come. Two trends have contributed to this greater role. One is globalisation and the growth of foreign investment in emerging market economies. In 1990, foreign investment in equities in many of these countries was close to zero. Now foreign investors, and in particular foreign institutional investors, are important capital market participants in each of the five Roundtable regions. They are not limited to the more advanced capital markets. Funds backed by bilateral and multilateral agencies like the International Finance Corporation (IFC), the European Bank for Reconstruction and Development

(EBRD), and the United States Agency for International Development (USAID) are some of the most important market participants in countries with less developed capital markets.

Table 7. Countries introducing mandatory privately managed pensions

Country	Date Introduced
Argentina	1994
Bolivia	1997
Chile	1981
Colombia	1997
Mexico	1997
Peru	1995
Uruguay	1997
China[1]	1997
Hong Kong, China	2000
Bulgaria	2001
Croatia	2002
Romania	2003
Kazakhstan	1998
Ukraine	2003
Hungary	1998
Poland	1999

1: Funds in China may be administered by individual state owned enterprises

158. The greatest growth has and will continue to come from domestic institutional investors. In the 1990's these included official privatisation funds in transition economies. While still significant in some markets, their role has been declining as the first phases of mass privatisation have come to a close and capital markets have matured. Much more important for the future are domestic pension funds. In 1981 Chile established mandatory, privately managed pension funds. In recent years, a number of countries have followed the "Chilean Model," and not only countries in Latin America. Since 1995, over a dozen developing and emerging market economies have required workers to save in pension funds that can invest some fraction of their portfolios in private securities (Table 7). Other countries, including Brazil, Korea, and Singapore have taken steps to encourage private pensions. Malaysia has a central provident fund that can hold a certain fraction of its assets in domestic equities. In Chile, the assets of these funds exceed annual GDP. While their holdings are still relatively small in countries that have introduced them later, there is little question that these funds will be significant forces in capital markets in the years to come[46].

159. Institutional investors can also include other domestic investment funds, like mutual funds or private insurance companies. When a private domestic investor has the capabilities to become closely involved in the governance of the company, it can be one of the strongest forces for improvement, or can facilitate abuse. In the SEE Roundtable, two polar cases where discussed. ICF investments of Croatia makes strategic investments in underperforming companies, including those with poor governance, and uses its influence to turn the company around, generating a significant return in the process. On the other hand, certain Bulgarian holding companies—some former privatisation funds—were also discussed that used control stakes to engage in a range of abusive intra-group transactions. Both these cases are in some ways exceptional, in part because domestic institutional investors (other than pension funds) are small in most developing and emerging markets.

[46] Oman (2003), chapter 3 discusses the role of pension funds in corporate governance in Chile.

160. Institutional investors can be effective advocates for corporate governance. However they do not always make the efforts they could to monitor and vote in the companies they own. The *Principles* call upon institutional investors to consider the costs and benefits of exercising their voting rights. Some OECD countries have begun to require certain institutional investors to disclose their voting policies, and in certain circumstances have made voting in the general shareholder meeting mandatory. In Chile, pension funds are now required to disclose their voting policies to members and regulators. What is important is not just that these funds vote, but that they make corporate governance part of their investment criteria, and that they invest the resources needed to use their voting rights and other influence to improve the governance of the companies they invest in. This is especially true for institutional investors supported by bilateral and multilateral aid agencies, or other funds with an official mandate, like mandatory pensions. These funds should be strongly encouraged to have well-developed corporate governance policies consistent with their duties to their beneficiaries.

Individual investors

161. While controlling shareholders always have a significant ownership stake, and institutional investors are of growing importance, in many companies individual portfolio investors still hold a majority of shares. Many of these investors do not closely monitor the companies they have shares in, and do not participate in the general meeting. This has led to complaints about a lack of an “equity culture” in many countries. However, the Roundtables have also confirmed that these countries do have shareholder advocates, and it is clear that individual shareholders are becoming more educated, organised, and vocal.

162. A deeper reason for shareholder passivity than a lack of motivation or interest is the costs to the investor of monitoring and voting for each stock in their portfolio. Where the costs of participation are high, it may simply not be rational for individual shareholders to be active corporate governance participants. Shareholder organisations that give constructive guidance on voting and other relevant issues may lower the cost of shareholder participation. Companies themselves may wish to create investor relations departments to facilitate more shareholder involvement. However significantly lowering the cost of shareholder participation in many countries will require greatly improved transparency and more effective general shareholder meetings.

163. This points to a fundamental conclusion of the Roundtables: while all shareholders can and should take voluntary actions to improve the governance of the companies they own, significant improvement will only come as part of broader efforts to enhance the legal and institutional framework. The most effective way to give controlling shareholders credibility is for the courts and regulators to protect the rights of other shareholders. Protecting the basic rights of shareholders and other stakeholders will also enhance the ability of institutional investors to act as a catalyst for better corporate governance at the company level. The White Papers for each of the regions provide more detailed recommendations on how different shareholders can assist in creating better corporate governance as well as offering guidance on improving the overall corporate governance regime.

IV. THE RESPONSIBILITIES OF THE BOARD

164. While board competencies, structures, and practices vary across countries, the board everywhere plays a central and critical role in the governance of the company. A strong board participates effectively in company strategy and provides proper incentives for management, maximising value for all shareholders while protecting the legitimate interests of other stakeholders. In contrast, boards in developing and emerging market economies all too often fall into one of two categories. One is the "rubber stamp" board that plays little role in governance. In this case the company is run by a controlling shareholder who deals directly with management. Board meeting and decisions are formalities (see Box 7). The other is the "family" board. Here, the controlling shareholder, important executives--often relatives of the controlling shareholder--and long trusted advisors do make strategic decisions. This kind of board can be quite effective at furthering the interest of the family that controls the company. Unfortunately, this interest may conflict with that of other investors, as well as the longer-term interest of the company.

165. Controlling shareholders are frequently in a position to choose all members of the board. These board members in turn may feel obligated to act in the interests of that controlling shareholder. They may even go so far as to see themselves as the *delegate* of the controlling shareholder: someone who votes as directed. In turn minority shareholders and in some cases other stakeholders have demanded to have their own delegates on the board. However, the Roundtables reasserted the principle that regardless of how they are chosen, board members should be capable of exercising informed and independent judgement, acting as representatives of all shareholders.

166. Improving boards has become a corporate governance priority in a number of countries. Reforms have been wide ranging, seeking to increase board accountability to all shareholders; ensure responsible behaviour to other stakeholders; enhance board power vis-à-vis management and controlling shareholders; and improve the capabilities of individual board members. Examples of specific reforms include clarification of board member duties in the law; requiring greater numbers of independent board members; encouraging the use of specialised committees, especially audit committees; developing the infrastructure for the ongoing training of board members; and in some cases making greater use of cumulative voting. Reform will continue: each White Paper provides detailed guidance on how to improve boards in its respective region.

167. There are important differences between boards across countries. For example, many countries have one-tier boards, but some have two-tier boards with a supervisory board and a management board—in this case "board" as used in this chapter is generally referring to the supervisory board. Some have a board of directors and "statutory auditors"[47] that are frequently referred to as an audit board, this can be considered another type of two-tier structure. Finally, a few countries have companies with all three company organs, i.e. a three tiered board structure. Another variation in structure is the use of specialised committees: some companies in Asia may make use of a number of specialised committees, but these committees are far less common in the other four regions.

168. Regardless of the differing details on their structures and how they operate, all boards have important commonalities. In most cases, these are common goals or functionalities: e.g. acting in the

[47] Statutory auditors and their functions are discussed in this chapter under Board Practices and Structures-Audit Committees and Audit Boards.

interest of the company and all shareholders; or playing an important role in major corporate transactions. One concept that has underpinned the *Principles* and the Roundtables is *functional convergence:* that even with differences in structures and practices, all boards can and should be capable of performing a common set of critical governance functions.

Box 7. The dilemma of board passivity

Boards, like shareholders, have a reputation for excessive passivity in a number of countries. One extreme case of board passivity was presented in the Asian Roundtable[48]:

> Board of directors (BOD) meetings were not even held and BOD minutes could not even be found in most Korean companies. Typically, boards were perfunctory affairs and rubber stamp mechanisms whereby the planning office of companies would draft the necessary board agenda based on the wishes of the controlling shareholder and then would approve them by stamping all the "seals" of all the directors that they would hold in their office. Many directors did not even know that board meetings were supposed to be held.

While this is an extreme example, board member passivity and the resulting "rubber stamp board" were widely noted in the Roundtables. Three sociological explanations have been offered. One focuses on the natural deference to authority and the hierarchical nature of decision making found particularly in many Asian countries. In these countries board members naturally defer to the chairman (or controlling shareholder), and do not wish to rock the boat. A similar explanation for transition economies emphasises the habits acquired under the central plan, which again lead to a tendency to defer to the board chairman. The third explanation is less country specific, and focuses on the "team" nature of the board. In this case, being part of the team, and co-operating with the rest of the board, is seen as being all important, and hence board members do not wish to rock the boat.

Other explanations may be possible. In Korea, the situation has improved: meetings are now held regularly, and minutes kept. Board behaviour changed because the law changed:

> With the recent onset of legal changes such as the presence of outside board members, the increase in shareholder activism through such means as legal actions, the strengthening of shareholder rights and more emboldened regulatory forces, the legal machinery governing boards finally has started to take form.

The Korean experience has implications for other countries. By changing board practices and composition, and the incentives of board members, reform can effectively motivate boards, in spite of a seemingly deeply ingrained culture of board passivity.

Legal duties of board member

169. Roundtables participants widely accepted that board members should act in the interest of the company and *all* shareholders (see Box 8). This observation is rooted in legal precedent, though the precise origin of board member duty varies country by country. Some countries, particularly civil law ones, explicitly mandate the duty of board members to act in the interest of the company. In common law countries, including, India, Malaysia Singapore and Hong Kong, China, board members have an implicit *fiduciary* duty to act in the interest of the company, even when law does not explicitly require it[49]. In some civil law countries such as Chinese Taipei, the duty of loyalty or an equivalent are not specified in company law. In these countries, courts have also established the fiduciary duty of board members. Roundtable participants emphasised that regardless of origin, board members' duty of loyalty to the

[48] Jang (2001)

[49] Discussions of directors' duties often refer to a set of fiduciary duties: duty to act in good faith, duty to avoid conflicts of interest, etc. Each of these fiduciary duties can considered as underpinning, or elaborating on, the general duty of loyalty.

company is practically universal. Company law normally prohibits board members from acting in their own interest, or the interest of a particular group—as distinct from the company—without explicit sanction from shareholders. This prohibits board members from taking actions that only benefit some shareholders, e.g. the controlling shareholder or the shareholders that voted for the particular board member.

Box 8. Board member duties: loyalty to whom?

Board members are guided in their decisions by duties and obligations specified in law and legal precedent. The *Principles* note that "board members should act…with due diligence and care…in the best interests of the company and shareholders". This reflects the widely recognised duties of "loyalty", the duty of board members to act in the interest of the company and the shareholders; and "care", the duty to act on an informed and prudent basis in decisions with respect to the company.

What exactly is the "interest of the company" that board members are supposed to act in? For practical purposes, this is generally interpreted as the long run interest of the shareholders. There are two basic arguments for this. The first is based on the property rights of shareholders. The shareholders are the company's owners, and as such are generally considered to be the supreme authority in the company, delegating their powers to the board, and are the ultimate beneficiaries of the company, i.e. the company's profit goes to them as dividends and capital gains. As the company's owners, beneficiaries, and ultimate authority, it is natural to assume that their interests and that of the company are analogous, and that board members should act in the interest of shareholders.

The second argument is economic, and rests on the claims that shareholders have with the company. Laws, contracts, and their ability to break off relations with the company generally protect other stakeholders. On the other hand, shareholders are the company's "residual claimants", absorbing the losses and acquiring gains that it generates. It is in the interest of shareholders that their company is operated efficiently and takes advantage of productive investment opportunities. This is also in society's interest—as long as the company honours its obligations to other stakeholders.

The duty of loyalty provides a basis for board member *accountability*. If the interest of the company is defined loosely, this transfers discretion to board members and may allow them to justify actions that benefited themselves or related parties, but not shareholders. Requiring board members to act in the interest of the company *and* shareholders clarifies the duty of board members, and ensures that board members are accountable to someone other than themselves. This accountability is enforced by the authority over board members that company law normally provides to shareholders.

Chilean company law provides a clear example of the board members' duty to the company and shareholders as a whole, and not to other groups[50]. . Article 42.1 notes:

"Directors shall not: 1) propose amendments to the by-laws or issuance of securities, or adopt policies or make decisions which are not in the corporate interest, but in their own interest, or that of related third parties."

It goes on to specify in article 39:

"The directors elected by a group or class of shareholders have the same duties for the corporation and the remaining shareholders, and they cannot fail them on the excuse of defending the interest of those who had elected them."

This last part is particularly important. Loyalty to shareholders does not mean loyalty to *some* shareholders, but loyalty to *all* shareholders.

170. In, India, Malaysia, Singapore and Hong Kong, China and other common law countries, board members are expected to perform their duties with "reasonable skill, care and diligence." As with fiduciary duty, these duties are implied by the board member's position, and may not be specified in company law. They require the board member to approach the affairs of the company in the same way that a prudent and reasonable person would approach their own affairs. This can be subjective, and does not

[50] As cited in Escobar (2002).

necessarily impose objective criteria such as a basic knowledge of financial statements, or attending at least two-thirds of the meetings of the board.

171. Like the duty of loyalty, the duty of care is specified in the company law of some civil law countries. For example, in Russia board members are required to act in “reasonable and good faith", in Thailand they must act with "care and honesty.” In Mexico, the board members have a mandate (*mandato*) as administrators of the company. As a *mandatarios* a board member must "act prudently, caring for the business as if it were his own"[51]. In Chinese Taipei, the mandate of the board members also imposes the equivalent of a duty of care via the Civil Code.

172. Like the duty of loyalty, the duty of care or a close equivalent can be found in practically all countries with open joint stock companies. The duty of care establishes the accountability of board members for errors deriving from a lack of effort and attentiveness, as well as conflicts of interest and other abuses of their position. However, the duty of care tends to be interpreted in a way that gives maximum discretion to board members. This is often reinforced by a local equivalent of the "business judgement rule" that, in the absence of conflicts of interest, gives board members wide latitude in determining what is in the interest of the company. This discretion is important if board members are to take justified risk and participate in the strategy of the company, but it can limit their accountability under the duty of care.

173. Roundtable participants would frequently state that "board members must be accountable to shareholders and responsible to stakeholders.” Accountability is grounded in the duties of loyalty and care. To the extent that good relations with stakeholders further the interest of the company and shareholders, then responsibility to stakeholders naturally follows from accountability to shareholders. Beyond this board members generally have a requirement to ensure that the company complies with the law, and honours its contractual commitments. Company law may elaborate a duty of the board member to the company to ensure compliance, or face damages if they do not. Relevant legislation may also specify that corporate officers, including board members, are responsible for particular actions of the company.

174. In addition to the fundamental duties of loyalty, care and ensuring legal compliance, board members have their own "governance and disclosure" duties. Company law and securities legislation place specific requirements on board members to follow certain administrative procedures and disclose certain information, for example specifying any relationship they may have with the company. Company law also generally requires board members to act honestly, and specifies penalties for wilful misinformation.

Civil and criminal liability of board members

175. Lists, sometimes long lists, of board member liabilities are a standard feature of company law and securities regulation. These lists may be further augmented by judicial precedent, especially in common law countries. Board members may be liable for various aspects of the duty of loyalty to the company as well as the duty of care. They are frequently liable for damages to the company, and sometimes third parties, resulting from an illegal action of the company that they facilitated. These lists also include liability for violation of various procedural duties. Board members may be liable collectively, individually, or frequently both.

176. In spite of the many liabilities board members may face, a number of Roundtable participants made statements very close to: "in country X, there are no cases I know of where shareholders have ever successfully sued board members for a violation of their duties". Such statements were not restricted to transition economies with relatively short histories of shareholder ownership. Even in those countries with

[51] Ritch (2001)

the most developed capital markets and institutional frameworks, including Chile, Chinese Taipei, Korea, and Singapore, shareholder suits have been scarce, at best. Clearly, if board members are not liable for breach of duties, those duties will have limited influence on their behaviour and accountability.

177. Three factors explain this paucity of shareholder suits, and the resulting implications for board member accountability: 1) the very nature of board member duties; 2) the specifics of company law, securities regulation, and their interpretation; and 3) the general challenges faced by judicial systems that have been so widely discussed in the Roundtables.

178. The overarching problem is the nature of board member duties. Board members must be loyal to the company, and in turn their other duties are also seen as being to the company. Even the duty to ensure legal compliance is seen as being to the company, with the board members liable for damages to the company resulting from an illegal action by the company that they helped bring about. Under these circumstances the company would presumably bring suits against board members, but who decides what actions the company takes? Normally the board itself decides.

179. In the case of a "rogue" board member who has taken some individual action to harm the company, then the various liabilities can be enforced by other board members, who can bring a suit against the rogue board member on behalf of the company. However many abuses discussed in the Roundtables involved decisions made by a majority of the board in favour of themselves, management, or a significant shareholder, but against the interest of shareholders at large, i.e. allowing the company to be tunnelled. Under these circumstances, it is shareholders who should be able to bring suit against board members.

180. Historically in some countries, shareholders could not sue board members under any circumstances: Malaysia did not allow for shareholder lawsuits against board members until 2001, Chile not until 2000. Currently, almost all countries do, at least in theory, allow for shareholders to sue board members when they violate their duties to the company. These generally include two kinds of suits: individual suits where particular shareholders sue for damages, and derivative suits, where a shareholder sues on behalf of the company and the damages awarded goes to the company. Until very recently, no non-member country participating in the Roundtables allowed for class action suits by shareholders. Chinese Taipei and China have begun to introduce these suits, as has Korea (a member of the OECD), and other countries are considering it.

181. As a matter of basic principle, individual suits are problematic: the board member is not liable to individual shareholders, but to the company and all shareholders. The individual shareholder seeks damages related to abuses done against the company as a whole, not directly against themselves. Derivative suits are more straightforward, and some countries only allow for derivative suits. Derivative suits however face a clear "free-rider" problem: some shareholders pay the cost if the suit fails, but all shareholders may gain. For both kinds of suits, courts frequently have a narrow view of the circumstances under which some shareholders can claim to represent the company, and conditions under which board members actually have to pay damages, alter decisions, and or stand down.

182. Company law and related regulation further complicate the process of holding board members liable. One element of this is the generally minimal nature of the duty of care. In addition, relevant legislation frequently contains provisions that specifically limit the ability of shareholders to sue board members. Law generally requires showing not just conflicts of interest or neglect, but that the gains to board members were material (substantial), that negligence or dishonesty was intentional, etc. In general, the burden of proof for shareholders may be quite high.

183. Beyond this, company law may not allow the filing of a suit unless a majority or super-majority of shareholders pass a supporting resolution in the general meeting. This again reflects the liability of board

members to the company and shareholders as a whole, but is clearly problematic in the presence of a controlling shareholder. Shareholders with a minimum, perhaps a high minimum (e.g. 33%) of the company's stock may be the only ones that can bring a suit. The very lists of liabilities for board members may actually deter suits, since each case may be quite narrow—an illegal action was involved, certain papers were not filed with auditors, etc.—and when added together may in fact leave significant gaps.

184. In addition to the general problems of particular shareholders suing on behalf of the company, and the various hurdles created by the law itself, probably the most widely cited reason for the rarity of shareholder suits was the delay and cost associated with the court system. This was a general problem cited in the Roundtables for all civil suits, not just shareholder suits.

185. One alternative to shareholder suits is civil and criminal action by public authorities. Roundtable participants emphasised that in many countries this was the principal means through which board members were held liable, if they were held liable at all. Company law and securities regulation in many countries does provide for criminal sanctions, including time in prison for certain violations of board members duties, e.g. providing wilfully and materially misleading information; gross negligence; etc. However, severe criminal penalties tend to occur only after spectacular failures, and may not be much more common then shareholder suits.

186. Securities commissions and other regulators can bring civil action against board members under relevant regulation, and can sometimes sue on behalf of shareholders. Civil action by regulators has clear advantages over private suits brought by shareholders. The regulator may be able to demand down payments for fines and damages and freeze or reverse certain actions of the board as the case works it way through the court system. Regulators may also be in a better position to represent the company and shareholders as a whole, and do not face free-rider problems. However, the resources of securities commissions and other regulators are limited and they are rarely in a position to police even a large fraction of all open joint stock companies.

187. The Roundtables left no doubt that the duties of loyalty and care need to be strengthened. The White Papers call for these duties to be further clarified in national legislation, narrowing legal gaps in the process. The procedures for individual and derivative suits should be streamlined, securities commissions should be able to file suits on behalf of shareholders, and in some cases so should other groups, like shareholder associations. Class actions remain controversial overall, but are a suggested reform in the Asian Roundtable. However, Roundtable participants agreed that civil and criminal suits should be a last resort, and that other mechanisms are needed to align the interest of board members, and *all* shareholders.

Board member effectiveness

188. Many Roundtable participants emphasised that the way to better boards is through better board members. An effective board is one composed of qualified, independent board members with the right incentives, training and adequate support. On the other hand, participants judged their own reality to be characterised by an abundance of weak, unqualified board members dependent on, and loyal to, the controlling shareholder.

189. Basic qualifications for board members tend to be minimal. They normally must be of a minimum age, usually the age of "majority" (18-21). In Singapore and Malaysia, they cannot be over 70. Generally board members cannot be convicted of certain crimes, including fraud, cannot be bankrupt, and in some cases cannot have served on the board of a company that went bankrupt.

190. Beyond the basic qualifications, some countries limit the number of boards that someone can serve on. This number ranges from a low 3 (Romania) to a high 20 (India). In many countries, board members

cannot serve on the boards of competing companies. Many countries require board members to be shareholders of the company, though in some cases having only one share may be sufficient. Some countries allow legal persons to be board members, some only allow natural persons, and some allow legal persons, but with a natural person as a "permanent representative." The by-laws of the company may specify additional requirements for board members.

191. Board members for banks often have additional requirements, including minimum levels of education. Some board committees and tiers, where they exist, may also have special requirements: for example one member of the audit committee or audit board may be required to be a certified accountant. Increasingly certain committees, and in some cases the board as a whole, must also have a minimum number of "independent" board members.

Independent board members

192. Globally, laws, listing requirements and codes are calling for more independent boards and more independent board members. Roundtable participants applauded the global drive for greater board independence, and called for its expansion and acceleration. But what exactly is "independence" and are independent board members automatically better then other board members?

193. In its recommendations for boards, the *Principles* focus primarily on conflicts of interest with management. In the Roundtables, the central problem is conflicts of interest involving a controlling shareholder. Historically, boards in these countries have not only had a high fraction of executive members, or recent executives, but also the non-executive relations and representatives of controlling shareholders. Frequently, an individual would serve on multiple boards in a business group controlled by a particular family. In each case, the board member may feel that their first loyalty lies with the controlling shareholder. The hope expressed by Roundtable participants was that by increasing the number of independent board members, the board would be less dominated by the controlling shareholder, and more capable of acting in the interest of the company and the shareholders as a whole.

194. In recent years, countries with unitary boards have begun, primarily through securities regulation or listing requirements, to require companies to have a minimum number of non-executive board members who may meet certain additional independence criteria. This can include a small fixed number—e.g. one in Chinese Taipei or two in the Philippines—or an overall proportion of the board. In India, at least one-third of the board in large companies must be "independent," in Kazakhstan and Korea, one-half. In countries with multi-tier board systems, company law prohibits executives serving on the supervisory board, or limits the proportion that can serve on both supervisory and management boards. For example in Russia, no more than half of the board can be executives who also serve on the company's executive, or management, board. A third way that non-executives have been mandated is through committee requirements. For example, Chile has introduced a supervisory "directors" committee that must have at least two independent board members. The audit committees mandated in other countries generally also require a minimum number of independent members.

195. What constitutes a non-executive, outside or "independent board" member often depends on the relevant legislation or code. Generally it excludes all managers and executives. However in Russia, the restriction in company law applies specifically to the executive board, managers not on that board could serve on the company's main board with no limitation. Increasingly, securities regulation and listing requirements have gone further in defining independence. Relatives of management and other board members, recent employees, and officers in related companies may be excluded.

196. Most importantly, "independent" increasingly means independence from significant, and especially controlling, shareholders. Securities regulation and listing requirements in Chile, Chinese Taipei, Korea

and Malaysia now all require some degree of separation from significant shareholders for independent board members, and voluntary codes encourage this in a number of other countries. This does not mean that independent board members should not own shares. Roundtable participants felt that it was counterproductive to severely limit the shareholdings of independent board members.

197. The increasing prominence of non-executive board members (though still small in relation to the overall size of the problem) is widely supported by the Roundtables. Nonetheless, it was understood that a fully "independent" board member does not necessarily bring added value to the board. Simply having no connections to the company does not guarantee that the board member will act in the interest of all shareholders, be responsible to stakeholders, or exercise adequate skill, care, and diligence in their decision making. As experience with non-executive board members has accumulated, it has become clear that board members with no special connection to the company can be as deferential to management or the controlling shareholder as any executive, and may have little incentive to devote much time or effort to their duties.

198. Many Roundtable participants and the *Principles* emphasise a "positive" definition of independence somewhat different from the "negative" definitions that are so widely used. The ability of a board member to exercise objective judgement, and provide informed opinions independent of the dictates or desires of particular shareholders or corporate insiders, is a positive indicator of independence. Board members with this sort of independence are in a stronger position to contribute to the strategy of the company, oversee management, and fulfil their duties to all shareholders. This "independence of thought" should also allow them to evaluate stakeholder issues more objectively.

Developing board professionalism

199. While demands on and for non-executive board members capable of exercising independent judgement have been increasing, supply remains limited. The resulting shortage of qualified board members was a frequent lament of the Roundtables. A typical company still tends to recruit board members from a small pool of men known by the controlling shareholder or related to the company in other ways. Creating a fully functioning market for board members will require tapping into a much larger pool of latent talent.

200. With the goal of developing new and better board members, institutes devoted to board member training and professionalism have been established in a number of countries, many in the last 5 years. Table 8 list some that have been established, but is far from comprehensive. Frequently modelled on the British Institute of Directors (IoD), these institutes seek to improve the performance of both executive and non-executive board members. Effective training often builds on the "learning by doing" process that new, or newly active, board members normally experience, with more of an emphasis on active learning rather than lectures. Multilateral agencies and donors including the Global Corporate Governance Forum (GCGF), along with private sector bodies such as the Yale Institute for Corporate Governance, have developed "training the trainers" workshops and other programs to assist these institutes, and encourage new ones. The GCGF has also developed a “tool kit” of instructions on how to set up and maintain institutes of directors.

201. Beyond training, these institutes, along with stock exchanges and sometimes others, have developed voluntary codes to inform the behaviour of non-executive board members. National IoDs also assist in developing evaluations for board members. Professionally implemented evaluations can be an effective tool for the board and shareholders, but are not widely used in developing and emerging market

economies. Again following the lead of the British Institute of Directors[52], some IoDs, including the Mexican Institute of Corporate Governance and the Russian Independent Director Association, have also begun to develop plans for "chartered" or "certified" board members. Building on current practices, the institute would certify that these board members have qualifications and knowledge that go beyond minimal requirements of company law. They would also attempt to ensure that the board members maintain their independence and behave in an ethical manner.

Table 8. Institutes of directors

Country	Institute(s)	Founded
Hong Kong, China	Hong Kong Institute of Directors	1996
Indonesia	Indonesian Institute for Corporate Directorship	2000
Malaysia	Institute for Corporate Governance	1998
Philippines	Institute of Corporate Directors	1999
Singapore	Singapore Institute of Directors	1998
Sri Lanka	Sri Lanka Institute of Directors	2001
Thailand	Thai Institute of Directors	1999
Brazil	Brazilian Institute of Corporate Governance	1995
Colombia	Confecámaras	
Mexico	Mexican Institute of Corporate Governance	2003
Peru	Corporate Directors Association	2002
Russia	Independent Director Association	2001
	Russian Institute of Directors	2001

The political board member

202. A special case of possible dependence involves the "political" board member. In many countries, companies, including privately controlled ones, feel obliged to have sitting members of parliament, prominent bureaucrats, party representatives, or former members of government on their boards. While these board members may bring a certain expertise to the company, the tendency in some countries for these board members to change after each election raises questions as to what exactly is their role on the board. Governments should be concerned about the impact on their credibility of their members serving on the boards of privately controlled commercial companies. In state controlled companies, Roundtable participants pointed out that board members should be chosen for the contribution they can make to the company, not on other criteria.

Voting, nomination, and remuneration

203. The *Principles* identify the ability to elect members of the board as a basic right of shareholders. The company law of all the countries that participated in the Roundtables confirmed this right. However in practice minority shareholders—which generally is most shareholders—may have little choice in who actually sits on the board, and no practical way of removing board members who favour the interest of the controlling shareholder over their own. Remuneration, another mechanism that could align the interest of board members with shareholders, is also generally controlled by the board itself, or the controlling shareholder. Voting procedures for board members has been a particularly prominent issue in all the Roundtables. The nomination, remuneration, and removal of board members are important as countries

[52] The Institute of Director in the UK introduced the concept of the 'chartered director', and has been given special authority to charter directors in Britain. The review required to become a 'Chartered Director' (C.Dir.) involves the evaluation of directors' knowledge, understanding, experience and probity.

move to the more advanced stages of the reform process and non-executives begin to play a greater role on the board.

204. In most countries companies have simple majority voting for each board member. In practice, this generally allows the controlling shareholder to have the decisive vote for the entire board. Controlling shareholders frequently have less then 50% of the company's voting rights, and one way to increase the influence of other shareholders is to make the general meeting more accessible. This would include reducing barriers to participation erected by the controlling shareholder and other corporate insiders.

205. Some countries have introduced specific mechanisms to reduce the dominant position of the controlling shareholder. The most popular is cumulative voting. A kind of proportional representation for the board, in a cumulative voting system shareholders do not vote separately for each board member, but assign votes across board members. 10-15% of the total vote is normally enough to select a board member. Under this system, the controlling shareholder would still choose most of the board, but other shareholders could elect some board members without the support of the controlling shareholder.

206. Cumulative voting is required for companies in Chinese Taipei, Kazakhstan, Moldova, and the Philippines, and for companies with more than 500 shareholders in Armenia and 1000 shareholders in Russia. It is also mandatory in China for companies where a controlling shareholder owns more than 30% of the stock, and in Romania if requested by a shareholder having at least 10% of the voting shares. Other countries now allow for cumulative voting on a voluntary basis: in Thailand and Korea it is the "default" voting mechanism, though companies normally change their charters to exclude it. Malaysia, India, and some other countries do not allow cumulative voting.

207. There are other mechanisms that allow non-controlling shareholders to influence the choice of board members. In some countries, other significant shareholders can appoint board members directly. Large shareholders in Korea have their voting rights capped at 3% when electing board members that will also serve on the audit committee. In Chile, pension funds are not allowed to vote for candidates related to the controlling shareholder. Shareholders without normal voting rights or with restricted voting rights can select a member of the board in Brazil.

208. These mechanisms may reduce the controlling shareholders' dominance of the board and were supported by many Roundtable participants. The White Papers support companies and shareholders having cumulative voting as an option. However, by its very nature, cumulative voting can encourage board members to think of themselves as representing particular blocks of shareholders, not the company and shareholders as a whole. The board members duty of loyalty to the company and all shareholders becomes more important, not less so, when cumulative voting or similar procedures are in place.

Nomination

209. Even when general meetings are accessible (see chapter III), and special voting rights in place, minority shareholders may still not be able to choose particular board members. The rules for Board member nomination, or "appointment" as it is characteristically called, differ across countries, but in practice tend to be dominated by the board itself, and by the controlling shareholder. Normally the board or its chairman can nominate board members directly. The controlling shareholder or other significant shareholders can in turn influence the board, or in some cases nominate directly themselves; e.g. in Singapore major shareholders can reserve the right to nominate board members in the company bylaws. Nomination committees are required for large companies in Korea and used in some other companies in Asia. When present, these committees generally dominate nomination, and while they normally have non-executive members, they reinforce the notion that the board controls nomination. Finally, shareholders normally can nominate board members through a standard shareholder resolution. However, placing one

of these resolutions generally faces various hurdles, sometimes including a relatively high minimum ownership requirement.

Removing board members

210. In many countries, board members are elected for only one year. However in some countries, particularly in Asia, board members have multi-year terms. These multi-year terms are frequently staggered, i.e. if the term is three years, only one third of the board is up for election per year. In Thailand, the third of the board that comes up for election is chosen randomly. In turn, some countries require that board members be re-nominated at the end of their term, in others re-nomination is automatic. Finally, in some countries shareholders can remove board members before their term expires, but not in all countries; or they can only be removed when explicit wrongdoing is alleged.

211. Multiyear terms, staggering (which can prevent a "clean sweep" of the board from ever happening) automatic re-nomination, and the inability to remove board members early are all "entrenching" mechanisms that can reduce the accountability of board members to minority shareholders. Of course controlling shareholders may dominate the board even without such mechanisms. However, as the protection of basic shareholder rights improve, these mechanisms will need to be addressed.

Remuneration

212. Remuneration practices for board members differ greatly across companies and countries. In some cases, board members may not paid by the company, or paid very little; in other cases the pay of board members would be considered relatively high. Companies often pay a basic monthly salary, plus meeting related expenses. Others use more sophisticated schemes based on the effort and performance of the board member. In a few countries, including Singapore and Hong Kong, China, companies have introduced stock options for board members. Some countries require individual reporting of compensation, some require reporting in the aggregate, and some require no disclosure of compensation. Finally, shareholder approval of board member remuneration may be required, though in most cases it is not.

213. Roundtable participants noted a few basic principles of remuneration. Very low levels of remuneration will clearly not attract the best non-executive directors, and may be a sign of something worse: in some countries board members are paid primarily by the groups of shareholders they “represent”, not bye the company. On the other hand, given the influence that the controlling shareholder and other corporate insiders have on board member selection and replacement, very high levels of compensation can also distort incentives. Remuneration should also be transparent to shareholders, and an effort should be made to explain to shareholders why board members are paid what they are. An example from the meetings: attracting qualified and independent non-executive board members may require a level of compensation that shareholders consider “high”. The company should not hide the compensation, but include the rationale for the payment in the disclosure and support it in the general meeting.

Information and support

214. Company law normally provides the board with broad powers over the company. However, to exercise this power effectively “board members [must] have access to accurate, relevant, and timely information’’ (*Principles*) and must also have adequate staff support. Company law varies in the “information rights” that directors have, but normally they have rights to access certain information on their own, have relevant information presented to them before the meeting, and can in some cases commission third party research at company expense. Audit committees and audit boards frequently have additional powers to access information in the company.

215. In practice, the amount of information provided depends on the board and its members: e.g. a board that performs primarily ceremonial functions and is not truly involved in running the company will not be given much information. Roundtable participants noted that for non-executive board members to make a contribution to the board, executive board members, the company secretary, and other staff must take some responsibility in providing relevant information to them in a timely manner. Board members themselves must also take the initiative, asking questions of the executive board members in the meeting, and taking advantage of other informational resources as available. Each White Paper includes recommendations to ensure that board members have the resources and information necessary for them to carry out their functions.

Board practices and structures

216. All company boards have broad powers that are similar. They are supposed to oversee the management or "administration" of the company. They must be engaged, albeit to varying degrees, in company strategy. They play a critical role in determining their own compensation and that of management, have the power to hire and fire executives, and can greatly influence the nomination and election of individual board members. They must ensure the company complies with its various obligations, including financial reporting and other disclosure requirements. And most importantly, they must fulfil their legal duties to protect the interest of the company and shareholders.

217. Specific competencies will not be the same. In companies with a formal management or executive "body," whether it is a board or committee, significant aspects of management and strategy may be delegated, with the (supervisory) board playing an oversight role. In other countries, the single unitary board is for all practical purposes the executive body, and will be heavily engaged in strategy and management. Normally boards do have wide powers of delegation, and their involvement in strategy and management will also vary across companies as well as across countries.

218. A key variable for the board is size. Roundtable participants generally felt that boards should be "big enough", but not too big. Two considerations are the different skills of board members, and potential conflicts of interest. Boards should have a range of skills from both their executive and non-executive members; this can include specific financial and legal knowledge, knowledge about the industry, analytical ability, the ability to represent the company, etc. At the same time, it should be noted that boards can bring in consultants or other advisors as needed on an ad-hoc basis. Having sufficient independent non-executive board members is essential to avoid conflicts of interest, and their presence is increasingly required by the rules for specialised committees and approving major transactions. At the same time, as boards begin to exceed a dozen members they may begin to become unwieldy. While the Bangladeshi example of a board with 160 members is an extreme one, the 20+ member boards that some Asian companies have will serve for little more than ceremony.

The board's role in major and related party transactions

219. When companies have controlling shareholders, are part of business groups, and have boards composed of executives and non-executives related to the controlling shareholder and or other parts of the business group, conflict of interest situations become practically unavoidable, and possibly routine. A large fraction of the board may be conflicted. All countries have procedures to address conflicts of interest on the board. However, it has become clear that these procedures may not be adequate to prevent transactions that favour the controlling shareholder or other corporate insiders.

220. Law requires board members to declare any potential conflict of interest to the board. Company law frequently has the additional requirement that a conflicted board member abstain from voting when they have a personal interest. These provisions are adequate to the extent that the board enforces them, but

in cases where a large fraction of the board may be conflicted, more may be required. Securities regulation and listing requirements in some countries required reporting these conflicts in the annual report, or immediately to the stock exchange, securities commission or the public at large. Roundtable participants were fond of noting that "sunshine is the best disinfectant", and these reporting requirements do reinforce the accountability of board members to shareholders.

221. Beyond disclosure, law may require that certain transactions be approved by a super-majority of the board. The matter may also be taken out of the board members' hands. In the Philippines, all related party transactions require approval by shareholders; with the immense exception of companies in the same business group, transactions between these companies are required to be "reasonable and fair." Other countries also require that certain major or related party transactions receive shareholder approval; in Russia the most important transactions require super-majority approval.

222. A critical question for the board and shareholders is the terms of the transaction: are they fair to the company, or are they biased in favour of the other (related) party. In some cases shareholders may be able to demand an outside appraisal. The board, and particularly independent board members, are increasingly playing a role here as well. Audit committees—which normally have a minimum number of independent members—are frequently required to give their opinion on a particular transaction, and submit this opinion to the board and or shareholders. They may also have the power to solicit an outside appraisal as part of this process. Independent board members in China can also receive an outside appraisal for major related party transactions, and they have the power to reject the transaction before being discussed by the whole board. Each of the White Papers contains further recommendations on board members and related party transactions.

Board tiers and committees

223. Many companies have one board. However others have both a supervisory board and a management (executive) board. Many also have statutory auditors that are sometimes referred to as an audit board. The board structure of the company is usually given by company law. However in some countries companies may have a choice of board structures or different companies may have different structures for other reasons: e.g. in Romania, most companies have an audit board (censors), but large companies adopting International Accounting Standards do not (see Table 9).

224. A management board is an executive grouping overseen by the supervisory board. Building on Dutch and German company law respectively, all companies in Indonesia and Croatia have management boards, whose members are somewhat confusingly called "directors". Most companies in Eurasia also have management boards. In Russia and Kazakhstan, company law dictates that companies may have a one person chief executive, or a collective executive, in this latter case these companies are also considered to have a management board. Generally there are limitations on members of the management board serving on the supervisory board.

225. Companies without management boards often have executive committees—a committee of the executive board members—and the practical difference between the two may be small. The executive committee may also be specified in company law, as is the case in the Philippines and Romania. In Chinese Taipei, company law specifies that the board can elect from its members a "Board of Managing Directors" that has certain statutory powers, but legal scholars do not consider this a separate board tier. One important difference between the two organs is that all members of an executive committee will serve on the board. This is not normally the case with a separate management tier.

Table 9.Board structures in selected OECD and non-OECD economies

Unitary Board	Separate Management Board
Hong Kong, China India Korea Malaysia Philippines Singapore Thailand *Bulgaria* *Former Yugoslav Republic of Macedonia* *Romania* Serbia and Montenegro United Kingdom United States	Indonesia *Bulgaria* Croatia *Former Yugoslav Republic of Macedonia* Georgia Germany Netherlands
Separate Audit Board	Separate Audit and Management Boards
China Chinese Taipei Armenia *Kazakhstan* Argentina Brazil Mexico *Romania* *Russia* Italy Japan	Azerbaijan *Kazakhstan* Moldova Ukraine Bosnia and Herzegovina *Russia*

Italics indicates that more than one type of board structure is allowed for.

226. While many companies may have executive committees, other committees are much less common. Large companies in Korea are required to have nomination committees, and listed companies in India are required to have remuneration committees. Voluntary codes recommend these committees in other countries. In each case, and in line with the *Principles*, these committees normally allow non-executive board members to play a leading role in determining company policy in an area where conflicts of interest are likely: nominating board members and paying executives. However where remuneration and nomination committees are not required they are not widely used.

Audit boards and audit committees

227. The company law of a number of countries requires companies to have audit boards made up of statutory auditors. These boards have different names in different countries—Censors, Supervisors, the Audit Commission, Consejos Fiscais, and Comisarios—but largely perform the same functions. Elected by the shareholders and frequently having legal duties similar to board members, the statutory auditors oversee the firm's internal auditing and the preparation of financial reports and other information given to regulators and shareholders. They frequently oversee compliance with the law and shareholder resolutions. While they may attend meetings of the primary board, they do not vote. They may have other powers as well. As described in company law, they would seem to have an important role in the governance of the company.

Experiences from the Regional Corporate Governance Roundtables

228. Instead of an audit board mandated by company law, boards increasingly are required to have an audit committee formed from the company's main board. Audit committees generally oversee the company's internal audit and reporting. In many cases, they may have a role in overseeing compliance. In addition, they normally have a significant influence on the choice of external auditor; they may oversee the control and risk management systems of the company; and they normally provide opinions on related party transactions to the rest of the board or shareholders. In addition to somewhat different powers, the main difference between audit boards and audit committees is that members of the audit committee also serve on the main board.

229. Audit committees are mandated by law in Singapore, and by listing requirements in Thailand, Malaysia and India. In Hong Kong, China, audit committees are required for companies listed on the Growth Enterprise Market (GEM). Chilean companies must now have a "directors" committee, which has many of the same functions as an audit committee. Companies listed on the New York Stock Exchange, which includes many large companies from Latin America and Asia, will be required to have audit committees if they do not already have audit boards.

230. Audit committees made up of non-executive and preferably independent board members were strongly supported by Roundtable participants, and are recommended by the White Papers. They are a way for the board to develop expertise, and maintain independence, in some of its most important competencies. The attitudes towards audit boards were on the other hand mixed. In many countries audit boards have performed poorly. Like other board tiers they have tended to fall under the influence of the controlling shareholder and other corporate insiders. They often lack the technical expertise increasingly necessary in the face of ever greater financial and operational complexity. Their relationship with external auditors is often unclear. Perhaps most importantly, by taking on certain functions, they may encourage a negligent attitude on the part of the main board.

231. Important questions remain about how to make audit boards more effective. As audit committees become more common in countries that also have audit boards, the relationship between the two will have to be clarified. Some Roundtable participants have recommended replacing audit boards altogether. However in most countries, audit boards are likely to remain, and will hopefully play a more effective governance role.

V. THE ROLE OF STAKEHOLDERS

232. The long-term success of the company depends on its ability to manage relations with a range of stakeholders and to encourage them to invest resources specific to the company. Contracts, laws, and their own ability to break off relations with the company protect stakeholders to varying degrees in all the countries that participated in the Roundtables. In some cases, powerful "social norms" and implicit contracts provide stakeholders with additional protection. However, the Roundtables have revealed gaps in the implementation and enforcement of contracts and other mechanisms designed to protect stakeholders. Some Roundtable participants also emphasised that companies may increasingly find it in their own interest to go beyond minimum legal compliance when dealing with stakeholders.

233. The list of potential stakeholders a company may have to consider is a long one, including customers, suppliers, governments, and the local community. One Roundtable participant even suggested the list should include future generations. The Roundtables focused on the roles of employees and creditors, as well as stakeholder issues more generally. Employees can influence the governance of the company through various mechanisms, especially consultation rights—through works councils for example--and in some countries through share ownership. In turn, effective governance requires that employees can voice concerns about corporate behaviour to the proper authority, and that mechanisms exist to align the interests of employees and shareholder.

234. In some countries, creditors are most notable for their virtual absence from providing finance to open companies. In others, they play a smaller role than might be expected. Poor protection of creditors' rights, and especially the non-use of legal procedures for reorganisation and liquidation, is one reason; financial crises, which have affected many Roundtable participants over the last decade, another. Conflicts of interests and problems with their own governance have also weakened banks.

The role of employees

235. Good employee relations can increase motivation, reduce turnover, and encourage workers to acquire skills that benefit the company. The governance mechanism at a minimum should ensure that the company honours its contracts with employees and relevant legislation. Beyond that, successful companies are ones that can constructively bring employees into the wealth creation process.

236. Unfortunately, some companies do not even meet the minimum requirements, breaking agreements, laws, and standards designed to protect employees. While all the Roundtable participants have laws to protect workers, and in some cases very extensive social and employee protection *de jure*, employees often have limited redress to protect their rights when those laws, or contracts, are violated. This is part of more general problems with enforcement that were widely noted in the Roundtables, and also reflects a myopic attitude that some companies seem to have towards outside resource providers. Methods to improve enforcement in this area are similar to those for improving the enforcement of investor protection, including increasing the capability of the judiciary and regulators, and making greater use of alternative dispute resolution.

237. The corporate governance of open joint stock companies[53], the subject of the Roundtables, is only a small part of the policy landscape involving employees and employment-related issues. Issues like unemployment or worker health and safety standards must be addressed directly through the relevant policy framework. Moreover there are other forms of ownership that may confer some control rights to workers. Traditionally, human capital intensive organisations have been organised as partnerships, or in the case of private universities and hospitals, as non-profit organisations. Worker-owned cooperatives are another organisational form that gives employees special control rights. While these forms of organisation have their advantages and disadvantages, in some cases they do provide alternatives to the shareholder owned corporation.

Employee participation in the governance of joint stock companies

238. There are a wide range of both formal and informal mechanisms through which employees other than management communicate with and influence the companies they work for. For example all the countries that participated in the Roundtables formally recognise the core labour standard of workers to associate freely and related rights. Mechanisms also exist for employees to participate more directly in the governance of the companies they work for.

239. In 19 of 32 Roundtable jurisdictions for which data is available, workers have the right to choose some members of the board, appoint works councils, and or some constitutional right to participate in the decision making process of the company[54] (see Table 10). Employee representation on the board, where employee representatives--usually from trade unions--will hold some proportion of board seats, is the least common of the three. Works councils are more common, and under current EU directives, will spread to Roundtable participants in Eastern Europe that wish to join the EU over the coming years. Employees elect representatives to the council, which must be consulted by the board of the company on matters that affect employees. While the council has the power to negotiate with the company, the company retains ultimate decision-making authority.

240. Works councils are one way that workers can have *consultation rights* in the company. They are not the only way however. In Romania for example, works councils do not yet exist[55], but boards are legally required to consult union representatives on issues that can affect workers. Not only can consultation give voice to worker concerns, it can be an important source of information for the board, especially independent board members, and for shareholders. Employee representatives can provide the point of view from the "shop floor," which may differ substantially from the view presented by other corporate insiders.

[53] The *Principles* specifically focus on publicly listed companies, though their potential usefulness for other companies is also noted. As described in Chapter I, Ownership and Control, the Roundtables also discussed open joint stock companies that where not listed, including companies whose privatisation had led to dispersed ownership.

[54] Botero el al (2003)

[55] Romania may introduce work councils as part of the process of joining the European Union.

Table 10. Employee Participation in Corporate Governance

Country	Employees Appoint Some Board Members	Works Councils Mandated by Law	Constitutional Reference to Employee Participation in the Management of the Company
China	Yes[1]	Yes	Constitutional Right
Chinese Taipei	Yes[2]	Yes	Mentioned
Hong Kong, China	No	No	No
India	No	Yes	State Policy
Indonesia	No	No	No
Korea	No	Yes	No
Malaysia	No	No	No
Pakistan	No	Yes	No
Philippines	No	No	Constitutional Right
Singapore	No	No	No
Sri Lanka	No	Yes	No
Thailand	No	No	No
Vietnam	No	Yes	Constitutional Right
Argentina	No	No	State Policy
Bolivia	No	No	No
Brazil	No	Yes	Constitutional Right
Chile	No	No	No
Colombia	No	No	State Policy
Ecuador	No	No	No
Mexico	No	No	No
Peru	No	Yes	State Policy
Uruguay	No	No	No
Venezuela	No	No	No
Bulgaria	No	Yes	No
Croatia	Yes[3]	Yes	No
Romania	No	No	No
Armenia	No	No	No
Georgia	No	Yes	No
Kazakhstan	No	Yes	No
Kyrgyz Republic	No	Yes	No
Mongolia	No	No	No
Ukraine	No	Yes	No
Russia	No	Yes	No

Source: International Institute for Corporate Governance/Lopez-de-Silanes 2003
1: Employee representatives serve on the supervisory board of joint stock companies.
2: Employees representatives serve on the boards of state owned companies
3: Employee representatives serve on the boards of state owned and some privatised companies

Employees as shareholders

241. Privatisation in Russia, South East Europe and Eurasia has made millions of employees shareholders in the companies they work for. In some companies in the other regions employees are also significant shareholders. Roundtable participants pointed out that employee owners are in a strong position to improve the governance of their company. They have particular knowledge about the company that other shareholders might not have. Since the company is the source of their livelihood, they have strong

incentives to ensure that it is successful. Being owners may also motivate employees to advocate corporate governance reform more generally.

242. Dominant controlling shareholders and weak boards diminish the potential advantages of having employees as shareholders. In many cases employees sell their shares as soon as possible. When they have held on to their shares, employee owners have faced barriers to full participation in corporate governance. Employees may be prevented from voting their shares, and may even have their shares voted by management. In Macedonia, employees where pressured into formally transferring voting rights to management, a practice that was legal at the time. Employees, like other shareholders, may not have the necessary information to exercise their vote effectively. They may also not have access to independent advice, but may be heavily influenced by management or other corporate insiders[56].

243. These problems are similar to ones faced by other shareholders. In addition, employees also face the threat of retribution by management if they choose to vote in an independent manner: demotion, being fired, etc. Roundtable participants noted that these problems can be addressed by bringing employee owners into the general meeting as normal participants, and ensuring that the meeting itself meets adequate standards: voting should be secure, and results confirmed by an independent party; management should not be able to vote employee shares, or any shares they do not have; confidential voting should be encouraged, and is highly relevant for proxies acting on behalf of employees; and relevant information should be distributed to all shareholders in a timely manner before the meeting. Kazakhstan now forbids employers to act as proxies for their employees. Some countries have also introduced cumulative voting, which would allow employees and minority shareholders to choose some board members, even when the controlling shareholder and their allies have a majority of votes in the general shareholder meeting.

244. A different kind of concern expressed in the Roundtables has been that when employees do use their votes, they tend to focus purely on "employee issues" and do not take into account the wider interests of the company. Cases were raised where employees focused on increasing compensation, and blocked needed restructuring--an issue of great importance in transition economies, and reminiscent of some worker owned companies in the former Yugoslavia. There was a feeling that in some cases employees may not see themselves as owners, and do not act as such. Bringing employee owners into the shareholder meeting, and giving them the same treatment as other shareholders, could help to alter this mindset. However, the best way to make employee shareholders feel like owners is broader based corporate governance reform that makes being a shareholder worthwhile.

Employee ownership through pension funds

245. In some OECD countries, employees are major equity holders through their pensions. Following the "Chilean model," privately managed employee pensions are growing rapidly in a number of other countries, albeit from a very small base. This growth has the potential both to change capital markets, and enhance the retirement income of several million individuals. In the Roundtables it was noted that these sorts of funds can be a major driving force for corporate governance reform. However, important caveats were also noted, based in part on the experience in OECD countries, and on the systems that have been developed in these countries to date. One issue is the governance of the fund itself, and ensuring that it respects its fiduciary duty to its clients, i.e. employees. Another was restrictions on fund investments that limit their ability to diversify internationally. Capital markets in most Roundtable countries can be volatile, and international diversification can be an important risk management tool. Most importantly, while these funds can be drivers for capital market development, their main goal must always be providing secure retirement income to future retirees.

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[56] Frémond (2000)

Box 9. Corporate governance: the wider context

A number of participants in Roundtables emphasised that the company and corporate governance do not exist in a vacuum. Good corporate governance can be assisted, or hindered, by the wider civil society-especially the media, the state of public governance, and a society's general attitudes towards transparency and accountability, i.e. social norms. This does not mean that corporate governance is an unchanging aspect of a country's culture. Countries can and have improved their corporate governance. However corporate governance does depend on the wider social context.

Shareholder advocates were some of the most vocal Roundtable participants, and their presence was confirmation of the general importance of a vibrant civil society. Civil society groups, i.e. non-governmental organisations (NGO), have led the push for greater transparency and better protection for shareholders and stakeholders in a number of countries. For example in Serbia and Montenegro, G-17, a group founded in opposition to the Milosevic regime, is now a leading advocate for improved corporate governance.

One essential element of the civil society is the media. The press can be one of the most effective "watchdogs," uncovering abuse of shareholders and other stakeholders and educating the public about issues related to corporate governance. However the media in some countries is relatively passive, the main purpose of business reporting appearing to be to attract and retain advertisers. On the other hand, the press can also be excessively sensationalist, spreading rumours that damage legitimate companies. Nonetheless, the press plays a critical corporate governance role, one that is enhanced by balanced reporting.

An active civil society, including voluntary corporate governance efforts, can attempt to substitute for the vacuum created by poor public governance. Many aid donors increasingly focus on NGOs for just this reason. However, to the extent that poor public governance breeds corruption and undermines the implementation and enforcement of law and regulation, poor public governance will lead to poor corporate governance. Hence, improved public governance can have a positive impact on corporate governance directly, and by strengthening the wider civil society[57].

Whistle blowers

246. Employees are usually the first ones to know about transactions and practices that violate the legal rights of shareholders and other stakeholders. "Whistleblowers" who reveal these abusive activities can be a critical source of information and are in many cases essential in bringing the appropriate civil and criminal action. The potential for employees to act as whistleblowers can be an important deterrent to abusive behaviour. Unfortunately, many of the countries that participated in the Roundtables offered little formal protection to whistleblowers, who can face unemployment, being "black-listed" by other potential employers and even subject to personal threats for revealing sensitive information. In some cases it may actually be considered a breach of duty for employees to reveal such information.

247. The Roundtables emphasised that countries should take action to protect whistleblowers, shielding them from liability, and in turn penalising employers who retaliate. In some jurisdictions, relevant authorities should also consider steps to protect the personal safety of whistleblowers. As part of wider efforts to improve both relations with employees and transparency and disclosure, companies should facilitate the internal flow of information through mechanisms like anonymous reporting by employees and creating an internal "ombudsman" to follow up on employee allegations of unethical behaviour.

Performance enhancing compensation

248. In the countries that participated in the Roundtables, most major companies have controlling shareholders, and these shareholders are generally effective at motivating and disciplining management.

[57] For a discussion of the links between public governance, corporate governance and the wider society see Oman (2003), chapter 1.

However, some larger companies, especially in Asia and Latin America, have begun to make greater use of performance-based compensation, including share-based compensation. This will be increasingly important as major companies in these regions begin to employ professional management at the highest level, and as part of wider corporate governance efforts to make companies accountable to all shareholders. This may also become relevant for other employees, as the global trend of increasing "human capital intensity" will also begin to affect leading companies that will need to attract and motivate high quality workers. However given the troubling performance of stock options as used in the US[58], Roundtable participants felt other kinds of compensation should be utilised, for example shares (not options) that can only be claimed after a certain period of time. In any case these plans must take into account regional practice and regulation. They should also be transparent to shareholders and their cost to the company accurately reported in financial statements.

The role of creditors

249. Bank loans, bonds, and other kinds of credit are normally the primary source of external funds for companies, and are a critical source of finance for private investment. In addition to providing loans, creditors can also develop long-term relationships with companies, providing long-term capital and perhaps acting as effective monitors of corporate governance in the process. However, in the Roundtables many participants noted that in their countries banks and other potential creditors were often less interested in lending to the private sector than in holding government bonds, and that the "relationships" between creditors and companies when they existed were not always ideal.

250. Like shareholders, creditors in these countries face "tunnelling" by companies they have provided funds to, and like shareholders, they often have difficulty in obtaining redress when their rights are violated. The specific kinds of transactions that companies use to expropriate creditors are in many cases the same as those used to transfer funds from minority shareholders: when the net assets of a leveraged company are reduced through tunnelling, the potential for default increases, and the value of both its debt and equity are reduced. In addition, companies may make excessively risky investments when net assets, and equity, are low: a high return will go to the (major) shareholders, but creditors will absorb any loss.

251. These abuses come at a high cost: creditors are less willing to lend to companies, and this in turn limits financial development, increases reliance on internal cash flow, and reduces investment and growth in the process[59]. Table 11 gives some indication of how much private credit firms have access to in a range of Roundtable and OECD countries. With the exception of a few countries in Asia, credit to the private sector and state controlled commercial enterprises is significantly higher in the developed economies listed on the table than in the developing and emerging market economies. Overall, credit to the private sector and state enterprises is 135% of total GDP for the five developed economies, but only 36% of GDP in the 20 developing and emerging market economies, and only 18% of GDP when the countries from the Asian roundtable are excluded.

Protection of creditors' rights

252. The rights of creditors depend on the contracts they make with firms--loan agreements and bond covenants--specific restrictions on certain actions by the company, and the specific regime for corporate insolvency and creditor protection. Creditors should be able to write a range of different contracts with companies and expect to have them enforced. In practice, the same delays and other difficulties that shareholders, employees, and other stakeholders face in the courts also bedevil creditors. Even pressing

[58] Bebchuk et al (2002)

[59] An overview on the links between credit market development and economic performance is provided by Levine (1997).

claims to pledged collateral can be difficult in many countries, and more sophisticated agreements are in some cases completely unenforceable. In one famous if extreme example, the Russian Supreme Arbitrazh Court ruled that derivative contracts were analogous to gambling, and could not be enforced. This limited enforcement severely restricts the risk-sharing mechanisms the company can employ.

Table 11. Total credit to the commercial sector in selected countries

Country	Credit to Private Sector and Commercial, State Controlled Enterprises (% of GDP) 2001
Bangladesh	24
China	124
Hong Kong, China	158
India	29
Indonesia	21
Malaysia	140
Pakistan	29
Philippines	44
Singapore	109
Sri Lanka	28
Thailand	108
Vietnam	35
Armenia	10
Azerbijan	5
Georgia	8
Kazakhstan	11
Kyrgyz Republic	4
Moldova	12
Mongolia	8
Ukraine	11
Argentina	23
Brazil	35
Chile	63
Colombia	26
El Salvador	41
Peru	20
Uruguay	51
Venezuela	12
Russia	12
Albania	4
Bulgaria	11
Croatia	36
FYR of Macedonia	17
Romania	7
Serbia and Montenegro	0.1
France	87
Germany	120
Japan	188
United Kingdom	135
United States	144
Roundtable average	**36**
Roundtable average excluding Asia	**18**
OECD average	**135**

Source: World Bank

253. In the law, creditors frequently have rights that go beyond the enforcement of contracts. For example, in many countries a company may not be able to transfer a liability to a third party without the explicit approval of the relevant creditor. Companies sometimes have means to bypass these restrictions. Instead of moving liabilities, they will move assets, "hollowing out" the company and leaving creditors with the shell. In some Asian countries, business groups make heavy use of loan guarantees, transferring effective liabilities in ways that are not transparent, to the detriment of both creditors and minority shareholders that unknowingly acquire the effective liabilities.

254. In some countries, courts may be able to block certain transactions or other actions if they are clearly intended to harm creditors. In some cases, they may also be able to "pierce the corporate veil" and hold controlling shareholders and corporate insiders accountable for transactions that were abusive to creditors. A related mechanism is "avoidance powers" that require funds tunnelled out of the company before insolvency to be returned to the company and its new owners, i.e. former creditors. Overall however, the redress that creditors have in the face of abusive transactions are limited.

255. One important difference between creditors and shareholders is that companies do not always have to pay dividends, but they do have to pay interest, if they are solvent. For this reason it is normal that creditors have a limited role in the governance of the company. This changes as the company approaches insolvency. In almost all countries, though to varying degrees, creditors do become involved with the governance of the company, and will frequently become the new owners of the company, once it is insolvent and begins formal procedures for reorganisation or liquidation.

256. On the other hand, in the countries that participated in the Roundtables, these procedures are simply not used very often. Table 12 provides averages of bankruptcy rates for a selection of Roundtable and OECD countries--this includes both liquidation and reorganisation. With the exception of Singapore, rates of bankruptcy in the emerging markets in the tables are a fraction, in some cases a very small fraction, of the rates of the four developed countries listed. There is no evidence to suggest that these economies are somehow more stable or their companies less bankruptcy-prone than companies in the sample of developed countries.

Table 12. The use of bankruptcy law in selected countries

Country	Ratio of Bankruptcy Fillings to Firms (%)-1990's
Argentina	0.12
Chile	0.28
Colombia	0.16
Peru	0.05
Hong Kong, China	0.55
Korea	0.17
Singapore	3.06
Thailand	0.13
Russia	0.31
France	2.62
Sweden	7.61
UK	1.85
US	3.65
Roundtable Sample Mean	**0.54**
OECD Sample Mean	**3.93**

Source: Claessens and Klapper (2003)

Experiences from the Regional Corporate Governance Roundtables

257. The limited use of both reorganisation and liquidation procedures are a widespread phenomenon that extends well beyond the listed countries. Some transition economies that participate in the Roundtables have never had a major non-financial company actually complete insolvency proceedings. Given their limited institutional capacities, including for example very minimal social safety nets, there may be good reasons why these countries do not enforce insolvency legislation as aggressively as in more advanced economies. Nonetheless the rare use of these laws was seen by the Roundtables as the principle weakness in protecting the rights of creditors.

258. From the discussions in the Roundtables, it became clear that there is a significant stigma attached to bankruptcy in many countries. This stigma is so great that a few countries have attempted to coin other terms to make insolvency more palatable. The terminal nature of insolvency proceedings in many countries may feed this stigma. As one Roundtable participant noted, "Historically, insolvency arrangements have not been conceived to serve as a framework for the resolution of financial distress but rather as funeral services for dead companies[60]". The potential for tunnelling or fraud as a contributing factor to insolvency may have also added to its negative reputation, and the somewhat ironic desire by most parties to avoid it altogether.

259. The Roundtables emphasised that the main reason formal insolvency procedures are infrequently used are the costs associated with the courts enforcing them. Compared to other commercial disputes, bankruptcy cases seem particularly prone to delays and judicial indecision that almost always comes at the expense of creditors. This may in part be another aspect of the stigma involved in actually declaring a company insolvent, but also reflects the capacity of the judicial system to enforce insolvency legislation. Outside research also finds a link between the efficiency of the judiciary and the use of insolvency law[61].

260. Creditors do lend to companies in developing and emerging market economies, if at lower levels than in developed economies, so how do they protect themselves? As described in the Roundtables, private banks that cannot rely on implicit government guarantees approach lending decisions carefully. Borrowers are fully screened, conditions for the loan are insisted on, and the loan agreement itself is carefully written. If a borrower does default, the bank will go to great efforts to "work-out" the loan, for example renegotiating the schedule of payment or agreeing to a debt equity swap, without using formal insolvency arrangements. During workouts the bank may become closely involved in the governance of the company. Formal insolvency, including the limited options for formal reorganisation, is generally seen as an inefficient last resort.

261. While creditors can operate to varying degrees in a range of markets, the evidence across countries indicates that better creditor protection will lead to greater lending to the private sector, and more specifically that insolvency legislation will be used[62]. There is also evidence that policy reform can overcome the stigma surrounding insolvency within a country. In Korea and Russia for example, the use of formal insolvency procedures have increased significantly since the introduction of major reforms. Reform can go too far: the introduction of a rigid system in Hungary led to literal mass bankruptcy before it was changed by the use of a more economic definition of insolvency. Since the regime was changed in Russia there have been cases of essentially solvent companies being seized by creditors.

262. While the relevant legislation has been changed again in response, the Russian case also illustrates the central role that judicial capacity plays in the insolvency regime. In Korea, where reform has been more successful, a specialised chamber was created within the Seoul district Court for insolvency. Other

[60] Nestor (2002)

[61] Claessens and Klapper (2002)

[62] La Porta et al (1997) and Claessens and Klapper (2002)

countries have also sought to improve their judicial capacity in this area: in Thailand, a system of specialised bankruptcy courts has been created; Mexico and Colombia have bypassed the normal judicial system all together, creating administrative "quasi-courts" to handle insolvency proceedings.

263. Improving the enforcement of insolvency legislation is a priority for the Roundtables. Creditor protection would also be enhanced if abusive transactions were more effectively restricted, and the enforcement of loan agreements improved. The overall goal of reform should not only be to protect creditor rights after insolvency, but to facilitate risk management and ensure fair treatment of creditors before insolvency. The White Papers for each region give further guidance on improving creditor protection. To further insolvency reform in Asia, the OECD has helped establish and organise the Forum for Asian Insolvency Reform (FAIR). The World Bank has also begun reviewing the protection of creditor rights as part of the Review of Standards and Codes (ROSC) process, and has recently established the Forum for Insolvency and Risk Management (FIRM) to improve the protection of creditors globally.

Bank reform and responsibility

264. In the literature on corporate governance and financial systems, there are frequent references to "bank centred (or oriented) systems".[63] In a bank centred system, banks are not only the principle source of finance, but are supposed to play a special role in overseeing the behaviour of the companies they lend to. While banks in certain OECD countries, particularly Germany and Japan, have historically played an important governance role, one conclusion of the Roundtables was that outside of insolvency, the role of banks in governance was limited in developing and emerging market economies.

265. One reason for the limited role of banks is the poor protection creditors generally receive in these countries. Faced with high risk, banks have in many cases focused on lending to governments and increasingly to consumers in some countries. When banks do lend, the discussion in the Roundtables indicated that they have little interest in becoming embroiled in the governance of the company; managing their portfolio of loans is enough. While there were a few counter examples of bankers sitting on boards or banks owning shares (outside of insolvency or debt workouts), these were the exception, not the rule. As Table 3 indicates, financial companies--primarily banks--are also controlling shareholders in a small fraction of companies (average of 4% for the countries in the table), but in many cases this is the outcome of debt work out or insolvency.

266. Banks have not only been hampered by poor creditor rights, in many countries they have been rocked by financial crisis. As can be seen in Table 13, since 1994 a number of countries that participated in the Roundtables were hit by financial crisis--including many of the more advanced economies. These crises damaged, and in some cases practically destroyed, banking systems. Even properly managed banks are susceptible to "runs" and can be severely damaged by macroeconomic instability. Bank regulation and central banking are both responses to this potential fragility. In addition these crises were not pure banking panics, with a number of other factors underlying these episodes[64]. Nonetheless, the lending practices and governance of banks may have made some countries more vulnerable to crisis.

[63] See for example Allan and Gale (2000).

[64] Useful surveys of the Mexican, Argentine and Asian crises of the 1990's include Radelet and Sachs (1998) and, Corsetti et al (1999).

Table 13. Roundtable participants experiencing financial crisis

Country	Beginning of Crisis
Argentina	1995, 2001
Brazil	1998
Mexico	1994
Uruguay	2002
Korea	1997
Indonesia	1997
Malaysia	1997
Philippines	1997
Thailand	1997
Bulgaria	1996
Croatia	1998
Romania	1997
Russia	1998

267. Banks in developing and emerging market economies frequently have ownership structures and other features that may create conflicts of interest and undermine their own governance[65]. In many developing and emerging market economies, banks lend to companies in the same business group, all controlled by the same controlling shareholder. Similarly, there may be interlocking ownership between the borrowing company and the bank, i.e. each owns part of the other. These relationships in turn lead to *related lending*: a bank making a loan on favourable terms to a related party. A recent study on related lending in Mexico revealed that 20 percent of bank loans in the sample period were to related parties, and that these loans were on better terms, were more likely to be defaulted on, and harder to recover, than loans to non-related parties[66]. The volume of related lending is almost certainly higher in some other economies that participated in the Roundtables: e.g. one meeting participant pointed out that in Indonesia, some banks had made up to 90% of their loans to related parties[67]. Related lending can be considered a kind of tunnelling that harms the banks minority shareholders, in many cases its depositors, and ultimately the government, which almost always offers explicit or implicit deposit insurance.

268. When banks are not owned by the companies they lend to, they are frequently owned by the state. This presents its own challenges, one of which is tendency to make loans on non-commercial grounds, and to roll-over these loans for borrowers approaching default, i.e. soft loans. Heavy "state guidance" can also lead to this sort of behaviour on the part of private banks. This can be a reflection of industrial policy, but when corruption is involved, it can also be another sort of tunnelling, in this case from taxpayers to the borrowing companies.

269. In response to the widespread crises of the last decade, national governments, often with the strong support of the World Bank, the IMF, and bilateral donors, have made substantial efforts to reform their banking sectors. Prudential regulation has been strengthened and regulators given more resources and power, while being held to high standards of accountability. Banks themselves have been recapitalised at sometimes great public expense, and in many cases management and ownership has been changed.

[65] For a discussion of the governance problems of banks, see Caprio and Levine (2002).

[66] La Porta et al (2002b)

[67] Kurniawan and Inrianto (2000)

Foreign ownership and competition has also been encouraged, and foreign owned banks have become major players in Latin America and Asia and dominate the market in South East Europe.

270. Crisis and the resulting reform process have begun to change the role that banks play in developing and emerging market economies. The combination of more effective regulation and greater market discipline will encourage banks to make loans based on calculated risk and return rather than connections. Reform may also facilitate banks playing the sort of monitoring role that some envisage for them. Nonetheless, the governance of banks, just like the governance of other companies in the five Roundtable regions, remains a work in progress. The Asian Roundtable has identified the improved governance of banks as one of its highest reform priorities, and the White Paper will provide guidance on what steps need to be taken in this area. In the other regions, improved governance of banks will also be an important part of ongoing corporate governance reform. The Roundtables will also follow the work of the Bank for International Settlements (BIS), which is developing corporate governance guidelines for banks

Ensuring responsible behaviour by the company

271. Discussions in the Roundtables revealed a clear view that companies should do a better job of ensuring the legal rights of all their stakeholders, not just creditors and employees. Improving the treatment of stakeholders depends in part on changes at the national level. Increasing the general capabilities of courts and regulators is one way to improve enforcement and encourage better treatment. Ensuring greater clarity in the legal rights of stakeholders is another: a range of potentially inconsistent and sometimes contradictory laws governs stakeholder relations in certain countries. Making board members, managers, and controlling shareholders directly liable for abuses against stakeholders is a third. Engaging in any sort of fraudulent or misleading activity, or breaking specific laws designed to protect stakeholders, may be the basis of legal action against individuals, and not just the company.

272. This is not just an issue for legislators or judges. The general opinion of the Roundtables was that companies must take steps to better comply with existing legislation and contracts. The board should be involved in major stakeholder issues, and understand the company's legal responsibilities and the significant liabilities and opportunities associated with relevant stakeholders. Along these lines, the company should also establish *compliance mechanisms*: internal systems for reporting, monitoring, and training that facilitate compliance with the law and are ultimately overseen by the board. The consensus of the Roundtables was that it was better for companies to take the lead in these areas than having compliance forced on them by heavier regulation and greater liability.

273. Participants in the Roundtables also pointed out that some companies increasingly find it in their own interests to go beyond legal compliance when dealing with stakeholders and the wider community. A number of companies in OECD countries have developed strategies for corporate responsibility designed to build trust and enhance their reputations with current and potential shareholders and customers. A central part of these strategies is *social reporting*, where companies report on their stakeholder policies and may produce a "triple bottom line" which includes not only financial performance but also the company's environmental and social impact.

274. Social reporting to date is not an unqualified success. It has developed into an industry whose main purpose seems to be enhancing the image of its clients. It was noted in the Roundtables that to be constructive, standards need to become more rigorous, and, as with other voluntary reporting initiatives, credible methods of confirming what companies report need to be established. The UN has helped create the Global Reporting Initiative to enhance standards in this area but it is voluntary. The OECD has developed Guidelines for Multinational Enterprises to facilitate responsible behaviour by companies that invest in developing and emerging market economies.

275. These issues are relevant not only for western multinationals, but also for companies from developing and emerging market economies. One example given in the Roundtables was that of PetroChina[68]. In 2000, the Chinese government planned an initial public offering (IPO) for state owned PetroChina, hoping to raise $5-$10 billion from western investors. Institutional investors greeted the IPO coldly, citing ethical, environmental and governance risks associated with the company. It is estimated that investors with $1 trillion in assets avoided the issue, and the Chinese government lowered their target to $3 billion. Investors shunned the issue not out of altruism, but in realisation that social and environmental issues could adversely impact the long run performance of the company. Overall, major western institutional investors that control trillions in assets, e.g. CalPERS, the retirement fund for California's state employees and a trend setter in this area, are making social and ethical concerns an explicit part of their investment strategies.

276. Institutional investors are not the only ones increasingly conscious about these issues. Companies in the Roundtable regions wishing to secure contracts with foreign multinationals may also need to enhance their own relations with stakeholders. For these reasons, companies increasingly will have to take into account the risks and opportunities associated with social, environmental, and other stakeholder issues if they wish to attract the investors or companies who are giving greater weight to these concerns.

[68] Simpson (2001)

VI. TRANSPARENCY AND DISCLOSURE

277. With few exceptions, companies and financial markets in developing and emerging market economies are opaque. This was the resounding opinion of the Roundtables, and devising regional strategies to increase transparency one of their key goals. A lack of transparency contributes directly to tunnelling by concealing related party transactions: both in direct disclosure about the transactions and their nature, and by obscuring the beneficial ownership of contracting parties. More generally, this opacity obscures corporate performance and creates a serious barrier to informed decision making by investors.

278. Transparency and disclosure is not only a topic for accountants and auditors: as discussed in Box 10, this opacity comes at a real economic cost. By obscuring relative performance, opacity can have an adverse effect on capital allocation, which in turn will lower productivity and per-capita income. It will raise the cost of capital, both because it specifically facilitates tunnelling, and by the more general impact it has on investor confidence. A higher cost of capital can in turn lead to lower investment and output. Lower investor confidence resulting from opacity will lead to less financial market activity, i.e. turnover and liquidity. In addition, by obscuring the extent and nature of private sector liabilities, opacity can contribute to financial crisis. Of course, this is not only an issue for developing and emerging market economies. Recent events have confirmed the type of costs that widespread opacity can impose in even the most advanced economies.

279. The last decade has witnessed a global effort to reduce the costs of opacity by improving the standards for both financial and non-financial reporting, and increasingly by making greater efforts to implement those standards. The most prominent of these efforts has been the drive to increase the compatibility of local accounting standards with the International Accounting Standards (IAS) drafted by the International Accounting Standards Board (IASB). While strongly supported by the Roundtables, the adaptation of new standards has raced ahead of implementation in many cases, leading to a growing gap between what should be reported and what is.

High quality standards for disclosure

280. Company law, securities regulation and stock exchange listing requirements may all have disclosure requirements for companies, as may other legislation, like competition law. Historically in some countries the requirements for financial reporting were driven primarily by the tax code, or the old central plan in a transition economy. Other countries might have much more sophisticated regimes developed specifically for investors based on international practices. In turn, accounting standards were frequently developed by professional bodies with varying degrees of autonomy, and authority. While substantial differences in standards remain, this is one area where true global convergence has been witnessed.

Box 10. The costs of opacity

A number of recent studies estimate the financial and economic costs of poor corporate disclosure. Bhattacharya et al (2002), using a dataset with over 50,000 companies from 34 countries, construct three measures of opacity based on company earnings statements, i.e. measures of earning aggressiveness, loss avoidance and earnings smoothing. From this, they estimate an opacity index for each country. After controlling for a number of other factors, they find that moving from less opaque (the top quartile of countries) to more opaque (the bottom quartile) increases the cost of equity by a statistically and economically significant 2.8-3.2 percentage points (depending on how the cost is calculated). They also find that moving from the top quartile to the bottom quartile is associated with an also significant 8.8 percent reduction in trading on the stock market.

Two studies estimate the impact of the disclosure regime on economic growth. One way that opacity might reduce growth is by retarding the development of those industrial sectors most dependent on external finance. Using the index for disclosure developed by the Center for International Financial Analysis and Research (CIFAR), Rajan and Zingales (1998) confirm that those industries most dependent on external finance grow more slowly in countries with relatively poor disclosure. They also find that the establishment of new firms is restricted when opacity is high: an indication of how adverse selection can reduce growth and innovation in countries with poor disclosure. Levine, Loayza and Beck (2000), also using CIFOR data, find that financial intermediation, e.g. banking, is more developed in countries with better disclosure, and that this financial development will in turn lead to faster growth.

Opacity, at both the company level and national level, can affect the level and nature of international capital flows, which again can come at a very high price. In a recent study by PriceWaterhouseCoopers (Wei et al 2001), it was estimated that many developing and emerging market economies had lost billions in foreign direct investment due to their overall levels of opacity, e.g. Argentina $18.7 billion, Brazil $40 billion, Hong Kong, China $10 billion, and Russia $9.8 billion. Rahman (1998) in a paper presented to the Asian Roundtable, discusses how poor disclosure before the 1997 crisis in East Asia contributed to high levels of debt, especially short-term foreign currency denominated debt, laying part of the groundwork for the disastrous events that would follow. Johnson et al also find a strong link between various measures of governance and the occurrence of financial crisis.

International Accounting Standards

281. As part of transition, to improve investor confidence after a crisis, or simply to tap into the expertise of the IASB, countries have increasingly made use of IAS (also referred to as International Financial Reporting Standards) to improve their own accounting standards. This is a process that has been encouraged by the World Bank, other multilateral organizations, and by national aid agencies. For example, in the 1990's a donor-supported program to develop accounting standards and train accountants and auditors in a number of countries in Eurasia used IAS.

282. The actual use of IAS varies country by country. A diverse group of countries including Bangladesh, Croatia and Peru use IAS as their national accounting standards. Other countries have begun the process of implementing these standards, starting with the largest companies. Standard setters in a number of other countries currently have active policies to move towards IAS. Indeed only a small fraction of the countries listed have standards that have been developed without reference to IAS (Table 14).

283. Some Roundtable participants stated that "there is only one IAS." Certain benefits of IAS, in particular facilitating cross-country comparisons of company performance and assets, may not be fully realised without widespread and rigorous adherence to these standards. In practice however, the degree of harmonisation varies country by country, and even those countries that use IAS exclusively may have not implemented all standards (36 standards are in effect at the time of writing), and may interpret certain standards differently. Currently in China, Romania, Kazakhstan, and (from 2004) Russia, IAS only holds for some companies, but not others. Being principles based, IAS is flexible enough to implement in a wide range of countries, but this flexibility also leads to differences in interpretation and usage. The adoption of IAS is also fully voluntary, and will remain under the control of national standard setters. This all but ensures that significant intra-IAS differences across countries will persist.

Table 14. Use of international accounting standards

Country	National Accounting Standards	IAS Permitted for Foreign Companies?
Bangladesh	IAS	Yes
China	IAS (B-Shares) Harmonised with IAS	Yes
Chinese Taipei	Distinct Standards	Yes
Hong Kong, China	Harmonised with IAS	n.a.
India	Harmonised with IAS	No
Indonesia	Harmonised with IAS	No
Korea	Distinct Standards	No
Malaysia	Harmonised with IAS	Yes
Pakistan	IAS	Yes
Philippines	Harmonised with IAS	No
Singapore	Harmonised with IAS	Yes
Sri Lanka	Harmonised with IAS	No
Thailand	Harmonised with IAS	Yes
Argentina	Harmonised with IAS	Yes
Brazil	Harmonised with IAS	No
Bolivia	Distinct Standards	No
Chile	Distinct Standards	Yes
Colombia	Harmonised with IAS	Yes
Mexico	Harmonised with IAS	No
Peru	IAS	Yes
Armenia	IAS	Yes
Azerbaijan	Distinct Standards	n.a.
Georgia	IAS	Yes
Kazakhstan	IAS (A-listed companies)	Yes
Moldova	Harmonised with IAS	No
Mongolia	IAS	n.a.
Ukraine	Harmonised with IAS	Yes
Bosnia-Herzegovina	IAS	n.a.
Bulgaria	Harmonised with IAS	No
Croatia	IAS	Yes
Macedonia	IAS	Yes
Romania	Implementing IAS	n.a.
Russia	Implementing IAS	n.a.

Source: International Accounting Standards Board website, national sources.

284. As countries introduce IAS, they also need to consider the impact this will have on the tax system, reporting by small and medium firms, and the degree of desired harmonisation between different kinds of company reporting[69]. As discussed below, they must also develop a framework to ensure that companies comply with these standards. The White Papers provide guidance for each region on how to complete the process of harmonising with IAS.

[69] UNCTAD has initiated discussions on the development of IAS compatible standards for small and medium enterprises.

Experiences from the Regional Corporate Governance Roundtables

Specific disclosure issues

285. Some specific areas of weaknesses for financial reporting noted in the Roundtables included consolidation, accounts payable and receivable, and other liabilities including guarantees. The proper consolidation of accounts is clearly relevant given the prevalence of business groups. Currently many countries still have very minimal or no requirements for this sort of consolidation. In some countries, companies have taken very optimistic stances on both accounts payable and receivable, and have opaquely shifted liabilities using other methods. Again, this may reflect specific gaps in existing standards. IAS address all of these issues, and Roundtable participants emphasised that the solution to these problems lie in implementing the relevant standards.

286. The most important area of omission identified in the Roundtables involved ownership and control. When beneficial ownership is not disclosed, related party transactions will be concealed, and tunnelling facilitated. Various parties may have responsibility for tracking and reporting ownership information, including registrars and companies. In general however, it is ultimately up to the individual to report on their ownership position. Many countries now have reporting thresholds, frequently at 5% intervals, i.e. an individual must report when they have 5% of a company's stock, 10% etc.

287. Nonetheless, ownership and control remains opaque in many cases. In practice, the concept of nominal ownership is still not well understood in some countries. Heavy use is made of offshore listings. In many cases shareholders face serious barriers in accessing information from registrars and similar sources, and the sort of ownership information that should be widely available remains controversial, i.e. should any shareholder be able to find out the holdings of any other shareholder? Overall, owners simply resist reporting. In one study of disclosure in Bulgaria, 90% of the requests by the securities commission to companies for ownership information were appealed. Individuals did not fill the void with their own disclosure[70].

288. To improve disclosure, it was noted that the individual should report beneficial ownership both to registries and when mandated by a threshold requirement. The information in registries should be available to all shareholders. The OECD has produced a template: "Options for Obtaining Beneficial Ownership and Control Information" that while focused primarily on private companies can also provide guidance to regulators in determining control for public companies.

289. The previous chapters make clear the importance of disclosing related party transactions, including the trading in the company's shares by executives and board members. Historically in many countries, while these practices faced various legal restrictions, actual public disclosure was not required. This is being changed. For example in 2001 the Brazilian Novo Mercado required disclosure of related party transactions and insider trading for listed companies. The main Brazilian stock exchange and securities commission are now extending these requirements to other companies. Listed companies, their board members and executives in other countries are now also increasingly required to disclose these sorts of transactions to the stock exchanges, securities regulator and or shareholders.

290. Closely related is reporting on "material events." Listed companies in many countries are now required to report planned transactions and other events that can have a significant impact on shareholders and the company. Examples include the departure of a board member or high-level executive, major acquisitions or divestitures and any significant change in market conditions.

291. Roundtable participants also recommended other areas where reporting could be improved. Executive and board member remuneration is not always reported, but should be. Companies should

[70] Tchipev (2002)

disclose more information on policies and objectives, for example elements of their strategy for risk management. Some participants also called for more information on board members to be publicly available, including details on their professional background, other boards that they serve on, etc.

292. The effort to improve accounting standards and other standards for disclosure is well advanced, but not complete. The White Papers provide guidance for each region on how to close specific gaps in disclosure requirements. IOSCO has also developed standards for non-financial disclosure and the ongoing reporting of material events that are widely supported by the Roundtables and provide additional direction for improving transparency in each region.

Ensuring effective transparency and disclosure

293. Even though standards for disclosure have improved, implementation has generally tended to lag. The process of transition in Russia, Eurasia and South East Europe has involved the construction of market-based systems for disclosure from scratch, an effort that is well advanced in each region. In Latin America and Asia, crises revealed sometimes devastating gaps between what companies reported, and their financial realties. In response, a number of countries have launched determined efforts to improve transparency.

294. An effective system for transparency and disclosure builds on three pillars. One is the legal and regulatory environment, including “quasi regulation” like listing requirements or comply or explain codes of corporate governance. The second is the technical capabilities, self-regulation, and independence of the accounting and auditing professions. The third is the internal control and external disclosure mechanisms of individual companies. In the end, only the company and those that control it can ensure its transparency.

295. One can envision one pillar “substituting” for the weaknesses of another: e.g. greater government regulation in response to weak self-regulation on the part of auditors. While the particular regime will vary country by country, with different combinations of government enforcement and self-regulation, the Roundtables agreed that achieving adequate transparency would require continuing improvements across all three pillars.

Regulators and stock exchanges

296. The specific disclosure requirements for companies may depend on company law, securities regulation, banking and other financial regulation, tax law and regulation, competition policy, and stock exchange listing requirements. In turn, the securities regulator, the monetary authority or other bank regulator, different ministries including Finance and Industry or their equivalents, and the stock exchange (or exchanges) may all play a role in overseeing disclosure.

297. In most countries, ensuring market transparency is a central function of the securities regulator. They normally have the power to interpret existing legislation, and in some cases issue new regulation, defining the disclosure requirements for companies and the obligations of registrars, financial intermediaries (brokers, etc.), the stock exchange, and other relevant parties. They may act as monitors and intermediaries, receiving information from companies, and then distributing it to the public. Most importantly, they generally have broad enforcement powers, being capable of both civil and criminal action against companies and individuals for violating disclosure requirements.

298. Frequently, the securities regulator delegates key oversight functions to stock exchanges. Instead of reporting directly to the regulator, companies may report information on material and related party transactions to their exchange. The exchange may also have an important role in setting disclosure standards through listing requirements. Over the last few years, stock exchanges, including those in Brazil,

Romania and Hong Kong, China have created special tiers or markets with additional disclosure requirements. In some countries, it may be the exchange, not the securities regulator, which authorises professional bodies to develop national accounting standards. They also have enforcement powers, and the responsibility to monitor compliance with listing requirements. One important difference between a stock exchange and a securities regulator is the penalties they can impose. Stock exchanges may be limited to trading halts and suspending or de-listing companies. While these can act as a deterrent, they will also penalise minority shareholders.

299. When a company reports material or related party information to the exchange or securities regulator, the exchange or regulator may distribute the information through an official gazette or, increasingly, post the information on their website. They may also be required to make an announcement in the press. In Hong Kong, China there are cases where the exchange must approve the press announcement before being released by the company. The exchange or regulator may be able to demand additional information or a clarification of what the company has reported. They may have other important discretionary powers. If a company feels that revealing certain information would harm its legitimate interest, then they may need to receive a waiver from the relevant body. In Argentina, after providing such a waiver, the securities commission monitors trading in the company's stock to ensure that the now privileged information is not being abused.

300. Roundtable participants noted that all too often regulators and exchanges are not vigilant in enforcing disclosure requirements, and may be undermined by gaps in the legal framework. In some countries, penalties for not filing important documents, including the annual report, may be low. The use of the national accounting standards may be seen as "voluntary": developed by a professional body and mandated by listing requirements, with no civil or criminal penalty for any kind of improper accounting. Securities regulators and exchanges may simply lack the resources to carefully monitor a large number of companies. Perhaps most significantly, it may be extremely difficult to hold board members or executives responsible for gross violations of reporting requirements. The White Papers discuss how to improve oversight of transparency and disclosure, and enforcement more generally.

301. As discussed in Chapter V, there has been significant reform to enhance the governance and prudential standards of the banking system in a number of countries. The standards for disclosure by banks and other financial institutions have been raised and the bank regulator, usually the central bank, empowered to implement those standards. The transparency of the banking sector has increased in many cases. It can be hoped that this ongoing reform will improve the long-run solvency of these institutions, and reduce the potential for systemic financial crisis.

The accounting and auditing professions

302. Many countries in Asia and Latin America have long traditions of self-regulation of accountants and auditors, the professional bodies of which have generally played a leading role in setting the standards for accounting and auditing. Over the last decade the World Bank, USAID and others have supported extensive efforts to develop accounting and auditing in transition economies. The OECD has also assisted in these efforts through its involvement in programmes for accountancy and auditor development in South East Europe and Eurasia.

303. A central element of these programmes has been facilitating the training of new auditors and accountants. The shortcomings revealed by financial crises and the drive for higher quality accounting standards have revealed the global necessity for better training for both new and current accountants and auditors. Professional bodies may be directly involved in training, and may be involved in licensing and certification. Certification is critical if expanded training efforts are to be meaningful. Roundtable

participants emphasised that these efforts should not be considered secondary. Ever rising standards demand dramatic increases in accounting and auditing skills.

304. In addition to certification and standards setting responsibilities that they may share with regulators and exchanges, self-regulation by professional bodies should mean just that: the organisation will police and discipline its members. These bodies have codes of ethics for their members and a body, e.g. a "judiciary council," to oversee compliance. Accountants and auditors will check the work of their peers, and if there is a potential problem, then the body will launch an investigation, and can normally penalise its members. This system has one significant advantage: it should mean less work for overtaxed securities regulators.

305. Professional bodies should have some incentive to regulate their members: bad conduct by one can cast a bad light on all. However, in practice peer review and self-regulation have tepid reputations with Roundtable participants. Accountants and auditors may be overly sympathetic with their peers, and it is not clear how self-regulation can avoid the critical conflict of interest: companies may prefer auditors who have a reputation for "flexibility."

306. Given the potential limits of self-regulation, various regimes to ensure auditor independence have been developed. Most common are basic restrictions on the auditor to ensure that they are not related to the company they are auditing: the auditor cannot be a shareholder, recent employee, etc. of the company. The law may also prescribe civil or criminal liabilities for auditors, but as with board members, these liabilities tend to be of a nominal nature--many countries have seen very few successful lawsuits against auditors. Some countries require audit firms to be licensed by the government, and can impose administrative penalties on audit firms. Many countries also require that the external auditor be appointed directly by the shareholders, or by an audit committee composed primarily of non-executive board members as a way of breaking the control of corporate insiders over the auditor.

307. Roundtable participants felt that while self-regulation should be improved, the clear limits of self-regulation warranted more effective government oversight. There was widespread support for better disclosure of the relationship between the company and the external auditor, including the specific contract, fees, and other services provided by the audit firm. Beyond this, some countries, including Brazil, are considering mandatory rotation of the audit firm, and limits on the non-audit services the audit firm can provide. Increasing the effective liability of auditors is also clearly a priority. IFAC and the US professional association of auditors have developed audit standards. While these can provide additional guidance, the FSF and others have raised the concern that these standards are being developed by self-regulatory organisations. IOSCO has also recently developed audit standards, and the White Papers provide additional recommendations on this critical issue.

The role of the company

308. Ultimately, it is up to each company and those that control it to ensure that the relevant and required information is disclosed in a timely manner. The Roundtables made clear that within the company, it is the board that must develop and oversee the mechanisms and policies that make this disclosure happen. In many companies, the audit committee, or audit board also plays a leading role, but the presence of these company organs does not absolve the full board of its responsibilities in these areas[71]. Nor does the use of external auditors. Board members must understand their role in the disclosure process and the relationship of the full board to the external auditors and audit committee or statutory auditors where relevant.

[71] Chapter IV discussed the audit board and audit committee.

Experiences from the Regional Corporate Governance Roundtables

309. If a company is to be transparent to shareholders, it must be transparent to board members. Roundtable participants emphasised the importance of mechanisms that helped to reduce opacity within the company. Companies should establish effective internal control systems. In some countries, including China, all listed companies are required to have such systems. They should make their risk management systems as transparent as possible, albeit a sometimes difficult task. Along these lines, companies should establish control mechanisms under the supervision of the board to ensure the company meets its disclosure requirements. The board, and especially members of the audit committee or audit board, should also use their own powers to prevent corporate insiders from abusing their positions and creating intra-company opacity--again, a potentially difficult task in practice.

310. Roundtable participants also pointed out that companies should take the initiative in communicating with investors. Companies were encouraged to establish websites with relevant information, including the particular items discussed above. They should react to market developments, for example confronting rumours causing unwarranted movements in share prices. Along these lines, some companies have established investor relation divisions to more effectively communicate with current and potential investors. Of course, these divisions should not supersede normal disclosure, and should be used to reduce opacity, not increase it.

311. There are exceptions of transparency in developing and emerging market economies. For those companies that have made serious efforts to improve corporate governance voluntarily, improving transparency and disclosure has been a top priority. Special stock market tiers that have more rigorous transparency and disclosure requirements and foreign listing are ways for these companies to *credibly* communicate to shareholders that standards have actually improved[72]. However the impact of these voluntary mechanisms is limited, both for the participating companies, and even more so for the market as a whole: Roundtable participants made clear that reducing opacity will require systematic efforts to implement all the high quality standards that so many countries have adopted.

[72] Patel et al (2003) presents evidence that foreign companies listed in the US via ADRs have greater transparency.

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GLOSSARY

Adverse selection: The negative implications of one party to a transaction having better information than another. Adverse selection can lead to lower quality products in a market. A classic example is the "market for lemons": if the quality of used cars (or any other item) is unknown to buyers, the lowest quality cars will drive the others from the market, since buyers will correctly assume that the only ones available are "lemons" (low quality), and will pay accordingly.

Alternative dispute resolution: The use of private arbitration and or mediation to resolve civil disputes that might otherwise go to court. For example, a stock exchange may offer private arbitration binding on listed companies to shareholders seeking redress for violations of their rights. While normally seen as a supplement to the judiciary, to be effective private arbitration and mediation must have some formal legal backing.

Annual report: A report issued by open companies to their shareholders each year. Normally contains information on overall performance, future prospects and audited financial information.

Annual general meeting (AGM): Annual meeting of shareholders, at which board members are elected and shareholder resolutions, items requiring shareholder approval (i.e. a merger) and external or statutory auditors may also be approved or rejected. Shareholders may also have the opportunity to put questions to the company's management.

American Depository Receipt (ADR): A certificate issued by a US depository that represents a number of shares of stock issued by a non-US company. ADRs are normally traded on a US exchange, but may not give the holder all the rights that shares in a US company would.

Audit board: An additional board tier composed of the company's *statutory auditors*. Audit boards or their equivalents exist in a number of countries, including Argentina, Brazil, China, Romania, Russia and Spain. Members of the audit board normally do not sit on the main board of the company (the board of directors or the supervisory board).

Audit committee: A committee formed from members of the company's board of directors or supervisory board. Non-executive board members normally make up all or a majority of the committee. The audit committee normally oversees the company's financial reporting and sometimes risk management and or legal compliance. The committee may also have the power to assess and / or block related party transactions.

Beneficial owner: The person who benefits from the ownership of a security or other property, the *de facto* owner. The beneficial owner may not always be the same as the nominal owner (who is registered as the owner or who holds the title to the property).

Business judgement rule: A rule or rules that give board members the benefit of the doubt with respect to normal business decisions, limiting potential liability in the process. Also see "duty of care".

Capital increase: An issue of new shares by a company.

Class action lawsuit: A lawsuit filed by one or more persons on behalf of a group of individuals all having the same grievance. Until recently these suits were only allowed in certain common law countries.

Closed company (or close corporation): A joint stock company normally owned by a small number of individuals. Shareholders in closed companies may face restrictions on selling shares to third parties.

Control pyramid: Ownership structure where a parent company will control a fraction of another company, which may own a control fraction of a third company, etc. This will allow the owner of the parent company to control the subsidiaries while having a fraction of the underlying ownership. Can be combined with cross-shareholdings to make very complex corporate structures.

Control transaction: A transaction that leads to a change in control of a company. This can include a controlling shareholder selling their control stake, someone taking a control stake in a widely held company, or the sale or merger of the company as a whole.

Controlling shareholder: A shareholder who has enough votes to choose a majority of the board and exert *de facto* control over management. A shareholder may be able to control the company while owning less than 50% of the equity through the use of shares with special voting rights, control pyramids, and other tactics.

Corporate governance: The relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Corporate insider: A company's board members, officials, and controlling shareholder. Can also refer to other *de facto* insiders, e.g. a shadow director or someone else who exerts control over day to day operations of the company.

Cross-shareholding: When two or more companies hold each other's shares. Frequently used in conjunction with control pyramids.

Cumulative voting: Under cumulative voting, shareholders assign votes to one or more candidates for the board, instead of voting separately for each board member. Each shareholder receives a number of votes proportionate to their shareholdings—i.e. their number of shares multiplied by the number of open board seats. Under cumulative voting, 10%-15% of vote is normally enough to select one board member. This may allow minority shareholders to choose some members of the board.

Derivative suit: A law suit seeking damages from board members or other company officers filed by a shareholder or shareholders on behalf of the company. If successful, damages can be used to defer the legal expenses of the filing shareholders, but the remainder is awarded to the company, not directly to the filing shareholders.

Duty of care: The duty of a board member to act on an informed and prudent basis in decisions with respect to the company. Often interpreted as requiring the board member to approach the affairs of the company in the same way that a "prudent man" would approach their own affairs. Liability under the duty of care is frequently mitigated by the business judgement rule.

Duty of loyalty: The duty of the board member to act in the interest of the company and shareholders. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders.

Executive board member: A board member who has a senior management position as well as being a member of the board. As managers or executives, they are paid employees of the company. In addition they have full board responsibilities.

Executive committee: A committee formed from the board's executive members. Like members of a management board, members of the executive committee may be titled "directors" and may have similar powers; however, unlike the management board, the committee is not a separate board tier.

General meeting: Meeting of shareholders, at which board members may be elected and shareholder resolutions, items requiring shareholder approval (i.e. a merger) and external or statutory auditors may also be approved or rejected. Shareholders may also have the opportunity to put questions to the company's management at the general meeting.

Generally Accepted Accounting Principles (GAAP): US standards for financial reporting. Set by the Financial Accounting Standards Board.

Golden share: The right to intervene and or vote on certain company decisions retained by a government in a privatised company. The golden share may give the government voting rights that exceed its remaining ownership. Often used to block unwanted changes in control.

Independent board member: A non-executive board member who has no business or contractual relationship (other than a service agreement as a board member) with the company, is not under the undue influence of any other board member or group of shareholders, and who is generally capable of acting in an informed and objective manner.

Institute of Directors (IoD): An organisation for board members that normally provides training along with other services. The original IoD was founded in the United Kingdom in 1903 and currently has over 50,000 members.

International Accounting Standards (IAS): The financial reporting standards issued by the London based International Accounting Standards Board (IASB). Dozens of countries have adopted IAS, or actively harmonize their accounting rules with IAS. IAS are also known as International Financial Reporting Standards (IFRS).

Management board: A board tier composed of the senior managers of the company. Companies with a management board will normally also have a supervisory board that oversees the management board (and may also have an audit board). None, or only a limited number, of the directors on the management board may serve on the company's supervisory board.

Minority shareholder: A shareholder whose stake in the company is too small to allow them to have a direct influence on the company's board or management. A shareholder who is not a controlling shareholder.

Non-Executive board member: A board member who, broadly speaking, does not take part in the day-to-day operations of the company, and is not an employee of the company.

Open company (or open corporation): A joint stock company that normally has a large number of shareholders. Shareholders in open companies can normally sell their shares to third parties without restrictions. Open companies may or may not be listed on a stock exchange.

Pierce the corporate veil: The ability of a company's debtors and sometimes others to hold that company's shareholders liable in response to fraud or other abusive actions.

Private benefits of control: The benefits that accrue to a controlling shareholder or other corporate insiders beyond the dividends, capital gains, or compensation commensurate to their investment or position. These can include non-pecuniary benefits—e.g. a desire to keep control of the company in the family—but all too often include pecuniary benefits diverted at the expense of other stakeholders.

Proxy: Someone empowered to vote on behalf of other shareholders at the annual general meeting (AGM). Also used to refer to the mail-in ballot that shareholders in some countries can use to vote in the AGM without attending.

Pre-emptive rights: The right of existing shareholders to participate in any capital increase. Pre-emptive rights should preclude the company selling new shares on favourable terms to only some shareholders or to non-shareholders.

Related party transaction: A transaction carried out between the company and one or more of its officers, board members, or significant shareholders, their close relatives or associates, or an entity in which they have an interest.

Self-dealing: Board members, company officers, or significant shareholders engaging in related party transactions with their company. Abusive self-dealing is synonymous with tunnelling.

Shadow director: a common law designation for someone who does not serve on the board, but exerts considerable influence on its deliberations.

Soft lending: Systemically making and rolling over loans on favourable terms to particular companies or regions for policy or political reasons.

Staggered board: A board where the members have multi-year terms, with only a fraction of board members elected at each general meeting, e.g. board members have three year terms, and one third are elected each year at the AGM. Also known as classified boards.

Stakeholders: Individuals or groups, in addition to shareholders, who have a significant interest in, and/or influence over, the company's operations and the achievement of the company's goals, such as creditors, employees, suppliers, customers, and the community.

Statutory auditor: Elected by shareholders to oversee the internal auditing and financial reporting of the company and in some cases compliance with regulation and shareholder resolutions. Statutory auditors make up the company's audit board.

Supermajority requirement: A requirement for certain items to be approved by the board or general meeting. May require two thirds, three quarters, or more of the votes, instead of a simple majority.

Supervisory board: A board tier of non-executives that oversee the company and the company's management board. Used in two tier or (if there is also an audit board) three tier boards.

Triple bottom line: Measures of a company's environmental and social impact, in addition to its earnings.

Tunnelling: The use of self-dealing by board members, company officers, or significant shareholders to divert resources from the company to themselves. Also known as abusive self-dealing.

Unitary board: A single tier board, i.e. no separate management board or audit board. A unitary board may still have specialised committees.

Vote in absentia: The ability of a shareholder to vote in a general meeting without attending, i.e. online, through a proxy or by mail.