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Handbook on International Corporate Governance

COUNTRY ANALYSES

Edited by **Christine A. Mallin**

HANDBOOK ON INTERNATIONAL CORPORATE GOVERNANCE

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Christine A. Mallin

Professor, Corporate Governance and Finance
Director, Centre for Corporate Governance Research,
University of Birmingham, UK
Editor, Corporate Governance: An International Review

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Contents

Figures

Tables

Contributors

Christina L. Ahmadjian, Professor, Hitotsubashi University, Chiyoda-ku, Japan, cahmadjian@ics.hit-u.ac.jp.

Melsa Ararat, Director, Corporate Governance Forum of Turkey, Sabanci University, Turkey, melsaararat@sabanciuniv.edu.

Philip Armstrong, Head, Global Corporate Governance Forum, Washington DC, USA, parmstrong@ifc.org.

Peter Bartha, Adjunct Professor, Schulich School of Business, Canada, pbartha@schulich.yorku.ca.

Martin J. Conyon, Professor of Management, The Wharton School, University of Pennsylvania, USA, conyon@wharton.upenn.edu.

Shri Bhagwan Dahiya, Director, Institute of Development Studies, and Professor of Economics, Maharshi Dayanand University, Rohtak, India, sbdahiya@vsnl.com.

Ben Davis, Economist with Genesis Analytics, an economic consultancy based in South Africa, bend@genesis-analytics.com.

James Gillies, Dean Emeritus of the Schulich School of Business, Canada, jgillies@schulich.yorku.ca.

Silvia Gómez-Ansón, Associate Professor of Finance and Accounting, University of Oviedo, Spain, sgomez@oviedo.es.

Danielle Kuchinskas, The Wharton School, University of Pennsylvania, USA, kuchinskas@wharton.upenn.edu.

Guy S. Liu, Senior Lecturer in Economics, Brunel University, UK, and Visiting Professor, Sichuan University Business School, China, Guy.Liu@Brunel.ac.uk.

Christine A. Mallin, Professor of Corporate Governance and Finance, Centre for Corporate Governance Research, University of Birmingham, UK, c.a.mallin@bham.ac.uk.

Andrea Melis, Associate Professor of Accounting and Business Administration, University of Cagliari, Italy, melisa@unica.it.

Ariyoshi Okumura, Chairman, Lotus Corporate Advisory, Inc., Former Managing Director, Industrial Bank of Japan, Former Board Governor, International Corporate Governance Network, aoklotus@quartz.ocn.ne.jp.

Nick Segal, Former Dean of the Graduate School of Business at the University of Cape Town 1999–2003; director of companies and other organizations and also works as a self-employed consultant, nsegal@xsinet.co.za.

Geof Stapledon, Managing Director Institutional Shareholder Services (ISS) Australia and Professor, Faculty of Law, University of Melbourne, Melbourne, Australia, geof.stapledon@issproxy.com.

Pei Sun, Lecturer in Industrial/Managerial Economics, Nottingham University Business School, UK, Pei.Sun@nottingham.ac.uk.

Till Talaulicar, Associate and Lecturer, Technical University of Berlin, Germany, t.talaulicar@ww.tu-berlin.de.

Piotr Tamowicz, Co-Founder, Polish Forum for Corporate Governance, Gdansk, Poland, przybyl-tamowicz@wp.pl.

Mehmet Ugur, Jean Monnet Reader in Political Economy, University of Greenwich, London, UK, m.ugur@gre.ac.uk.

Axel v. Werder, Professor of Organization and General Management, Technical University of Berlin, Germany, a.werder@ww.tu-berlin.de.

Introduction and overview

Christine A. Mallin

In recent years many countries have experienced economic downturns, financial scandals and corporate collapses. As part of the response to these events, countries across the globe have either introduced corporate governance codes or strengthened their existing codes and guidelines.

The Organization for Economic Cooperation and Development (OECD) issued its revised corporate governance principles in 2004, and the International Corporate Governance Network issued its revised Statement on Global Corporate Governance Principles in July 2005.

The purpose of this volume is to highlight the development of corporate governance in a range of countries from different parts of the world. The volume has five parts which focus on different regions and thereby illustrate the evolution of corporate governance in both developed and emerging markets, in different legal settings, and with varying ownership structures.

Corporate governance in Europe

Part I focuses on corporate governance in various European countries. Within Europe there exists both the unitary board system of governance and the dual board system. Corporate governance developments in the UK are covered in Chapter 1 by Chris Mallin. The UK has a dominance of institutional share ownership and a unitary board structure whereby executive and non-executive directors serve on one board. Silvia Gómez-Ansón provides an insightful view of corporate developments in Spain while Axel v. Werder and Till Talaulicar provide a detailed analysis of the corporate governance developments in Germany. Germany, of course, has a dual board system with a supervisory board and management board. The German law of codetermination mandates employee representation on the supervisory board up to a maximum of half the supervisory board membership, depending on the size of the company. Finally, Andrea Melis provides an interesting analysis of developments in corporate governance in Italy, with its unique provision for a board of statutory auditors.

Corporate governance in Central and Eastern European countries

Russia and Poland are the two countries featured in Part II. Peter Bartha and James Gillies detail the development of corporate governance in Russia and ponder on how it might develop in the future. Meanwhile in a Polish context, Piotr Tamowicz analyses the system of corporate governance that has developed in Poland. The privatization waves which occurred in both countries in the 1990s inevitably influenced the way in which the corporate ownership structure developed in each country, and we can see how this influences the implementation and effectiveness of corporate governance in both Russia and Poland.

Corporate governance in South East Asia

In Part II, corporate governance developments in China and Japan are discussed. China has been seeking, successfully, to expand its socialist market economy which has led to the privatization of many state-owned enterprises, although the state still retains a significant influence in many enterprises, even once they are privatized. Inevitably the influence of the communist party is a key influence on the development of corporate governance in China. Guy Liu and Pei Sun analyse the developments in this rapidly evolving country.

There have been a number of major corporate governance developments in Japan, especially since the bursting of Japan's economic bubble, and the chapter by Christina Ahmadjian and Ariyoshi Okumura details these with clarity.

Corporate governance in the USA and Australia

Like the UK, the USA and Australia have a dominance of institutional investor share ownership. However, institutional investors are much more proactive in their approach to corporate governance issues in the USA than in Australia, and this is reflected both in the levels of proxy voting, where the USA traditionally has high levels, and also in the level of share activism generally.

Martin Conyon and Danielle Kuchinskas discuss corporate governance developments in the USA, and have a particular emphasis on aspects of the remuneration (compensation) committee. In contrast to the USA, Geof Stapledon details corporate governance developments in Australia.

Corporate governance: additional dimensions

Part V contains discussion of the developments in corporate governance in three countries: Turkey, South Africa and India. Melsa Ararat and Mehmet Ugur have written an interesting analysis of corporate governance developments in Turkey. The South African corporate governance developments are comprehensively covered by Philip Armstrong, with Nick Segal and Ben Davis. Finally, corporate governance developments in India are discussed in detail by Shri Bhagwan Dahiya.

Conclusions

This volume contains chapters on the development of corporate governance from many different regions around the globe. While the stage in the corporate governance life cycle may vary from country to country, there are certain core features which emerge, such as the importance of transparency, disclosure, accountability of directors and protection of minority shareholders' rights.

I would like to thank the authors for their time in writing these chapters. They have made a unique contribution to our understanding of corporate governance developments in a range of countries, reflecting as they do different nationalities, and professional backgrounds and experiences. Their understanding of, and enthusiasm for, corporate governance will encourage a deeper comprehension of the contribution that corporate governance has to offer in both developed and developing countries.

PART I

CORPORATE GOVERNANCE IN EUROPE

1 Corporate governance developments in the UK

Christine A. Mallin

Introduction

Corporate governance has gained an increasingly high profile in the last decade. The interest in corporate governance spans countries and continents, and applies not only to large public corporations but also to a wider range of business forms including state-owned enterprises, family-owned firms and not-for-profit organizations.

Sir Adrian Cadbury, who chaired the UK's Committee on the Financial Aspects of Corporate Governance which reported in 1992, stated that corporate governance was 'the system by which companies are directed and controlled' (Cadbury 1992, p. 15). This definition is succinct but clearly conveys the importance of controls in the company. A wider definition was given by the Organization for Economic Cooperation and Development (OECD 2004), which stated that corporate governance was 'a set of relationships between a company's management, its board, its shareholders and other stakeholders. [It] also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined' (p. 11). As we can see, this definition views corporate governance from a much wider perspective and takes account of the various stakeholder groups, not just the shareholders. It also emphasizes the importance of corporate governance as an enabling device for setting, achieving and monitoring corporate objectives and performance.

From just these two definitions, it is easy to understand why corporate governance is so important to companies, investors and stakeholders, and why it is a topic that has a pan-European and indeed global appeal. It is fundamental to well-run firms and helps ensure that the assets of the firm are secure and not subject to expropriation by individuals or groups within the firm who could wield excessive power. Corporate governance therefore helps a firm to be sustainable in the longer term.

In this chapter, the evolution of corporate governance in the UK is discussed, together with the influential growth in ownership of UK equity by institutional investors such as pension funds and insurance companies.

UK developments in corporate governance

Cadbury Report (1992)
In the UK, it was after the failures of Coloroll and Polly Peck that the Committee on the Financial Aspects of Corporate Governance was established in May 1991. The committee published its report in 1992, and it became widely known as the Cadbury Report, after its chair, Sir Adrian Cadbury. The report is widely recognized as having set the foundations for a 'best practice' system of corporate governance, both in the UK and subsequently in many countries across the world which incorporated some or all of its recommendations into their own corporate governance codes.

At its core, the Cadbury Report recommended that companies should appoint three independent non-executive directors, separate the roles of chair and CEO, and have an audit committee and a remuneration committee. A nomination committee was identified as one possible way to ensure a transparent appointments process. The Cadbury Code (1992) stated that non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.

Cadbury (1992) stated: 'apart from their directors' fees and shareholdings, they (non-executive directors (NEDS)) should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement' (para. 4.12).

There have been numerous reports elaborating on aspects of the Cadbury Report over the last decade or so, including Greenbury (1995), Hampel (1998), the Combined Code (1998), Turnbull (1999), Higgs (2003), Smith (2003), the revised Combined Code (2003) and the revised Turnbull Guidance (2005). These are discussed below.

Greenbury Report (1995)
Disquiet over the size of directors' remuneration packages and about the level of disclosure of directors' remuneration in the annual reports of companies led to the establishment of the Greenbury Committee. Chaired by Sir Richard Greenbury, it reported in 1995 with comprehensive recommendations regarding disclosure of directors' remuneration packages. The remuneration committee, comprising independent non-executive directors, was to be central to its recommendations of strengthening the accountability and enhancing the performance of directors. Relating directors' remuneration to the performance of the company was the other important aspect of the report.

Hampel Report (1998)
The Hampel Committee was set up in 1995 to review the implementation of

the Cadbury and Greenbury committee recommendations. Reporting in 1998, the Hampel Committee said ‘we endorse the overwhelming majority of the findings of the two earlier committees’. As with the earlier reports, the Hampel Report emphasized the important role that institutional investors could play in corporate governance.

Combined Code (1998)

The Combined Code (1998) drew together the recommendations of the Cadbury, Greenbury and Hampel reports. The Combined Code operates on the ‘comply or explain’ basis mentioned above. One part of the Combined Code referred to the directors carrying out a review of the effectiveness of the system of internal controls including ‘financial, operational, and compliance controls and risk management’.

Turnbull (1999)

The Turnbull Committee, chaired by Nigel Turnbull, was established by the Institute of Chartered Accountants in England and Wales (ICAEW) to provide guidance on the implementation of the internal control requirements of the Combined Code mentioned above. The Turnbull Report confirmed that it is the responsibility of the board of directors to ensure that the company has a sound system of internal control, and that the controls are working as they should. The board should assess the effectiveness of internal controls and report on them in the annual report.

Higgs (2003)

The Higgs Review, chaired by Derek Higgs, reported in January 2003 on the role and effectiveness of non-executive directors. Higgs offered support for the Combined Code while also making some additional recommendations which included stating the number of meetings of the board and its main committees in the annual report, together with the attendance records of individual directors; a chief executive officer should not also become the chair of the same company; non-executive directors should meet as a group at least once a year without executive directors being present, and the annual report should indicate whether such meetings have occurred; and chairs and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles. Many of the recommendations were included in the revised Combined Code (2003) as supporting principles, and some were modified, for example, the recommendation that a CEO should not also become chair was amended so that this would be feasible after consultation with major shareholders.

Smith (2003)

The Smith review of audit committees, a group appointed by the Financial Reporting Council, reported in January 2003. The review made clear the important role of the audit committee ‘while all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control’ (para. 1.5).

UK Directors’ Remuneration Report Regulations 2002

In 2002 the UK Directors’ Remuneration Report Regulations (DTI 2002) were introduced. These contained some important provisions including that quoted companies must publish a detailed report on directors’ pay as part of their annual reporting cycle and that this report must be approved by the board of directors. A graph of the company’s total shareholder returns over five years, against a comparator group, must be published in the remuneration committee report. The names of any consultants to the remuneration committee must be disclosed, including whether they were appointed independently, along with the cost of any other services provided to the company.

Importantly, companies must hold a shareholder vote on the directors’ remuneration report at each general meeting. The vote is advisory in nature but none the less if shareholders vote against the directors’ remuneration report then the board of directors would do well to heed the signal that the investors are unhappy with the directors’ proposed remuneration. Glaxo Smith Kline was the first company to experience the disapproval of the investors through this advisory vote.

Revised Combined Code (2003)

The Combined Code (2003) has two main parts: one on companies and one on institutional shareholders. It builds on the earlier reports and incorporates various recommendations from the reviews of Turnbull, Higgs and Smith.

The role of boards and board subcommittees is central to a good corporate governance structure. The UK’s Combined Code (2003) recommends splitting the roles of chair and CEO so that too much power is not concentrated in the hands of a single individual. It also recommends that an audit committee be established and this will act as a link between the external auditors and the audit committee; that a remuneration committee be established to set the remuneration of executive directors; and that there should be a formal and transparent nomination process for nominating new directors, and a nomination committee could be set up to fulfil this role. In all of these committees, the independent non-executive directors are very important as they should bring their objective judgement to these roles.

The board should undertake a formal and rigorous annual evaluation of its own performance and of the various committees and of individual directors.

Revised Turnbull Guidance (2005)

In 2005, revised guidance on Turnbull was published. Boards are encouraged to review their application of the guidance on a continuing basis and to look on the internal control statement as an opportunity to communicate to their shareholders how they manage risk and internal control. They should notify shareholders, in the annual report, of how any ‘significant failings or weaknesses’ in the effectiveness of the internal control system have been dealt with.

Company law reform

The government published the Company Law Reform Bill in November 2005 which proposed reforms to, *inter alia*, encourage shareholder engagement and a long-term investment culture, and ensure better regulation. It will impact on areas such as a company’s annual general meeting and also on codifying directors’ duties and responsibilities. The UK also has an important role to play in ensuring that its voice is heard in the current European Union developments relating to company law and corporate governance.

Changing pattern of share ownership

No discussion of corporate governance developments in the UK would be complete without discussion of the pattern of share ownership in the UK.

In the UK there has been a significant change in the pattern of share ownership in the last 40 years, with institutional shareholders (pension funds, insurance companies, mutual funds) becoming much more influential. For example, in the UK, according to the Office of National Statistics (2005) at the end of 2004, institutional investors owned nearly 50 per cent of UK equity, overseas shareholders (predominately institutional investors) owned 32.6 per cent, and individual shareholders owned just over 14 per cent of UK equity. If we look back some 40 years we would have seen that individual shareholders held the majority of shares: 54 per cent in 1963. Given the extent of share ownership by institutional shareholders, it is not surprising that they can wield substantial power and influence.

The influence of institutional investors is not limited to their involvement in UK equities, as they like to diversify their portfolios by investing overseas; conventional wisdom says that this is one way to earn an appropriate return while lowering the overall risk of the portfolio. In this sense, the institutional investors are not putting ‘all their eggs in one basket’. When institutional investors are seeking new investments overseas, they will look for standards of corporate governance that they are familiar with and which should help protect their investment and ensure them of an appropriate return. Hence, overseas markets have tended to develop corporate governance codes of which at least some of the principles seem familiar, for example, the establishment of key board committees, and the presence of independent non-executive directors.

Role of institutional investors

As mentioned above, institutional investors have become very powerful in the UK, and various other countries including the United States, because of the size of their shareholdings. In the UK there is the expectation that institutional investors will play an active role in the companies in which they invest.

Myners Review (2001)

The Myners Review, chaired by Paul Myners, was commissioned by the Treasury and reported in 2001. The review was fairly wide ranging and covered various aspects relating to fund management, trustees, life insurance, and so on. However, in relation to institutional investors, the general flavour of the report was that there was much expected of them by the various codes discussed earlier but that, despite their power and influence, they seemed reluctant to take action to intervene in underperforming companies.

Institutional Shareholders' Committee (2002)

In response to the findings of the Myners Review (2001) and the threat of legislation by the government to try to make institutional investors more activist, the Institutional Shareholders' Committee (ISC 2002) issued a statement on the responsibilities of institutional shareholders.

The ISC stated that the policies on activism that they described are designed to deal with the underperformance of companies and hence ensure that shareholders derive value from their investments. They stated that institutional shareholders should have a clear statement of their policy on activism and on how they will discharge their responsibilities; they should monitor performance, and intervene when necessary. Finally, they should evaluate and report on their activities. Overall, the statement aims to enhance 'how effectively institutional shareholders discharge their responsibilities in relation to the companies in which they invest'.

Institutional Shareholders' Committee (2005)

In September 2005, the ISC published a review of their 2002 statement of principles on the responsibilities of institutional shareholders and their agents. The review monitored the progress of the statement for the two years since its launch in 2002 and concluded that there had been a general increase in the level of engagement with investee companies. Therefore the Statement of Principles issued in 2002 has stayed the same but with two modifications. First, the word ‘activism’ has been replaced by ‘engagement’ and this change ‘is to emphasise the importance now attached by institutional investors to developing a high quality all-round relationship with the companies in which they invest’. Second, as it is a listing requirement that companies must comply with the Combined Code (2003) or explain why they do not, there is no need for institutional investors to state in their policy that they require investee companies to do this, that is, it is a given that investee companies should comply or explain with the recommendations of the Combined Code.

Conclusions

There have been a multitude of corporate governance reports in the UK, a number of which have set the scene for corporate governance developments worldwide, notably the Cadbury Report (1992). The UK’s ‘comply or explain’ approach seems to work well and has been adopted by many countries.

The trend is towards improved corporate governance driven by the influence of powerful institutional investors (especially pension funds) who are themselves being exhorted to be more activist in their approach to their investee companies and to be more proactive in intervening in underperforming companies.

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2 Recent corporate governance developments in Spain

Silvia Gómez-Ansón

Introduction

This chapter reviews the corporate governance situation of Spanish quoted companies, and the legal corporate governance developments that have taken place recently. First, it refers to the Spanish institutional setting, and second to the Spanish codes of best practice and legal rules that have been issued during the last years, and finally it describes the corporate governance practices of Spanish quoted companies.

Spain's institutional setting

The 'law and finance' literature initiated by the works of La Porta et al. (1997b, 1998) argues that how well capital markets function depends on several factors: customs, rules, laws and regulations, and how they are enforced. The origin of a country's commercial/company law (British, French, German or Scandinavian legal origins) helps explain the country's law on creditor, shareholder and private property rights as well as the country's level of bank and stock market development.[1] Spain belongs to the group of countries with a French civil law origin. Table 2.1 shows the legal, equity and debt financing, as well as ownership characteristics of Spain, and compares them with the characteristics of the mean English common law, German civil law and French civil law countries, as well as those of the US, the UK and Germany.[2] Spain has an anti-director rights index of 4 over 6, a higher score than the mean French civil law country (2.33), although lower than that of the US and the UK (5). The creditor rights index is 2 over 4 for Spain, while for the mean French civil law country it is 1.58 and for the mean English common law country it is 3.11. The rule of law score for Spain is 7.8 over 10, a higher score than the mean French civil law country (6.05), but lower than that of the US (10) and the UK (8.57). The rating on accounting standards for Spain is 64 over 100, higher than the mean French civil law country (51.17), but lower than that of the mean English common law country (69.62). According to these figures, Spain presents a higher protection of shareholders' and creditors' rights, as well as higher accounting standards than the mean French civil law country, but lower scores than English common law countries, that is, the

US or the UK. Consequently, the development of capital markets in Spain has been traditionally lower. As shown in Table 2.1, in year 1994 the ratio of domestic firms listed over the whole population of firms was considerably lower in Spain than in the mean English common law country, as was the ratio of initial public offerings (IPOs)/population (with data from 1996–97). Nevertheless, this situation has changed over the last few years. While in 1994 the stock market capitalization of the Madrid Stock Exchange amounted to €122,312 million, it was €430,653 million in 1999 and €672,235 million in 2004.

Another characteristic that Spanish firms share with firms of other French civil law countries, is their high ownership concentration. La Porta et al. (1999) report that while the three largest shareholders hold 50 per cent of firms' shares in Spain, this figure stands at just 20 per cent in the US and 19 per cent in the UK. The proportion of firms with no controlling shareholder (that is, a shareholder whose voting rights exceed 20 per cent), is 35 per cent for large listed companies and zero per cent for medium-sized listed companies in Spain, whereas levels for the US stand at 80 and 90 per cent, respectively (see Figure 2.1).

These figures are corroborated by both Crespí-Cladera and García-Cestona (2002) and Faccio and Lang (2002). The latter authors document that widely held companies account for only 10 per cent of the total for the whole sample of companies listed on the Spanish stock market when 10 per cent ownership is used as the threshold. The majority of large shareholders are family groups (67 per cent) and widely held financial companies (15.07 per cent). Moreover, for the whole sample of quoted companies on Spanish stock exchanges, Sacristán and Gómez (2005) document that most listed firms have a majority shareholder: 75.47 per cent of the joint electronic and traditional market sample (total sample) and 79.76 of the traditional market sample using the 20 per cent threshold, and 89.23 per cent of the total sample and 99.88 per cent of the traditional market sample using the 10 per cent threshold.

In addition, Spain underwent considerable economic restructuring founded on liberalization and deregulation in the financial sector and key product markets during the last decades of the twentieth century. Public sector restructuring and the privatization of state-owned enterprises (SOEs) were a major part of this reform. According to the OECD (2003), this privatization programme raised US$38,401 million between 1990 and 2001, thereby ranking Spain fourth of the 15 long-standing EU countries in terms of revenues from privatizations. The privatization of SOEs by public offerings helped create a 'popular capitalism' in Spain. While state participation in the stock market decreased at the end of the twentieth century and the beginning of the twenty-first (from 16.64 per cent in 1992 to 0.43 per cent in 2002), shareholdings held by individuals and families increased considerably (from 24.44 per cent in 1992 to 28.31 per cent in 2002, which is an increase of 15.83 per

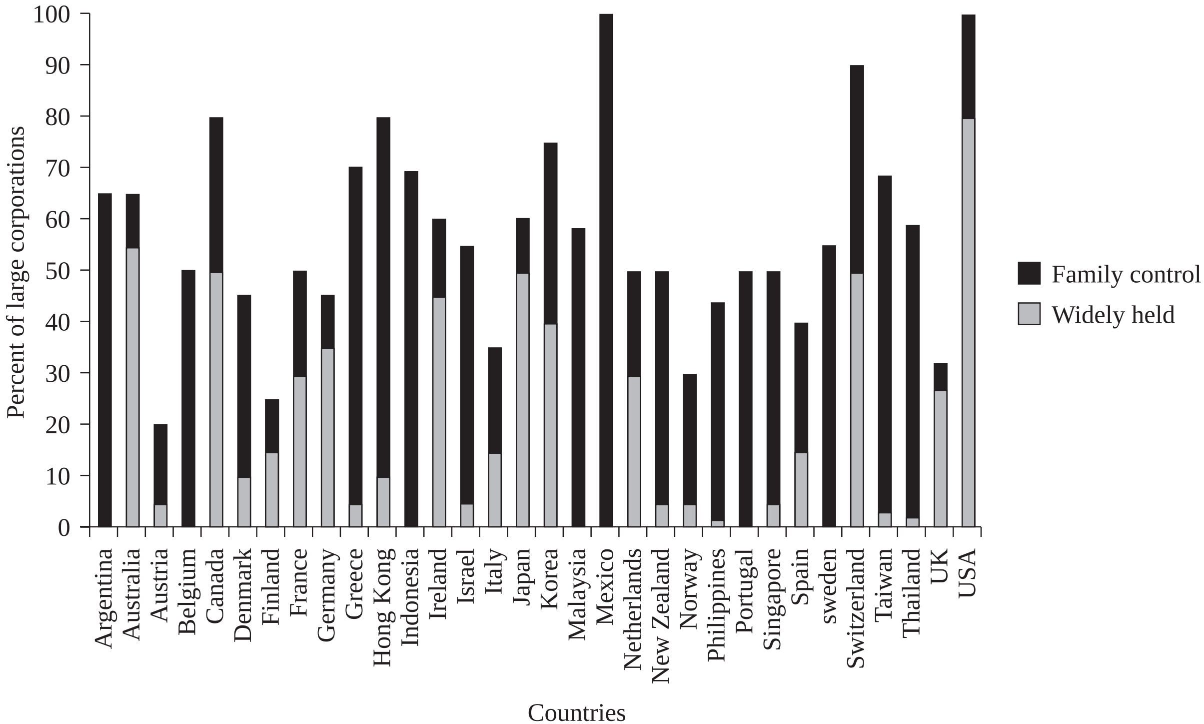
Table 2.1 Comparative features by legal origin of countries

Measure	English common law origin (average)	USA	UK	German civil law origin (average)	Germany	French civil law origin (average)	Spain
Shareholder rights index							
Anti-director rights index (aggregation of shareholder rights, ranges from 0 to 6)	4.00	5	5	2.33	1	2.33	4
One share, one vote (equals one if the law requires that ordinary shares carry one vote per share)	0.22	0	0	0.33	0	0.24	0
Creditor rights index (aggregation of creditor rights ranges from 0 to 4)	3.11	1	4	2.33	3	1.58	2
Rule of law (assessment of law and order, ranges from 0 to 10, 0 minimum)	6.46	10.00	8.57	8.68	9.23	6.05	7.80
Rating on accounting standards	69.62	71	78	62.67	62	51.17	64
GNP per capita (constant US$ 1994)	9,353	24,740	18,060	22,067	23,560	7,102	13,590
Average market capitalization of firms (US$m)	6,586	71,650	18,511	8,057	8,540	1,844	1,256
Equity finance							
Stock market capitalization held by minorities/GNP (1994)	0.60	0.58	1.00	0.46	0.13	0.21	0.17
Domestic firms listed/population (1994)	35.45	30.11	35.68	16.79	5.14	10.00	9.71
IPOs/population (1996–97)	3.11	3.11	2.01	0.12	0.08	0.19	0.07
Debt finance							
Debt/GNP (1994)	0.68	0.81	1.13	0.97	1.12	0.45	0.75
Debt/sales (1996)	0.26	0.18	0.11	0.30	0.10	0.27	0.25
Ownership of three largest shareholders (1995, 1996)							
Mean	0.43	0.20	0.19	0.34	0.48	0.54	0.51
Median	0.42	0.12	0.15	0.33	0.50	0.55	0.50

Table 2.1 Continued

Measure	English common law origin (average)	USA	UK	German civil law origin (average)	Germany	French civil law origin (average)	Spain
Control of large publicly traded firms (1995, 1996)							
Widely held (equals 1 if there is no controlling shareholder with more than 20% of the firm's shares)		0.80	1.00		0.50		0.35
Control of medium publicly traded firms (1995, 1996)							
Widely held (equals 1 if there is no controlling shareholder with more than 20% of the firm's shares)		0.90	0.60		0.10		0.00
Pyramid and not widely held (equals 1 if the controlling shareholder exercises control through at least one traded company, 20% threshold)		0.00			0.40		0.38

Sources: La Porta et al. (1997a and b, 1998, 1999).



Sources: La Porta et al. (1999, Tables 2 and 3).

Figure 2.1 Widely held versus family-controlled firms as a percentage of large corporations around the world cent). The privatization process helped enlarge the Spanish stock market. The Madrid Stock Exchange's 1990 capitalization was €49,679.61 million. In 1995 it rose to €99,689.59 million and in the first quarter of 2004 to €311,550.85 million. Using June 2004 data, the market capitalization of companies privatized by IPOs was €168,347.085 million, 56 per cent of the market capitalization of the firms that made up the Ibex-35 Index, and 54 per cent of the market capitalization of the Madrid Stock Exchange General Index.

Another remarkable feature of the quoted companies is the presence of families as major blockholders (Crespí-Cladera 1998). According to Crespí-Cladera and García-Cestona (2001), family groups owned 10.96 per cent of the shares issued by quoted companies. Reyes and Sacristán (2003) find that for 26.19 per cent of quoted firms, the largest shareholder was an individual or a family. Similar results are reported by Santana and Cabrera (2001) and by Galve and Salas (1993) (26.10 per cent for 1990). Sacristan and Gómez (2005) document that the importance of family groups as blockholders for quoted companies is even larger. When using 20 per cent ownership as the threshold, they document that the main largest shareholders are families and individuals (40.1 per cent of the closely held (with large blockholders) firms), followed by non-financial companies (35.9 per cent of closely held (with large blockholders) firms). Using 10 per cent as the threshold, the number of firms with a large shareholder increases. Families and individuals are again the predominant largest shareholder, followed by non-financial companies (see Table 2.2). Moreover, they document that families tend to use indirect ownership and pyramids to channel their investments and that family-dominated firms are frequently managed by members of the controlling family, with their control rights exceeding their cash-flow rights.

As different authors have suggested, this allocation of control rights largely seems to influence corporate governance, and consequently firms' value and economic development. For instance, Morck and Yeung (2004) find a strong correlation between corruption and family control. Countries with a high incidence of family control over large firms have low compliance with tax laws, high official corruption, low judicial efficiency and integrity, inefficient bureaucrats with low autonomy and high regulatory barriers to entry.

Given these features, as argued by Shleifer and Vishny (1997), in Spain, controlling shareholders may expropriate wealth from outside shareholders. Spanish companies, a priori, should face agency costs, not so much related to the conflict of interest between managers and shareholders, but to the conflict of interest between majority and minority shareholders. Different factors are expected to decrease these conflicts of interest between majority and minority shareholders, for example, the presence of a second large shareholder in a large number of the companies; a high ratio of cash flow to control rights; or the rare deviations from the one-share, one-vote rule. Other factors that may

Table 2.2 Spanish firms' largest shareholder

Type of owner	Total sample					Electronic market	Traditional market
	%	Min.	Max.	Mean	Std dev.	%	%
Banks	12.31	5	95.13	37.60	30.37	18.3	1.4
Families and individuals	36.92	0.5	99.99	43.92	27.77	24.6	59.4
Foreign companies	14.87	5.05	95.18	27.06	26.93	19.8	5.8
Non-financial companies	31.79	5.07	99.55	45.84	29.25	31.7	31.9
Other financial companies	2.1	37.8	98	68.69	26.69	2.4	1.4
Pension, mutual funds	1.5	1.295	31	12.5	16.14	2.4	0
State	0.5	28.5	28.5	28.5	–	0.8	0
Total sample	100	0.5	99.99	41.19	29.14	100	100
No. of firms			195			126	69

Note: The data refer to firms quoted on the Spanish Stock Exchange in 2002.

Source: Sacristán and Gómez (2005).

reinforce the power of large shareholders and managers in the quoted companies are: a significant percentage of top executives belong to the large shareholder group; there are mainly family groups; or there is an incipient takeover market with few hostile takeovers.

Spain's corporate governance reforms

The first Spanish Code of Best Practice was issued on 26 February 1998 (Olivencia Report, 1998). A government mandate had approved the creation of a committee to draft a code of best practice for firms that issue securities on the stock exchanges. The creation of this committee, presided over by Professor Dr M. Olivencia, was accompanied by the introduction of other reforms that aimed to modernize the entrepreneurial environment in Spain, that is, legal reforms aimed at liberalizing markets and privatizing SOEs.

Compliance with the recommendations in the code was optional rather than compulsory. Like other codes, it set out recommendations on the responsibilities, structure and organization of the board of directors with the aim of improving its monitoring role. Some of its 23 recommendations, such as those relating to the establishment of a majority of non-executive directors, those on the establishment of specialized committees made up exclusively of non-executive directors (that is, the auditing, remuneration or appointment committees), those on the need to disclose managers' and directors' pay details, and those referring to the need for directors' remuneration to be dependent on the firm's value or on the directors' efforts, were similar to those contained in the Cadbury Report (see Chapter 1, this volume). Other provisions, for example those calling for a minimum and maximum board size of between five and 15 members, respectively, or those related to establishing a retirement age for directors, were different.

Specific aspects of the code aimed to reflect the institutional characteristics of Spanish companies, especially those dealing with the protection of minority shareholders. For instance, the code distinguished between three types of directors: non-executive directors representing large shareholders, non-executive independent directors and executive directors. The proportion of non-executive directors representing large shareholders and non-executive independent directors on the board should reflect the proportion of large investors' shareholdings and the size of the free-float.

Compliance rates since the code was established were to some extent less successful than expected. According to a questionnaire issued by the Spanish Supervisory Agency (CNMV) in 2001, of the 67 firms (representing 73 per cent of the Spanish stock market capitalization) that answered the questionnaire, the mean compliance rate amounted to 77 per cent of the code recommendations, but only five firms had adopted the 23 recommendations. The recommendations that companies were most reluctant to adopt were those related to the creation of board committees composed exclusively of non-executive directors (only 45 per cent of the firms adopted this recommendation), the disclosure of directors' and CEOs' pay details (52 per cent) and the establishment of a retirement age for the CEO and a formal proceeding to elect directors (52 per cent). The questionnaire also showed that the companies in the sample had increased their board size since the issuance of the code in order to increase the number of non-executive directors, rather than reduce the number of internal or executive directors. Privatized firms and firms that had recently gone public exhibited greater compliance rates, whereas 'old companies', those with a long history of quoting, were more reluctant to change their corporate governance structure (Fernández et al. 2004).

Following the corporate scandals at the beginning of the twenty-first century, and the Winter Report, in 2002 the Ministry of Economy appointed another committee that was to issue a second code of best practice. The Aldama Report was published in January 2003. Its recommendations were similar to those of the Olivencia Report, but the new report emphasized the need to regulate the information provided by the companies to the market, in particular, the need to regulate the corporate governance information that should be released by quoted companies both in the Annual Corporate Governance Report and on the web page.

The Aldama Report coincided with a period of legislative reforms. At the end of 2002, the Law of Reform of the Financial System obliged companies to set up an audit committee composed of a majority of non-executive directors. In April 2003 the Spanish takeover law was modified. The new law requires that a takeover be launched not only when a certain threshold of ownership by the acquiring company is about to be surpassed, but also when the acquiring company changes a significant percentage of its board of directors. The modification of the takeover law of 2003 also extended the possibility of improving the offer in the event of competing offers.

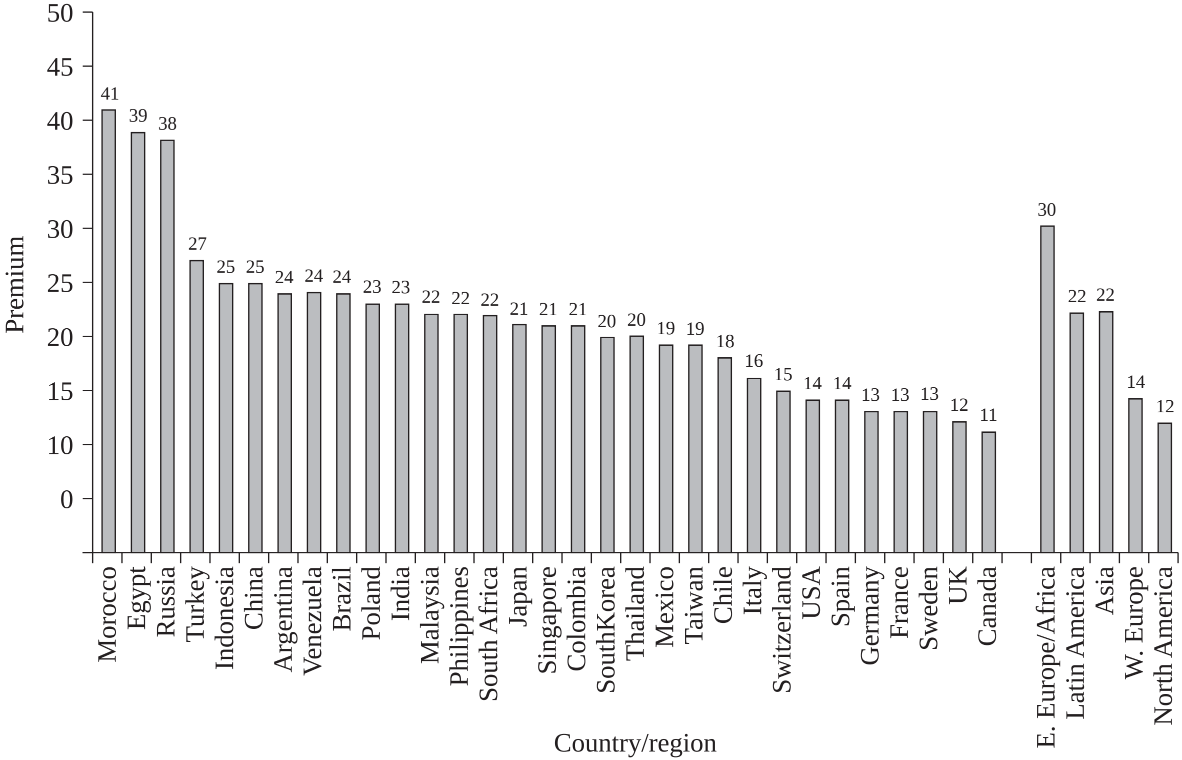
In addition to these new laws, in July 2003, following the conclusions and recommendations of the Aldama Report, the Transparency Law[3] reformed Spanish company law and established the obligation to publish a Rule of the Board of Directors and a Rule of the Shareholders' Meetings, and to register such rules with the Spanish Supervisory Agency. The Transparency Law also established the need to publish, from 2004 onwards, a compulsory annual Corporate Governance Report and to disclose corporate governance information on the companies' web page. This law was further developed by a rule laid down by the Ministry of Economy at the beginning of 2004[4] and by two directives from the Spanish Supervisory Agency. Directive 1/2004[5] established a list of more than 70 questions that quoted companies are obliged to answer in the Annual Corporate Governance Report. These questions refer to the firms' ownership structure, the structure of the company's management, related party transactions, risk control systems, the general shareholders' meeting and anti-takeover amendments. Furthermore, Directive 1/2004 establishes the obligation for quoted companies to declare their fulfilment of the recommendations of the two codes of best practice (the Olivencia and the Aldama reports) following the Anglo-Saxon 'comply or explain' rule. This directive also established a list of issues about which quoted companies should provide information in their web pages. These issues relate to the firms' ownership structure, their corporate governance structures, shareholders' rights as well as financial information. The second directive of the Supervisory Agency was published in 2005. It refers to the Annual Corporate Governance Report and the information that savings banks have to provide. In addition, a new rule published in 2004 (Orden EHA/3050/2004), which was further developed by Directive 1/2005, regulated the information about related party translations that companies that issue equity traded on the stock exchanges should disclose.

On 29 July 2005, the Spanish Cabinet appointed a new group of experts to harmonize and actualize the best practice recommendations of the Olivencia and the Aldama reports. The new report will also incorporate the recommendations of the European Commission and other international institutions. This group has recently proposed a new code of best practice for quoted companies. The proposal will be subject to public consultation until the end of February 2006, and the final version will be made public by 31 May 2006.

Corporate governance situation

All these rules have increased considerably the level of information disclosure of Spanish companies, but have also made corporate governance part of the agenda of quoted companies. As a consequence of these legislative reforms, a significant number of quoted companies reformed their rules in 2003 and 2004, and transparency of information and corporate governance practices have improved significantly. This situation is reflected in the premium that investors would pay for a well-governed Spanish company: according to McKinsey (2002), just 14 per cent, the same premium that investors would be willing to pay for a well-governed US or Western European company (see Figure 2.2). This premium is lower than the one investors would be willing to pay for a Swiss or Italian company and just 1 point higher than the premium that investors would be willing to pay for a well-governed Swedish, German or French company.

The improvement of Spanish quoted companies' corporate governance practices is also reflected in Heidrick & Struggles (2005), which states that Spain is showing a marked improvement in good corporate governance practices. Spanish companies rank sixth of the ten countries included in the study, although their rating (12.19) is still below the 2005 European average (12.68). Nevertheless, it is remarkable that Spain moved from ninth position in the



Source: McKinsey (2002) Country region.

Figure 2.2 Premium that investors would pay for a well-governed company

2003 study to sixth in the 2005 ranking, up by 3.29 points. Spanish companies show a medium spread between best and worst companies.

This new scenario has been accomplished by a new hybrid model of corporate governance which adopts practices from different systems, especially Anglo-Saxon codes (Heidrick & Struggles 2005). The Heidrick & Struggles report highlights the significant issues for this change: the dramatic fall of state ownership in recent years; a steady increase in the proportion of equity held by domestic firms; and the increase in the ratio of non-national shareholders (from 10 per cent in 2003 to 24 per cent). Consequently, the report states that 'Spain is moving steadily from a state-led to a broadly state enhanced corporate governance and labour-relation system'. Among the positive features of Spanish companies the report mentions that board and board committees meet frequently (more frequently than the European average) and that each company has at least two board committees (in 1999, 25 per cent of the Ibex-35 companies had no committees). Nevertheless, the report points out that in 57 per cent of companies, the committee chairs are not independent; that in just 11 per cent and 14 per cent of the companies, respectively, the audit and the nomination and remuneration committees are composed of independent non-executive directors; that company boards tend to be fairly large; and that the composition of Spanish boards continues to be the main weakness of its corporate governance structure. Boards comprise a large proportion of reference shareholders and executive directors, and the share of non-nationals is relatively low, as is gender diversity. Furthermore, the average tenure of board members is longer than it is in Europe.

The conclusions of the Observatory of Good Practice for Spanish quoted companies (2003) of the Foundation of Financial Studies of the Spanish Institute of Financial Analysts (Fundación de Estudios Financieros, 2004) also point to the improvement of corporate governance practices in recent years. In 2003, the Observatory analysed 201 variables that referred to four main categories: (i) firms' ownership structure; (ii) boards of directors; (iii) shareholders' rights; and (iv) disclosure of information of the companies that comprise the IBEX-35 Index: the 35 firms with the highest market capitalization among Spanish quoted firms. The market capitalization of these firms on 1 July 2003 amounted to €289,747.30 million.

Regarding the firms' ownership structure, the conclusions of the Observatory reinforce the high ownership concentration of quoted firms. The mean largest shareholder held more than 25 per cent of the firms' shares, while the five largest shareholders owned, as a mean, more than 40 per cent of the firms' shares. Median values for these variables were very similar to the mean values: the median ownership of the largest shareholder amounted to 21 per cent, while the median ownership held by the five largest shareholders amounted to 39 per cent.

This high degree of ownership concentration determined a low percentage of free-float of Spanish companies, with a mean of 56 per cent. All companies had a large shareholder, that is a shareholder owning more than 5 per cent of the firms' shares, with the major large shareholders being non-financial companies (17.39 per cent of the firms' shares), individuals and families (almost 11 per cent), banks (8.45 per cent) and mutual and pension funds (5 per cent). Mutual and pension funds featured in more than 50 per cent of the firms, while families featured in only 34 per cent. The shares held by the Spanish State amounted to 1.47 per cent. The mean, direct and indirect, ownership held by states (the Spanish State and other foreign states) amounted to only 2.30 per cent. The median stake owned by the states was close to 0.

In contrast to this high ownership concentration, internal or executive ownership was shown to be fairly low. In 2003, although, the members of the boards of directors had a mean ownership of more than 10 per cent of the firms' shares and executive directors had 7.24 per cent, the corresponding median values were considerably lower: 0.15 per cent for directors as a whole and 0 per cent for executive directors. Internal ownership was significant only when an individual or a family group was a major blockholder of a company. Actually the correlation coefficient between individual and family shareholdings and internal ownership was close to 1. These figures reveal that internal ownership is, as a median, fairly low in Spanish large quoted firms. For example, for the US, for Fortune 500 firms, the average managerial holding ranges between 10.6 and 12.4 per cent (Jensen and Warner 1988; Morck et al. 1988; Cho 1998), while for medium-sized companies it amounts to 20 per cent (Denis and Kruse 1999). In the UK, the average managerial ownership ranges between 13.3 per cent and 16.7 per cent (Short and Keasy 1999; Faccio and Lasfer 2001).

With respect to the characteristics of the boards of directors, the study revealed a mean board size of 15 directors, with some companies having a fairly large board. This figure of 15 directors is larger than that reported by previous studies for other markets. For example, Barnhart et al. (1994) and Yermack (1996) report a mean board size of 12 for the US market. This is also larger than the mean board size of European companies (less than 13 directors) (Heidrick & Struggles 2005). The mean number of board meetings per year amounted to 10, indicating that boards met fairly regularly, about once a month.

The composition of the boards reflected the high ownership concentration of Spanish firms. As a mean, directors representing large shareholders comprised 41.62 per cent of board directors, independent directors 36.76 per cent, executive directors 17.89 per cent and grey (usually priorly employed) directors 3.73 per cent. A remarkable negative aspect of Spanish companies is the low differentiation between the posts of CEO and chairman of the board, with a large number of companies making no distinction (77 per cent). Similar figures are documented by Faccio and Lang (2002) for Spain. With reference to the boards' committees, less than two thirds of the companies (65.71 per cent) had an executive committee, while in compliance with the law all companies had an audit committee; for 71 per cent of the companies, the chair of the audit committee was an independent director. In 2003, nearly all companies also had a remuneration and nominees committee (now 100 per cent of the Ibex-35). Its mean size was 3.5 directors, it mainly comprised non-executive directors and in all the companies it was chaired by a non-executive director. Other committees, such as a strategic committee or an international committee, are not so common. Slightly more than 25 per cent of the companies had other committees in addition to the executive, audit and remuneration and nominees committees. These figures tend to suggest an adequate, although non-optimal, structure of Spanish firms' boards of directors.

The board members generally received remuneration through fixed payments (68.57 per cent of the companies), and only a relatively small number of companies remunerated their directors using option plans or variable schemes. The mean remuneration paid to external directors (for those companies that disclosed it) was €56.537 per year (this figure does not include payments for committee members).

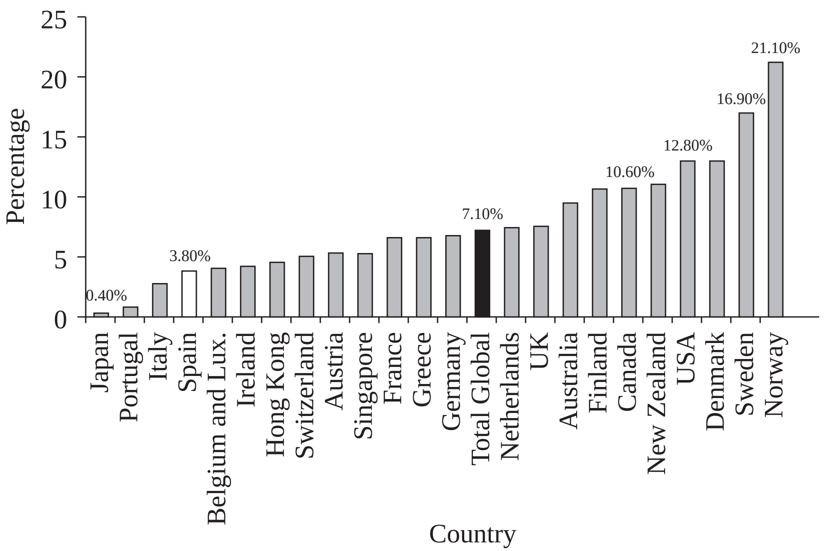
With respect to shareholders' rights, the Observatory showed that no company had issued non-voting shares, while slightly more than 10 per cent of the companies claimed to be aware of pacts among their major shareholders (in 2004 when the companies were obliged to publish this information, seven out of the 35 companies comprising the Ibex-35 Index stated that they were aware of these pacts). Although many companies restricted their shareholders' rights by requiring a minimum number, or percentage, of shares for attending the general shareholders' meeting, the number or percentage of shares required to attend the meeting was not high. Also, a relatively small percentage of companies allowed electronic or postal voting (only 12 per cent), while almost all companies had established a Shareholder Office with an email contact address. Furthermore, following the Transparency Law, by the end of 2004, all quoted companies had approved a Rule of the General Shareholders' Meeting. These data reveal that in terms of shareholders' rights, improvements are to some extent still outstanding. Rights can be reduced by anti-takeover devices. Although these are not generally used now, some companies still limit the percentage of votes for significant shareholders, establish a quorum higher than that required by the law for the shareholders' meeting or establish the requirement of majorities above those required by law in order to approve either regular or special issues at the meeting.

The fourth category referred to the disclosure of information. It revealed the need to increase such disclosure regarding corporate governance. This need has largely been accomplished by the new legislation that has recently been passed.

Another issue that has acquired considerable importance worldwide and which may be related to good corporate governance practices is the diversity of boards and, especially, the board's gender diversity. This is an area in which the Spanish quoted companies need to improve. As shown in Figure 2.3, according to a study for the companies that formed part of the FTSE All World Developed Index, in gender diversity, Spain occupied one of the bottom positions, with just 3.8 per cent of the boards' seats occupied by women, a percentage that is significantly lower than the average of 7.1 per cent. Scandinavian companies occupied the highest posts of the ranking followed by firms from Anglo-Saxon countries. The late incorporation of Spanish women into the labour market as well as cultural reasons could help to explain this situation.

Conclusion

Overall, the Heidrick & Struggles study (2005) and the conclusions of the Fundación de Estudios Financieros (2004) point to a positive trend in Spanish



Source: Fundación Ecología y Desarrollo (2004).

Figure 2.3 Gender diversity of the board of directors of the companies included in the FTSE All World Developed Index corporate governance practices, which is expected to continue. The codes of best practice and the new legislation have played a significant role. Nevertheless, there are still areas for improvement. For instance, Spanish companies continue to be reluctant to provide individual data of directors' salaries and CVs and the age of board members; there are still grey directors on the boards; the percentage of executive directors is higher than for the mean European company; diversity, especially gender diversity, is quite low; and there are still violations of the one-share, one vote rule.

Notes

1. It is not only legal traditions that may influence a country's growth. La Porta et al. (1997a) argue that hierarchical religions, which they define to include Roman Catholicism and Islam, are less conducive to the growth of large businesses. Accordingly, Stulz and Williamson (2003) show that a country's principal religion (a proxy for culture) helps predict cross-country variation in creditors' rights. Catholic countries provide creditors with weaker rights than other countries do, and firms in Catholic countries use less long-term debt.
2. The source of this information has been the articles published by La Porta et al. (1997a and b, 1998, 1999).
3. Ley de Transparencia de las Sociedades Cotizadas, Ley 26/2003.
4. Orden ECO/3722/2003, de 26 de diciembre.
5. Circular 1/2004, de 17 de marzo, de la Comisión Nacional del Mercado de Valores.

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3 Corporate governance developments in Germany

Axel v. Werder and Till Talaulicar

Introduction

Corporate governance can be defined as the system and the processes by which companies are directed and controlled (see Cadbury 2002, p. 1). Corporate governance deals with the alignment of managerial decision making with the interests of (other) corporate stakeholders and shareowners in particular. Since the interests of top management and stakeholders can diverge, corporate governance mechanisms for controlling managers are necessary. Corporate governance includes the general framework of governance rules and regulations which are to be specified on different levels of regulation. The first level consists of mandatory stipulations set down by law (for instance, in the German Stock Corporation Act). Beyond this level of legislative regulation, there are rules of soft law like international and national codes of corporate governance (for instance, the German Corporate Governance Code). Finally, within the remaining discretion, the single firm can decide upon specific regulations as they are constituted in, for instance, the statutes of the company, firm-specific codes of corporate governance, the rules of procedure for the organs of the company as well as in the individual contracts with the organ members. Indeed, corporate governance depends not only on this regulatory framework but also on the factual processes that develop in these rules and activate governance practices. None the less, these frameworks give governance processes and specific governance solutions their direction.

Governance-related subject matters have a long tradition in Germany under the heading of corporate constitution (*Unternehmensverfassung*). The corporate constitution rules the rights and duties of the company's organs and their members, in the case of the German stock corporation (*Aktiengesellschaft*, *AG*) of the management board (*Vorstand*), the supervisory board (*Aufsichtsrat*) and the shareholders' assembly (*Hauptversammlung*). Accordingly, the corporate constitution is characterized by an internal governance perspective. However, corporate governance is much broader because it also captures external relationships of the company. In this vein, the Anglo-American debate emphasizes in particular the interests of the shareholders and other investors in so far as corporate governance deals with 'the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment' (Shleifer and Vishny 1997, p. 737). Furthermore, topics of auditing and accounting were not tackled under the former German heading. This broader governance debate, for which the original English term is used in German, too, has been discussed in Germany since the mid-1990s (for instance, Picot 1995; Scheffler 1995; Feddersen et al. 1996) after its initiation in the Anglo-American landscape. None the less, German corporate governance gained particular attention abroad (for instance, Vagts 1966; Conard 1984; Roe 1993) because the German system of corporate governance differs significantly from the predominant Anglo-American one. In a nutshell, there are three structural peculiarities of the German stock corporation which has a two-tier structure, a collegial management board and – depending on its size – a codetermined supervisory board. Although these peculiarities still prevail, important changes have taken place that make a more detailed review of the German governance scenery mandatory.

Some fundamentals of the German corporate governance system

Choice of a legal form

German company law offers several alternative legal forms that founders (or founded companies) can choose from. The choice of a legal form has a tremendous effect on the company's governance because the possibilities of management to exercise control depend, to a large extent, on the legal rules which regulate the respective framework constituted by the chosen legal form (Grundei and Talaulicar 2002). Two general categories of legal form can be distinguished. Unincorporated firms are associations without independent legal existence (roughly: partnerships) whose partners (apart from exceptions) are personally liable. On the contrary, incorporated firms (roughly: corporations) are organized in a corporate form, that is, the firm itself is a legal entity, and the liability (of the company) is restricted to corporate assets. Two concrete forms of corporation are of major concern: the limited liability company and the stock corporation.

Based on the number of firms as well as on sales figures, corporations are most frequently organized as limited liability companies (*Gesellschaft mit beschränkter Haftung*, *GmbH*). The popularity of this legal form can be traced back to its structural flexibility because the law of the limited liability company leaves a high degree of latitude to the founders or owners of the firm when designing its constitution and deciding upon the rights and responsibilities of the corporate organs and their members. In contrast, the Stock Corporation Act (*Aktiengesetz*, *AktG*) is characterized by the strictness of its norms. As a consequence, deviations from the Act are only admissible in those cases to which reference is explicitly made in the Act. In addition, the *AG* demands a higher founding capital (amounting to at least €50,000), whereas a *GmbH* can be founded with a legal capital of €25,000. The necessary legal capital has been decreased to €10,000 by the most recently adopted Minimal Capital of the Limited Liability Company Act (*Gesetz zur Neuregelung des Mindestkapitals der GmbH, MindestkapG*), which is intended to make setting up business easier and to strengthen the *GmbH* in the international competition of legal forms. Based on the assumption that roughly one-half of all *GmbH* is liable to tax on sales (Hansen 2002, p. 149), there were about 900,000 *GmbH* registered in Germany in 2003 (sales tax statistics are available at www.destatis.de/download/d/fist/fistdow3.xls, as of 16 August 2005).

In contrast, the number of *AG* amounted to a much lower figure of 16,050 in April 2005 (Deutsche Bundesbank 2005, p. 46). None the less, the number of *AG* has increased significantly during the last ten years (from 3,527 in 1994). This increase is caused, *inter alia*, by the Small Stock Corporations and Deregulating Stock Corporation Law Act (*Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts*), which was part of the economic action programme for stimulating growth and employment of the then federal government and which became effective on 10 August 1994. This law is intended to facilitate the going public of medium-sized companies and to strengthen the capital market, because the stock corporation is (apart from the very seldomly used *Kommanditgesellschaft auf Aktien, KGaA*) the only legal form that is allowed to issue stocks. In particular, this law released small and newly founded stock corporations from some special formal regulations and codetermination (see below), which were previously mandatory without exception for this legal form and considered to be a barrier against choosing this corporate form and also, as a consequence, against going public.

Since the stock corporation is the only legal form which allows the company to go public and to gain capital from the stock market, the stock corporation is the legal form chosen most frequently by large-scale companies. In 2002, 74 of the 100 largest German companies, based on value added, were organized as a stock corporation, whereas only seven of these firms were limited liability companies (Monopolkommission 2004, p. 234). The corporate governance debate focuses predominantly on these major public stock corporations. None the less, some scholars have emphasized that the governance wisdom gained for major corporations cannot be applied to small- and medium-sized or newly founded companies without modification. Therefore the peculiarities of start-up companies have been analysed (for example, by Talaulicar et al. 2001). Increasing importance is also to be expected with regard to the governance of public sector companies (for instance, Schneider 2005). Although privatization of these companies has proceeded to a large extent (Bortolotti et al. 2003), many important organizations remain under public law and make sector-specific governance modalities necessary.

However it can be reasonably assumed that these companies will refer to standards of best practice which have been adopted for major stock corporations. In accordance with the prevailing debate, the German stock corporation will therefore stand at the centre of our analyses.

Structure of the stock corporation

Compared with the Anglo-American board model, the German stock corporation features three structural peculiarities. First, the German stock corporation has a two-tier (or dual board) structure which strictly separates the roles of management and supervision. Whereas the management board is responsible for directing the enterprise, the supervisory board appoints, supervises and advises the members of the management board. However, in order to secure a balance of power and management's independence for running the day-to-day business of the firm, a management board member can be recalled only for good reason (for instance, because the management board member neglects his/her duty, lacks the required knowledge, abilities and expert experience to properly complete his/her tasks or has not been discharged by the company's shareholders). In any case, strict separation of management and supervision demands that the same person cannot be a member of both the management and the supervisory boards of the company.

Second, in the case of multipersonnel management boards, which are common in larger companies and even mandatory in stock corporations having more than 2,000 employees, all board members have to participate in the management of the company on equal terms. They are jointly accountable for the management of the enterprise. No management board member (or CEO) is allowed to issue directions to the remainder of the board. The supervisory board, or in the absence of a decision concerning this matter the management board on its own, can nominate one member as chair to coordinate the work of the management board. However, this chairperson is *primus inter pares* and not allowed to instruct his or her board colleagues.

Finally, the supervisory board can be and often is codetermined. Depending on the size of the company, not all members of the supervisory board are elected by the shareholders at the general meeting. Rather, up to one-half of the board members are elected by the domestic workforce of the company. These representatives of the employees are equally obliged to act in the enterprise's best interests as are the representatives elected by the shareholders. The supervisory board of stock corporations is generally composed of one-third employee representatives. In enterprises having more than 2,000 domestic employees, half of the board members are elected by the workforce. However, the chair of the supervisory board, who commonly is a representative of the shareholders, has the casting vote in the case of split resolutions. Stock corporations having fewer than 500 domestic employees are not obliged to appoint employee representatives to their supervisory boards if, and only if, they are either family owned or founded after 10 August 1994.

Besides these structural peculiarities which have no equivalent in the Anglo-American board structure, there are further corporate governance elements which differentiate the German system from its Anglo-American counterparts and which are described in the next subsection.

Systemic characteristics of German corporate governance

In principle, two distinct mechanisms for corporate control can be differentiated: external control via the market and internal control via the boards of the company (Walsh and Seward 1990). The Anglo-American corporate governance system can be characterized as a market-based one. Alignment of management and shareholder interests is achieved by the market for corporate control because poorly performing companies become hostile takeover targets and will dismiss failing managers if hostile takeover bids succeed. The market for corporate control requires a highly developed stock market and dispersed ownership, neither of which could be observed in Germany until recently. In September 2004, only 666 corporations were publicly listed, whereas the number of domestic companies noted on the New York Stock Exchange or the Nasdaq amounted to 1,823 and 2,907 firms, respectively. In the UK, 2,409 companies were publicly listed (Deutsches Aktieninstitut 2004, p. 02-3). The stock market capitalization as a percentage of GDP amounted to 45.2 per cent by the end of 2003 in Germany and is much lower than in the US (131.4 per cent) or in the UK (136.7 per cent) (ibid., p. 05-3). Additionally, the ownership concentration of German firms tends to be comparably high and intercompany shareholdings are (still) a very common phenomenon (for instance, Wymeersch 1998, pp. 1168–9).

The prevailing control mechanisms of German stock corporations are therefore internal in nature. Furthermore, due to the limited possibilities of capital market-based financing, the German system was to be characterized as bank-centred (Roe 1993). That is, corporate banks played a major role in financing and supervising the companies. German firms had a comparably high debt to equity ratio (see Deutsches Aktieninstitut 2004, p. 04-2) and bank managers were frequently appointed to the supervisory boards of their borrowing companies (for empirical data, see Hansen 1994, p. R 78). Quite often, bankers filled the chair position of the supervisory board. In addition to cross-company shareholdings, interlocking directorates were generally not a rare phenomenon (Pfannschmidt 1993). These ownership and supervisory board characteristics led to the designation of Germany Inc., the so-called ‘*Deutschland AG*’.

In this regard, some changes have taken place which refer to both the further development of the stock market and the unwinding of ownership and supervision network structures. In the context of globalizing capital markets, major German companies have adjusted their finance strategies (see Ringleb et al. 2005, p. 12; for the development of the finance structure of non-financial corporations, see Deutsche Bundesbank 2004, p. 28). Accordingly, a greater portion of capital is borrowed from the global capital markets. As a consequence, these companies have to adhere to the rules of these global markets. Credit ratings become very important because they are strongly associated with capital costs. In addition, legal and factual improvements contribute to a further development of the German capital markets. Several Financial Market Promotion Acts have codified German capital market law and internationally competitive standards for capital market regulation (for an overview, see Nowak 2004). For instance, a Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel*, *BAWe*) was established for the first time in 1995, whereas federal supervisory offices covering banking (*Bundesaufsichtsamt für das Kreditwesen*, *BAKred*) and the insurance industry (*Bundesaufsichtsamt für das Versicherungswesen*, *BAV*) have a very long tradition in Germany. On 1 May 2002, these three federal supervisory offices were combined by creating the newly established Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, *BaFin*). By doing so, one single all-embracing government regulatory authority was created with responsibilities for supervising credit institutions, financial services institutions, insurance companies and securities trading. The integration intends to make it easier to keep track of and handle the growing integration of capital markets, corporate relationships and risks (for more information, see www.bafin.de/bafin/aufgabenundziele_en.htm, as of 16 August 2005).

A Financial Reporting Enforcement Panel (FREP) has recently been established, and started its work on 1 July 2005. This institution organized under private law carries out random tests of the financial statements of publicly listed companies as well as selective inquiries if it receives information relating to an error in a financial statement. Whenever an enterprise does not cooperate with the FREP, the state agency *BaFin* is employed because it is authorized to use means available under public law in order to enforce the examination of the accounts (for more information, see www.frep.info, as of 16 August 2005).

The growing importance of stock market investments is also related to alterations of the pension system as people have to arrange private retirement provisions in order to secure their livelihood despite the expected demographic developments and an ageing population. In this vein, institutional investors that do not hold creditor relationships with the respective companies have also become much more influential in Germany (Deutsches Aktieninstitut 2004, p. 08.1-3-c).

In contrast, German universal banks have changed their governance strategy and decided to reduce their influence. This was preceded by public criticism because some corporate scandals which received huge publicity could not be avoided even though these companies were under the influence of some major commercial banks. These criticisms were taken up in the 1998 Law on Control and Transparency in the Corporate Sector (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, *KonTraG*), which is intended, *inter alia*, to strengthen the supervision of the stock corporation, to promote the independence of the auditor and to critically assess company ownership as well as the exertion of bank influence. More precisely, the *KonTraG* requires stock corporations to establish a risk management system for the early detection of corporate threats and specifies the information supply of the supervisory board. Furthermore, the supervisory board (and no longer the management board) has to mandate the auditor. Finally, the right of a bank to vote on the stock that a bank customer has deposited with it has been restricted. This so-called *Depotstimmrecht* provided banks with an important influencing mechanism in the past because most shares were (unregistered) bearer shares that private (and passive) shareholders usually deposited with their bank.

Banks suffered additionally from lower margins in their classical business domain of borrowing money. Alternative businesses such as investment banking therefore became more attractive (Vitols 2005, p. 387) and made withdrawals from supervisory boards and divestitures necessary in order to avoid conflicts of interest. Finally, the de-bundling of cross-shareholdings was generally intended to be promoted by the tax reform 2000 which was combined with a reform of corporate taxation. In a highly controversial section of the corresponding Tax Reduction Act, capital gains from the sale of cross-corporation shareholdings were exempted from tax. Although these rules have been in effect since the 2002 tax year, the effectiveness of this amendment tends to be moderated because many portfolios have not yet been de-invested due to their (too) low market value caused by the bearish stock market at the beginning of the new decade.

The corporate governance debate in Germany has usually been prompted by internal control deficits that eventually led to corporate scandals and breakdowns. None the less, one outstanding milestone is the takeover of Mannesmann by Vodafone AirTouch. Albeit significantly seldom, there were also previous unfriendly takeovers in Germany. However, these changes in control arrangements were not decided via the market but negotiated between the large blockholders and influential corporate constituencies (Jenkinson and Ljungqvist 2001). In particular, the banks played an important role in affecting the outcome of the bid and the future fate of the target company (Franks and Mayer 1998). In this regard, the Mannesmann takeover was different. It marks the first unfriendly takeover by a public tender offer. In addition, the target company did not consult politicians and banks about thwarting the takeover attempt. Rather, the then chairman of the Mannesmann management board, Klaus Esser, wanted the market (or his company's shareholders) to decide whether they would accept the tender offer or whether they believed that their share of stock would perform better if Mannesmann were to stay independent. Although there was some debate as to whether this case marks a turning-point towards a more market-based and shareholder-orientated corporate governance system, the prevailing opinion is that the German corporate governance system has neither altered fundamentally nor converged towards the Anglo-American one (for example, O'Sullivan 2003). In any case, however, in the face of this takeover, in conjunction with various corporate breakdowns that occurred at the same time, most prominently the bankruptcy of Philip Holzmann AG, the German federal chancellor decided to establish a government commission on corporate governance that led to additional changes of the regulatory governance environment.

Recent developments

Legislation

The modernization of the German Stock Corporation Law can be described as a permanent and gradual reform process. The last fundamental change to the Stock Corporation Act dates back to the year 1965, but since then many amendments have been passed. In this regard, the pace of these reforms has accelerated and the frequency and intensity of legal amendments has reached a new level during the last few years. In 2000, Chancellor Gerhard Schröder established a government commission on corporate governance that was assigned to assess the current governance system in Germany and to develop regulatory recommendations for the further improvement of this system. This commission submitted its final report containing about 150 recommendations in July 2001 (Baums 2001). First, the report led to the establishment of another government commission with the remit to develop a corporate governance code for German listed companies (for more details, see the next subsection). Second, recommendations that could be passed within the then legislative parliamentary period were included in the Law for the Further Reform of Corporation and Accounting Law, and of Transparency and Publicity (*Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität*, *TransPuG*) that was adopted on 19 July 2002. This Act contains the legal requisites that are necessary for the disclosure regime which will apply to the corporate governance code (see below). In addition, the *TransPuG* stipulates, *inter alia*, rules both for improving the information provision of the supervisory board by the management board and also for swearing the supervisory board members to secrecy about the received information.

Third, the federal government consolidated the remaining recommendations of the commission into a 10-point programme on promoting corporate integrity and investor protection that was presented in summer 2002. Based on this programme, a more detailed catalogue of measures for improving corporate integrity and investor protection was developed and presented on 25 February 2003. This catalogue addresses the following topics (see the English translation, released on 11 March 2003, of the press release from 25 February 2003 by the Federal Government):

1. personal liability of members of the management and supervisory boards to the company: improvement of the shareholders' right of action;
2. introduction of personal liability of members of the management and supervisory boards to investors for deliberate or grossly negligent provision of false information about the capital market; improvement of collective enforcement of investor claims;
3. further development of the German Corporate Governance Code, in particular on the transparency of share-based or incentive-based remuneration ('share options') received by directors;
4. further development of balance sheet regulations and adjustment to international accounting standards;
5. strengthening of the role of the auditor;
6. monitoring of the legality of actual company accounts by an independent agency ('enforcement') at capital market-orientated companies;
7. continuation of the stock exchange reform and further development of the supervisory law;
8. improvement of investor protection in the so-called 'grey capital market';
9. guarantee of the reliability of company ratings by financial analysts and rating agencies; and
10. stricter penalties for crimes committed in the capital market sector.

This catalogue of measures forms the blueprint of the recent legal initiatives of the federal government. Many aspects have already been addressed by new legal amendments, for instance, the Law on Corporate Integrity and Modernization of the Right of Contestation (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*, *UMAG*), the Law on Introducing Model Trials by Shareholders (*Gesetz zur Einführung von Kapitalanleger-Musterverfahren*, *KapMuG*), the Law on Improving Investor Protection (*Gesetz zur Verbesserung des Anlegerschutzes*, *AnSVG*), the Accounting Law Reform Act (*Bilanzrechtsreformgesetz*, *BilReG*) as well as the Financial Statements Monitoring Act (*Bilanzkontrollgesetz*, *BilKoG*).

Only one issue, namely the personal liability of management and supervisory board members when they misinform their shareholders, has been removed from the agenda without action for the time being. The federal Ministry of Finance drafted a Capital Market Information Liability Act (*Kapitalmarktinformationshaftungsgesetz*, *KapInHaG*), which was, however, criticized by business and law associations due to its alleged extensiveness. Furthermore, the decision to suspend this legal project is backed with reference to planned corporate law rules by the European Union (EU), which are currently under preparation and have to be accounted for in domestic law making.

The German Corporate Governance Code

Background of the Code Contrary to other countries, a code of corporate governance for German firms has long been regarded as unnecessary, since essential governance aspects that are typically addressed by these codes (see, for instance, Gregory and Simmelkjaer 2002) are already mandatory under German law. However, following some private initiatives (competing rather than converging) drafts for a voluntary corporate governance code were drawn up (Schneider and Strenger 2000; v. Werder 2001). Subsequently, the Federal Ministry of Justice appointed a government commission to develop a uniform code for German listed companies in order to further strengthen the governance quality and to consolidate German corporate governance rules and make them transparent for both national and international investors. This German Corporate Governance Code (GCGC) was adopted on 26 February 2002. The Code has a legal basis after Article 161 of the Stock Corporation Act was amended by the *TransPuG* to demand a declaration of conformity with the Code's recommendations.

The GCGC primarily addresses listed corporations. With respect to their obligatory nature, three kinds of Code rules have to be distinguished. First, the GCGC contains provisions that firms are compelled to observe under applicable law ('must provisions'). The remaining categories ('shall recommendations' and 'should or can suggestions') both consist of rules which are not obligated by law. As a consequence, companies can deviate from these rules. However, deviations from recommendations which are marked in the text by use of the word 'shall' must be disclosed in the annual declaration of conformity ('comply or explain'). Third, the Code contains suggestions which are marked in the text by use of the words 'should' or 'can' and which can be deviated from without disclosure. These suggestions are intended to encourage progress without inhibitory requirements. In sum, the status of the Code rules which go beyond the law enables companies to reflect sector- and enterprise-specific requirements. Thus the GCGC contributes to more flexibility and more self-regulation in the corporate constitution.

Structure of the Code The Code is structured in seven sections. In a foreword, some basics of German corporate governance and the GCGC are explained. The Code norms refer to shareholders and the general meeting (section 2), the cooperation between the management board and the supervisory board (3), the management board (4), the supervisory board (5), transparency (6) as well as reporting and audit of the annual financial statements (7). Worth mentioning, among others, are the following Code norms: that providing sufficient information to the supervisory board is the joint responsibility of both the management and the supervisory boards; that good corporate governance requires an open discussion between the boards, as well as among the members within the boards, and that these necessities can only be accomplished if confidentiality is assured; that the performance of the management board members as well as the efficiency of the supervisory board must be evaluated; that the remuneration of management and supervisory board members shall be reported individually; and that the company should enhance its transparency by providing more and more easily accessible information.

Acceptance of the Code The acceptance of the GCGC is analysed in annual studies by the Berlin Center of Corporate Governance (v. Werder et al. 2003, 2004; v. Werder and Talaulicar 2005). The most recent study was finalized in spring 2005 (v. Werder and Talaulicar 2005). The then valid Code version contained a total of 72 recommendations and 19 suggestions. The study's sample consisted of all 715 companies listed on the Frankfurt Stock Exchange. Some 210 useable questionnaires were returned.

The study shows that (i) overall the GCGC meets with great approval, (ii) its acceptance tends to increase with the size of the companies and (iii) the Code continues to contribute to corporate governance changes more than three years after its adoption. The average compliance rate with the recommendations is 81.6 per cent. The companies that belong to the DAX, that is the blue chip index in Germany which includes the 30 largest German securities in terms of market capitalization and order book turnover from classic and technology sectors, apply 96.3 per cent of all recommendations. By the end of 2005 the compliance rate will approach 83.6 per cent (or for the DAX companies, 97.3 per cent).

However, 39 (in the DAX: 6) recommendations are neuralgic since they are rejected by more than a tenth of the enterprises. Such recommendations will decrease to 33 (or with regard to the DAX to 5) by the end of 2005. The neuralgic provisions can be further grouped depending on whether they are at least being complied with by the majority (more than 50 per cent) or being rejected by most of the companies. Three 'shall' recommendations are rejected by the majority of all firms. These are the norms to agree upon a suitable deductible if a directors and officers (D&O) insurance is taken out for the members of the management and supervisory boards as well as to individually disclose their compensation. By the end of 2005, the deductible will be put into practice by three-quarters of the DAX companies, whereas two-thirds of them, and only every third enterprise in the survey, will disclose the individual remuneration of its management board members. Individual figures concerning the supervisory board remuneration are disclosed by 45.6 per cent of all companies and by 82.8 per cent of the DAX companies.

Compared with the Code recommendations, the 'should' or 'can' suggestions show a lower level of acceptance (amounting on average to 58.6 per cent for all companies and to 82.2 per cent for the DAX). This result is hardly surprising in so far as the companies may ignore the suggestions without being compelled to disclose this deviation in their declaration of conformity. Thus, the public pressure to implement the suggestions is less. None the less, the compliance rate of the suggestions will increase, too. By the end of 2005, the average (DAX) company will comply with 61.2 per cent (84.4 per cent) of the suggestions.

The lower acceptance of the suggestions compared with the Code recommendations is also evident from the bigger percentage of both the neuralgic suggestions and those being rejected by the majority. Eighteen of the 19 suggestions prove to be neuralgic. Four of them are being and will be complied with by less than 50 per cent of the enterprises today and in the future. These Code norms suggest that shareholders should be able to follow the general meeting using modern communication media, to comment on the Code suggestions in the annual corporate governance report, to stagger the appointment periods for the members of the supervisory board as well as to link the performance-related pay of the supervisory board to the long-term performance of the company.

Future developments

Legislation and the Code

Corporations may reject Code norms if they are inexpedient under very specific conditions. However, the norms might also be rejected if they run counter to the personal interests of the management (v. Werder and Talaulicar 2003). Whereas disclosure and public scrutiny as well as bandwagon effects may lead to higher compliance rates, some Code norms might need to be enforced more – which eventually can only be done by the legislator. In this regard, the low compliance rate with the recommendation to disclose the remuneration of individual management board members led the legislator to pass a Law on Disclosure of Management Board Remuneration (*Gesetz über die Offenlegung der Vorstandsvergütungen*, *VorstOG*). Accordingly, listed corporations are legally obliged to disclose the remuneration of their individual management board members. Since these amendments become effective for the accounting year starting after 31 December 2005, the required data will therefore be released in 2007 at the earliest. However, the Law provides an opting-out clause, that is, the general meeting can release the management board from this disclosure obligation if at least 75 per cent of the attendant shareholders approve this exemption.

This Law is not intended to replace but to supplement the Code. Disclosure of individual remuneration will make it easier to assess whether the remuneration of individual management board members is suitable. Additional criteria for the suitability of management board remuneration are stipulated in the Code. In this regard, the Code states, *inter alia*, that the overall compensation of the management board members shall comprise a fixed salary and variable components, that variable compensation should include one-off and annually payable components linked to business performance as well as long-term incentives containing risk elements and that all compensation components must be appropriate, both individually and in total. With respect to stock options or comparable instruments (for instance, phantom stocks) the Code recommends that compensation components shall be related to demanding, relevant comparison parameters, that changing such performance targets or the comparison parameters retroactively shall be excluded and that for extraordinary, unforeseen developments a possibility of limitation (cap) shall be agreed by the supervisory board.

The Code commission is a standing commission. Consequently, its members convene at least once a year in order to discuss corporate governance developments in Germany and abroad and to assess whether amendments of the GCGC are necessary. The most recent amendment of the Code was passed on 2 June 2005. With reference to the proposals by the EU, independence criteria for supervisory board members were defined. According to this, independence means that the supervisory board member has no business or personal relations with the company or its management board which cause a conflict of interest. In addition, the Code provides requirements that the chair of an audit committee shall have specialist knowledge and experience in the application of accounting principles and internal control processes. Furthermore, the Code contains new recommendations for the election and the selection of the supervisory board members. More precisely, the Code recommends that elections to the supervisory board shall be made on an individual basis; that applications for a juridical appointment of supervisory board members, which can be requested if the supervisory board is understaffed and lacks a quorum, shall be limited in time up to the next general meeting; that proposed candidates for the supervisory board chair shall be announced to the shareholders; and that it shall not be the rule for the former management board chair or a management board member to become supervisory board chair or chair of a supervisory board committee. In sum, ten new recommendations were added, with which compliance has to be declared in the forthcoming statements of conformity. Thus, the amended Code contains 82 recommendations and (unvaried) 19 suggestions (the amended version can be downloaded from: www.corporate-governance-code.de/eng/kodex/index.html, as of 16 August 2005).

Modernizing codetermination

A very striking and highly controversial element of German corporate governance is the structure of codetermination via the supervisory board of the stock corporation. None the less, both the government commission on corporate governance as well as the one on the GCGC did not discuss potential weaknesses and necessary improvements of this German-specific institution. Whereas the Code commission was assigned to develop a GCGC under the given legal conditions, the corporate governance commission did not address the topic due to the limited time-frame of the commission and to ongoing discussions on the European level about the codetermination regime of the Societas Europaea. Yet the chair of the commission stressed that this omission does not imply that the commission denies a need to discuss the appropriateness of codetermination arrangements, particularly in international holding companies (Baums 2001, p. 6).

In this recently intensifying discussion, the supervisory board with equal representation of shareholder and employee representatives takes centre stage. Whether the system of codetermination diminishes firm performance is still open to debate. Empirical verifications of this hypothesis are particularly difficult due to the lack of suitable control groups, because all German stock corporations with more than 2,000 employees fall in the group of companies which feature supervisory boards with equal representation (see above). None the less, some scholars have attempted to show that the comparably low market value of German companies is related to the regime of codetermination with equal representation of employees and shareholders on the supervisory board (Gorton and Schmid 2004).

In any case, criticisms against the current system of codetermination, which is associated with large supervisory boards having up to 20 members, some of which are union deputies, have become more widespread. These criticisms address in particular the following issues: that the employee representatives are elected only by the domestic workforce; that they may, as a consequence, be partial towards the interests of the domestic workforce; that they may be unaware of their responsibilities for supervisory topics other than labour issues; that they may demand concessions on behalf of labour interests in return for their approval to some of management's plans; and that they may lack the required knowledge, abilities and expert experience to complete their tasks properly as members of the supervisory board (v. Werder 2004, 2005).

Depending on the assessment of the gravity of these problems, different future perspectives of codetermination are conceivable. At the extremes are the suggestions to retain the current arrangements unchanged or to abolish these rules completely. Intermediate solutions include the proposals to modify the current system (for instance, by abolishing single rules such as the delegation right of the unions); to layer the level of codetermination (for instance, by restricting codetermination to the one-third representation of employees on the supervisory board); to release some company types from the codetermination regime (in particular, international holding companies that employ the vast majority of their workforce abroad); or to substitute the current system of employee representation in the supervisory board by establishing a separate organ (consultation council) for asserting the information and consultation rights of the workforce (v. Werder 2004).

A more detailed discussion of these problems and possible solutions is necessary. Most recently, on 26 July 2005 the German federal chancellor established a government commission to analyse the codetermination rules in the EU member states, to assess the strengths and weaknesses of the German codetermination regime and to develop practicable reform suggestions. The final report of the commission will be submitted on 1 September 2006.

Concluding remarks

As we have shown, many corporate governance developments have taken place in Germany in recent years. However, these developments do not constitute a fundamental change in the corporate governance system. Rather, regulatory changes are primarily aimed at further improving the modalities of managing and supervising corporations within the corporate governance system in order to attenuate its downsides and to develop its strengths. In this regard, an accelerating pace as well as an increasing intensity of reforms are to be observed. The GCGC marks a milestone in this advancement because the establishment of this instrument adds a new regulatory level to the regulatory framework of corporate governance which has not previously been employed in Germany.

It seems reasonable to expect future developments of corporate governance to be increasingly shaped by EU initiatives. The influence of European recommendations and directives could account for the fast adoption of the Law on Disclosure of Management Board Remuneration (*VorstOG*) as well as the establishment of the government commission on codetermination. In addition, the standing Code commission has to review European developments and to assess the necessity of Code amendments in response to these developments. The debate about good corporate governance will therefore continue.

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4 Corporate governance developments in Italy

Andrea Melis

Introduction

Italy is usually catalogued under the 'insider-dominated' corporate governance systems in international taxonomies (Franks and Mayer 1995; La Porta et al. 1999). Indeed, the prevailing corporate governance system has been characterized by an underdeveloped equity market (for example, La Porta et al. 1997), relatively poor capital market orientation (Pagano et al. 1998), and a limited role played by the market for corporate control (Volpin 2002).

However, because of its own unique features, the Italian corporate governance system does not easily fit into international taxonomies (Melis 1999). For instance, in contrast to other insider-dominated European corporate governance systems such as that in Germany, banks do not usually have a direct significant influence on the corporate governance of non-financial listed companies (Bianco and Casavola 1996; Airoldi and Forestieri 1998). With few exceptions, banks are neither involved in the corporate strategies' formulation and implementation, nor considered as a partner for corporate strategy by the senior management. They usually exercise an influence in corporate governance only when a non-financial company gets into financial trouble (Melis 1999). In contrast with Anglo-American corporate governance systems, in Italy the major corporate governance concern is not about 'strong managers' who must be held accountable to 'weak owners' (Roe 1994). Large shareholders do have an incentive to exercise monitoring over senior managers (Shleifer and Vishny 1986). Empirical studies on Italian listed companies (for example, Molteni 1997; Melis 1999; Bianchi et al. 2001) confirm that senior management is accountable and 'loyal' to large controlling shareholders. In fact, CEO turnover is more closely related to relevant changes in the ownership and control structure than to corporate performance (Brunello et al. 2003).

The presence of large shareholders reduces the well-known agency problem that arises between senior management and shareholders; however, the agency problem is not eliminated, but shifted towards the relationship between different types of shareholders: the controlling shareholder(s) and minority shareholders.

As with other French civil law-based systems, the key corporate governance issue in Italy has concerned the lack of protection of minority shareholders, who have often been victims of abuse of power by the controlling shareholder(s) (Melis, 1999, 2000; La Porta et al. 2000). Italian company law has been considered to favour excessively the certainty of corporate control at the expense of (minority) shareholders' protection (Bianchi et al. 2001).

In fact, La Porta et al. (1998) point out that in 1994, Italy ranked among the countries with lowest legal protection for investors among the industrialized countries, and Zingales (1994) reported an average voting premium (voting shares price versus non-voting shares price) of 82 per cent on companies listed on the Milan Stock Exchange. 'Weak managers, strong blockholders and unprotected minority shareholders' sums up the key corporate governance issues in Italian listed companies (Melis 2000: 351). Hence CONSOB (Commissione Nazionale per le Società e la Borsa) (1996) and the Bank of Italy (1996) stressed the need of a reform to improve the entire corporate governance system in Italy. The consequent debate has led to a series of reforms, in the form of either laws or 'soft laws'.[1]

The main purpose of this chapter is to describe and examine the most relevant corporate governance developments, taking into account both the normative developments, such as laws and codes of conduct, as well as actual developments in corporate practices. The chapter is structured as follows. In the next section, the ownership and control structure of Italian listed companies will be described. Then the key corporate governance developments will be examined, including the 1998 Draghi Law, the Preda Code of Conduct and some of the most recent developments concerning corporate governance following the Parmalat scandal.

Ownership and control structure in Italian listed companies

The ownership structure of listed companies is characterized by a high level of concentration. Although the share percentage owned by the major shareholder has been declining over time (see Table 4.1 for the 1996–2004 trend), CONSOB (2005) reports that the average major shareholder still owns approximately 33 per cent of total share capital.

The identity of the major shareholders reveals that: (a) the state and local municipalities are gradually (but significantly) reducing their once huge stakes in listed companies; (b) institutional investors rarely own a significant stake in a single company; and (c) families still have, either directly or via a non-listed company, a relevant stake in corporate shareholdings (see Table 4.2).

Approximately 60 per cent of the companies are characterized by either a majority or a working type of control, and 15 per cent are controlled via a group of shareholders who belong to a shareholders' agreement (*patto di sindacato*). Indeed, only one listed company out of four is not controlled by a blockholder or a group of blockholders via a shareholders' agreement (see Table 4.3).

Table 4.1 Ownership structure of Italian listed companies

Concentration[1]	1996	1997	1998	1999	2000	2001	2002	2003	2004
Largest shareholder	50.4	38.7	33.8	44.2	44.0	42.2	40.7	33.5	32.7
Other major shareholders	10.7	8.4	9.7	8.2	9.4	9.2	8.0	11.6	13.0
Market	38.9	52.2	56.5	47.6	46.6	48.6	51.2	54.9	54.3
Total (rounded)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: 1. As a percentage of the market value of the ordinary share capital of all the companies listed on the Stock Exchange.

Source: Elaborated from CONSOB (2005). Data updated at 31 December 2004.

Table 4.2 Major shareholdings in companies listed on the Italian Stock Exchange[1]

Type of shareholder	Proportion[2]								
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Foreign resident	4.5	5.0	5.9	6.2	6.5	5.6	4.9	6.7	7.3
Insurance company	1.9	2.2	2.5	1.5	3.2	1.8	1.1	1.2	1.4
Bank	4.3	5.1	4.8	5.3	5.9	4.4	3.4	3.9	3.5
Foundation	3.8	3.1	5.1	4.5	5.0	4.9	4.5	3.6	3.3
Institutional investor	0.8	0.1	0.1	0.2	0.3	0.1	0.7	0.0	0.1
Other company	8.2	14.4	12.6	19.4	17.2	18.2	16.8	12.3	13.7
State or local authority	32.5	12.1	8.8	10.6	10.2	11.1	12.3	11.2	10.7
Individual	5.5	4.8	3.8	4.5	4.9	5.0	5.1	6.2	5.7
Total	61.5	46.8	43.6	52.2	53.2	51.1	48.8	45.1	45.7

Notes

1. Shareholdings of more than 2 per cent of the voting capital at the end of December 2004.
2. Percentage ratio of the market value of the major holdings calculated with reference to ordinary share capital to the market value of the ordinary share capital of all the companies listed on the Stock Exchange.

Source: Elaborated from CONSOB (2005) based on CONSOB ownership transparency database.

Table 4.3 Control structure of Italian listed companies

Type of control[1]	1996	1997	1998	1999	2000	2001	2002	2003	2004
Majority control	66.8	48.1	32.3	55.0	51.4	49.7	46.0	40.2	32.7
Working control	12.2	12.4	21.7	16.7	18.5	22.5	28.4	25.5	27.2
Under shareholders' agreement	4.8	6.3	7.4	10.8	9.6	11.4	10.2	15.3	15.1
No controlling shareholder(s)	16.2	33.2	38.6	17.5	20.5	16.4	15.4	19.0	25.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: 1. Percentage ratio of the market share value of the ordinary share capital of the companies subject to each type of control to the market value of the ordinary share capital of all the companies listed on the Stock Exchange.

Source: Elaborated from CONSOB (2005). Data updated at 31 December 2004.

Berle and Means-type public companies (Berle and Means 1932) are an exception in Italy, and often a temporary one. The cases of Olivetti and Telecom Italia in the late 1990s seem to support this argument. In 1998, as soon as several capital increases had diluted existing blocks to meet liquidity needs, Olivetti's CEO assembled a group of investors and gained control of the company. After its privatization in 1997, Telecom Italia was characterized by a rather widespread ownership and control structure that was uncommon according to Italian standards. In 1999, Telecom Italia was the target of an exceptional (according to the Italian standards) hostile takeover and its control was secured via a complex pyramidal structure.

In the absence of an institutional framework facilitating more dispersed ownership or mechanisms for financial supervision, pyramidal groups are a common device to maximize the ratio between the amount of the resources controlled and the own capital invested to maintain the control of a company.

Pyramidal groups work as organizations in which legally independent firms are controlled by the same shareholder (or group of shareholders) via a chain of ownership relations (Onida 1968; Saraceno 1972; Bianco and Casavola 1999). For example, a family firm A owns 51 per cent of company B, which in turn owns 51 per cent of company C. Company A is still able to maintain control of company C even though its direct stake in C is nil.

In practice, the situation is usually much more complicated with the use of devices such as non-voting shares[2] and shareholders' agreements (see Zattoni 1999). Figure 4.1 illustrates the control structure of Telecom Italia group, before its merger with its subsidiary Telecom Italia Mobile.

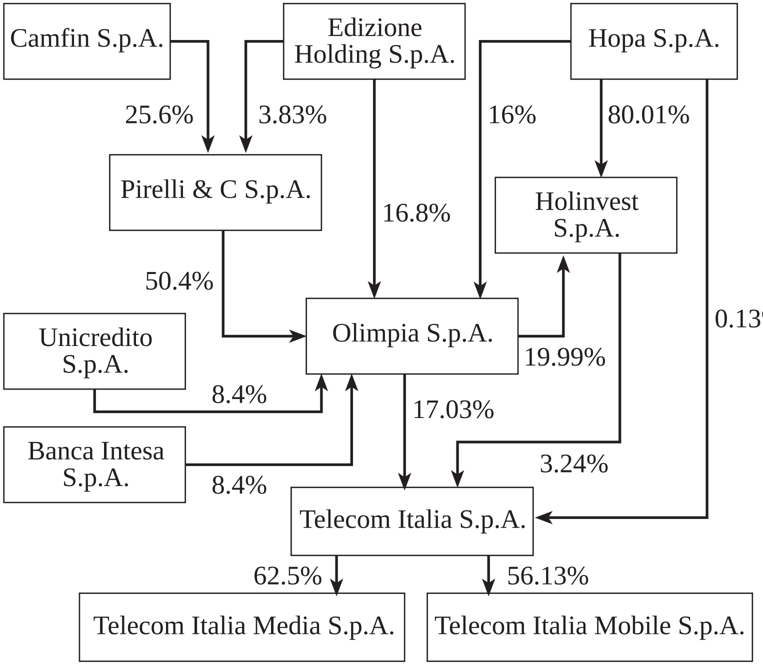
As the share percentage owned by the major shareholder has been declining over time, more and more companies are controlled by coalitions of large shareholders via shareholders' agreements (see Table 4.1 for the 1996–2004 trend). Italian shareholders' agreements do not require the transfer of shares (or voting certificates) to a trustee, but usually bind their members to vote as a 'block' during shareholders' meetings and/or board of directors' meetings, and often impose restrictions on the transfer of shares (see Table 4.4).

The Draghi Law (1998): improving minority shareholders' protection?

The need to improve corporate governance and align it to international standards gave birth to a debate among corporate directors, academics, policy makers and business media which eventually led to a law for listed companies, in force since July 1998. The 1998 law is also known as the Draghi Law, after its drafting committee's chairman.

The Draghi law (1998) regulates the financial markets and corporate governance in listed companies, with the main purpose of 'strengthening investors' protection and minority shareholders'.

Previous studies report that, indeed, the Draghi Law seems to have effec-



Notes: Edizione Holding, Pirelli, Hopa, Banca Intesa and Unicredito have signed a shareholders' agreement on Olimpia. Telecom Italia ownership structure is characterized by approx. 36 per cent of its total number of shares with no voting rights.

Source: Company sources. Updated at 31 December 2004.

Figure 4.1 Telecom Italia's control structure

tively increased the protection of minority shareholders (Melis 2000; Bianchi et al. 2002; Volpin 2002; Bianchi and Enriques 2005). For example, by adopting the index of shareholder protection used by La Porta et al. (1998), the impact of the law is an improvement in shareholder protection from 1 to 5 (out of a scale of 6) since 1994 (Aganin and Volpin 2004: 10). Furthermore, private benefits of control seem to be declining, at least in terms of investor perceptions. Linciano (2002) provides evidence that the voting premium has steadily diminished over the period that the Draghi committee was in operation, culminating in a drop of 7 per cent in the premium at the time of the passage of the law.

Bianchi and Enriques (2005) argue that although some obstacles remain, the legal changes prompted by the law have made the legal environment more favourable to institutional investor activism than it was before.

Table 4.4 Types of shareholders' agreements involving listed companies

Type of agreement	Companies listed on the main market		
	Number of agreements	Voting rights (1)	Number of companies (2)
Blocking	7	50.8	7
Voting	10	40.8	8
Global (3)	39	47.8	37
Total	56	46.9	49

Notes: Disclosures pursuant to Article 122 of the Draghi Law (1998). (1) As a percentage of the total ordinary share capital. (2) The total does not coincide with the sum of the individual figures because in some cases more than one shareholders' agreement concerned the same company. (3) Agreements that include both voting and blocking clauses.

Source: Elaborated from CONSOB (2005). Data updated at 31 December 2004.

A detailed examination of the Draghi Law is beyond the scope (and the length) of this chapter. Only the key corporate governance-related issues will be briefly described.

Shareholders' agreements

Shareholders' agreements must be fully disclosed to the public (Draghi Law 1998: art. 122), otherwise any shareholders' resolution passed with the determining vote of such shareholders is 'voidable'. Mandatory disclosure also applies for the shareholders' agreements of a non-listed company controlling a listed company. Moreover, their duration cannot be for longer than three years, after which agreements are to be renegotiated.

Shareholders who intend to accept a public offer to buy (or exchange) are given the right to withdraw from the agreement without notice (Draghi Law 1998: art. 123).

These provisions were aimed at weakening the effectiveness of the shareholders' agreement as a device to maintain control, and have marked an important change in Italian corporate law, which had traditionally favoured corporate control stability over contestability (Marchetti 1998). However, Cardia (2005) notes that, in order to avoid the right of withdrawal, in some cases the shareholders' agreement concerns a non-listed company that controls a listed one.

Internal controls: the role of the board of statutory auditors

Italian listed companies are characterized by a complex accountability and monitoring system (see Melis 2004 for an in-depth description). The prevailing board structure is a sort of 'half-way house' between the British unitary board and the German two-tier board structure, as it is composed of a board of directors (*Consiglio di Amministrazione*) and a board of statutory auditors (*Collegio sindacale* or *Collegio dei sindaci*). Both the boards are appointed by shareholders at the general meeting.

The Draghi Law has not provided any regulation on the board of directors, but has modified the role and functioning of the board of statutory auditors. Previously, the board of statutory auditors' main duty was to monitor accounting issues to safeguard corporate property.

The Draghi Law (1998: art. 155) has solved the potential overlap with the external auditing firm, leaving the latter the duty of auditing financial statements. The board of statutory auditors has been given the responsibility to check (a) the compliance of acts and decisions of the board of directors with the law and the corporate by-laws and (b) the observance of the so-called 'principles of correct administration' by the executive directors and the board of directors (art. 149).

Minority shareholders' rights

The Draghi Law has brought significant changes in the area of minority shareholders' rights, in order to enhance them.

First, minority shareholders with at least a 5 per cent stake (or lower according to corporate by-laws) are given the right to bring derivative actions against directors (Draghi Law 1998: art. 129) as well as the right to file a complaint to the courts for relevant irregularities by directors or statutory auditors (art. 128). However, Enriques (1998) argues that, especially with regard to the largest listed companies, such a threshold is very high and hinders possible action. Indeed, Ventoruzzo (2004) reports that such a right has never been used.

Second, the law (art. 139) has made proxy solicitations easier for minority shareholders. Shareholders with at least a 1 per cent stake in a listed company may engage qualified intermediaries (for example, banks, securities firms, asset management companies, and so on) to solicit proxies from other shareholders for use at the shareholders' general meeting. This is a great change as previous regulation focused on deterring proxy voting by reducing the risk of a relevant 'concentration' of proxies in the hands of banks.

Also, voting by mail is no longer prohibited – the law allows for corporate by-laws to decide whether to make it possible. However, Bianchi and Enriques (2005) report that apparently no listed company has decided to allow it.

The law (art. 125) has also reduced the threshold required for a group of shareholders to ask directors to convene a shareholders' meeting from 20 to 10 per cent. It also allows corporate by-laws to set a lower threshold. However, Bianchi and Enriques (2005: 27) note that such a right is 'very weak', as it is not 'self-enforcing', as, for example, in the UK. Directors may, in the 'company interest', refuse to call a meeting. In such a case, minority shareholders are obliged to turn to the courts, with all the relevant costs that this action involves.

Minority shareholders' representation has been ensured on the board of statutory auditors (Draghi Law 1998: art. 148). At least one statutory auditor (at least two, when the board is composed of more than three auditors) is to be appointed by the minority shareholders. Melis (2004) points out that the size of the board matters with regard to minority shareholders' protection. Some powers may be exercised only by at least two statutory auditors jointly and only in a five-member board can minority shareholders appoint two statutory auditors. Empirical evidence (see CONSOB 2002) reports that not only are approximately 92 per cent of the boards composed of three members, but also that after the Draghi Law, ten companies reduced their board size from five to three members, while only one increased it from three to five members. Nevertheless, it may still be considered as an improvement as Melis (1999) reported that, previously, in approximately 50 per cent of non-financial listed companies the controlling shareholder(s) were allowed to appoint all statutory auditors.

Mandatory public bids

The Draghi Law (1998: arts 105–12) has introduced a regulation more similar to those in force in other European countries, such as France and the UK. Its key elements are:

1. 'The full mandatory public bid', that is, an investor acquiring more than 30 per cent of the equity of a company is obliged to make a full offer for all the company's ordinary shares at a price that is an average of the market price of the last 12 months and of the price paid for buying shares from the previous controlling shareholder(s).

   This provision is aimed to give minority shareholders of a target company the opportunity to gain the same economic benefits as the majority shareholder(s). However, there is some evidence that it has not produced the expected results. For example, when in 2001 Pirelli and the Benetton family acquired the control of Olivetti from Mr Colaninno and his partners for a price that represented an 80 per cent control premium over the market price, Olivetti's minority shareholders were not given the opportunity to participate in the offer, since Pirelli and its allies did not reach the 30 per cent threshold.
2. The 'residual mandatory public offer', that is, any shareholder who owns at least 90 per cent of the ordinary shares must make an offer for the remaining voting shares, at a price set by the Stock Exchange Commission.

This regulation is aimed at granting minority shareholders a fair exit price when a company is substantially owned by a single shareholder, and consequently there are not enough outstanding publicly held shares to ensure a regular market.

3. The ‘passivity rule’, that is, once a bid is in place, the target company can no longer adopt defensive moves without the approval of at least 30 per cent of its shareholders.

   This provision, whose purpose is to foster the contestability of corporate control, proved to be significant in the case of Telecom Italia’s hostile takeover by Olivetti in 1999 (Spaventa 1999).

The Preda Code of Conduct

Since the Cadbury Report (1992), the international debate about corporate governance has given rise to the worldwide emergence of a great number of codes of best practice, which usually enact soft law and set standards for good governance in the corporate sector.

In 1999, the Italian Stock Exchange established a committee concerning corporate governance issues. The Preda Code represents one of the first examples of self-regulation in the Italian corporate system. The code was issued in October 1999, then substantially revised and updated in July 2002. Like the Cadbury Report (1992, para. 3.7), the guiding principle in applying the Preda Code is ‘freedom with accountability’. This means that a listed company is free to choose its own governance structure given that it ensures the transparency of its choice, by disclosing to what extent it complies with the code and by giving reasons for any area of non-compliance.

In 2001, the Stock Exchange established the so-called ‘STAR’ (*Segmento Titoli ad Alti Requisiti*) segment, which certifies listed companies with a market capitalization lower than €800 million that comply with specific requirements concerning liquidity, disclosure and corporate governance. For these companies, the adoption of some recommendations of the Preda Code concerning independent non-executive directors, internal control, performance-related executive remuneration and the investors’ relations (see below) is mandatory.

Since 2001, disclosure about compliance with the code is no longer voluntary for listed companies. It has to be provided in an annual corporate governance report which must be available to shareholders before the annual general meeting and to the public; the report is to be sent to the Stock Exchange, which will place it on its publicly available website.

The Preda Code focuses on the main gap left by the Draghi Law, that is, issue relating to the board of directors. Its 2002 version comprises 14 chapters. In the following subsections the key recommendations of the code as well as the areas of compliance or non-compliance of listed companies will be briefly described.

The role of the board of directors

The Preda Code (1999, 2002, para. 1) recommends that the board of directors should deal with the corporate strategy, by setting the company's strategic objectives and ensuring that they are achieved. For this reason, matters of special importance should be reserved for the exclusive competence of the whole board of directors, including:

- the examination and approval of the company's strategic, operational and financial plans and the corporate structure of the group; and
- the examination and approval of transactions having a significant impact on the company's profitability, assets and liabilities or financial position, especially when they concern related parties' transactions.

In its 2002 version, the code also recommends that the presence of a shareholders' agreement or the appointment of an executive committee should not relieve the board of directors of any of its strategic tasks.

Using a sample of Italian listed companies which represented 90 per cent of the listed companies, Assonime (2004a) reports that 87 per cent of the companies fully comply with these recommendations.

The composition of the board of directors

The Preda Code (1999, 2002, para. 2.1) recommends that the board of directors should be composed of executive and non-executive directors. For their number and authority non-executive directors should carry a significant role in the board's decision-making process.

Indeed, non-executive directors generally comprise the large majority of the board of directors, especially in presence of a controlling shareholder (see Table 4.5). The high non-executive to executive directors ratio does not seem to be a consequence of the Preda Code recommendation, as non-executive directors comprised the great majority of listed companies' boards even before the advent of the Code (see, for example, Molteni 1997; Melis 1999). As there is a lack of empirical studies on the subject in the Italian context, it is hard to judge to what extent non-executive directors actually have a significant role in the board's decision-making process.

Independent directors

The Preda Code (2002, para. 3) recommends that 'an adequate number' of directors are to be independent and points out that while in public companies the independence of directors is from executive directors (especially the CEO), when the ownership and control structure is concentrated, as in the great majority of listed companies, the most important aspect is the independence from the controlling shareholder(s).

Table 4.5 Composition of board of directors by type of control of listed companies

Type of control (1)	Executive	Non-executive	Total
Majority control	3.0	6.7	9.7
Working control	3.1	7.6	10.7
Under shareholders' agreement	4.7	7.9	12.6
No controlling shareholder(s)	4.7	7.7	12.4

Note: (1) See note 1 in Table 4.3

Source: Elaborated from CONSOB (2005). Data updated at December 2004.

Therefore, it defines an independent director as one who:

- does not entertain, directly, indirectly or on behalf of third parties, nor has s/he recently entertained, with the company, its subsidiaries, the executive directors or the shareholder or group of shareholders who control the company, business relationships that are significant enough to influence his/her autonomous judgement;
- does not own, either directly or indirectly, or on behalf of third parties, an amount of shares enabling him/her to control or notably influence the company or participate in shareholders' agreements to control the company; and
- is not close family of the company's executive directors or a person who is in the above-mentioned situations.

Assonime (2004a) reports that the board of directors is, on average, composed of 4.5 directors (approx. 40 per cent of the directors) that are defined as independent in the companies' corporate governance reports. Whether alleged independent directors are truly independent and able to do their job properly is certainly difficult to assess.

The chair of the board of directors

The Preda Code (1999, 2002, para. 4) points out that the CEO and chair roles are different, and stresses the role of the latter in running the board of directors. The chair is responsible for calling meetings, setting the agenda, arranging in agreement with executive directors the distribution of adequate and timely information to the directors (especially the non-executive directors) and ensuring that all the directors are able to make a knowledgeable and informed contribution to the meeting.

However, it also acknowledges that 'it is not infrequent in Italy for the same person to hold both positions or for some management powers to be delegated to the chairman'. Therefore, the code (1999, 2002, para. 4) does not recommend the separation between the CEO and chair positions, although it is recommended by most of codes of best practice worldwide. It only recommends that when the two positions are not separated or the chair is delegated some executive powers, adequate information about the duties and responsibilities of the chair should be provided in the corporate annual reports as well as in the corporate governance reports.

Indeed, most of the listed companies do distinguish between the positions of CEO and chair, although the latter is often delegated some executive powers, especially in non-financial companies. Assonime (2004a) reports that when some powers are delegated to the chair, most of the companies do disclose them in their corporate governance reports, as recommended.

Information to the board of directors

The Preda Code (1999, 2002, para. 5) recommends that the exercise of the powers delegated to executive directors and the executive committee[3] should be accompanied by the provision of an adequate and timely flow of information to the boards of directors and statutory auditors on a regular basis. Executive directors should report also on transactions which are atypical, unusual or with related parties whose examination and approval are not reserved to the board of directors.

Assionime (2004a) reports that only one-third of the companies analysed declared that they had complied with this recommendation. Furthermore, even complying companies rarely explain the procedures employed.

Confidential information

With regard to the handling of confidential information, the Preda Code (1999, 2002, para. 6) recommends that listed companies adopt procedures for the internal handling and disclosure of price-sensitive information, as well as information concerning transactions that involve financial instruments, carried out by persons who have access to relevant information.

Cavallari et al. (2003) report that the great majority of the listed companies comply with this recommendation. The degree of compliance has increased to 90 per cent in 2003 from 58 per cent in 2001.

The appointment of directors

The Preda Code (1999, 2002, para. 7) recommends that the election of members of the board of directors should take place in accordance with a transparent procedure. Detailed information regarding the candidates should be available to shareholders in advance. The 2002 version of the code stresses the need to include an indication of the candidate's eligibility to qualify as an independent director. Assonime (2004a) reports that the great majority of the companies comply with this recommendation.

The code (1999, 2002, para. 7) acknowledged that usually 'proposals for the election of directors are put forward by the controlling shareholders, who obviously make a preliminary selection of the candidates'.

In the companies where the corporate ownership and control structure is dispersed, the code (1999, 2002, para. 7.2) recommends that a nomination committee is to be set up to propose candidates for election in cases when the board of directors believes that it is difficult for shareholders to make proposals. The nomination committee should be composed of a majority of non-executive directors.

Assonime (2004a) reports that only approximately 10 per cent of the listed companies have set up a nomination committee, which is composed of a majority of non-executive directors in most cases. Such a low rate is explained by the average concentrated control structure that characterizes Italian listed companies.

The remuneration of directors

The Preda Code (1999, 2002, para. 8.1) recommends that companies set up a remuneration committee, which should be composed of a majority of non-executive directors to avoid conflicts of interest. The remuneration committee has the task of formulating proposals for the remuneration (including stock-option plans and the like) of executive directors and directors appointed to special offices. Any formal decision is still to be taken by the board of directors as a whole, as required by Italian law (see Civil Code art. 2389).

Assonime (2004a) reports that over 70 per cent of the companies have set up a remuneration committee, which in most cases comprises a majority of non-executive directors.

The internal control system

The Preda Code (2002, para. 9.1) defines the internal control system as 'the set of processes serving to monitor the efficiency of the company's operations, the reliability of financial information, the compliance with laws and regulations, and the safeguarding of the company's assets'.

It is recommended (2002, para. 9.4) that those who run the internal control system should not be placed hierarchically under a person responsible for operations to prevent interference with their independence of judgement. Zanda (2002) argued that the internal auditing staff should be placed hierarchically under either the chair (when s/he is a non-executive director) of the board of directors or the audit committee (if this committee is set up, see below).

However, empirical evidence shows that it is often placed hierarchically under the CEO (Zanda 2002) or other senior managers (Tettamanzi 2000). Cavallari et al. (2003) report an improvement in this practice – in 83 per cent of the companies analysed, the internal control manager is hierarchically independent with respect to the heads of operational areas.

The code (2002, para. 9.4) also recommends that the internal control system should report on its activity to the executive directors, the members of the board of auditors, and to the audit committee (see next subsection).

The audit committee

The Preda Code (1999, 2002, para. 10.2) recommends the setting up of an 'internal control committee' (that is, an audit committee) within the board of directors. This committee should give advice and make proposals to the board of directors in the following areas:

- assessing the adequacy of the internal control system;
- monitoring the work of the internal auditing staff; and
- liaising with the external auditing firm.

It should report to the board of directors on its activities at least twice a year, at the time when the annual and semi-annual financial statements are to be approved, and to the board of statutory auditors. The participation of the chair of the board of the statutory auditors at the audit committee's meetings is also recommended, in order to foster cooperation and avoid potential conflicts due to their overlapping duties.

The 2002 version of the code (para. 10.1) has stressed the fact that the audit committee should be entirely composed of non-executive directors, a majority of whom should be independent directors. In cases in which a company is controlled by another listed company, the audit committee should be made up exclusively of independent directors (paras 3 and 10).

The lack of independence of the audit committee members from the controlling shareholder was, indeed, one of the key causes of the Parmalat scandal (Melis and Melis 2005).

Assonime (2004a) reports that approximately 80 per cent of the listed companies analysed have adopted an audit committee, which in over 90 per cent of the cases is entirely composed of non-executive directors, who are almost always independent. In 60 per cent of the cases, the committee is composed entirely of independent directors.

Transactions with related parties

The 2002 version of the Preda Code added a specific section dealing with recommendations on related party transactions. In particular, the code (2002, para. 11) recommends that related party transactions[4] should be treated according to criteria of 'substantial' and 'procedural' fairness.

Substantial fairness is related to the fairness of the transaction from an economic point of view, as for instance when the valuation of a good is in line with the market price. It should be pursued by independent advisers, who would act as experts for the valuation of assets and for the provision of financial, legal and/or technical advice.

The board of directors should assess the independence of experts and, to foster this independence, the code recommends that different experts should be used in the most important transactions for each related party.

Directors who have an interest (regardless of whether there is a conflict), even if only potential or indirect, in a transaction with related parties should promptly inform the board of directors of the existence of such interest, and leave the board meeting when the issue is discussed.

Assonime (2004a) reports that 75 per cent of the companies declare that they comply with these recommendations. The rate of compliance of larger companies increases to over 90 per cent.

Relationships with institutional investors and other shareholders

One of the core objectives of the Preda Code is to foster a more in-depth knowledge of the company on the part of the (minority) shareholders. In order to achieve this purpose it is recommended (1999, 2002, para. 12) that companies designate a person (or create a corporate structure, in cases of large companies with a dispersed ownership) to be responsible for maintaining a continuous dialogue with shareholders generally, and especially with institutional investors.

Assonime (2004a) reports that the great majority of the companies have set up an internal structure dedicated to investor relations, in many cases creating a section on their website, where company documents are downloadable.

Shareholders' meetings

The Preda Code recommends that the board of directors should seek the shareholders' approval concerning a set of rules to ensure the orderly and effective conduct of the ordinary and extraordinary shareholders' meetings, while guaranteeing, at the same time, the right of each shareholder to speak on the matters on the agenda (2002, para. 13). This is a problem that is also common in Anglo-American companies (see, for example, Monks 2005 concerning the Exxon Mobil case).

Assonime (2004a) reports that only about 60 per cent of the companies analysed declared that they complied with this recommendation.

Statutory auditors

The Preda Code (2002, para. 14) recommends that statutory auditors, appointed either by the controlling shareholder(s) or by minority shareholders, should be independent and act exclusively to pursue the interests of the company and overall shareholders' value, rather than acting as stewards of that specific group of shareholders that appointed them.

The code stresses the importance of the treatment of confidential information by statutory auditors in accordance with company guidelines.

As with the appointment of directors, the code (2002, para. 14) recommends that the election of members of the board of statutory auditors should take place in accordance with a transparent procedure. Detailed information regarding the candidates should be available to shareholders in advance.

Assonime (2004a) reports that basically all companies declared that they complied with this provision.

Developments since Parmalat

The Parmalat case, along with other less high-profile corporate scandals, put the whole corporate governance system under pressure. For example, Ferrarini and Giudici (2005) report that the number of Italian companies accessing the bond markets has collapsed since the Parmalat scandal. In fact, although Parmalat is not to be considered as a particularly Italian case, it has been perceived as such by a large part of the Anglo-American business community (Melis 2005).

It is beyond the scope of this chapter to examine what caused Parmalat's corporate governance failure. Instead, the major developments concerning corporate governance issues in Italy after the Parmalat scandal will be briefly described. Some of them are, indeed, the aftermath of Parmalat, while others are not strictly related to it.

The 2004 company law reform

The 2004 company law reform represents a strong movement towards organizational flexibility at the board level. However, while the Company Act was being enacted, serious financial frauds, including Parmalat's, were uncovered and investigated. Such frauds clearly raised issues for the company law reform, which had been elaborated in a different (ante-Parmalat) scenario.

Its most important innovation regarding corporate governance is that companies are given the freedom to choose between three different board models:

- the Italian traditional board structure, which is set as the default, with a board of directors and a board of statutory auditors, appointed by the shareholders;
- a British-type unitary board structure, with an audit committee, entirely composed of independent non-executive directors, appointed by the board of directors, within the board; and

- a German-type two-tier board structure, with a management committee (*Consiglio di gestione*), and a supervisory council (*Consiglio di sorveglianza*). It differs from the German structure in that (a) labour representation is not mandatory and (b) members of the management committee are not necessarily executives.

Despite the great innovation in regulation, empirical evidence shows that basically none of the listed companies has changed its board structure. Only one company has adopted the unitary board structure, while two have adopted a two-tier board structure with a supervisory council.

The limited time that has passed since the change in legislation may explain only a part of the evidence. The choice to maintain the traditional board structure may be path dependent. Most of the companies might choose to maintain the 'traditional' board structure not because it is more efficient or any better than the others, but because it is the one they have always had. Path dependence and the above-mentioned influence of financial frauds seem to explain better why the great majority of companies have chosen to maintain their board structure.

The 2004 Assonime handbook on corporate governance reports

At the beginning of 2004, Assonime[5] published a handbook (Assonime 2004b) to help listed companies to improve the quality of information provided in their annual corporate governance reports. The handbook draws a distinction between 'required' information (related to the Preda Code recommendations) and 'useful' information, that is, information that is not required by the code, although it is potentially of interest for investors in the market.

Assonime (2004b) stresses the importance of comparability of corporate governance structures and, consequently, of the information provided in the corporate governance reports. Therefore, it recommends that companies:

- structure their corporate governance report in two parts, comprising an overall framework and an analytical section in which the compliance or the reasons of non-compliance for every single recommendation of the Preda Code are disclosed; and
- include a set of summary tables (provided in the handbook) which sum up their compliance with the code's recommendations.

Assonime (2004a) reports that approximately 42 per cent of the companies have structured their corporate governance report according to the handbook's recommendations, and over 62 per cent of the companies adopted the above-mentioned tables in their 2004 corporate governance reports.

External auditor's engagement

Italian regulation and national standards on external auditing were questioned following the Parmalat scandal.

In Italy, the external auditing firm is appointed by the shareholders' meeting, taking into consideration the positive opinion of the board of statutory auditors. Auditor rotation is mandatory: after three appointments (that is, nine years), a listed company is required to rotate its lead audit firm. Italian regulation is one of the strictest on this issue. Ferrarini and Giudici (2005: 27) argue that 'the emphasis on relaxed Italian auditing standards is misplaced', and Melis (2005) points out that concerning external auditing the Parmalat case is not 'particularly Italian'.

However, the Parmalat case has shown some flaws in the regulation. First, it now seems evident that there is no point in requiring mandatory chief auditor rotation, if the chief auditing firm can significantly rely on 'subcontractors', that is, other auditing firms which audit subsidiary firms of the group, which are not obliged to rotate. Second, mandatory auditing firm rotation may be flawed if the audit partners are not required to rotate as well. They may change the auditing firm in which they work (as they did in the Parmalat case), and keep on auditing the same company.

After the work of the Galgano committee, Italian policy makers seem likely to tighten auditor rotation rules, by reducing the length of the engagement and introducing audit partner rotation.

Adoption of International Financial Reporting Standards (IFRSs)

After the Parmalat scandal, the effectiveness of Italian accounting standards was questioned. Although it has been shown (see Melis and Melis 2005) that the Parmalat case is not due to a failure of generally accepted accounting principles, Italy has been internationally perceived as having weak accounting standards (for example, Buchanan and Yang 2005).

Since 2005, not only has Italy complied with the EU requirement regarding the adoption of the IFRSs for the preparation and presentation of consolidated financial statements by, *inter alia*, listed companies; but also, Italian policy makers have required the mandatory adoption of IFRSs by listed companies with regard to the preparation and presentation of their non-consolidated (that is, separate or individual[6]) financial statements since 2006.

In addition, in order to safeguard, *inter alia*, the interests of minority shareholders, Italian law (Decree no. 38, 28 February 2005) limits the distribution to shareholders of most of the gains[7] derived by fair value measurements, which are to be credited to a non-distributable reserve. The law implies that most of these gains are to be considered as 'unrealized', therefore it limits the decision-making power of the controlling shareholder(s) who might decide to distribute them at the expense of minority shareholders, creditors and other corporate stakeholders.[8]

Conclusions

Stanghellini (1999: 1) noted that writing about Italian corporate governance is like 'shooting at a rapidly moving target'. Indeed, regulation and actual corporate practice have been changing fast in recent years, although they have not solved completely the key corporate governance issue concerning the relationship between controlling and minority shareholders. The overall awareness of the importance of corporate governance issues has increased among senior managers and directors of listed companies.

The Draghi Law (1998) is a cornerstone, with its explicit aim to strengthen minority shareholders' protection. In fact, there is evidence that minority shareholders' protection has improved since the law was instituted, although companies have not always truly supported its aim.

The Preda Code of Conduct (1999, 2002) has focused on the role, composition and functioning of the board of directors. With its recommendations it has had a significant impact on the corporate governance structure of Italian listed companies. For example, empirical studies conducted before (Molteni 1997) or after (Melis 1999) the Draghi Law report that the board of directors was rarely characterized by the presence of committees, the only exception being the executive committee. Furthermore, Melis (1999) reported that 70 per cent of the listed companies analysed in late 1998 had no plans to set up any corporate governance-related committee in the near future. Nevertheless, only a few years after the Preda Code (1999, 2002), the great majority of the listed companies, if not all, have at least some of the committees recommended by the code of conduct.

Disclosure (or rather the lack of it) regarding corporate governance was a key issue in the Italian corporate system. For example, after the Draghi Law, Melis (1999) complained about the lack of publicly available information from and about listed companies concerning their corporate governance. However, since 2001 all listed companies are required to issue a publicly available corporate governance report. Moreover, the Assonime handbook (2004b) has provided guidelines that should improve comparability and overall quality of information regarding corporate governance in the different companies.

What happened at Parmalat was a real shock. The 2004 company law reform, which had given companies the freedom to choose their board structure, was contextualized in a different scenario and barely featured in actual corporate practice, as basically none of the listed companies has changed its board structure.

Although Parmalat did not comply with the key recommendations of the

Preda Code regarding internal controls and independent directors, and cannot be considered a 'particularly Italian case' (Melis 2005), the quality of Italian accounting and auditing standards and regulations was questioned. Financial reporting and corporate governance are strictly related to one another. The mandatory adoption of IFRSs by listed companies for all types of financial statements (consolidated, separate and individual) should improve financial reporting quality. Furthermore, the debate is likely to lead to a stricter mandatory auditor rotation.

Notes

1. 'Soft laws' refers to 'corporate rules and guidelines promulgated by private organizations rather than by legislatures, government regulators, or judges' (Cheffins and Thomas 2004: 276).
2. The principle of 'one share, one vote' is not adopted by Italian law. The only limitation to the issue of non-voting shares is that their total par value cannot be higher than the total par value of voting shares.
3. Sometimes Italian listed companies set up an executive committee within the board of directors. This committee is composed of executive directors and tends to absorb most of the key functions of the board of directors, often leaving the rest of the board the duty to ratify what is decided in the executive committee (see Molteni 1997).
4. The code refers to International Accounting Standard 24 (see IASB 2004a) to define a 'related party transaction'.
5. Assonime is the association for Italian limited liability companies which aims to foster the development of a modern legal framework and institutions beneficial to the proper functioning of the market economy.
6. Separate financial statements are 'those presented by a parent, an investor in an associate or a venturer in a jointly controlled entity, in which the investments are accounted for on the basis of the direct equity interest rather than on the basis of the reported results and net assets of the investees'; see International Accounting Standard 27 (IASB 2004b, para. 4). Individual financial statements are those presented by a company that does not present consolidated financial statements.
7. The law explicitly mentions only the following gains as distributable: (a) held for trading financial assets, (b) fair value hedge financial instruments and (c) operations in foreign currency exchange markets.
8. See Melis et al. (2005) for a further analysis about the 'distributability' of fair value gains and the interests of the different corporate stakeholders.

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PART II

CORPORATE GOVERNANCE IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

5 Corporate governance in Russia: is it really needed?

Peter Bartha and James Gillies

Introduction

Over the past decade, and especially in the aftermath of the financial crisis of 1998, federal authorities and major business interests in Russia have been cooperating to create a better environment for investors, particularly minority shareholders, and define the framework for owner–manager relations. In the legislative and regulatory areas as well as in actual business practice, new initiatives are now in place to protect shareholders' rights, elect independent directors, enhance the disclosure of information, provide for accountability and move towards transparency. Step by step, various components of a corporate governance framework are being put in place. The domestic reform movement is greatly aided by the efforts of international agencies and multinational accounting, consulting and legal firms active in Russia.

Scholarly observers no less than investors can justly take heart in these developments. Yet they should not overlook that the meaning, importance and application of corporate governance in Russia could either be the same as in the West or totally different from it. It all depends . . . Indeed, there is much in the Russian corporate governance scene that reminds one of Winston Churchill's famous characterization of Russia as 'a riddle wrapped in a mystery inside an enigma'.

- Some 80 per cent of investors in Russia polled by Standard & Poor's believe that the quality of corporate governance determines capital spending decisions and hence is of the essence for the future development of the economy (National Council 2004, pp. 10 and 74). At the same time, 80 per cent of the Russian public is reported to question the very foundations of corporate governance, namely the legitimacy of private ownership as it exists today, and want a re-examination of the property distribution that came about since the early 1990s (*Country Profile* 2004).
- The 'shareholding class' in the country accounts for a fraction of 1 per cent of the population,[1] the prime minister is on record as saying that he wouldn't invest his own money in the stock market (*Vedomosti* 2004)

and even among such experts as university professors of corporate governance only a handful have ever attended a shareholders' meeting.[2] Yet there is a vibrant intellectual climate in which highly professional work is done on corporate governance issues and new initiatives are studied, advocated and debated in conferences, public forums, academia, the media and the Russian parliament.

- Mikhail Khodorkovsky, arguably Russia's richest citizen and twice winner of the 'best manager of the year' award,[3] exhorts his fellow oligarchs to adopt a socially responsible stance in corporate governance practices – while sitting in jail and awaiting trial on various charges. Senior executives in Russia express concern that the government's action 'demonstrates the increase of two substantial risks: the selectiveness of the application of the law and the insecurity of property rights', but 'say unanimously that the "Yukos affair" does not call into question Russia's adherence to the fundamental values of the market economy' (*Entrepreneurial Ethics* 2004, p. 27).

I.

Corporate governance, as the term is understood in the West, arises out of a simple concept: if you are playing with someone else's money, you are accountable for it. All else follows from this proposition. Since the pooling of private savings and the utilization of this fund of capital by private corporations is the essential characteristic of Western capitalism, it can be said that corporate governance itself is the product, or result, of capitalist evolution. There is no doubt that effective corporate governance has been a significant and even necessary condition for rapid economic growth, but it would be a mistake to believe that corporate governance is anything more than a facilitating instrument.

Organizations that conduct business have always received their legitimacy from the state or an equivalent ruling body; records to that effect go back to the Code of Hammurabi in 1780 BC. The modern corporation had its first manifestation in the Western world in the seventeenth century when monarchs granted charters to groups of individuals to undertake specified commercial activities. Charters granted life to an organization independent of its owner–participants. The distinct legal identity gave rise to the need for a more or less permanent management structure and provided the basis for the continuity of the organization regardless of the involvement or lifespan of the individual owners. Thus began one of the major characteristic of the modern corporation – the separation of management from ownership. Things, of course, did not always go well with the chartered companies as they often failed in their stated purposes for reasons of bad judgement, changing circumstances or outright fraud, and the shareholders had to absorb catastrophic losses.

Through the nineteenth century, economic thinking evolved to the point where it had became a widely accepted view that the true wealth of a nation depended upon the efficient production of goods and services and not on the accumulation of gold bullion and treasures as previous generations had envisaged. Moreover, after Adam Smith it was recognized that efficient production is the result of the division of labour which, in turn, is optimized by the substitution of machines for physical exertion. This then led inexorably to the conclusion that if a nation was to become wealthy, it needed to generate enough production over consumption to permit the generation of savings and transform the savings into investment capital to finance the acquisition of machines and hence more and more production. The invention of the corporation was the means that encouraged the pooling of savings and the channelling of these funds to productive use.

Almost concurrently with the organizational evolution of the corporate form, the legal foundations were put in place. In the English-speaking world, two major rulings in the nineteenth century provided the definitions that are, by and large, still comprehensive and relevant today. In the United States, Chief Justice John Marshall described the corporations as:

> [A] collection of individuals united in one collective body, under a special name and possessing certain . . . capacities in its collective character which do not belong to the natural persons composing it. Among other things it possesses the capacity of perpetual succession and of acting by the collective vote or will of its component members . . . It is in short an artificial person existing in contemplation of the law and endowed with certain powers . . . as distinctly as if it were a real personage.[4]

In the UK, Lord Alfred Denning elaborated on this as follows:

> A corporation may in many ways be likened to a human body, it has a brain, a nerve centre which controls what it does. It also has hands that hold tools and acts in accordance with the directions from the centre. Some of the people in the corporation are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind and the will. Others are directors and managers who represent the directing mind and will of the company and control what it does. The state of mind of these managers is the state of mind of the company and is treated in law as such. So you find in law the fault of the manager will be the personal fault of the corporation. (Smith 1969, p. 78)

The corporation is an economic structure, but it exists by virtue of being a legal entity. As such, it includes the following characteristics:

- the right of individuals to create an organization that is to all intents and purposes a form of private government;

- the creation of a legal entity that exists separately from its members and has permanent existence;
- the right to acquire other corporations and engage in activities of its own choice;
- the separation of ownership and management and the division of authority between management and a board of directors, governors or overseers; and
- the limited liability of those who invest in it (Gillies 1992).

The concept of corporate governance came about as a natural consequence of the separation of management and ownership. Individuals who entrust their money to a corporation are, in effect, placing their trust in hired managers. They need someone to oversee the managers and ensure that the funds are properly used. Thus, almost from the inception of shareholder-owned companies, owners have come to rely on ‘overseers’ (directors) to perform this function. Directors are not viewed in law as agents of the shareholders, but they are regarded as having a fiduciary duty to act honestly and in good faith with a view to the best interests of the corporation. Correspondingly, they are given almost unlimited powers to ensure that the corporation is operated in an effective fashion.

The board of directors is elected by the shareholders; it is self-governing and it has the power to appoint or remove the management. The term ‘effective corporate governance’ is taken to refer to the manner in which the board of directors fulfils its responsibility for overseeing the general operations of the enterprise. Effective governance gives the providers of capital (shareholders) some control over how their funds are used. It is an assurance that shareholders are kept informed on how the enterprise is being managed and that the invested funds are being put to use in a beneficial yet prudent and honest fashion. Relying on the board of directors, shareholders assume less risk and hence are willing to provide capital at a lower cost. Here, then, is the linkage to economic growth. Other factors being equal, the cost of capital tends to be lower and its availability greater when the so-called corporate governance risk is taken out of the investment equation.

The economic case for corporate governance presupposes a variety of conditions; that private savings constitute the predominant source of equity capital; that corporations seek to draw on external funds to augment their internally generated capital, that the supply of funds and the demand for new investments are channelled through the capital market; that significant numbers of corporations are publicly traded; that large and dispersed groups of individuals and institutions have investment portfolios and these are composed of diverse share holdings; that the ownership and management of corporations are separated; that a competent and impartial judiciary exists for the enforcement of contracts and the settlements of disputes; and so on.

When these conditions are not present, as is case for the most part in Russia, the question arises: who needs corporate governance and why?

II.

Russia's transition from socialism to capitalism during the past decade and a half has been characterized by the absence of large numbers of domestic investors. For most of that period, foreign investors – with the exception of largely speculative ventures – have not been much in evidence, either. The initial shock to kick-start the transition towards capitalism came with the privatization of the early 1990s. 'It sounds ironic', notes Janos Kornai, a prominent scholar of transition economies, 'but the truth is that the expression "mass privatization", used as a synonym for give-away and voucher schemes, is the inverse of the "mass collectivization" familiar from the history of Stalinism . . . Luckily . . . the forcing of the change [in the 1990s] was done by milder means' (Kornai 2000, p. 24).[5]

Privatization was not popular at the outset and, partly reflecting distaste for how it was carried out, most Russians seem to have remained opposed to much of it.[6] According to a poll conducted by American researchers, 83.9 per cent of Russians believe that all heavy industry must belong to the state and should not be given over to private ownership. As to public views concerning reliance on market forces, the researchers found that 93.9 per cent think that the government ought to guarantee a job to everyone who needs one and 66.1 per cent think that the state should limit the incomes of the rich (Carnegie 2001).

But there is probably more to unfavourable public attitudes than a reaction to the method of privatization. Russia's experience with socialism in its various manifestations from tentative to brutal had lasted for more than 70 years – long enough for generations to acquiesce to it as a way of life. Furthermore, even prior to the October Revolution of 1917, Russia could hardly be described as having had a capitalist market system. In terms of ownership and economic decision making, the vast majority of the population experienced only nuanced variations in the system throughout most of the twentieth century – whether under tsarist or Bolshevik rulers. Then all things changed. The reform years of Mikhail Gorbachev's *perestroika* and *glasnost* culminated in the political upheaval and economic sea-change of the 1990s that swept away the foundations of stability and predictability.

And there was still another, seldom emphasized, dimension. Although the leaders of the privatization effort were members and appointees of the Gaidar government and strongly backed by President Boris Yeltsin, much of the intellectual, logistical and even financial support for their plans and programmes came from abroad. A powerful apparatus of international economic agencies rolled in, so to speak, and many prominent American economists lined up to counsel, advise, urge, motivate and assist the Russian reformers. Prominent among the advocacy groups were the World Bank and its International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), the USAID organization and agencies of the European Union.

The results of the 1992–94 privatization campaign were remarkable (Lieberman and Veimetra 1996, p. 739):

> In just two years the Russian government was able to . . . (1) corporatize and register over 24,000 medium and large state-owned enterprises as joint stock companies; (2) distribute vouchers to virtually the entire population in some 89 oblasts, territories and autonomous republics; (3) privatize over 16,500 enterprises . . . Over forty-one million Russian citizens became shareholders through either direct ownership of shares in the newly privatized companies or share ownership in voucher investment funds.

The dubious pleasure of 'share ownership' was short-lived for most Russians who placed their vouchers in investment funds. The funds, which were largely unregulated and unsupervised, exchanged the vouchers for shares of newly privatized enterprises as they were supposed to do – and then often disappeared. Few individuals would have been bothered to try and track down their entitlement. And those who did were in for a disappointment because there were no properly functioning share registries in operation. It remains a mystery to this day just where and in whose hands those voucher-spawned enterprise shares ended up.

In 1994 the Russian parliament rejected the government's proposed second phase. Yet the programme continued by presidential decree and initially involved privatization for cash and later took the form of the notorious 'loans-for-shares' auctions. In 1995–96,

> significant stakes in thirteen high potential, natural-resource-based firms were handed over . . . to Russian commercial banks, all apparently owned by a group of financial 'oligarchs' connected to the presidency . . . [Only] those in a self-designated inner circle were allowed to bid, and the bids were totally rigged. The government did not repay the loans and the shares, and ownership of some of the best remaining assets passed to the oligarchs. To give some idea of the results, the Uneximbank obtained 38 per cent of the shares of Norilsk Nickel, a firm that is (reportedly) presently making annual profits of $2 billion US, on the basis of a $170 million US loan. (Nellis 2002, p. 37)

With 20–20 hindsight, most observers take a critical view of privatization imposed from the top and conclude that '[a] small number of individuals, who mostly achieved initial wealth through favorable deals or outright theft from the government, ended up controlling most of Russia's major firms and, to a nontrivial extent the [Yeltsin] government itself' (Black et al. 2000, p. 1746). There is, however, a contrary *realpolitik* argument that carries considerable weight even in retrospect: namely, that given the power relations in the country during the early 1990s, mass privatization was the only politically feasible alternative to doing nothing.

The underlying motivation of the reformers and their Western advisers was to create a 'people's capitalism' in one fell swoop. In most instances, however, the voucher scheme turned out to be either a licence for embezzlement or the opportunity of a lifetime for management buy-outs at very low prices. The loans-for-shares deals, in turn, gave rise to Big Business dominated by a handful of oligarchs.[7] Thus, ownership became characterized by (i) large holding companies and financial-industrial groups, of whom the 23 largest control more than a third of Russia's industry in terms of sales (*Financial Times*, 7 April 2004) and (ii) medium-sized joint-stock companies where 'insiders', mainly enterprise managers, hold a dominant two-thirds of the shares in the majority of firms (Blasi et al. 1997, p. 118). Consolidation of capital and concentration of ownership is continuing by means of takeovers; surveys indicate a continuous process of property redistribution with the ownership of major blocks of shares changing in 6–8 per cent of industrial enterprises annually (Golikova and Burmistrova 2003).

III.

The rapid and radical transformation of ownership into private hands was not accompanied by the introduction of a workable legislative framework or any effective corporate governance mechanisms. Indeed, attempts to rein-in the 'Wild East capitalism' (Lieberman and Veimetra 1996) began in earnest only with the passing of laws on corporations and the stock market in 1995/96. Even then, the application and enforcement of the laws remained sporadic. This was in large part because of the lack of a professionally competent judicial system across the country. Major initiatives by regulatory authorities, by organizations of key market players and by large financial–industrial groups, the so-called FIGs, themselves got truly underway after the 1998 financial crisis. Since that time, a host of legislation and amendments to the old ones have been passed, the federal regulatory agency has developed and implemented a broad range of rules, a code of corporate conduct has been issued, the major stock exchanges have tightened their listing requirements and the courts have assumed an active role in dealing with violations of the law, the enforcement of contracts and dispute resolutions. In addition, the subject of corporate governance has become a newsworthy public issue in the media, largely as a result of Russia's very own corporate governance scandals of 2000 when armed thugs came to storm and occupy company premises on behalf of dissident groups of shareholders and managers.

The corporate governance infrastructure now in place can be grouped together under four headings: (i) legal framework, (ii) regulatory apparatus,

(iii) securities market and (iv) non-governmental organizations. The main components of each are briefly described below.

Legal framework

Six major statutes of the Russian Federation deal with key aspects of corporate governance and other laws are at different stages of development in the legislative process:

- The Civil Code (1994), of which the first part defines the forms of corporate entities and the basic principles of their governance.
- The Law on Joint-Stock Companies (1995) sets out the terms and conditions of the establishment, operations and procedures of joint-stock companies (corporations), including the rights of the shareholders and the powers of the executive body (top management) and the supervisory body (board of directors).
- The Law on the Equity Market (1966) regulates the issuing and trading of securities and the activities of the professional participants in the market and sets up the Federal Commission for the Securities Market for this purpose.
- The Law on the Protection of the Rights and Legitimate Interests of Investors in the Equity Market (1999) prescribes measures for greater transparency in the capital-raising process and assigns greater responsibility to issuers, independent appraisers and auditors for disclosures made in prospectuses.
- The Law on Bankruptcy (2002), replacing the Law on Insolvency (1998), determines bankruptcy procedures and introduces bankruptcy prevention measures.
- The Arbitrazh Procedure Code (2002), elaborating the Law on Arbitrazh Courts (1995), defines the structure and activities of a specialized arbitration court system for settling property and commercial disputes between companies and individual entrepreneurs, both Russian and foreign. These courts adjudicate conflicts arising out of corporate law, including disputes between companies and shareholders.

Domestic as well as foreign observers are in general agreement that these laws taken together with more recent amendments constitute a reasonably clear and adequate basis for effective corporate governance consistent with the standards outlined in the OECD Principles of Corporate Governance (2004). There are, of course, many gaps and weaknesses, such as problems with disclosure rules, financial reporting standards, takeovers and abuse of related party transactions. The most frequently voiced concern, however, relates to shortcomings in the judicial system.

The chairman of a fund management company puts it this way: ‘We all take it for granted that a judiciary that interprets the laws and allows for them to be enforced properly does not exist in Russia. It looks like it does on paper, but anybody who has been involved with the legal system knows that the judicial system is entirely corruptible’ (Sucher 2004, p. 3). A tax expert concurs: ‘On paper, the laws are not necessarily all that bad in many respects. It is how the law is actually applied that leaves much to be desired – primarily because of corruption within the judicial system’ (Kubina 2004, p. 17). And the head of a prime investment house observes: ‘the further away from Moscow you go, the more the application of the law can be arbitrary or can be influenced by bribery and corruption pressures’ (Costello 2004, p. 8).

Regulatory apparatus

Supervisory and regulatory oversight of the activities of the securities industry and the operations of the securities market is the responsibility of the Federal Service on Financial Markets (established in 2004), formerly known as the Federal Commission on the Securities Market (FCSM) (established in 1992). The Federal Service licenses stock exchanges, prescribes criteria and rules for listed issues, regulates investment and brokerage firms and controls the registry of shareholders. With respect to joint-stock companies, however, it has no authority on its own to require compliance in such matters as the disclosure of financial information, restrictions of insider trading, the structure, composition and activities of boards of directors and the like. When it comes to dealing with the practice of corporate governance in business firms, the Federal Service can be expected to follow the procedures established by its predecessor organization. Thus, it would rely on a combination of (a) issuing regulations within its areas of jurisdiction; (b) publishing instructions that amount to recommendations without the force of law; (c) co-opting ministries and government agencies to issue binding rules, as it were, on behalf of the Federal Service; and (d) persuading stock exchanges and self-regulatory organizations to use certain recommended provisions as their own requirements.

A prime example of this approach has been the handling of the Code of Corporate Conduct (also referred to as the Corporate Governance Code) in the 2002–03 period. Work on the code was initiated by the then FCSM, involved consultations with the business community through industrial and professional associations and the product was approved by the government ‘as a code of best practice recommendations’ (Belikov 2003). Although carrying the imprimatur of the federal government, the code as a whole was presented to interested parties as a document for their consideration and voluntary adoption. At the same time, however, certain sections of the code were incorporated by the FCSM into regulations, other parts reappeared as new listing rules by stock exchanges and still other elements remained as non-obligatory recommendations.

The OECD, Russian Corporate Governance Roundtable's *White Paper* (2002) stressed the importance of enforcement and argued that 'since its creation in 1992, the FCSM has been understaffed and under-funded while its already long list of responsibilities has been expanded . . . The first priority of the FCSM should be to ensure the integrity and fairness in the securities market' (paras. 197 and 200).

Securities market

The organized Russian equity market consists of 11 stock exchanges licensed by the FCSM, now Federal Service, of which nine are more or less active and two account for most of the trading volume. The largest is the Moscow Interbank Currency Exchange ('MICEX') – Equity Section, followed by the electronically operated Russian Trading System ('RTS') Stock Exchange. MICEX, as its name suggests, was established as a currency exchange and today trades in some 40 listed and about 140 unlisted stocks. The second-largest exchange, RTS, also trades in about 40 listed and some 250 unlisted stocks. These equities represent approximately 300 issuers – out of the estimated number of 60,000 open joint-stock companies in Russia whose shares could be legally traded without any restriction.[8]

Apart from being a very thin market with only a handful of liquid securities, the central problem from a corporate governance perspective is that, in the words of the head of MICEX, 'the stock market does not fully meet the Russian economy's development requirements. It is less than efficient in fulfilling its main task, which is to accumulate savings and transform them into investments in the real economy' (*Moscow Times* 2004, p. 4). The obvious question is whether this failure is a cause or an effect. On the one hand, it has been estimated that \$60 to \$70 billion of savings are kept, so to speak, under mattresses and about half of this amount is a source of potentially investible capital. On the other hand, a whole slew of surveys demonstrate that Russian companies for the most part prefer to avoid significant proportions of external financing and rely instead on internally generated funds and/or transfers from related companies. Indeed, there have been only a few and comparatively small initial public offerings (IPOs) in the history of the Russian stock market.

Driven for the most part by forces that influence market capitalization, the securities market is orientated towards the needs of certain specific categories of portfolio and strategic investors: Westerners who hold minority positions in the few listed Russian joint-stock companies, domestic and Western speculative investors and major domestic players in takeover manoeuvres. There are as yet no significant institutional investors in the market, though it is widely expected that with pension reform underway, the emerging state and private pension funds may come to have a major presence and influence in the near future.

The prime investment banking and brokerage firms cater to the market participants with the customary range of services plus others. For example, reacting to the heavy losses suffered by their Western clients in the period of the 1998 financial crisis, investment houses linked up with special-interest groupings and made a special effort to have their nominees (usually their own senior employees) elected as independent directors in the hope of acquiring some measure of influence on boards composed of majority owners/managers. The investment houses have also become a major force in promoting corporate governance reform. Several of these have developed their own methodology and database for calculating and comparing the corporate governance ratings of the largest listed joint-stock companies and have become a major advocate/participant in corporate governance reform.[9]

Non-governmental organizations (NGOs)

Special-interest business and professional associations play a threefold role: they shape the corporate governance framework through research-based policy advocacy, they enhance corporate governance skills and competencies in business through training and education and they promote the adoption of good corporate governance practices through intermediation between companies, regulators, politicians and expert professionals. In addition to domestic organizations, international agencies operating in Russia also fall in this category,[10] including the World Bank, its affiliate the IFC, the International Monetary Fund, the OECD and the EBRD. Each of these is active in public education, policy advocacy, professional training and active intermediation.

Among major domestic NGOs the oldest is the Investor Protection Association (IPA) (2000) established in the wake of corporate governance scandals for the purpose stated in its name. Supported in large measure by foreign portfolio investors, the IPA and its affiliate the Independent Directors' Association were originally chiefly concerned with the composition and procedures of boards of directors as a means of safeguarding the rights of minority shareholders. Over time, however, the IPA has broadened its membership base and its scope of activities; it conducts surveys, disseminates privatization information and generally promotes better corporate governance practices and has become closely associated with the OECD. The Independent Directors' Association, in turn, has branched out on its own; also engaged in major policy studies and educational ventures, taking over many of the training programmes financed prior to 2004 by the IFC.

The Russian Institute of Directors (RID) (2001) was founded by a group of large Russian companies as an expert body with a primary educational and training objective. Its activities have included the development of professional and ethics codes for directors and corporate secretaries. Very active through international connections, the RID has also conducted a number of major surveys and issued analytical studies on the state of corporate government. It has been particularly close to the FCSM and played a major role in developing and subsequently promoting the Code of Corporate Conduct. The Institute of Professional Directors (2002) receives support primarily from the network of regional energy companies and its focus is on training directors for these companies. Other organizations involved in corporate governance issues are professional associations, such as those of auditors and regional registrars, and a number of prominent university-affiliated research institutes.

Of particular interest is the formation of the National Council for Corporate Governance (2003). It is 'a permanent non-government advisory body established at the initiative of the largest Russian issuer companies and investors, with participation of the high-ranking officials of the federal authorities who are in charge of the development of the capital and investment markets'.[11] The legitimacy of the Council is enhanced by the support of such organizations as the Russian Union of Industrialists and Entrepreneurs and the Russian Chamber of Commerce and Industry, and also the organizational and financial commitments of blue chip companies and high-profile oligarchs whose names appear on the membership list. Thus, the National Council could emerge as a powerful peak NGO with influence on both government policies and business practices.

IV.

The key element in the practice of corporate governance is board performance. In the majority of Russian companies, however, there is no clear-cut separation of roles and responsibilities between board and management. This is the case not only in FIGs and other large integrated business groupings, but also in medium-sized and small enterprises that were established at the time of privatization. Most of these relatively smaller firms have undergone consolidation and are now controlled by a single individual or group, often managers or local entrepreneurs who are the dominant owner. Nominally open joint-stock companies and thus public corporations under the law, they have in effect come to operate in the fashion of private corporations or family businesses (Viyugin 2004).

Studies conducted at the enterprise level indicate that at the heart of the corporate governance problem is not the traditional Western preoccupation with the separation of ownership and control, but rather a uniquely Russian distinction between 'insiders' and 'outsiders'. In management-controlled companies, of course, the dominant owner and the top manager are usually one and the same. In companies where an outsider acquires the dominant ownership, an interesting transformation takes place (Regional Think Tank Programme 2004, p. 133):

> For the most part, the outside owner or its representatives run the company. If a company employs a hired executive management, the major owner usually reserves for itself the right to form and control the operation of the board of directors and makes use of other informal strict controlling procedures. The major outsiders' access to insiders' information about the company makes the major outsider a 'new insider'. The only outsiders become the minority shareholders . . . not affiliated with the management or [dominant] business owners.

It is hardly surprising that the insiders want to keep the outsiders 'out' and all the pertinent information and decision-making powers 'in'. This is one reason why the vast majority of Russian companies eschew reliance on external financing.[12] Opacity is seen as a business asset and transparency as a liability. Even some of the largest firms that are more open to the idea of IPOs and the tapping into domestic and foreign capital markets are reported to be reluctant to let more than a quarter of their total equity be held by external investors.

In this environment, to paraphrase Gilbert and Sullivan, the minority shareholder's lot is not a happy one. In the words of the chairman of the Federal Service on Financial Markets, the corporate governance scene in Russia is 'not like we see elsewhere'. One of the distinct features he singles out is that 'in Russia it is most unlikely that you can even dream of minority shareholders being appropriately represented on the level of the board of directors in a publicly-owned company'. Indeed, he goes on, 'minority shareholders [are] actually merely being represented by minority members in the boardroom' while power is in the hands of the majority of directors 'who are either holding [most of the] assets or who are actually agents of the real owners of the properties' (Viyugin 2004).

The insider/outsider dichotomy is a defining characteristic of corporate governance in Russia. It is different from the inherent conflict of interest between owners and managers, as conceptualized in the so-called 'agency problem', and hence it presents a different kind of challenge for scholars and practitioners alike. In the Anglo-American setting, the underlying assumption of the corporate governance model is a *weak owner/strong manager* structure with a focus on mitigating managerial abuse against the backdrop of widely dispersed ownership and elaborate legal protections of minority interests. In the Continental European, and especially German context, the model is predicated on a *strong owner/weak manager* construct where management may lack performance incentives, but the banks as controlling owners provide both the required investment capital and the necessary monitoring capability.

There is a debate in the literature as to which, if any, of the Western models is more appropriate under Russian conditions. A review of developments since approximately 1998 suggests that much of the driving force for corporate governance reform in Russia has been provided by international agencies and multinational law and accounting firms which are steeped in the Anglo-American traditions of business. Indeed, most of the observed legislative, behavioural and operational change to-date has been compatible with the Anglo-American approach to corporate governance. But some observers argue that the rise of the bank-led industrial groups is an indication that Russia might be leaning towards the Continental European model. This approach is said to be 'more aligned with Russian culture and history, which combine paternalistic and hierarchical control with participative decision-making' (Judge and Naumova 2004, p. 305).

Instead of thinking in terms of one or the other model derived from the practice of highly developed economies in the West, it might be more productive to consider possible future variations along the insider/outsider dimensions. The current corporate governance situation in Russia can generally be characterized as consisting of strong insider (dominant owner–manager) and weak outsider (minority owner). Under such conditions there is no separation of ownership and control, and consequently there is little inherent reason for corporate governance itself. But a broad range of developments is waiting in the wings, so to speak, that could strengthen the outsider and/or weaken the insider and thus bring about a better balance. A future scenario can include such driving forces as a more stringent enforcement of laws, the growth of buy-ins and joint ventures involving large Western companies, more recourse to domestic and foreign capital markets, a proliferation of boards with independent directors, better disclosure practices and the adoption of international accounting standards, the emergence of institutional investors and, perhaps most importantly, a more active state authority.

One of the promising evolutionary changes is the reform of the pension system and the expected growth of managed pension funds as institutional investors. This, in principle at least, could greatly strengthen the outsider, the minority owners, at the expense of the current dominant owner–manager coalition and hence provide an incentive for effective corporate governance practices. But this can occur only if the fund management companies are able to act as regular shareholders and vote their holdings at general shareholders' meetings – something they are explicitly forbidden under existing legislation. Without voting rights and thus without the clout to gain seats on the board, pension funds can only be providers of passive capital and have no impact on corporate governance.

Another positive change would be a more open Russian economy to globalization as reflected in international capital flows and foreign trade. The aggregate level of foreign investment is very low in both absolute and relative terms. The cumulative foreign direct investment inflow in the 1990s was some $20 billion and it has continued at an annual rate of around $2 billion in recent years. On a per capita basis this represents less than one-tenth of foreign direct investment in other transitional economies of central Europe (*Country Profile* 2004, p. 53). Observers attribute this situation to a combination of foreign reluctance to invest in Russia and Russian hesitation to accept, let alone welcome, foreign investment. And there is a concern that ‘Russia’s attitude of benign neglect toward foreign investment [might be] beginning to lapse into indifference or even to retrench into a policy of hostility to foreign investment, at least in some sectors’ (Sommers 2004, p. 1).

Corporate governance risk is said to be a key reason for Western reluctance to invest in Russia. Conversely, it is suggested that ‘investors are willing to pay a premium on the shares of companies with good corporate governance’; in the case of Russian companies a survey found that the theoretical premium averages 38 per cent (McKinsey 2002, p. 6). Good corporate governance, then, can be both a cause and an effect of greater foreign investment and hence a factor in Russia’s economic growth. The question is: how big a factor?

V.

The importance of corporate governance for the Russian economy is more often asserted than substantiated in the literature. Statements in the *White Paper* such as ‘effective corporate governance is the key to Russia’s future’ are intuitively appealing, especially at a high level of abstraction where corporate governance is defined as ‘the system by which companies are directed and controlled’ (OECD, Russian Corporate Governance Roundtable 2002, p. 1). To be fair, the definition is further elaborated:

> This involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide the proper incentives to pursue objectives that are in the interest of the company and the shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources effectively.

The attraction of corporate governance is that it is a good thing *per se*; the economic equivalent of motherhood. However, as a comprehensive overview of the field notes: ‘Beyond the observation that financial market development is related to key governance institutions such as investor protection, the broader relationship between governance arrangements and growth, while well known from theory, has been difficult to discover in practice’ (OECD 2004, p. 24).

This conclusion is just as applicable to Russia as to any other country. Adequate investor protection and related measures will contribute to the healthy development of the financial markets to gather, channel and allocate capital and thereby promote a sustainable and growing market economy. Thus, corporate governance should be seen for what it is, namely a highly desirable – though by no means paramount or sufficient – precondition for capital investments and hence growth.

As noted earlier, more than 80 per cent of investors polled by Standard & Poor's (Russia) believe that the quality of corporate governance is the main determinant in making investment decisions. Yet when actual investor behaviour is pitted against survey responses, the picture is rather different. Without belabouring the point, consider the headlong rush of foreign investors to China – where the state holds an average 70 per cent ownership stake in companies traded in the country's two stock exchanges and where even the idea, let alone the enforcement, of corporate governance is merely three years old (Standard & Poor's 2003). And much of the inflow is intended to stay; 'China has welcomed direct foreign investment, which has bolstered growth by increasing the stock of fixed capital and by providing new technology and management know-how. Joint ventures with foreign firms produce 27% of China's industrial output' (*The Economist*, 2004, p. 8).

The extent to which the quality of corporate governance may be an incentive or its absence a deterrent is largely dependent on investor characteristics and motivations. For example, among participants in Russia's fledgling venture capital market which handles around $1 billion of funds predominantly from domestic sources, governance is a minor issue. These private equity firms invest in non-listed portfolios in the expectation that some attractive exit path would soon open up and they could sell on the investments at a profit either through IPOs or directly to local or foreign strategic buyers. Given potential returns in the 50 per cent range, the uppermost objective of these Russian private equity firms is to 'find a company with the right [management] team' (*Country Monitor* 2004, p. 1), never mind governance considerations.

The perspective of the broader investment community echoes the views of the Russian speculative investors. Reporting on the relative importance of various criteria for international funds when selecting investments in Russia, an Ernst & Young study observes: 'One of our most striking findings is the fact that the profile of a company's management matters more to fund managers today than size or even profitability' (Ernst & Young 2003, p. 2). To be sure, fund managers are also concerned with board composition, ownership structure and transparency, but these governance issues are not on the top of their list.

A 2003 study conducted by the Russian Institute of Directors – itself a prominent advocate of better corporate governance practices – found that there is indeed a positive correlation between good corporate governance and changes in stock prices, but only in the case of a very small group of blue chip companies and only up to a certain level of stock prices. As for investments in other listed Russian corporations, the study suggests that ‘in most cases it was actually the size of the company and its market share that are the main or perhaps even the exclusive factors that investors rely on when deciding to buy the stock of a Russian company’ (Belikov 2004, p. 2).

Never the less, the study suggests a remarkable market dynamic at work. It notes that the main players in the Russian investment market are speculative domestic and foreign portfolio investors who focus on the shares of 10–15 very large companies. Although comparatively risk tolerant, even speculative investors are prepared to pay a premium for the shares of companies that move from primitive to acceptable standards of corporate governance.[13] By so doing, however, they push up share prices to a level where it no longer makes speculative sense to buy them. The study argues that most Russian blue chip companies have already reached this point and can increase their market capitalization only by attracting conservative (rather than speculative) largely foreign portfolio investors. Thus, the market makes for continuous corporate governance improvements. In the case of blue chip companies, the pressure is to adopt a standard that approximates ‘best Western practices’ because conservative foreign investors will expect it and pay the premium for it. For the second echelon of companies who are in the market or about to enter it, the speculative portfolio investors will push and pay the premium for the transition to an acceptable level of corporate governance. And once the share prices of these firms too rise beyond the horizon of speculative investors, the second echelon will join the ranks of blue chip firms and will also be seeking to attract the conservative investors. They will be followed by the third echelon of firms priced at a level attractive to speculative portfolio investors, and so the process continues.

Conclusion

This chapter began by asking whether there is any need for corporate governance in Russia – a country without a well-developed capital market, without a large number of publicly listed companies, without many shareholders and without the ‘agency problem’ that comes from the separation of ownership and control. A brief overview of the events of the past decade and of the direction of change in the country suggests an affirmative answer. The adoption of a good corporate governance system – both at the macro legal-regulatory setting and at the micro level of business practices – can speed up and smooth the transition to a fully operational market economy. During mass privatization a decade ago the absence of the right structures, institutions and processes caused a major transformation effort to go awry. Now the appropriate framework, instruments and know-how are in place to generate and allocate capital effectively and efficiently. By developing a set of corporate governance practices and fostering a corporate governance culture, Russia is wisely pre-investing in its future.

Notes

1. According to a survey conducted by the Russian Institute of Directors, the ‘big and biggest’ 87 joint-stock companies report a total of 1.5 million shareholders. However, this total includes a great deal of duplication. A better, though still greatly inflated, indicator is the average number of shareholders in one enterprise (6,000 excluding the unique case of Gazprom) multiplied by the number of companies. The resulting total is somewhat over 500,000 – still twice or three times as high as suggested by direct estimates. ‘Structures and Activities of Boards of Directors of Russian Joint Stock Companies’, www.rid.ru.
2. Authors’ anecdotal survey of more than 100 participants in corporate governance courses for Russian academics 2001–04, Schulich School of Business, York University, Toronto.
3. The competition was sponsored by the Association for the Protection of Investors’ Rights and Khodorkovsky’s company, Yukos Oil, won first prize in the categories of ‘best investor relations’, ‘best annual report’ and ‘best website’.
4. *Dartmouth College versus Woodward* (1819) 4, Wheat. 518.
5. Also on this point, see ‘Chubais on Stepashin and the “Irreversibility of Russian Reform”, Russian and Eurasian Affairs Program, *Carnegie Endowment for International Peace*, Meeting Report, 19 May 1999: ‘Asked about his role as privatization minister from 1992–1994, [Anatoly] Chubais conceded that his privatization efforts could be characterized as “Bolshevik-style” – lacking public support and quickly executed. Chubais said that he forged ahead with privatization in the face of universal public and governmental opposition . . . His strategy was to privatize as quickly as possible . . . As a result, there now is private property in Russia, he said, which limits forces that oppose the country’s emerging market economy’.
6. A different perspective was offered by Ruben Vardanian, president and CEO of the Russian brokerage house Troika Dialog in his presentation to the World Economic Forum in Davos in February 2001: ‘We must confront the reality in Russia of the Original Sin. The Original Sin in Russia was that privatization was artificial. It was ordered by a distant and incomprehensible Power and forced on an uncomprehending and usually unwilling People. It is no great insight to look back on the past ten years in Russia and to make this statement. But the consequences of that Original Sin naturally color all perception in Russian business and society on the full spectrum of questions concerning corporate governance’.
7. Anatoly Chubais is quoted: ‘My opponents tell me that the privatization was wrong, that it was against the interest of the people. But I did not do it for the people of my generation. I did it for our children. I am convinced that in a generation or two, people will look at us differently, and the sense of injustice will pass in those who will come after us’, ‘Father to the oligarchs’, *Financial Times*, 13 November 2004, p. 14.
8. Data on issuers calculated from the web pages of the two exchanges.
9. Firms such as Troika Dialog and Brunswick Warburg UBS were among the leaders, but have in recent years largely left the field to Standard & Poor’s, the specialized rating agency.
10. These government-financed organizations can be legitimately described as ‘non-governmental’ in the Russian context as they in fact operate at arm’s length *vis-à-vis* the federal government.
11. The Council defines its goals as:

    - monitoring the corporate governance situation in Russia and highlighting the achievements of well-managed and effective Russian companies;
    - mending the existing legislation and supporting the enforcement mechanisms applying to corporate relations;
    - making amendments to the National Code of corporate behaviour devised by the FCSM;
    - conducting a national corporate governance rating;
    - providing education for Russian business community on the importance and significance of corporate governance; and
    - consulting Russian companies in drawing up and implementing their own corporate governance codes based on internationally recognized standards.

    Source: www.nccg.ru.

12. Igor Belikov illustrates this with reference to Italian examples and quotes a Milanese businessman's rationale for buying back his company's shares: 'We had to disclose information on our strategy, enabling our direct competitors to see what we were doing' (Belikov 2003, p. 23).
13. The higher level of corporate governance that is beyond the threshold of speculative portfolio investors and practised by some of the largest Russian companies is described in the study as 'such policies as the consolidation of ownership in the parent company, disclosure of the main beneficiary owners, discontinued practices of asset stripping, a move to reporting consistent with International Accounting Standards, the passing of a code/declaration of corporate conduct, election of a few well-reputed foreign businessmen as independent directors [by the controlling shareholder(s)], establishment (or announcement) of two or three board committees (such as the audit, remuneration and nomination committees), payment of sizable dividends, payment of interim dividends . . . and issue (or announcement) of alternative dispute resolutions' (Belikov 2004, p. 3).

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6 Corporate governance in Poland

Piotr Tamowicz[1]

Background

Poland as a ‘catching-up’ country has gone through significant transformation during the last 15 years. The structure of all aspects of the market has changed with new economic and legal institutions entering the scene. The stock market, privatization schemes, pension reform, and a new legal framework have been created and developed, and the economy has been liberalized and opened up, attracting foreign players and capital. All these institutional settings created new guidelines and rules for corporate players to follow. Although creating coherent and effective corporate governance mechanisms has not been at the heart of these institutional reforms, the outcomes are generally positive. The legal and economic infrastructure is close to the European average and is gradually improving. Players are more active and sensitive to corporate and stakeholder relations. The biggest problems Poland faces are with respect to enforcement, the judicial system and governance practice. In this chapter we present an overview of the state of corporate governance in Poland, beginning with the ownership structures and therefore the character of agency conflicts, followed by an analysis of minority interests and new developments in governance arrangements.

From state control to blockholders

The agency problems in Polish corporations have evolved significantly over the last decade, along with the changes in ownership and control structures, shifting from rather dispersed (not too concentrated) to large blockholders.

The rise of socialist ownership structures

Following the Second World War, Poland began what was to be almost 40 years of communist rule that significantly affected the structure of the economy, and the allocation of resources as well as corporate ownership. Because of the political situation, most private property was nationalized. As a result, private entrepreneurship was largely limited to micro enterprises (crafts) by the late 1950s. The corporate sector was dominated by state-owned entities, without any tradable claims. Indeed, they had no economic autonomy since they were unable to compete even with one another. The residual private sector was strictly controlled, with significant entry barriers in the form of licensing and asset rationing. Although pre-war corporate law was still in force, no new entities emerged and no market in ownership claims existed (either in the form of a stock exchange or a private mergers and acquisitions (M&A) market). By the end of the 1970s the situation had not changed, with the exception of some attempts to involve workers of state-owned enterprises in the decision-making process (through the so-called 'workers' councils').

The year 1980 saw the eruption of significant political changes, heralding a slow but continuous departure from the homogeneous structure of the corporate sector. While the formal ownership of state-owned enterprises was still fully in government hands, the decisive control over assets and finance began to be distributed among major corporate players. A quasi-supervisory board dominated by employees (a so-called 'employees' council') and a general assembly of employees was created in each state enterprise. The councils had considerable power to monitor managers (and even to fire the CEO). From the governance point of view, concentrated and formal state ownership was balanced by real insider control.

The distribution of corporate control brought mixed results. In general, control over managers was tightened and in numerous cases improvements in performance were evident. However, under soft budget constraints and without any external threat (takeover or bankruptcy), managerial secrecy was still paramount. This has resulted, for instance, in a huge appropriation of enterprise assets, including tunnelling and self-dealing, since 1988.

The stabilization plan that was put in motion in 1990 (the so-called Balcerowicz plan) laid down the foundation for the development of modern private corporations and new governance mechanisms. The control over resources and legal barriers to entrepreneurship were abolished, facilitating the establishment and development of private corporations with tradable claims and sophisticated internal structures. Hard budget constraints, extension of control to banks and suppliers who could force a company into bankruptcy as well as privatization schemes resulted in a significant transformation of state-owned enterprises.

Ownership and control in non-listed companies

The private corporation sector comprises thousands of limited liability and stock companies that originated as family firms or evolved from government-led privatization. Little is known about their precise ownership and control structures. The most systematic observations that are available concern mostly former state-owned enterprises taken over by employees and managers. However, all of them are methodologically constrained due to the inability to establish the ultimate owner and to separate cash-flow rights from voting control.[2]

The overall picture that comes out of these studies reveals that ownership and control, although initially dispersed among various corporate players, finally evolved and tended to be centralized in the hands of a small group of investors: top managers/key employees and/or external investors. In the case of purely private companies, control is largely in the hands of the founders who simultaneously manage the company or supervise (as chair of the supervisory board).

One of the earliest studies in that respect found that in nearly all of 40 corporations (in limited liability or stock company form), the largest shareholder held about 50 per cent of the shares, generally with a 70–85 per cent stake. In a few cases, two partners shared ownership almost equally. Eight out of 23 corporations were in the hands of senior managers and/or employees; private individuals and foreign or joint-venture entities controlled ten enterprises each. In 22 cases, managers and other employees together controlled the company with managers holding on average 22 per cent of shares compared with 49 per cent in employees' hands (Belka et al. 1995).

In companies privatized through employee and management buy-out schemes, control and ownership was finally transferred to managers and outside investors irrespective of initial settings, that is, ownership structure that had emerged just after the privatization was completed (Kozarzewski 1999, 2000). The biggest increase in corporate shareholdings is in the case of outsiders (a fourfold increase in 1995 compared to the early 1990s). In 1995, in about 38 per cent of the analysed companies, an outside investor held at least 20 per cent of the shares, and in 50 per cent of other companies outsiders were among the top ten shareholders. The transfer of control was extended over time due to tight regulations built in to company statutes by managers and employees to prohibit uncontrolled 'leakage' of shares outside the company. For instance, in more than 75 per cent of companies analysed by Kozarzewski (1999) any share sales were subject to the written consent issued by management or the supervisory board. Moreover, existing shareholders usually had the first claim on shares.

In spite of these constraints imposed by company players, the transformation of ownership and control arrangements in respect of small and medium-sized privatization buy-outs led to the creation of a controlling owner or a small group of owners inside or outside the company (Kozarzewski and Woodward 2001).

Similar patterns of ownership transformation took place among companies privatized through the free-voucher scheme (so-called 'mass privatization').[3] Starting from particular politically predetermined ownership structures, the bulk of companies involved in the scheme were sold by the national investment fund and other shareholders to ultimate controlling owners. The share of the largest shareholder went up between 1996 and 2000 initially by only a small fraction, and then by larger amounts. By the end of 2000 the largest shareowners had almost full control over the companies (Grosfeld and Hashi 2001).

Listed companies
The initial ambitions and plans to create a public capital market based on privatization initial public offerings (IPOs) have been significantly influenced by Anglo-Saxon thinking and privatization achievements. As a result, the early privatization efforts aimed at the creation of rather dispersed ownership structures, with IPOs managed so as to attract as many individual investors (households) as possible. This strategy lasted from 1990 to 1993 and culminated in the privatization of one of the largest retail banks (Bank Śląski) where any individual investor was allowed to buy only three shares. This unavoidably popularized shareholding but created a lot of confusion and criticism when half a million investors stormed brokerage houses to buy shares and then immediately tried to sell their holdings. The strong interest in share investments was also moderated by the market crash that followed shortly after the Bank Śląski flotation.

Subsequently, at the beginning of the 1990s, with few public companies being traded on the stock exchange, the concentration of voting control was very moderate with the median size of the largest blockholder amounting to about 18 per cent. Between 1991 and 1996, with new flotations coming from the state and private sectors, a modest upward trend emerged, pushing concentration of control up to about 25–26 per cent (the median for largest blockholder).

In the mid-1990s, the privatization strategy changed and the government began to favour direct sales of significant blocks of shares to foreign strategic investors combined with public float. This was immediately reflected in market and corporate structures. While between 1991 and 1996 the concentration of voting power increased by only a few percentage points, in the next two years it almost doubled. In 2000, the concentration of voting control amounted to 39 per cent of votes. This figure is even higher – 46 per cent – if one allows for the consolidation of shares owned by founders. While in 1997 half of the public companies saw the stake of their biggest shareholder at less than 33 per cent, in 2001 that figure had dwindled to about a quarter. Moreover, the increase in the power of the largest shareholder has not been balanced by the power of other players who are very unlikely to create any strong coalitions. The median size of the second, third and fourth blocks in the case of non-financial corporations at the end of 2000 amounted to 10, 5 and 0 per cent of voting rights, respectively.[4]

The figures reported for ownership and control indicate that in spite of the initial attempts, Polish listed corporations fall into the continental (or insider) model of agency and ownership/control relations. With a 39–45 per cent median for leading blockholders, Poland is in the middle of Central and East European markets. This figure is also similar to that observed in Western markets (see Table 6.1).

Table 6.1 Blockholding in Europe

Country	No. of companies analysed	1st largest blockholder (median in %)	2nd largest blockholder (median in %)
Czech Republic	57	52.6	25.3
Estonia	21	52.6	12.6
Hungary	64	43.5	18.0
Latvia	43	51.3	7.7
Lithuania	46	42.2	11.3
Poland	210	39.5	10.4
Romania	115	53.0	16.0
Slovakia	34	39.4	18.8
Slovenia	136	22.3	12.1
Russia	na	32*	na
Austria	50	52	2.5
Belgium	140	56	6.3
France	40	20	5.9
Spain	193	34.5	8.9
Holland	137	43.5	7.7
Germany	372	57	0
Sweden	304	34.9	8.7
Italy	214	54.5	5
UK	207	9.9	6.6

Note: * Average, not median.

Sources: Based on Barca and Becht (eds) (2001); data for Central and Eastern Europe based on Pajuste (2002); data for Russia derived from Sprenger (2002, p. 6).

Legal foundation of governance and shareholders' rights

Since the inception of market reforms in 1990, Poland has made a significant effort to modernize and develop its whole legal and regulatory infrastructure including capital market and corporate law provisions. Although some deficiencies still exist, the law generally accommodates all major institutions that are important for shareholders.

The most critical provisions for corporate governance mechanisms are provided in the Commercial Code enacted in 1934 and generally rooted in the German civil law tradition. In 2001 the code was updated and modified to redress the most obvious deficiencies. It sets the general rules for corporate internal arrangements, providing for a two-tier board structure (separate management and supervisory boards), shareholders' powers and numerous minority-protecting prescriptions such as the right to call a shareholders' meeting, the right to challenge some companies' resolutions, the right to elect supervisory board members (cumulative voting) and access to information. There is no general rule on codetermination, however the commercialization and privatization laws provide for employee representation on the supervisory board (and on the management board) in privatized state companies.

The weakest and most criticized points in this regulation are those concerning the inability to vote either by mail or by the internet, the obligation to register shares prior to the shareholders' meeting, the high (10 per cent) limit required to call a shareholders' meeting as well as some legal inconsistencies in the definition of supervisory board accountability. Some other important provisions are incorporated into the capital market regulations (Law on Public Trading in Securities). This includes mandatory disclosure of information, takeover rules and special controlling powers (the so-called 'auditor for special purposes').

In spite of these considerable developments in its legal infrastructure, Poland still has problems with enforcement of ambitious legal provisions and the efficiency of the judicial system (see Table 6.2 for data on the abuses of stock exchange regulations). All this points to the fact that abuses of shareholders' rights are still common; however, there are some signs of improvement. The nature of these abuses evolved together with the changes in ownership and control levels. Initially, when ownership was moderately dispersed, opportunistic behaviour of managers was the major issue. This has taken the form of empire building, high remuneration contracts, favourable share options, and failure to reveal important information to shareholders and others.

The types of conflict changed with the appearance of blockholders, when relations between the controlling investors and minorities became a source of friction. Consequently, in recent years all kinds of shareholders' rights violations have been observed. In many cases, strategic shareholders have been accused of transfer pricing through various additional fees and costs. For instance the largest tyre maker, Stomil Olsztyn, controlled by Michelin, was suspected of transferring profits through excessive licence fees, disadvantageous export contracts and costly research and development support. It was estimated that these transfers might even amount to $50 million of additional costs for Stomil. This same scenario appeared in Agros – one of the largest players in the food-processing industry. After a takeover by Pernod Ricard, the company was accused of signing an unfavourable contract concerning the distribution of vodka beverages, awarding Pernod the exclusive 25-year lasting right to vodka brand names registered for Agros in the US without any fee being charged to the company. The controversy was brought to light when analysts revealed that the brand names were Agros's most valuable asset.

Table 6.2 Statistics on abuse of shareholder rights (number of cases)

Form of abuse	1996	1997	1998	1999	2000	2001	2002	2003	Total
Not disclosing information on acquiring or disposing of blocks of shares	7	6	19	4	7	5	11	7	66
Disclosing false information	4	1	1	1	3	–	–	4	14
Insider trading	6	4	1	8	10	6	12	9	56
Share price manipulation	0	1	5	4	2	4	12	11	39
Other	14	23	28	12	10	23	26	18	154
Total	31	35	54	29	32	38	61	49	329

Source: Polish Securities and Exchange Commission.

Another mechanism to obstruct minorities was through offering surprisingly low prices in the mandatory bids with a considerable discrepancy between the price for the controlling blocks and the price offered to the remaining shareholders. Some inconsistencies in legal provisions even made it possible for some takeovers to be feasible without a mandatory bid. This avenue was explored, for instance, by Pernod Ricard, who took control of Agros by acquiring a private company holding a strategic stake in Agros. Buying additional shares of a listed company from the state also allowed the mandatory bid to be avoided.

Takeover regulations have also been obstructed in another way. In a number of cases, share prices of quite large corporations owned by strategic investors had been underperforming in the market for several years: shares of another tyre maker, Stomil Debica – controlled 60 per cent by Goodyear – dropped by 70 per cent within three years and as a result Goodyear was suspected of being interested in pushing down the price to de-list the company cheaply.

Another group of problems included actions to hinder the execution of minority rights. This took the form of putting off or delaying the date of the general shareholders' meeting or rejecting particular shareholders' casting votes, which often resulted in the holding of two concurrent general meetings and the appointment of duplicate statutory bodies.

Whereas the list of anecdotal evidence on the expropriation of minorities is lengthy, the studies that systematically document the scale and extent of this practice are rare. Preliminary evidence in that respect is provided by Claessens et al. (2002), who discovered that, based on panel data for the 1997–2000 period, the value of corporations diminishes with the separation of control rights from cash-flow rights and when foreign strategic investors have a controlling interest. Paradoxically, this is not the case when companies are controlled by domestic investors. These findings confirm a common feeling that expropriation of minorities occurs. Trojanowski's (2003) study on block transfer premiums, however, suggests that the extent of these abuses is not so great since the control premium is fairly low (8 per cent) compared to other developing markets.[5]

Governance players

The developments in corporate governance practices that are reported mostly among listed companies are a response to market incentives that are created and transferred to companies through many channels, which can be grouped into three main categories.

NGOs and the media

Non-governmental organizations seem to be efficient in raising public awareness and promoting good governance practices. However, the number of NGOs active in that area is very small and those that are in place face some development barriers. The Individual Shareholders' Association (ISA), established in 1999, is the oldest and most active NGO with respect to minority rights. Apart from many promotional and educational campaigns, the ISA has been involved in many proxy fights since that time. The most spectacular was the case of Mostostal Płock – a civil engineering company – where the coalition of minority shareholders and the ISA with proxies from its members were able to elect one representative to the supervisory board. In another case the ISA strongly opposed a planned economically dubious merger between Mostostal Siedlce and its major shareholder Polimex, the latter being in a very poor situation economically. The merger finally took place but the terms and conditions were much sounder. In addition, the ISA forced Mostostal to declare publicly its policy with respect to dividend payouts. With a network of regional offices and about 2000 members, the ISA is playing a very positive role.

Another promoter of good governance is the Polish Forum for Corporate Governance which was launched in early 2001 by the Gdansk Institute for Market Economics. In spite of its academic background, it has been engaged in many practically orientated projects including among others drafting a voluntary governance code, corporate governance rating and thematic website. The third notable NGO is the Responsible Business Forum – the leader in promoting corporate social responsibility (CSR). This association, set up in 1999, deals with public awareness campaigns, issues a yearly report on CSR developments in Poland, and promotes governance and ethical codes. To complete this picture, the Shareholdership Promotion Foundation was set up in 2001 by academic institutions and a respected private brokerage house. It focuses mostly on the efficient capital market and has been engaged in some public campaigns for better regulations. The Polish Institute of Directors was also established in 2003, mostly providing training for management.

Although all the above-mentioned institutions are very active in the corporate governance area, the scale and the form of their activities is significantly constrained by funding. Most, if not all of them are financed from donations with minimal, or no, support from governmental sources. When donations come from the corporate sector, NGOs tend to engage only in the promotion of best practice, intentionally avoiding any strong and outspoken criticism as it might harm their future fund-raising prospects. These problems may be overcome if funding comes from foreign institutions, or those domestic sources that would have the strongest interest in better governance (institutional investors, for example). However, neither source is very accessible.

The funding problems that may discourage NGOs from being too critical about corporations are fortunately not so common in the case of the media.

Therefore the media could both promote best practice as well as publicize practices and corporate arrangements that interfere with shareholders' rights. In fact recently there have been many examples of both types of action: an annual award for the most shareholder-friendly company, funded by the business daily *Parkiet*, as well as the disclosure of scandalous insider trading practices among a group of some institutional investors.

Public and capital market authorities

The role of public authorities, including government and its agencies as well as capital market authorities, in advocating good governance is not so straightforward as those of NGOs. This is the result of the government's overlapping functions as an owner and as a regulator. The positive account of public authority actions includes a best practice code imposed by stock exchange authorities as well as some other actions and regulatory amendments that provide for stringent protection of shareholders in terms of disclosure and mandatory bids. On the other hand, the government has restricted the governance mechanisms of state-controlled companies by introducing a ceiling on management remuneration. This has created a lot of confusion and irritation among business circles, who argue that it could lead to tunnelling and opportunistic behaviour. Paradoxically, just three years after the remuneration ceiling was imposed, the Ministry of State Treasury issued a set of governance guidelines for state-controlled companies that even incorporated some provisions derived from the stock exchange governance code. This formal step forward, however, produced little if any result. As a recent report on state policy in respect of its shareholdings revealed, the government in fact lacks any real and consistent ownership policy and supervisory system (NIK 2005). Another confusing action undertaken by the government is the plan to impose a 'golden veto' scheme (to replace the golden share institution) to retain some control over strategic decisions in certain larger politically sensitive companies.[6] The imposition of a stock exchange best practice code is – to some extent – another example of contradictory signals for companies. The tentative execution and wishful prescriptions concerning governance arrangements has created more confusion than improved practice.[7] Another questionable move of the public authorities was to increase the threshold for a mandatory bid and their policy to make the delisting of public companies more difficult.

Institutional investors

Pension funds with their $15 billion in assets are becoming the most powerful players on the public capital market. They progressively contribute to advances in governance standards, leading to an improvement in the overall shareholders' activism movement. The institutional investors most frequently take the lead in monitoring corporate managers and performance. Since the late-1990s they have been involved in numerous corporate disputes that have led to the replacement of supervisory board members or improvements in conditions offered in mandatory bids. However, the institutional investors' involvement in enforcing good governance has not come up to expectations. Some regulatory constraints, such as ceilings for investing abroad, the requirement of a minimum rate of return as well as market structure (the four largest pension funds are responsible for about 75 per cent of the market) discourage them from implementing more active investment strategies. Moreover, the whole pension sector is very young and immature, and the funds themselves need to improve their own governance practices before taking a real lead in governance reforms in the market. An analysis conducted in 2003 by the Pension Funds Supervisory Authority revealed that the majority of funds lacked written internal rules in respect of managing conflicts of interest, voting policy and insider trading (KNUiFE 2003). The picture is changing slowly, with ING Nationale Nederlanden pension fund being the first to draw up its own internal governance guidelines with a few provisions being also relevant for their portfolio companies.

Venture capital and private equity funds operating in Poland play a surprisingly positive role in transferring good governance practices. The sector is not too big with about 30 management companies, $4.5 billion under management and a portfolio of about 300 companies. Most of these funds are of foreign origin with close links to renowned international investors (the European Bank for Reconstruction and Development, the International Finance Corporation and CalPERS, for example). This link, as well as specificity of equity investments (which stresses good governance as a way of lowering investment risk), means that fund managers are very effective governance 'reformers', whose actions also affect the public capital market as they have floated many companies on the Warsaw Stock Exchange. It is worth mentioning that the first management stock option plan was introduced in 1995 in a software company, Computerland, at that time controlled by a private equity fund. The venture capital and private equity funds were among the first to reform the position of supervisory boards, empowering them with real decisive powers (for example, control over sensitive transactions, appointment of an auditor) and structuring them so that they have become more credible (with the introduction of some kind of independent board members: persons not linked to a particular controlling shareholder). Moreover, the venture capital society is the first professional group to develop its own set of governance rules applicable to portfolio companies.

Recent developments in governance practices

Just five years ago poor statutory arrangements, low corporate and equity culture and a general unwillingness to go beyond the minimum standards required by law projected a rather discouraging image of the governance system in Poland. This picture is changing, although the pace of change is questionable in the light of the challenges awaiting the economy.

The improvements that have been made in governance arrangements are not widespread across the corporate sector. The group of leaders is rather limited and cannot be precisely defined. This includes companies that pay much more attention to governance standards than others, disclose more information (although generally, disclosure his improved except for private companies), and care about relations with their investors, providing them with reports and analysis. They also try to experiment with some 'innovations' in their statutes, such as board committees or independent board members.

The quickest changes appeared in the area of disclosure and access to information. Almost all listed companies run corporate websites, providing investors, in addition to the mandatory financial reports, with basic company charters and documents such as statutes, board by-laws, annual reports, shareholder assembly announcements and others. However, there is still a deficit of detailed governance reports as well as information on remuneration policy and management contracts. Providing material for shareholders' meetings (via websites) and information on candidates for board membership in advance of the general shareholders' meeting could also be improved.

There are also some examples of promising improvements in internal governance arrangements. The introduction of independent board members seems to be one such promising and the most far-reaching innovation. Although there seems to be general hesitation as to how this institution should be defined, structured and introduced, some 11 companies took the risk of experimenting with the idea. The largest domestic media player (Agora), two banks (BZ WBK, BRE Bank) and a software company (ComputerLand) have decided that their boards should comprise a majority of independent members. Five of the 11 have introduced the 'minority solution', that is, there should be at least two independent board members. The largest and renowned software maker Prokom has introduced an exceptional solution with only one independent member in the supervisory board. Another variation was applied by the large furniture maker (Forte), where 50 per cent of the supervisory board are independent members. However, with such a balance, the decisive vote is held by the chairman (who is not an independent member).[8]

The large kitchen equipment manufacturer Amica has also adopted an interesting and noteworthy way of instituting independent board members. The right to propose candidates for independent membership is held by the minority shareholders only, whose status is specifically defined (as those who own not more than 10 per cent of votes). During the election, each share carries one vote and additionally each shareholder (including the controlling one) may exercise no more than 5 per cent of his/her votes (voting cap). Moreover, independent board members have veto rights with respect to board decisions on sensitive transactions and the election of the auditor.

LPP – a medium-sized manufacturer and distributor of clothing – has recently declared that it will publish information about candidates for supervisory board membership on its website ten days before the shareholders' meeting, thus breaking with the poor tradition of announcing board candidates just minutes before voting. Seven other companies (Agora, BZ WBK, Amica, Netia, Eldorado, EFL and Prokom) also recently introduced some new measures to control related party transactions, going beyond current law provisions.

Some other examples of governance developments (although not very common) include improvements in corporate by-laws with respect to shareholder meetings, providing shareholders via a website with a template of the proxy documents, transmission of the company's general meetings via the internet as well as drawing up and disclosing detailed minutes from all of the general assemblies including discussions, motions and resolutions.

To complete this picture, there has been increasing interest in corporate social responsibility. Although CSR is generally treated as something strange and unusual there are many examples of ethical codes, social programmes and environmental policies adopted and reported by private and listed companies.[9]

Conclusions

Although the list of deficiencies and various weaknesses in the corporate governance system is long, the overall account is rather positive. Corporate and shareholder conflicts, doubtful enforcement and myopic regulators cannot preclude that the overall improvement is immense compared to the early 1990s. A significant part of this improvement can be attributed to the accession to the European Union and growing concern about the effectiveness of the legal infrastructure. The biggest problems faced by the governance system are on the behavioural side: enforcement and practice. This can be addressed by encouraging shareholder activism, improving private and public enforcement actions and public awareness campaigns. Independent and non-financially constrained NGOs can play a very important role in that process, providing balance and challenging benchmarks for weak and inefficient government agencies.

Table 6.3 Summary issues

Item	Poland
Key advances	• Corporation governance theme has attracted some public attention • Significant improvements in legal standards protecting minority rights • Further improvements in legal framework expected due to the obligation to adjust to European Commission directives and recommendations • Some companies 'experiment' with new governance arrangements (independent board members, board committees, corporate websites)
Key problems	• More shareholder activism needed; pension funds should be more active in promoting good governance standards • Poor liquidity of stock market makes voting control hardly contestable • Excessive political influence over management and supervisory boards of some state-owned companies • Insufficient interest in governance practices of family owned companies • Inefficient judicial system
Governance codes/guidelines available	• 'Best practices' adopted by Warsaw Stock Exchange in 2002 and amended in 2005. Introduced on a 'comply or explain' basis • Voluntary 'Corporate Governance Code' developed by Polish Forum for Corporate Governance (acting by the private think-tank, Gdansk Institute for Market Economics). Introduced on a 'comply or explain basis'. Structured in a similar was as OECD Guidelines with the emphasis on balanced structure of supervisory board • Internal corporate governance guidelines adopted by some pension funds (provisions on managing conflicts of interest, transparency, insider trading, voting policy in portfolio companies)

Notes

1. The author is co-founder of the Polish Forum for Corporate Governance. He would like to thank Maciej Dzierżanowski, Michał Przybyłowski and Grzegorz Milewski for their comments.

2. Several studies deal with ownership and control structures of private (non-listed) Polish corporations, for example: Belka et al. 1996; Kozarzewski 1999, 2000; Gardawski 2000; Grosfeld and Hashi 2001.
3. Mass privatization covered 512 larger industrial companies. Sixty per cent of their shares has been distributed among 15 investment funds established for this purpose, with the leading fund holding 33 per cent of the shares. The rest of the shares were split equally among the other 14 funds: 25 per cent was retained in state hands, and the final 15 per cent distributed among employees.
4. For more detailed figures on ownership and control of Polish corporations, see Dzierżanowski and Tamowicz (2002).
5. This low premium might also be attributed to poor market liquidity.
6. The European Commission will probably oppose this solution.
7. The most controversial is the requirement to have a majority of independent supervisory board members, which is inconsistent with prevailing ownership structures. This issue is further elaborated in Dzierżanowski and Tamowicz (2003), which deals with governance codes in Poland.
8. The law does not require the chairman of the supervisory board to be independent.
9. For a discussion of this issue, see the recent report on CSR in Poland, edited by the Responsible Business Forum, www.fob.org.pl.

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PART III

CORPORATE GOVERNANCE IN SOUTH EAST ASIA

7 State-dominated corporate governance system in transition: the case of China

Guy S. Liu and Pei Sun

Introduction

If one message is to be garnered from the proliferation of international corporate governance literature since the late 1980s (for example, Charkham 1994; Shleifer and Vishny 1997; La Porta et al. 1998, 2000), it is that the considerable cross-country variation on how business enterprises are governed has a profound impact on a country's international competitiveness in the epoch of globalization. Nowadays, it is virtually commonplace to claim that an effective corporate governance system in the business sector, however the word 'effective' is defined, constitutes one of the key micro foundations for economic prosperity at the macro level. In other words, there is a robust causal link between the effectiveness of corporate governance mechanism and a competitive corporate sector, which is in turn one of the most crucial determinants of national economic performance. For instance, the different records of economic growth between the US and the UK on the one side and Japan and Germany on the other during the last two decades of the twentieth century invite heated debate on the pros and cons of the Anglo-American corporate governance system *vis-à-vis* their German and Japanese counterparts (for example, Porter 1992; Mayer 1998; Allen and Gale 2000). The less than satisfactory transition experience in Eastern Europe and the Former Soviet Union in the 1990s can also be attributed, in significant measure, to the failure in establishing a sound corporate governance system encouraging wealth creation rather than asset stripping (Black et al. 2000; Stiglitz 2001).

China's continued blossoming as one of the world's major economic powers in the twenty-first century, likewise, has attracted an increasing body of research on the functioning of its economic system. Nevertheless, few aspects of China's economic transition and emergence into the world economy have been as poorly understood as its stock market and the associated corporate governance system, though it has a large potential of 'throwing off its emerging status to become the biggest and most vibrant in Asia' (Walter and Howie 2003, p. 242). In view of this shortcoming, this chapter provides an overview of the fledging corporate governance system in China since the early 1990s. Characterizing it as 'state dominated', we focus on the examination of the ubiquitous and complicated role of the Chinese state in developing and reforming its corporate governance system, in which a large number of the problems were ironically produced by the state itself.

Overview of the Chinese corporate governance system

It is virtually impossible to understand the emergence of the state-dominated corporate governance system without putting it into a broader context of China's 1990s economic reform. Unlike the big-bang mass privatization approach adopted by the Eastern European and Former Soviet Union (EEFSU) countries, the Chinese government, consistent with its gradualist and evolutionary reform strategy, has explicitly pursued a '2-R' policy – *retain* the government control of large state-owned enterprises (SOEs) that operate in the strategic sectors and *retreat* from small and medium-sized enterprises that operate in highly competitive markets (Green and Liu 2005). With regard to the restructuring of large SOEs, corporatization and stock flotation are the key measures used in the hope of transforming the SOEs into real modern business organizations while maintaining controlling state shares. In addition, the stock market has become a convenient vehicle of tapping household savings to finance the distressed SOE sector, not least because the cost of bank financing is escalating as the frail state banking system has deteriorated over the last decade. Thus it is little wonder that the government seems so enthusiastic about promoting the rapid expansion of the domestic stock market, which is further demonstrated in Table 7.1.

Over the period from 1992 to 2002, all the listed companies, more than 80 per cent of which are ultimately controlled by the state by 2001 (Liu and Sun 2005), have tapped public funds amounting to RMB 683.97 billion. In comparison, the companies have made net profits of RMB 476 billion in total (see Table 7.1), indicating that overall they have taken more funds from the public than they have returned. If we assume the proportion of state ownership in a company is 40 per cent on average, then RMB 582 billion is the net taking by the state from the public over the 11 years, indicating that RMB 475 million has been tapped by each listed company. Therefore, the following characterization of China's stock market is quite telling: 'it is operated by the state, regulated by the state, legislated by the state, and raises funds for the benefit of the state by selling shares in enterprises owned by the state' (Walter and Howie 2001, p. 4).

In contrast to the administratively independent regulatory bodies in the US and the UK, the state monopolizes access to equity finance in the sense that it has a final say on which firm is qualified to raise equity funds through initial public offerings (IPOs). Consequently, it is not surprising that the domestic equity market is primarily populated by a large number of former SOEs, though at face value state shares account for less than 50 per cent of total

Table 7.1 Development of China's stock market and its listed companies, 1992–2002

Year	No. of listed firms	Equity capital raised (RMBbn)	Total net profits of all listed firms (RMBbn)	Return on net assets (%)	Market capitalization as % of GDP
1992	53	5	2.4	14.3	3.93
1993	183	27.64	13.7	14.7	10.2
1994	291	9.98	21.4	13.2	7.89
1995	323	8.55	21.1	10.8	5.94
1996	530	29.43	28.2	9.6	14.5
1997	745	85.61	46.8	9.7	23.44
1998	851	77.8	48.8	7.5	24.52
1999	949	89.68	62.9	8.2	31.82
2000	1,088	154.09	77.2	7.6	53.79
2001	1,160	118.21	69.6	5.4	45.37
2002	1,224	77.98	83.9	5.7	37.43
Total		683.97	476		

Source: China Securities Regulatory Commission (2003), *Statistical Yearbook of China Securities and Futures*, www.csrc.gov.en.

shares subscribed in the public companies. Another distinct feature of the public corporations, until mid-2005, has been the strict constraint on the tradability of the corporate stocks, among which nearly two-thirds cannot be freely traded on the equity market.

As shown in Table 7.2, stocks on the Chinese stock market can be classified into two broad categories according to their tradability on secondary markets. Non-tradable stocks include state shares, legal person shares and employee shares,[1] while the tradable counterpart is composed of A-, B- and H-shares. A-shares are equity stakes sold through IPOs to domestic retail or institutional investors and traded on the secondary market. B-shares refer to those traded in foreign currencies (US dollars on Shanghai Stock Exchange and Hong Kong dollars on the Shenzhen Stock Exchange) by overseas and domestic investors.[2] H-shares generally concern those issued by Chinese public limited companies to foreign investors through listings on the Hong Kong Stock Exchange. With respect to the official definition of the non-tradable part, state shares are held by government agencies or state-authorized organizations at either the central or local levels, whereas legal person shares are those owned by domestic institutions and enterprises with legal person status.[3] However, it is difficult to appreciate the subtle difference between the two categories without examining in detail the incorporation and listing process of Chinese companies.

To the extent that a majority of Chinese listed firms are transformed from former state enterprises, Figure 7.1 illustrates a typical restructuring process of an SOE in preparation for its public listing.[4] It is called ‘carve-out’ listing in the sense that the former SOE carved out a portion of profitable physical assets to establish a new company for flotation. In return for the assets injected, the parent SOE receives non-tradable state or legal person shares in the new company, which is then listed on equity markets by selling new tradable shares (A-, B- or H-shares) to the general public. Since the post-restructuring state and legal person shares are not tradable on the secondary market, it in principle prevents a rapid dilution of state ownership, which was precisely designed to assuage the ideological concerns of conservatives within the communist party especially in the early 1990s.

Alongside the wave of global corporate governance movement, the state has also engaged in some institutional reforms aiming to improve the efficiency of corporate governance. Table 7.3 provides a taxonomy of legislation and regulations that highlights the reform progress.

As shown in Table 7.3, the development of corporate governance in China started in December 1993 with the enactment of the Company Law, regulating the basic governance framework of modern business enterprises. The law specifies the ‘one-share, one-vote’ principle, and thus distinguishes Chinese firms from those in other countries where voting rights can be different from

Table 7.2 Aggregate distribution of the official shareholding classes in Chinese publicly listed companies (%)

	1997	1998	1999	2000	2001	2002	2003
Total non-tradable shares	65	66	65	64	65	65	65
of which,							
State shares	32	35	37	39	46	47	47
Domestic legal person shares	30	28	26	23	17	17	17
Overseas legal person shares	1	1	1	1	1	0.7	0.8
Employee shares	2	2	1	1	1	0.3	0.2
Total tradable shares	35	34	35	36	35	35	35
of which,							
A-shares	23	24	26	28	25	26	27
B-shares	6	5	5	4	3	3	3
H-shares	6	5	4	4	6	6	6
No. of listed companies	745	851	949	1088	1160	1224	1287

Note: The table reports the aggregate distribution of the officially defined shareholding classes in all of the Chinese public corporations. *State shares* are stocks held by government agencies, such as state asset bureaux and government-authorized institutions. *Legal person shares* are owned by domestic/overseas institutions, be they enterprises or other economic entities enjoying legal person status. *Employee shares* are offered to workers and managers of a listed company usually at a substantial discount. *A-shares* are the ordinary equity shares mostly held and traded by retail/institutional investors in RMB on the domestic stock exchanges. *B-shares* refer to those that were once exclusively traded by foreign investors denominated in foreign currencies until 2001, when domestic investors can also hold these shares. *H-shares* concern the shares issued by Chinese corporations to foreign investors through listings on the Hong Kong Stock Exchange.

Source: China Securities Regulatory Commission.

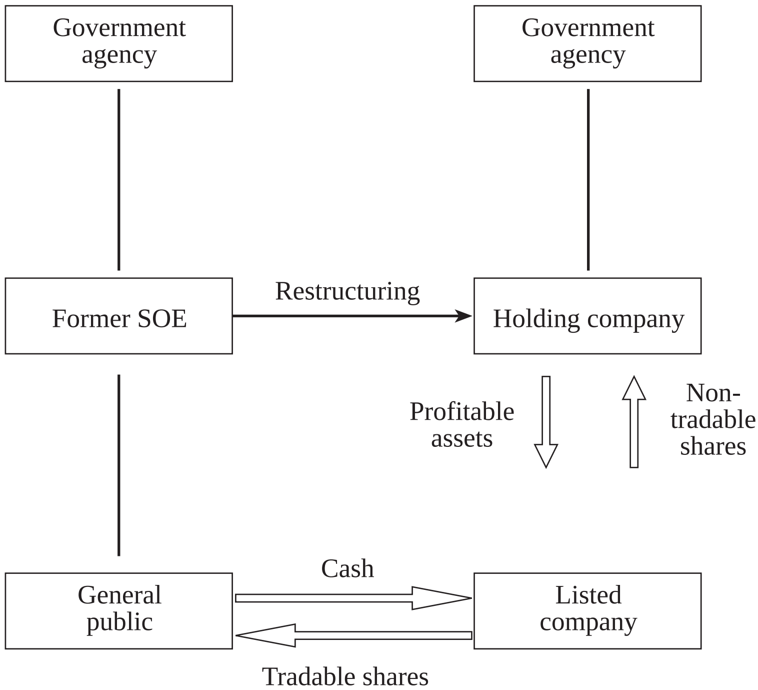

Figure 7.1 The 'carve-out' listing of a Chinese SOE

shareholding rights. Also, the law adopts the German two-tier board governance structure – board of directors and a supervisory board – for Chinese companies. However, it differs from the German board structure in that the supervisory board does not have the right to appoint and dismiss executive board directors in China, and more importantly, no sufficient resources and meaningful enforcement mechanisms are put in place to ensure its monitoring function. Five years after the introduction of the Company Law, the Securities Law was enacted with the aim of ensuring that stock markets be transparent, open and fair for investors.

However, as far as the protection of minority investors' interests is concerned, the legislation is inadequate in many respects, largely due to the government's limited experience at the time when the laws were drafted. For example, there is a lack of effective measures to prevent controlling shareholders from expropriating the assets of the publicly listed companies. To redress the problem, the government further introduced a series of supplementary regulations: one year after the introduction of the Securities Law, the Ministry of Finance issued a new regulation that required listed companies to

Table 7.3 Laws and regulations in China's corporate governance development

Legislative/regulatory body	Year	Document of legislation and regulation	Main points
People's Congress	1993	Company Law	Provides legislation to set up a modern company in China
Commission of Economic System Restructuring	1994	Regulatory opinions on shareholding Limited companies	Provides regulatory codes for the set-up of shareholding firms
People's Congress	1998	Securities Law	Provides legislation for a stock market that is to be transparent, open and fair for public investors
Ministry of Finance	1999	The accounting principles for related-party transactions and their disclosure	Introduces new rules to disclose related-party transactions
China Securities Regulatory Commission (CSRC)	2000	Notice to the listed companies providing loan guarantees to other companies	Bans listed companies from providing finance guarantees for related parties

Table 7.3 Continued

Legislative/regulatory body	Year	Document of legislation and regulation	Main points
Shanghai Stock Exchange (SSE)	2000	Guidelines for corporate governance of companies listed on the SSE	Provides detailed codes of corporate governance for firms listed on the SSE
CSRC	2001	Guiding opinions on establishing an independent director system in listed companies	Specifies 1/3 of board directors to be independent
CSRC, State Economic & Trade Commission (SETC)	2002	Code of corporate governance for listed companies	Provides the State regulatory code guidelines for firms establishing a corporate governance system
CSRC	2002	Regulatory measures for listed companies' mergers and acquisitions	Encourages takeover, which can be made in two forms: negotiated transfer of non-tradable shares and tender offer for tradable shares

CSRC, Ministry of Finance, and SETC	2002	Notice on the transfer of state shares and legal person shares to foreign investors	Allow foreign investors to take over Chinese listed companies
People's Bank of China	2002	Corporate governance guidelines for commercial shareholding banks	Provides the code of corporate governance for banks
CSRC and People's Bank of China	2002	Pilot procedures regarding qualified foreign institutional investors (QFIIs) in the domestic securities market	Allows QFIIs to enter the Chinese stock market

improve information disclosure on their related-party transactions. Moreover, to prevent the controlling shareholder's appropriation of the company assets, not only did the Shanghai Stock Exchange (in 2000) introduce the first systematic corporate governance code, albeit of a voluntary nature, for listed companies, but the China Securities Regulatory Commission (CSRC) also introduced three supplementary regulations. First, in 2000 it banned listed companies from providing loan guarantees for any related parties, including their parent firms and their unlisted subsidiaries. Second, it issued the regulatory concept of 'the five separations': the separation of a listed company from its controlling shareholder with regard to its employees, assets, accounting, business operations and organizations. Third, since 2001, it has been mandatory for all listed companies to appoint independent directors that account for at least one-third of board directors. However, the existing evidence on the introduction of independent directors in listed companies is not as encouraging as one might have expected. Schipani and Liu (2001) report that 'many independent directors find it difficult to exert any substantial influence, other than symbolic, with the board'. Lin (2001) finds that the position of non-executive directors is reserved for honorary appointments of distinguished personalities, who are assumed to be able to lend prestige to the company or provide political or commercial connections. A more general concern is about the scarcity of qualified candidates for the independent directorships in the current institutional context (Tam 1999).

The state further drafted a more detailed corporate governance code for the domestic listed companies in January 2001, and this took effect in 2002. The code combines all the governance measures introduced previously; in particular, it requires listed companies to establish specialized committees within the board of directors, such as an audit committee, a nomination committee and a remuneration committee. It would seem that the code imposes both the Anglo-American one-tier model with specialized committees and the German two-tier board structure on Chinese corporations.

In addition, new regulations were enacted in 2002 with respect to the market for corporate control. Specifically that can be achieved, first, by a tender offer for tradable shares in the open market, and second, by block transfers of non-tradable shares outside the market. The competition for corporate control was further enhanced by allowing foreign entry, since the three government departments jointly issued a regulation permitting state or institutional shares to be transferred to foreign investors.

Dual role of the state: regulator versus company owner

As we have seen in the section above, the government has played a key role in introducing new regulatory measures that are mandatory. For instance, the compliance of audit committees in British quoted corporations tends to be a market-led voluntary practice, but in China audit committees have their regulatory status, which is designed and enforced by the government departments: the CSRC and the State Economic and Trade Commission (SETC) (Chambers 2005). One explanation for the direct involvement of government in the development of institutional infrastructure, rather than the British-styled market self-regulation, is that legal development is still in its infancy in emerging economies like China as compared with developed countries (Liu 2005). With an incomplete legal system, a certain degree of government involvement can be a viable alternative for promoting capital market development (Pistor and Xu 2005).

One of the foremost concerns about the role of government in the corporate governance system is the inherent conflict of interests induced by the fact that while the state acts as the regulator of the system, it is also the controller of a majority of the listed companies. Liu and Sun (2005) identified that more than 80 per cent of listed companies were ultimately owned either by central or by local governments via a stock pyramid mechanism (see Table 7.4). That the state is the controlling shareholder of listed companies could result in a conflict of interest with the government's social and regulatory responsibilities. By way of illustration, in 2002 the CSRC decided to transform the non-tradable shares into tradable ones. The dumping of non-tradable shares on to the market implied that stock prices would plummet as a result of the surge of supply. Since the sell-off was not expected to generate enough financial interest due to the strong negative response from the retail investors, the government departments, as the holders of the controlling non-tradable stocks, were not enthusiastic about the plan. Furthermore, the conversion of non-tradable to tradable shares threatened the vested interests of various local government agencies which had once captured enormous rents for the non-tradability arrangements. So despite the potential efficiency improvement that could have resulted from the share-conversion reform, covert resistance from local government, together with the retail investors 'voting with their feet', ruined the sell-off plan. It was suspended until 2005 when a trial of the reform has been resumed by a limited number of companies.

The conflict of interest between the SETC and the CSRC shows the politics dimension on China's corporate governance development (for example, Green 2004). In particular, the separation of the state's ownership function from the state's market regulation function causes a conflict of interest between different government departments. It has been advocated that the state should withdraw its control of companies as the best solution to the problem. Although the reform has been developing along this direction, the progress of privatization is slow and gradual (Liu et al. 2005). Moreover, the complete removal of state ownership from the corporate world is infeasible due to the existing political and ideological constraints. However, corporate

Table 7.4 Who ultimately controls China's listed companies by the end of 2001?

Status of the largest shareholder of a publicly listed company	Number of companies as percentage of total number listed	Average controlling stakes held by largest shareholder (%)
State as the ultimate controlling shareholder		
Direct control		
Government departments/agencies	9.0 (102 firms)	38.1 (16.5)
Indirect control		
State-controlled institutions of which	72.6 (825 firms)	49.1 (16.7)
(1a) State-controlled publicly listed firms	2.6 (30 firms)	52.9 (19.2)
(2a) SOEs	58.9 (668 firms)	49.4 (16.5)
(3a) State-controlled unlisted companies	10.0 (114 firms)	46.6 (17.2)
(4a) State-owned academic institutions	1.1 (13 firms)	43.7 (14.7)
Total state-controlled companies	81.6 (927 firms)	47.9 (17.0)
Non-state firms/families as the ultimate controlling shareholder		
(1b) Non-state-controlled publicly listed firms	0.2 (2 firms)	19.1 (10.4)
(2b) Unlisted collective firms & TVEs	4.8 (54 firms)	41.5 (17.9)
(3b) Unlisted domestic private firms	12.8 (145 firms)	33.9 (13.8)
(4b) Unlisted foreign private firms	0.7 (8 firms)	36.8 (17.5)
Total non-state controlled companies	18.4 (209 firms)	35.9 (15.4)
Grand total of firms in the sample	100.0 (1136 firms)	45.7 (17.4)

Source: Liu and Sun (2005).

governance reform has not been brought to a halt by this constraint. The CSRC has enhanced its leading role in the reform in collaboration with other government departments, notably the SETC. Conflict can only be resolved either by the replacement of one with another or by coordination. China has adopted the latter approach by strengthening the collaboration between government departments in advancing the reform. For example, Table 7.3 shows that the CSRC in conjunction with other government departments introduced a series of new regulations to improve corporate governance in 2002. It also strengthened the enforcement by employing more resources to intensify investigations: 220 investigations were conducted during 2000–02, equal to the sum of all investigated cases during 1993–98. Of the 220 cases, 92 were found guilty, and fines imposed on them amounted to a total of RMB 1.5 billion (*Shenzhen Business Daily*, 18 February 2002).

Our discussion indicates that the internal conflict of interest within the state is one particular problem in China's corporate governance. So far the problem has been addressed by strengthening the coordination between government departments that have different interests and functions with respect to the stock market and the corporate sector.

Ownership concentration, state control and asset expropriation

Ownership structure is a vitally important variable affecting corporate governance behaviour. Often, the moral hazard problem of management is more dominant in a dispersed ownership structure since companies with such a structure are usually under the control of internal management. In contrast, when ownership is highly concentrated, the private control bias that leads to potential fund diversion and asset expropriation by controlling shareholders becomes the more relevant concern (Johnson et al. 2000; La Porta et al. 2000; Denis and McConnell 2003).

China is no exception to this, since there has been serious concern about the private control bias in recent years due to the highly concentrated ownership structure in listed companies. As seen in Table 7.4, on average the state holds about 48 per cent of shares, similar to the amount held by companies controlled by private parties. Indeed, it is widely reported that asset expropriation by controlling shareholders has become a common phenomenon in China. It was estimated by the CSRC that assets that had been tunnelled by the largest shareholders amounted to RMB 138.6 billion during 1997–2002, which is equivalent to an average of RMB 40 million per firm per year. For instance, it was discovered by the CSRC that a family controlling shareholder in 2003 diverted RMB 102 million from its public company, HaCi Co. Ltd, to the parent company, HaCi Holding Ltd. Meanwhile, the private owner further transferred RMB 253 million to his unlisted arm, Haerbin High Tech Ltd (Shanghai Stock Exchange 2005, p. 139). In the same year, another nine private controlled listed companies were also found guilty of serious asset expropriation behaviour.

Private companies are not alone in undertaking perverse tunnelling activities; government shareholder expropriation can best be illustrated by the case of Kelon Co. Ltd. According to Liu and Sun (2006), before Kelon went public, the Rongqi township government in Guangdong province held 80 per cent of cash-flow rights over the firm. Its ownership stakes fell sharply to little more than one-third of the total after the flotation (see Table 7.5). Nevertheless, the government still maintained a larger shareholding than the 'critical control level' (Cubbin and Leech 1983) calculated in Table 7.5, which clearly indicates that the government control in Kelon remained incontestable. Therefore, a substantial deviation of cash-flow rights from control rights prevents the dilution of government control after the listing. That is, the government

Table 7.5 Kelon's top ten shareholders after Hong Kong and Shenzhen quotation

After Hong Kong but before Shenzhen listing		After Shenzhen Listing	
Top ten shareholders	Shares held (%)	Top ten shareholders	Shares held (%)
Guangdong Kelon (Rongsheng) Group	38.31	Guangdong Kelon (Rongsheng) Group	34.06
Standard Chartered Bank	12.31	Standard Chartered Bank	8.63
HSBC Co. Ltd	12.04	HSBC Co. Ltd	7.47
Chase Manhattan Bank	10.19	Franklin Templeton Group	6.92
Citibank N.A.	6.16	Chase Manhattan Bank	5.87
Morgan Stanley Dean Witter Hong Kong Securities Ltd	1.87	Citibank N.A.	5.24
Bank of Bermuda Ltd	0.54	Deutsche Bank AG	2.85
Jardine Fleming Broking Ltd	0.53	Morgan Stanley Dean Witter Hong Kong Securities Ltd	0.74
Deutsche Bank AG	0.5	Jardine Fleming Broking Ltd	0.64
Merrill Lynch Far East Ltd	0.49	Tongyi Securities Investment Fund	0.17
		Taihe Securities Investment Fund	0.17
Critical control level	37.32		33.44

Source: Liu and Sun (2006).

contributed only 34 per cent cash flow but enjoyed virtually complete control of the company. The dilution of income rather than control rights makes the government indifferent to the dividends it receives from the listed firm; rather, it captures private control benefits at the expense of long-run profitability.

As a result, Rongqi township government via its controlled Guangdong Kelon (Rongsheng) Group diverted a total of RMB 1.26 billion ($150 million) from the listed Kelon Electrical Holdings Co. Ltd through a string of secretive related-party transactions from 1997 to 2001. Table 7.6 organizes most of these into three categories and displays them in detail. Note that such related-

Table 7.6 Major fund diversion between Kelon and Guangdong Kelon (Rongsheng) groups, 1997–2001

Year	Kelon → Rongsheng Group[1]	Rongsheng Group ←Kelon[1]	Balance (RMB)
Bank loans and interest payments[2]			
1997	308,373,000	410,299,000	–101,926,000
1998	7,163,622,000	7,106,870,000	56,752,000
1999	4,389,922,000	4,362,194,000	27,728,000
2000	4,599,826,000	4,496,662,000	103,164,000
2001	5,083,814,000	4,378,515,000	705,299,000
Sub-total			791,017,000
Loans guarantee[3]			
2001	211,220,000		211,220,000
Payment transfer[4]			
2001	101,370,000		101,370,000
Total			1,103,607,000

Notes:

1. Kelon → Rongsheng Group: the direction of fund diversion is from Kelon to its parent; Rongsheng Group → Kelon: the reverse.
2. Bank loans and interest payments: the situation in which Kelon and its holding company share their respective lending quota in commercial banks by obtaining loans in each other's name. That is, the holding company has access to bank loans taken out by Kelon, and the reverse also holds. Moreover, they pay back the debt and interest to each other: For example, Kelon may have to pay the principal and interest that its parent owes to the banks. The annual and accumulated balances of the fund exchange are shown in the 'balance' column.
3. Loans guarantee: the holding company has illicitly asked one of Kelon's subsidiaries to stand guarantee for a bank loan worth RMB 0.21 billion in mid-2001. Since the holding company failed to service this debt, Kelon was obliged to pay the principal and interest.
4. Payment transfer: the holding company has asked Kelon to buy products in 2001 from a joint venture between Kelon and the Sanyo Group (Japan) at a cost of RMB 101.4 million, which Kelon has paid for in cash.

Source: Liu and Sun (2006).

party transactions are a two-edged sword, that is, *on balance* the controlling shareholder could either tunnel funds from its listed subsidiary or inject cash into the company for the benefit of all shareholders (Friedman et al. 2003). Table 7.6 shows that in 1997, the holding group in effect contributed more than RMB 100 million net to Kelon. The dynamics, however, was a reversed trend that signified the increasing expropriation of Kelon's funds, especially in the years 2000 and 2001. Taking 2001 as a case in point, it can be seen from Table 7.2 that the government-owned holding company managed to channel more than RMB 1 billion from Kelon in less than 12 months, given that the net assets Kelon had at year-end 2000 was only RMB 3.96 billion.

In addition to the tunnelling problem, Kelon had also experienced agency problems because of the separation of management from state control, which allowed managerial discretion and opportunism. For example, the expenses–sales ratio was 50 per cent higher in Kelon than its competitors in 1999 and it rose further to 166 per cent in 2000. The higher degree of separation of management from ownership makes state-controlled public corporations not very different from many UK and American companies from the perspective of ownership separation. This largely explains why both state-controlled and ownership-dispersed private companies experience a similar agency problem – managerial moral hazard.

Clearly, the Kelon case demonstrates that public companies under government control can induce two governance problems simultaneously. The first is the exploitation of minority investor interests by controlling shareholders. This is similar to what we have observed in Continental European and South East Asian companies with the family as the ultimate controller, where the separation between managers and family owners is minimal. The second is management unaccountability, which usually occurs in ownership-dispersed US and UK companies. That is to say, the Chinese experience augments the conventional wisdom concerning the link between ownership structure and corporate governance problems: government-controlled public companies threaten to combine the incentive problems associated with their family counterparts both in terms of large shareholder expropriation and with the widely held companies on managerial unaccountability.

Fighting large shareholder expropriation by regulation

The significant scale of large shareholders' predatory behaviour reflects institutional deficiencies in enabling the public to play an effective role in monitoring listed companies. To address the issue, the government has introduced a series of regulations that aim to improve the disclosure of corporate information to the public. These include the Accounting Principles for Related-party Transactions and their Disclosure, issued in 1999, Notice to the Listed Companies Providing Loan Guarantees to other Companies, in 2000, and

Chapter 7 on information disclosure and transparency in the Code of Corporate Governance for Listed Companies in China, with a regulatory status jointly issued in 2002 by two government departments – the CSRC and the SETC.

Chapter 7 of the Code is very similar to the OECD standard of corporate governance in requiring that disclosure be accurate, timely and complete on all information regarding the corporation, including financial and operating results, company objectives, related party transactions, major share ownership and voting rights, and other corporate governance issues such as remuneration policy and the selection of board directors. However, some differences remain between the OECD Principles and the Code. The former emphasize the disclosure of foreseeable risk factors and issues regarding employees and other stakeholders, which are absent in the latter document. This shows the different benefits that each document confers on the groups of stakeholders and shareholders. In addition, OECD Principles state precisely that external auditors shall be responsible for the disclosure of information to shareholders. But China is different: the secretary of the board of directors shall be in charge of information disclosure, reflecting a key difference in emphasis of different bodies to be accountable for disclosure between the two documents.

The OECD Principles and the UK code of corporate governance are voluntary codes for corporations to adopt, but empirical evidence shows that they are sufficient to make corporations responsive to the improvement of their governance practices in line with recommendations (see Marchica and Mura 2005; Thompson, 2005). In contrast, given the regulatory status of the Chinese Code, will the mandatory approach ensure that public corporations comply with the new regulations? Table 7.7 shows the number of cases that were found to violate the rule of disclosure over the period from 2002 to 2004.

Each year from 2002 to 2004 more than 5 per cent of listed companies were

Table 7.7 Number of companies identified as violating Chapter 7 of the Code between 2002 and 2004

	No. of all identified firms with violation	No. of identified private firms with violation	Total no. of listed companies
2002	72	23	1224
2003	61	24	1287
2004	75	35	1377
Total cases	208	82	–
of which repeat violations	45	23	–

Source: Adapted from Shanghai Stock Exchange (2005, Table 7.1).

found to have violated the regulation of disclosure, and this proportion is little changed even three years after the introduction of the rule. Surprisingly, of all the cases in the table, 31 per cent were privately controlled companies in 2002, with 39 per cent in 2003 and 47 per cent in 2004. Thus these ratios were higher than the proportion of private companies in the total number of listed companies (18.4 per cent in 2001, see Table 7.4). One reason for this is that more than half of them were loss-making, with average earnings per share (EPS) of –0.002 in 2003 and –0.015 in 2004. And they are even lower than the average of all the 'wrongdoers': 0.01 in 2003 and 0.002 in 2004 (Shanghai Stock Exchange 2005, Table 7.5). According to the regulations, a company with three consecutive years of losses will be de-listed from the market, so loss-making firms may have a higher motivation to risk violating the Code.

Another major reason for violating the rules is the temptation to yield to asset tunnelling (Shanghai Stock Exchange 2005). Some 53 per cent of violations were related to the provision of loan guarantees and fund transfers to the controlling shareholders' related parties. In addition, 27 per cent of the firms perpetrated fraud in their accounting reports to mislead public investors.

That there is no sign of decline in the incidence of violation after three years since the introduction of the Code has largely to do with the moderate levels of punishment. Among the 208 violation cases in Table 7.7, only 29 were fined, less than 15 per cent of the total. The rest were dealt with through public shaming (35 per cent) and a disciplinary warning (51 per cent), the latter thus being the major form of penalty for code violation (Shanghai Stock Exchange 2005, p. 132). The light penalties may partly explain why enforcement of the law and regulations is not very effective in ensuring that companies comply with the Code for governance improvement.

To summarize, in order to fight large shareholders' predatory behaviour and other irregularities, since 2002 the Chinese government has made efforts to strengthen its regulatory framework via the improvement of information disclosure and transparency at the company level. The battle, however, is far from over. This is because the benefits of wrongdoing are much higher than the costs in the current institutional environment, where legal and regulatory enforcement tends to be weak.

Conclusion

From the investors' viewpoint, can China be regarded as a country with a weak corporate governance system in which minority shareholder rights are inadequately protected and law and regulations are poorly enforced? This chapter offers two views of the issue. First, as the regulator for the emerging equity market, the state is a leading player in the improvement of the institutional and corporate governance system through an intensive campaign on the import of corporate governance best practice from the West. In particular, it adopts a mandatory approach with the aim of building up investor confidence in the listed firms. In addition, as the owner of the majority of publicly listed companies, the state also has an interest vested in the sustainable growth and profitability of corporate business. Through the improvement of internal governance structure, it hopes to reduce the managerial moral hazard. Thus, the objectives of maintaining investor confidence and of controlling agency costs on the part of the state explain why China has been able to move rapidly in introducing corporate governance laws and regulations, at least on paper.

The second view relates to the internal conflict of interest within the state. The separation between ownership and regulatory functions is a two-edged sword. It is good for bringing state firms under law and regulation control, but it creates a conflict of interest. In particular, when ownership interests clash with regulatory interests, then which one should be treated as the priority? The conflict can be solved by strengthening central coordination, but there has to be a certain degree of compromise between the two conflicting parties – both government departments. The compromise may explain why the enforcement of corporate governance regulations is relatively soft and inadequate due to the inter-agency struggle. When the state is the dominant shareholder in the majority of the listed companies, it could be more difficult to enforce the rules on these companies in a rigorous manner. Therefore, the soft enforcement may be endogenous to the state-dominated corporate governance system, but this will result in a significant reduction in the cost of violating the rules not only for state-controlled listed firms but also for their private counterparts.

It is clear from our elaboration above that with the state-dominated system in place, achieving adequate and effective enforcement of laws and regulations in practice rather than on paper is a key challenge for China in order to improve its corporate governance, which in turn has a significant bearing on the efficiency of its financial system and the long-term competitiveness of its business sector.

Notes

1. It should be noted that non-tradable does not necessarily mean non-transferable, since state and legal person shares can be transferred among various institutions subject to government approval, but the crucial point here is that after the transfer these shares still remain non-tradable on the market. Employee shares are offered to workers and managers of a listed company usually at a substantial discount. Initially they were not tradable until they had been held for a minimum of six to twelve months and the company concerned has filed an application of market transaction to the securities regulatory commission.
2. The separation of A- and B-shares is due to the inconvertibility of RMB in China's capital account.
3. A substantial part of the negligible percentage of shares held by overseas institutions (overseas legal persons) are actually Chinese firms registered in Hong Kong or other tax-friendly jurisdictions.
4. For an informative description of the share types and listing process of the firms from a practitioners' perspective, see Walter and Howie (2003, chs 4 and 5).

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8 Corporate governance in Japan

Christina L. Ahmadjian and Ariyoshi Okumura[1]

Introduction

Since the early 1990s, corporate governance in Japan has been in the process of transformation. The post-war system of governance, marked by the balance of a set of intertwined stakeholders – labour, management, capital, buyers and suppliers, and the state – has been unravelling as foreign investors pressure firms to adopt more 'Anglo-American' practices and Japanese corporate executives institute more flexible and fast-paced decision-making systems. As the pillars on which the Japanese system was based – the main bank system and bank-based finance, the permanent employment system and cross-shareholding – weaken, the post-war system has become obsolete, leaving a 'corporate governance vacuum' that a new system has yet to fill.

In some areas, changes have been striking. Managers have shifted their attention towards delivering a return on equity investment to shareholders. The old consensus-based system of decision making has given way to stronger CEOs, as well as greater autonomy for divisions and business units. New accounting regulations have increased reporting transparency and loosened the obligational networks of cross-shareholding. Foreign investors hold substantial stakes in an increasing number of firms. In other aspects, however, changes are less pronounced. Independent directors are still rare. Executive compensation remains at moderate levels, and senior executives are cognizant of the need for balance between their compensation and that of their employees. While restructuring is widespread, Japanese firms have yet to adopt US values that justify downsizing in the interests of shareholder value. Furthermore, even as of 2005, the mention of the words 'corporate governance' in a roomful of Japanese corporate executives or government officials would likely trigger a bitter argument on whether Japan should abandon the 'Japanese' values and practices that had been so effective in guiding the 'economic miracle' of the post-war period to become more like the United States.

The post-war system of corporate governance

Bank-dominated financial system

One of the central features of the post-war financial system was the main bank system. During the post-war period, firms were heavily dependent on bank loans to fund their rapid growth. The main bank coordinated a firm's financing activities and watched it carefully to ensure that it had the managerial capability to grow, continue to procure financial services and pay back its loans. Main banks led restructuring activities when a firm faced financial crisis, and were known to intervene when they believed senior management to be no longer competent. Banks were able to do this in part through utilizing the enormous hidden reserves accumulated within their security portfolios. In the early post-war period, banks had purchased shares in firms to cement ongoing banking relationships. Although these shares had appreciated dramatically, accounting regulations allowed banks to continue to report them at book value, giving them a huge cushion of unreported gains.

Cross-shareholding

Cross-shareholding was another key feature of the post-war system. This refers to two types of relationship – the direct exchange of shareholding stakes when firm A holds shares in firm B, and vice-versa, as well as indirect relationships, when firms are tied through a third party; in other words, firm A holds shares in firm B, which holds shares in firm C (Okabe 2002). As a result of cross-shareholding, corporations and financial institutions were dominant shareholders in many firms: in the late 1980s, financial institutions held over 40 per cent of shares of listed firms, while industrial corporations held about 24 per cent (Tokyo Stock Exchange 2003a).

Corporate and financial shareholders tended to have business interests above and beyond their equity investments. For example, buyers held stakes in their suppliers; groups of affiliated firms, such as the railroads, department stores and entertainment businesses, held each other's shares; life insurance companies held shares in firms to which they sold employee life insurance policies; banks held shares in firms that depended on their services. Because shareholding supported business relationships and provided a framework for long-term obligational relationships, financial institutions and corporations were extremely unlikely to sell these shares, and were thus known as 'stable shareholders'.

This does not mean that shareholders did not care about the value of their equity investment. Rather, shareholders tended to consider the value of their investment based on not only the value of the equity stake, but also the value of the entire, ongoing business relationship.

The permanent employment system and norms of community

It is impossible to discuss the post-war corporate governance system without reference to permanent employment, the system by which employees of large firms were assured a job until retirement. This system arose in the post-war period, through an implicit agreement in which management exchanged permanent employment for labour peace and cooperation (Gordon 1985; Kume 1998).

Management's obligation to maintain employment became a deeply ingrained norm. Distinctions between management and labour, and between executives and employees were narrowed, as senior management came from the ranks of other employees. There evolved a strong sense of a company as a community, in which shareholders had a secondary role (Dore 2000). This perspective was epitomized by Nozawa Shohei, the president of the failed Yamaichi Securities, who burst into tears at a press conference, later explaining: 'I couldn't help but cry when I thought about the future of our 7,600 employees and their families' (Yamamoto 1999).

These norms around company as community extended to a firm and its suppliers, customers and other business partners. It was seen as heartless for a firm to sever a relationship with a long-term supplier, or for a bank to fail to assist a troubled customer. A critical task of management was to balance these obligations to employees, suppliers, customers and other stakeholders and allocate pieces of the economic pie (which, during the post-war period was ever-increasing) among these stakeholders.

Boards of directors and decision making

In the post-war system, firms had a distinctive set of decision-making practices and board structure. Boards tended to be large – for example, in 1990, Sony's board had 36 directors while Nippon Steel's had 42. Board members tended to have operating responsibilities and outside board directors were rare and far from independent. Outside directors were often *amakudari* – government officials 'sent down from heaven' in the direct translation from Japanese, to provide a conduit between the company and a ministry and to spend a few years before retirement supplementing their meagre government salaries at far more lucrative private sector rates. Other outside board members were often executives from banks, customers or parent companies, sent to oversee the operation, solidify good relationships or lead the turnaround of a troubled company.

One reason why boards were large was that board membership was the ultimate prize of the permanent employment system. A diligent and loyal employee could aspire to become a board member, even if the position of president (*shachō*) was out of reach. In the absence of gross negligence or criminal behaviour, the president could expect to move up to become chair, or *kaichō*, and then to senior adviser (retaining a company car, office and other perquisites).

The Japanese Commercial Code also required firms to have *kansayaku*, or statutory corporate auditors whose role was to audit the board of directors for compliance to law and business judgement and to check financial audits. Large firms were required to have at least three *kansayaku*, one of whom had to be an outsider (these outside *kansayaku* cannot really be called independent, because the position was open to former employees, provided that they had not worked for the firm for five years). Although according to the law shareholders appointed the *kansayaku*, in fact, they served at the pleasure of the president. Although the *kansayaku* reported their findings to the annual shareholders' meeting, they had no vote at board of directors' meetings, and no power to appoint or dismiss the president.

Commercial Code

The *kansayaku* system bears a weak resemblance to the German supervisory board system. This is not a coincidence: the first Japanese Commercial Code, promulgated in 1899, was drafted by a German based on the German commercial code (Milhaupt and West 2004). The present Commercial Code is largely the product of revisions beginning in 1949 under the US Occupation, which remodelled the code based on the Illinois Code (the drafters of the code were lawyers from Illinois and graduates of the University of Chicago (ibid.). The American influence is apparent in a strong emphasis on the rights of shareholders for example, the requirement of 'one share, one vote'.

In some respects, the shareholder protections of the Commercial Code have been honoured mainly in their breach. During the post-war period, professional gadflies known as *sōkaiya* accepted money from companies in return for refraining from asking embarrassing questions at shareholder meetings, and preventing other shareholders from doing the same. Firms responded to the *sōkaiya* by paying them off (in the mid-1990s, several extremely well-respected companies were found to be paying hush money to *sōkaiya*) and by holding their annual general meeting on the same day near the end of June, so that *sōkaiya* could not attend all of them. This day, known in Japanese as the *shūchūbi*, was a big day for the police, who would send officers to prevent violence from breaking out in these encounters between management, shareholders and criminal groups.

Although the *sōkaiya's* influence waned through the 1990s, their influence persisted in an antipathy to shareholders by senior management. It is easy to sympathize with corporate executives, whose antagonism towards shareholders has been tinged by a historical association between shareholder activism and organized crime.

The state and administrative guidance

Another pillar of the Japanese post-war system of corporate governance was the state, which provided guidance and a safety net for financial institutions and corporations. Financial institutions were protected by the 'convoy system' maintained by the Ministry of Finance, which restrained any single financial institution from getting too far ahead of the others and provided a support system for the poor performers (Hoshi and Kashyap 2001). Government ministries also looked out for corporations, often through the retired officials placed on the corporate board. This system of administrative guidance limited firms' degrees of freedom in creating innovative and distinctive strategies, but, in theory at least, reduced risk by limiting their actions to those approved by the bureaucrats. In practice, risk was often increased, as financial institutions in particular ignored basic principles of risk management in their lending activities under the belief that the convoy would protect them. This system also encouraged the phenomenon of 'zombie' companies – perpetually failing companies, kept afloat through repeated capital infusions and failed restructuring plans.

The post-war system as an effective system of corporate governance

Researchers in the 1980s and 1990s provided convincing evidence that the post-war system of interlinked institutions of banking, cross-shareholding, permanent employment and the guiding hand of the state was an effective system of governance (Aoki 1990). For example, main banks were found to monitor firms (Sheard 1989), stepping in to remove underperforming chief executives (Kaplan 1994), providing liquidity in times of financial crisis (Hoshi et al. 1990) and choreographing turnarounds and restructuring (Hoshi and Kashyap 2001). American management experts such as Michael Porter (1992) and Lester Thurow (1992) even argued that the Japanese system of corporate governance was superior to that of the US, since the patient capital of banks and long-term outlook of stable shareholders engendered a long-term focus. Other researchers showed how the Japanese system provided flexibility for firms to move out of failing industries and refocus without the mass downsizings and disruptions of the US system (Dore 1986).

Culture or institutions?

It is tempting to argue that the post-war system had deep cultural roots. Japanese managers themselves often attribute their own behaviour and the practices of their firms as being defined by Japanese culture. The obligational relationships among firms, permanent employment, age-based promotion and limited outside representation on boards of directors all evoke Japanese cultural norms for interpersonal relationships. Sharp discontinuities between the pre- and post-war systems, however, show little evidence of cultural determinism. The pre-war system was characterized by active stock markets (inspired by Edo-period rice exchanges) and a high reliance on equity finance (Hoshi and Kashyap 2001). Independent directors, who represented the interests of large shareholders, were common (Ramseyer and Miwa 2002).

Permanent employment was rare in the earliest years of industrialization, and was a gradual accommodation, first to labour shortages around the time of the First World War and then to labour unrest after the Second World War (Gordon 1985).

Although the post-war system did not spring naturally from Japanese culture but rather came from specific conditions of wartime mobilization, post-war devastation, occupation and unrest, it is indisputable that over time, the Japanese came to see this system as culturally compatible and to attribute to it deep traditional roots. The association between the post-war system and Japanese culture, whether accurate or not, has led to great reluctance to change and is arguably a factor in the remarkable inertia of the economy in the face of the collapse of the bubble economy and economic stagnation of the 1990s.

Cracks in the post-war system

Beginning in the mid-1980s, the post-war system was buffeted by a number of shocks, which eventually led to pressures for corporate governance reform. Some of the most important ones include a move away from the main bank system, unwinding of cross-shareholding, increase in foreign shareholders and the financial crisis of the 1990s.

The weakening of the main bank system

During the mid-1980s, the largest and most solvent firms began to move away from the main bank system. Regulations were liberalized to allow firms to access international capital markets and firms shifted from banks to direct financing through capital markets. Bank debt as a percentage of total assets for manufacturing firms declined from 34.7 per cent in 1980 to 12.6 per cent in 1997 (Hoshi and Kashyap 2001, p. 247). As firms became less dependent on main banks, banks increasingly lost their governance function. In search of replacement for lost business, banks increasingly extended loans to smaller and riskier borrowers, planting the seeds of the bubble economy of the late 1980s and its crash in the early 1990s.

Unwinding of cross-shareholdings

The waning of main bank influence was accompanied by an unwinding of cross-shareholdings. These decreased from 18.3 per cent in 1987 to 10.5 per cent in 1999 and the ratio of stable shareholding decreased from 45.8 to 37.8 per cent during the same period (NLI Research Institute 2000; see also Okabe 2002).[2] Financial institutions sold shares to recoup unrealized gains in shares that had appreciated dramatically over long years of stable shareholdings, and thus lost the hidden reserves that they had used in the past to stage bailouts of companies. A revision in accounting regulations required shareholdings to be reported at market value, meaning that these shareholdings were now a source of risk and could no longer be seen simply as a means to maintain long-term business relationships (Okabe 2002). This does not mean that all cross-shareholdings were unwound – firms and banks tended to negotiate sales of shares very carefully to prevent a precipitous drop in the price of the shares and to keep them out of the hands of potentially hostile buyers.

Increase in foreign portfolio investment

Foreign portfolio investors purchased many of the cross-held shares unloaded by financial institutions. The decline in shareholding by financial institutions during the 1990s (from 45.2 per cent of unit shares in 1990 to 34.1 per cent in 2002) is almost exactly mirrored by an increase in holdings by foreigners from 4.2 to 16.5 per cent during the same period (Tokyo Stock Exchange 2003a). The purchase of Japanese shares by foreigners was part of a worldwide phenomenon, as institutional investors, especially those from the US and the UK, began to diversify into international equity. Between 1990 and 1998, Americans, for example, increased their holdings of foreign shares from $197.3 million to $1.4 trillion (Steinmetz 1999).

Foreign investors were largely institutional investors, in Japan for a return on their investment rather than to support a larger set of business activities. They brought calls for corporate governance reform – more transparency, greater attention to return on investment and better communication with shareholders. In 2001, the International Corporate Governance Network (ICGN), a group of global institutional investors, held their annual meeting in Tokyo to bring their message of governance reform directly to the Japanese market.

Financial crisis

Another impetus for reform was the financial crisis of the 1990s. After the asset bubble burst in the early 1990s, the economy staggered from periods of crisis, to promises of growth, back to crisis again. Unprecedented failures of firms and financial institutions and gross ethical lapses of not a few famous and once reputable firms led business leaders and government officials to think about reform.

Some of the earliest efforts for corporate governance reform originated among business leaders. One particularly meaningful initiative began as a study group on corporate governance in early 1994, led by Nakamura Kaneo, then chairman of the Industrial Bank of Japan, and involving chief executives of some of Japan's most influential firms. This effort brought forth the establishment of the Japan Corporate Governance Forum, which drafted a manifesto of Corporate Governance Principles published in both English and Japanese (Japan Corporate Governance Forum 1998).

While the relationship between the crisis of the 1990s and corporate governance reform is important, it should not be overemphasized. In the financial sector, where the crisis was most acute, there were few calls for corporate governance reform from either executives or government officials (Nakamura of IBJ was an exception).[3] Even among corporate executives, there was a fractious debate as to whether corporate governance reform was an appropriate response to crisis. While business leaders such as Miyauchi Yoshihiko of Orix and Idei Nobuyuki of Sony argued for adoption of Anglo-American practices, other leading figures, most prominently Okuda Hiroshi, chairman of Toyota and Mitarai Fujio, chairman of Canon, argued that Japanese firms should not abandon the Japanese system (particularly, insider-dominated boards and the permanent employee system).

A corporate governance vacuum

There is little consensus over whether weaknesses of the Japanese system of corporate governance caused the crisis of the 1990s. It is indisputable, however, that by the end of the 1990s, the system had been severely weakened, resulting in a corporate governance vacuum. The main bank system no longer functioned, as large firms procured capital elsewhere and the banking system was too focused on survival to provide much monitoring. While cross-shareholdings remained, changing accounting regulations meant that firms and financial institutions had to consider the market value of these shares and treat them as financial investments. Foreign portfolio investors, strongly committed to Anglo-American governance practices, dominated Japanese equity markets. The government also had retreated from the business of industrial policy and reduced, if not eliminated *amakudari* board appointments of retired government officials. The business environment had changed from a clear course of catch-up with the industrialized Western nations to one requiring risky, uncertain decisions about investment in new technologies and markets. A new corporate governance system was necessary to respond to this new structure of ownership and business environment. Yet, domestic institutional investors such as insurance companies and investment trusts remained silent and passive.

Corporate governance reforms of the 1990s and early 2000s

New institutions and practices were required to govern Japanese firms in this new business environment. Although emergence of these new institutions was slow and marked by heated debate and resistance, the 1990s were a period of transition in Japanese corporate governance.

Legal and regulatory reforms

The 1990s were a particularly active period for revision of laws related to corporate governance, in particular, accounting regulations and the Commercial Code. The revisions in accounting regulations were particularly important as they were central to the weakening of cross-shareholding. These revisions were part of the Big Bang, a set of reforms in financial practices announced in 1996 and designed both as an antidote to the financial crisis and a policy to secure the role of Tokyo as a global financial centre. Several revisions had particular implications for corporate governance. In 2001, firms were required to report cross-shareholdings at market value (Okabe 2002, p. 33), meaning that they could no longer carry cross-held shares on their books with little concern for their financial implications (they were required to report shares held for investment purposes at market value beginning 2000). In 1999, firms were required to report consolidated financial results and rules for consolidation were strengthened so that firms were required to consolidate not only subsidiaries over which they had controlling ownership stakes, but also subsidiaries over which they had de facto control, for example, through dispatch of management.

Throughout the 1990s, a number of revisions were made to the Commercial Code, including liberalization of stock options and share buybacks, and in 2002 the most substantial revision since the early post-war period was passed. This revision included provisions for one of the most disputed issues in Japanese corporate governance – independent directors. It allowed firms to choose between what was commonly referred to as a ‘US-style’ board, with three committees – nominating, compensation and audit – which were to be dominated by outside directors (defined as directors who were not currently employed by, and had never been employed by, that company or any of its subsidiaries). Firms that adopted the board with committee system were not required to have the *kansayaku*, or statutory corporate auditors, that had been required of all companies previously.

While firms could either opt for this new system or maintain the existing *kansayaku* system, most decided to retain the existing one. By 2004, only 60 publicly quoted firms, 18 of them members of the Hitachi group, had adopted the board with committees system and there was no sign that these numbers would increase dramatically in the near future (JACD 2004).

One of the most interesting aspects of commercial code reform in Japan was that it gave firms considerable flexibility to choose their governance structures (Milhaupt 2003). This was in sharp contrast to most other Asian countries, where independent directors were legally mandated. The Tokyo Stock Exchange (and other Japanese stock exchanges) further supported this flexibility and did not require firms to adhere to any corporate governance regulations, such as independent directors.

Changing business practices and the JCGIndex

Because legal reforms gave Japanese firms considerable flexibility in their governance practices, in order to assess the extent and quality of corporate governance reform, it is necessary to look at changes at the firm level. We examine some of the major changes in business practice based on data collected by the Japan Corporate Governance Research Institute in its 2004 Japan Corporate Governance Index (JCGIndex) survey (JCGR 2004). Since 2002, this survey has been sent annually to firms listed on the First Section of the Tokyo Stock Exchange. Based on the survey, a JCGIndex, ranging from 0 to 100 points, was created for each company. Table 8.1 presents a list of the firms that had the highest JCGIndex scores in the 2004 survey.

The JCGIndex survey assigns a general index to each responding firm, and also assesses a firm's corporate governance in terms of four components: 1) corporate objectives and CEO responsibility; 2) structure and function of the board of directors; 3) management system; 4) transparency and communication with shareholders. Table 8.2 shows the average levels for each of these components for firms responding to the 2004 survey.

Our discussion below is based on responses from 341 firms (of 1,560 listed firms) received in 2004 (over the 2002, 2003 and 2004, the JCGR has calculated indexes for a total of 477 firms).[4]

Board reform

Perhaps the leading indicator used to measure corporate governance around the world is the independence of boards of directors. In Japan, much of the debate around corporate governance reform has centred on whether Japanese firms require independent directors, and a number of leading executives have criticized independent boards as an 'American' practice that is inappropriate for Japan.

The JCGIndex survey indicates that sentiment against independent boards is widespread and board reform is progressing slowly. The survey asked firms about the number and background of independent directors and the process by which these directors were appointed and compensated. As Table 8.2 shows, in 2004, responding firms received an average of only 27 per cent of a total of 25 points allocated to board structure and function. Of the four components of corporate governance, firms achieved the lowest results for structure and function of the board.

Despite resistance to independent directors in many firms, a handful of firms were actively introducing independent directors. In 2004, for example, according to a survey by the *Nihon Keizai Shimbun*, Japan's leading business newspaper, foreigners held over 33 per cent of the shares in 82 listed firms (*Nihon Keizai Shimbun* 2004). There was also a trend to increase the independence of *kansayaku* required by the Commercial Code for firms that had not adopted the committee structure. Some firms appointed *kansayaku* with rich business experience and independent judgement – though it was by no means clear how widespread this practice was, and whether the role of the *kansayaku*,

Table 8.1 *Top 50 JCGIndex firms, 2004*

Firm	JCGIndex	Firm	JCGIndex
Toshiba Corp.*	83	Komatsu Ltd	65
Teijin Ltd	81	Anritsu Corp.	
Sony Corp.*	80	Nichirei Corp.	64
Nikko Cordial Corp.*		Showa Shell Sekiyu K.K.	
Omron Corp.	79	HOYA Corp.*	
Sanyo Electric Co., Ltd		Marubeni Corp.	
Orix Corp.*	76	Yamaha Corp.	63
Konica Minolta Holdings, Inc.*	75	Mitsui O.S.K. Lines, Ltd	
Daiwa Securities Group Inc.*		Yokogawa Electric Corp.	62
Matsushita Electric Works, Ltd	74	Bandai Co., Ltd	
Sumida Corp.*	73	(anonymous 1 firm).	
Meitec Corp.		Sohgo Security Services Co., Ltd	61
Eisai Co., Ltd*	72	Takeda Pharmaceutical Co., Ltd	60
Hitachi, Ltd*	71	Tokyo Electron Ltd	
Mitsubishi Electric Corp.*		Sumitomo Corp.	
Asahi Glass Co., Ltd	70	Resona Holdings, Inc.*	
Benesse Corp.		Natori Co., Ltd	59
Nomura Holdings, Inc.*	69	Yamaha Motor Co., Ltd	
Nomura Research Institute, Ltd	68	Nifco Inc.	
NEC Corp.		Hitachi Software Engineering Co., Ltd*	
Asahi Breweries, Ltd	67	CSK Corp.	
Mitsui & Co., Ltd		Hitachi Chemical Co., Ltd*	58
Sankyo Co., Ltd	66	Nippon Steel Corp.	
Aeon Co., Ltd*		Tokyo Gas Co., Ltd	
		(anonymous 3 firms)	

Note: *Firms adopting boards with committees.

Table 8.2 Average JCGIndex across four components of corporate governance, 2004

Category	Maximum points (A)	Mean (B)	Achievement rate* (B)/(A)
I Corporate objectives and CEO responsibility	28	11.9	42.5
II Structure and function of board of directors	25	6.7	26.8
III Management system	27	16.0	59.3
IV Transparency and communication with shareholders	20	10.4	52.0

Note: *Percentage of total points for each component, averaged across all responding companies.

with limited power and no voting rights on the board, gave even independent and well-qualified people the power and resources to monitor the chief executive and board.

Another trend was the reduction of the size of boards of directors by removing most executive directors. Sony began this practice, which they named the *shikkō yakuin* (corporate executive officer) system in 1997, when it reduced its board from 38 to 10 members. This system promised to increase the speed and flexibility of decision making, and diffused widely across firms. By 2002, 34 per cent of listed companies had adopted it (Tokyo Stock Exchange 2003b). Although many firms explained their adoption of the system in terms of improving corporate governance through separation of execution and monitoring functions of management, adoptions of the *shikkō yakuin* system were rarely accompanied by a significant increase in independent directors, and thus, this system was one in which insiders monitored other insiders.

Disclosure and transparency

Of all the corporate governance reforms, improvements in disclosure and transparency were perhaps the most thorough. In 2000, the president of Shoei Co. dismissed the shareholder activist Yoshiaki Murakami, by saying 'I am the president, I don't need to talk to every investor' (McIntyre 2000). By the mid-2000s, it was difficult to imagine a president of a leading company with this attitude (or at least who was willing to voice this attitude to newspaper reporters). Firms created investor relations departments and CEOs spent an increasing percentage of their time talking to investors, particularly foreign ones. A study of how CEOs spent their time, sponsored by the Japan Association of Corporate Directors, found that since the 1980s, CEOs had increased the amount of time spent speaking to investors and analysts (JACD 2005).

The results of the 2004 JCGIndex survey underscore this trend. The JCGIndex allocates 20 points to investor relations and disclosure, and, on average, firms achieved 52 per cent of these points (see Table 8.2). This suggests that while firms were placing a much higher emphasis on investor relations and disclosure than on board independence, they still had a long way to go in improving transparency.

Internal compliance and management systems

Governance reforms have also been pronounced in internal control and risk management systems. As Table 8.2 shows, on average, firms surveyed achieved 59 per cent of the total of 27 points awarded to firms for internal control and risk management systems (questions included the existence of financial targets for subsidiaries and divisions, the structure of the internal control system, and the role of the CEO in overseeing these systems). Increased attention to these systems is in part a response to crises during the 1990s and early 2000s, including substantial losses at Sumitomo Corporation and Daiwa Bank due to rogue traders, cover-ups of defects by Mitsubishi Motors, sales of spoiled milk by Snow Brand, and inadequate maintenance and monitoring of nuclear power plants by Tokyo Electric Power.

Commitment to shareholder value

During the 1990s and early 2000s, attitudes of corporate executives transformed dramatically, as they came to see shareholders less as criminal elements and more as an important constituency. This is not to say that Japanese managers came to subscribe to the mantra taught in US business schools that the sole objective of the firm is to maximize shareholder value. While a few firms were very explicit in noting shareholder value as one of their primary goals, most others took a weaker stance, promoting shareholders from last in line of the list of stakeholders to one closer, if not equal, in status to employees and customers (Learmount 2002).

The JCGIndex asked CEOs to list their most important stakeholders. Some 34 per cent of respondents listed shareholders as number 1 and 35 per cent as number 2 (55 per cent listed customers as number 1 and 31 per cent listed customers as number 2). When asked if they agreed that the objective of the firm was to maximize shareholder value, 36 per cent responded that it was the most important objective, while 44 per cent responded that it might be the most important objective in theory, but it was not appropriate in Japan.

While Japanese executives remained ambivalent about shareholders, they became much clearer that the focus of the firm should be profits rather than simply growth at all costs. According to a survey conducted by the Ministry of Finance in 1999, 22.54 per cent of the 1,207 firms responding said that they already used return to equity (ROE) to measure performance, 26.5 per cent said that it was necessary to start to use ROE as a measurement of performance, and 33.6 per cent said that it was probably important to use ROE to measure performance (Ministry of Finance 1999, p. 15).

Which firms are reforming their governance practices?

The JCGIndex survey also provides some important insights into which kinds of firms are reforming their governance. In general, larger firms were more likely to respond to the JCGIndex – on average, respondents were nearly double the size of the average Tokyo Stock Exchange First Section listed firm in assets and sales. The responding firms are higher in return on assets, return on sales and return on common stock. If we assume that the responding firms are more interested than most listed firms in corporate governance, we can conclude that interest in corporate governance tends to be focused in larger, higher-performing firms.

Companies responding to the JCGIndex survey were grouped into two categories: high JCGIndex firms, with JCGIndex levels one standard deviation or more above the mean, and firms with JCGIndex levels one standard deviation or more below the mean. JCGIndex surveys from 2002 to 2004 indicate that firms in the high JCGIndex group tended to be larger and have a larger percentage of foreign ownership than other firms (26.1 per cent versus 8.3 per cent for low JCGIndex firms). Thus, it is clear that larger companies with high levels of foreign ownership are reforming their governance.

One interesting trend is the appearance of a number of large, mainstream, 'traditional' Japanese firms with high JCGIndex levels. In 2004, Toshiba had the highest JCGIndex. Other firms ranking in the top 50 per cent include Mitsubishi Electric, Nippon Steel and Hitachi (see Table 8.1). In the mid-1990s, supporters of corporate governance reform tended to be firms that were considered somewhat out of the mainstream because of high levels of foreign ownership, young and innovative CEOs, or non-traditional corporate cultures (Sony and Hoya were some of the leaders in governance reform). By 2004, it was clear that corporate governance reform was a concern for a much broader range of companies. Even in 2004, however, the average JCGIndex for responding firms was only 45 out of 100 points (and, it is likely that non-responding firms, with their lower interest in corporate governance, would rank even lower). This indicates that corporate governance reform still has a long way to go.

Future prospects for corporate governance in Japan

Over the last decade, the debate on corporate governance has contrasted two extremes – whether to become 'like the US' or retain the post-war Japanese system of governance. Yet, as we noted earlier, retaining the 'traditional' post-war governance system is no longer an option, since it has been severely weakened by the demise of the role of the main bank, unwinding of cross-shareholdings, changes in accounting standards and increased investment by foreigners. However, nor is there much sign of convergence to US practices. While the legal and regulatory framework, firm practices, and attitudes among managers towards corporate governance changed considerably during the 1990s, the intense opposition to independent directors and continuing mixed feelings about shareholders among Japanese corporate leaders makes adoption of the Anglo-American system unlikely. Moreover, major changes in the Japanese system are unlikely unless shareholder activism is awakened among domestic institutional investors

It is not enough to simply say that the emerging system will be a hybrid of Anglo-American practices and the post-war system, since there are many forms that such a hybrid could take. One possibility is that two corporate governance sectors will emerge: one inhabited by firms with high percentages of foreign ownership that will look highly Anglo-American, and another of domestic-focused firms that will retain much of the flavour of the post-war system. Another possibility is that a consensus on a new model will emerge as firms integrate the shareholder value model with the existing 'company community' model, including shareholders as a valued stakeholder, and balancing long-term returns to shareholders with employees and the community.[5]

Elements of this new model are likely to include a few independent directors, though not a majority, and an increased willingness of executive directors to consider management decisions from the perspective of shareholders (though it is not clear that this could ever replace true independent monitoring). The new model is likely to include greater attention to compliance and risk management, though, again, it is not clear that these systems can function effectively in the absence of independent boards.

One element that is unlikely to be seen is excessive executive compensation that has been so much of a problem in the US. Japanese senior executives seem quite adamant that their salaries remain in reasonable proportion to that of employees, and justify this in terms of norms of fairness and social stability.

Whether a new Japanese model emerges depends in part on the evolving attitudes of Japanese investment funds and their preferences for a hybrid Japanese or Anglo-American system. This has yet to become clear, as domestic institutional investors remain virtually silent on corporate governance. One exception is the Pension Fund Association (PFA), which manages about $80 billion of corporate pension money, and is becoming a vocal advocate of reform. The PFA has adopted guidelines for exercising voting rights against underperforming firms, and in 2004 initiated a corporate governance fund, investing in firms whose governance most closely adhered to Anglo-American standards.

The eventual shape of Japanese corporate governance will also depend on whether a relationship can be established between corporate governance and performance. This question is still a matter of debate. Results of the 2002–04 JCGIndex survey indicate a clear relationship between corporate governance and performance. Firms that score highly on the JCGIndex, in other words, firms which have adopted more ‘Anglo-American’ practices in terms of board independence, disclosure and transparency, and accountability to shareholders, tend to have higher performance, as measured by returns on assets, on equity and on common stock.[6] It is not clear, however, whether this is because better-governed firms perform better, or, because better-performing firms are more likely to reform their governance practices. Since governance reform in Japan is relatively recent, it will take several more years before the direction of causality becomes clear.

Conclusion

Since the 1990s, the Japanese system of corporate governance has experienced significant changes in response to a prolonged economic crisis, an increase in foreign investment, and global momentum for corporate governance reform. Perhaps the most important impetus for change, however, has been transformation of the financial system and structure of corporate ownership, and change in the business environment. The decline of the main bank system and of administrative guidance, an increased reliance on capital markets, and the end of the national strategic objective of catching up with the West, have led to a governance vacuum. Many, but not all, Japanese firms have been searching for new governance practices to fill this vacuum and to assure themselves that the economy is able to restart its historical path of growth and vitality, while addressing new challenges of globalization, an ageing population, and increased uncertainty in technology and markets.

The process of reform has appeared to be quite slow, due to widespread questioning and dispute regarding the appropriate form of governance for Japan. Much of this argument has been on a very theoretical level. Corporate governance, however, is not merely a matter of scholastic argument, but one of practical activism – and is a means to ensuring sustainable growth of corporations and economies. More research is needed into the relationship between corporate governance and corporate strategy, and performance. Japan is an ideal place to study these links, and we believe that research on these relationships will provide object lessons for other corporate societies in emerging and developed economies.

Notes

1. The authors would like to thank Kazuyo Morita for her excellent research assistance.
2. Cross-holdings are cases in which two firms hold each other's shares. Stable shareholding is the sum of cross-held shares, shares held by financial institutions, shares issued by financial institutions and held by non-financial firms, and shares issued by related firms to total shares, at market value. See also Okabe (2002) for a thorough discussion of the unwinding of shareholdings.
3. Another exception is Resona Bank, which was recapitalized at the determination of the Financial Services Agency (FSA) and restructured with a board of directors dominated by independent directors.
4. More information about the Japan Corporate Governance Institute, and the JCGIndex can be found at www.jcgr.org. Ahmadjian is a director of this institute, and Okumura is an adviser.
5. There are signs that firms are doing this, with an increased attention to CSR, or corporate social responsibility. We are concerned that in many cases, the focus on CSR provides firms with an excuse not to think about corporate governance, though we see a trend for excellent firms to consider corporate governance and providing a return to shareholders as an important component of social responsibility.
6. Based on a comparison of performance between firms that had JCGIndex over one standard deviation above the mean, and firms whose JCGIndex was one standard deviation below the mean.

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PART IV

CORPORATE GOVERNANCE IN THE USA AND AUSTRALIA

9 Compensation committees in the United States

Martin J. Conyon and Danielle Kuchinskas

> The typical large company has a compensation committee. They don't look for Dobermans on that committee, they look for Chihuahuas – Chihuahuas that have been sedated. (Warren Buffett, Chairman of Berkshire Hathaway)

Introduction

The compensation committee is the cornerstone of the executive pay-setting process. It is the subcommittee of the board of directors responsible for determining CEO compensation (Baker et al. 1988). The absence of a credible compensation committee gives the CEO a chance to behave opportunistically. In short, if the CEO controls the compensation committee, he/she effectively sets his/her own pay. In such situations, compensation contracts are likely to be suboptimal and not serve shareholders' interests. Instead, they are more likely to favour incumbent management. For instance, CEO pay may become excessive or incentives set too low (Bebchuk and Fried 2004). In consequence, corporate governance theorists have long argued for strong independent outsiders on boards. Investors, such as Warren Buffett, also want compensation committees to include watchful directors (Dobermans) and not affiliated directors (Chihuahuas). The rationale for this seems clear. If insiders, such as former employees or relatives, are members of the committee, a potential conflict of interest arises. A central research question, then, is whether the compensation committee is effective in setting CEO pay.

In the wake of various corporate scandals in the US, a number of examples of compensation committee failure have arisen. Consider Tyco International (Ltd), which supplies products to a variety of sectors, from healthcare to security. Tyco's financial records were reviewed in 2002, and shortly after the Securities and Exchange Commission (SEC) charged its CEO, Dennis Kozlowski, with civil fraud and a trial followed. He was accused of issuing bonuses and loans to himself and other executives, and employing company money for his personal use (see Tyco Fraud Information 2005). This is an example of managerial power; contracts were not optimally set in the best interest of shareholders. During the trial, directors argued that these plans were unauthorized, but Mark Swartz, former chief financial officer of Tyco, claimed that Phil Hampton, the former chairperson of Tyco's compensation committee, had approved the spending. There is difficulty in determining whether Hampton did approve any of this spending, as he died of cancer in 2001, before the scandal became known (Reuters 2004). In fact, Kozlowski was convicted in June 2005, for grand larceny, conspiracy, falsifying business records and securities fraud. Since the new senior vice president of human resources, Laurie Siegal, has begun working for Tyco, she has reformed its compensation committee and modified former compensation practices (Meisler 2004).

Another salient example centres on the case of Richard Grasso, the former chairman of the New York Stock Exchange. In August 2003, the NYSE disclosed that Grasso would receive $139.5 million compensation, as well as other controversial contract provisions. The storm following the announcements led to Grasso's resignation. Subsequently, he has been sued by the Attorney General of New York, alleging that his compensation was objectively unreasonable, especially for a not-for-profit organization. Moreover, Grasso's pay was allegedly the product of a process that permitted him to wield improper influence over the compensation committee and the board of directors.[1] Again, this example shows the strong possibility of a compensation committee failing to determine appropriately the level of CEO compensation.

However, it is legitimate to ask whether these particular examples reflect the more general case. Are compensation committees, in general, effective or ineffective when setting CEO compensation? Our goal in this chapter is twofold. First, we explain how compensation committee structure influences CEO pay. We also review the extant literature. The existing evidence shows an array of differing results. However, there is little strong evidence that compensation committees containing affiliated directors lead to excess compensation arrangements. Second, we present new evidence on US compensation committees between 1998 and 2003. Our results show that compensation committees are becoming more independent over time. In 1998, 64 per cent of firms had compensation committees with no affiliated directors, rising to 78 per cent in 2003 (see Table 9.4, below). In addition, the fraction of independent directors on compensation committees has increased between 1998 and 2003. The econometric results show that the presence of affiliated directors on the compensation committee, such as former employees or director interlocks, is not typically correlated with CEO compensation. This evidence, therefore, does not support managerial power-type models, which predict that insiders and affiliated directors on compensation committees lead to greater executive compensation (Bebchuk and Fried 2004).

The rest of this chapter is organized as follows. The next section briefly reviews prior research on compensation committees. The following section documents new findings on compensation committees in the United States, and the final section offers some conclusions.

Previous research on compensation committees

Previous research has examined the existence and composition of compensation committees and the effects of these committees on executive pay. Compensation committees are the main institution that determines executive pay (Baker et al. 1998). An important research goal is to test whether these compensation committees are effective at aligning shareholder and manager interests.

The central theory proposed in previous research is that compensation committees containing insiders or affiliated directors will lead to high levels of executive pay and incentives that shield the executive from risk (Daily et al. 1998). Managerial power models, exemplified by Bebchuk and Fried (2004), also predict that affiliated directors on compensation committees will set pay that favours the CEO at the expense of shareholders. When insiders, such as current or former employees of the firm, are members of the committee, a potential conflict of interest may arise. Compensation committee members are more loyal to the incumbent CEO. Affiliated directors will award pay levels that are greater than they would be if the compensation committee were independent. In addition, they set incentive contracts, such as bonuses and stock awards, contrary to shareholders' interests. Securities regulation reflects concerns about conflicts of interest and opportunistic behaviour of affiliated directors on the compensation committee. The NYSE corporate governance rules specify that listed firms must have a compensation committee comprising independent outside directors.[2]

However, the presence of insiders or affiliated directors on compensation committees does not necessarily lead to inefficient pay contracts. Anderson and Bizjak (2003) argue that CEOs who own substantial equity, manage recently created firms, or are founders may choose to sit on the compensation committee in order to design efficient contracts for other senior executives. In addition, insiders may have general or specific information about the organization or corporate strategy that is useful to the compensation committee in the design of incentives. These monitoring and information transmission functions may be beneficial and lessen organizational costs. In short, there are two competing views about insiders and affiliated directors on compensation committees. Their presence can promote opportunistic behaviour, leading to inefficient contracts; or it can lessen contracting costs, leading to efficient contracts. We now consider some of the empirical evidence.

Main and Johnston (1993) is an early study that examines compensation committees and CEO pay. They analyse a sample of 220 British companies in 1990.[3] Thirty per cent of firms had a compensation committee in 1990 and larger firms were more likely to adopt than smaller ones. Fewer than half of firms had independent committees made up exclusively of outside directors. Twenty per cent of firms had two or more executives as members of the committee. In the early 1990s, British compensation committees were prone to insider influence. Main and Johnston use regression methods to assess the impact of compensation committees on the level and mix of CEO pay. They find that CEO pay is 21 per cent greater in firms adopting compensation committees. The authors conclude that compensation committees are ineffective at restraining CEO pay and aligning shareholders and managerial interests. However, in a cross-section regression, it is difficult to disentangle concerns about reverse causation. If high-quality firms are more likely to adopt compensation committees, the binary variable measuring committee presence could simply reflect hiring of better quality CEOs. In consequence, the positive association between pay and compensation committees is also explicable as an optimal contract.

Conyon (1997) examines the effect of corporate governance innovations on executive pay in a sample of 213 UK firms between 1988 and 1993. The paper uses panel data techniques to test, for instance, the effect of adopting a compensation committee on changes in executive compensation. The study shows that, in some circumstances, companies that adopt a compensation committee have lower rates of growth in executive compensation. One interpretation of this result is that if CEO pay is excessive, companies adopting compensation committees appear effective at curbing this surplus. The results are different from those of Main and Johnston (1993). One reason is that Conyon (1997) controls for firm fixed effects and looks at the growth in executive pay.

Conyon and Peck (1998) examine the relation between board control, the compensation committee and executive pay. The authors use panel data on the 100 largest UK firms between 1991 and 1994. The compensation committee measure is either the proportion of outside directors on the committee, or a binary variable equal to one if a committee exists. In 1991, 78 per cent of firms had a compensation committee increasing to 99 per cent in 1994. The proportion of independent directors on the committee increases from 87 per cent in 1991 to 91 per cent in 1994. The study shows that CEO pay is greater in firms with compensation committees or those with a greater fraction of outsiders on the committee. This is contrary to the authors' expectations, as independent directors on compensation committees do not lead to low CEO compensation. More importantly, the research also shows that the link between pay and performance is greater in firms with a greater proportion of outside directors on the compensation committee. This is in line with expectations; compensation committees align the incentive component of CEO pay with shareholder interests.

Daily et al. (1998) focus on the relation between compensation committees and CEO pay. The authors use a random sample of 200 publicly traded US companies from the 1992 Fortune 500. They then analyse pay data on these firms over the period from 1991 to 1994. They identify whether the compensation committee contains affiliated or interdependent directors, or CEOs of other firms. Affiliated directors include non-management directors who maintain some form of personal or professional relationship with the firm, subsidiaries or its management. Interdependent directors include only non-management directors who had been appointed during the tenure of a focal firm's incumbent CEO. The expectation is that committees containing these types of directors will pay CEOs more. Daily et al. measure executive compensation in three different ways: non-contingent pay (for example, salary), contingent pay (for example, stock options) and total pay. They find no relationship between these measures of CEO pay and the proportion of affiliated directors on the compensation committee. In addition, there is no connection between CEO pay and the proportion of interdependent directors or between CEO pay and the proportion of CEOs from other firms on the compensation committee. The results of this study suggest that affiliated directors do not cause excessive pay.

Newman and Mozes (1999) examine whether compensation committee composition influences CEO pay practices. Their sample consists of 161 Fortune 250 firms in 1992. They identify potentially biased board members who determine CEO compensation. Such insiders can be an employee of firm A; a former employee of firm A; an employee of firm B when B has business dealings with firm A; the CEO of firm A who is on the board of directors of firm B; a former employee of firm B when the CEO of A is on the board of directors of B. They define an insider-influenced firm as one with a compensation committee containing at least one insider. They hypothesize that having insider-influenced firms leads to pay outcomes that are more favourable to the CEO than to shareholders. They find that about 52 per cent of firms are insider influenced. They do not find that CEO compensation is greater in firms that have insiders on the compensation committee compared to firms with only independent directors. This suggests that committees with affiliated directors do not lead to excessive levels of executive pay. However, Newman and Mozes find that the relation between pay and performance is more favourable towards the CEOs in firms that are insider influenced. Newman (2000) extends this research and examines the association between the firm's ownership structure and the presence of insiders on the compensation committee. The study finds that greater CEO stock ownership is associated with more insiders on the committee. The stockholdings of non-executive employees is negatively related to the presence of insiders.

Conyon and He (2004) test the effectiveness of compensation committees using three-tier agency theory (Antle 1982; Tirole 1986) and contrast it to a managerial power model. At the heart of the three-tier agency model is the idea that shareholders (the principal) delegate monitoring authority to a separate supervisor (for example, a compensation committee) who evaluates the agent (for example, CEO). Whether the supervisor will work in the principal's best interest or instead collude with the agent depends with whom the supervisor's interests are more closely related – the shareholders (principal) or management (agent). Other empirical research has not used the principal–supervisor–agent framework to evaluate the effectiveness of compensation committees. Instead, its focus is on traditional two-layer principal–agent models (for example, Conyon and Peck 1998) or managerial power models (for example, Bebchuk et al. 2002). The value of the three-tier agency model is that it focuses attention on supervisors' incentives to promote shareholder welfare. To test the model, Conyon and He (2004) use data on 455 US firms that went public in 1999. The study finds support for the three-tier agency model. The presence of significant shareholders on the compensation committee (that is, those with share stakes in excess of 5 per cent) is associated with lower CEO pay and higher CEO equity incentives. Firms with higher-paid compensation committee members are associated with greater CEO compensation and lower incentives. The managerial power model receives little support. They find no evidence that insiders or CEOs of other firms serving on the compensation committee raise the level of CEO pay or lower CEO incentives.

Vafeas (2003) studies 271 US firms between 1991 and 1997 to test the relation between insider presence on the compensation committee and CEO pay. He finds that there has been a decline in the number of committees with insider participation. The basic fixed effects regression results show that insider presence on the committee does not influence total pay, non-contingent pay (such as salaries), or contingent pay (such as stock options). There is some evidence that non-contingent pay is greater and contingent pay lower, if the insider on the committee was also present in 1991. The results point to few current effects of committee composition on CEO pay.

Anderson and Bizjak (2003) examine the empirical role of the CEO and the compensation committee in setting executive pay. They present a comprehensive panel data study of US firms between 1985 and 1998. The dataset consists of 110 NYSE listed firms. The authors test whether greater compensation committee independence promotes shareholder welfare. They also test whether the CEO's presence on a committee leads to more favourable CEO compensation. Regulatory changes in the United States that discourage the presence of insiders on the compensation committee after 1993 partly motivate this study. They find that insiders represent 13 per cent of compensation committees between 1985 and 1993 but only 4.8 per cent between 1994 and 1998. In addition, affiliated directors represent about 28 per cent of compensation committees between 1985 and 1993, but only 19 per cent between 1994 and 1998. Consistent with this, outsider director representation increases from 59 to 75 per cent between these two periods. CEOs and insiders have less influence on executive pay setting, measured by these characteristics, over time. The fixed effects regression analysis shows no correlation between pay levels and the fraction of outside directors on the compensation committee, or pay and the presence of the CEO on the compensation committee. In short, there is no evidence that outside directors set lower CEO pay levels, or that CEOs opportunistically use the position on the committee to set higher pay. The study finds that the fraction of outsiders on the compensation committee does not influence pay sensitivities, which align shareholder and managerial interests. In addition, the authors find that equity and stock option incentives are greater when the CEO is a member of the compensation committee. The study cautions against the received wisdom that independent outsiders on the compensation committee yield superior pay scenarios or that insider presence leads to worse outcomes. The empirical evidence from their study is not consistent with such a view.

Compensation committees in the United States

We shall now present new evidence on US compensation committees. Our analysis is significantly different from previous studies. First, we present evidence, using data from 1998 to 2003; previous studies have not considered such an extended time series. For example, the paper by Conyon and He (2004) uses data that finishes in 2001, and Anderson and Bijack (2003) use data that finishes in 1998. Our data extend beyond these studies and is timely, as it encompasses pay-setting mechanisms in the post-Enron era. Second, our analysis uses a larger sample, about 1500 companies each year from 1998. Prior studies use smaller sample sizes; for example, the studies reviewed in the previous section used fewer than 250 firms, except Conyon and He (2004) which instead focused on about 450 IPO (initial public offering) firms. The results we present in this chapter are both more recent and general.

We use the Investor Responsibility Research Center (IRRC) directors database supplied by Wharton Research Data Services (WRDS). The IRRC provides impartial research to shareholders and firms worldwide.[4] The dataset contains details on the structure and practices of the boards of directors at a large number of American companies. IRRC data have been used in previous corporate governance research (for example, Gompers et al. 2003). The data is of annual frequency and covers board members of the S&P 500, S&P MidCap and S&P SmallCap firms starting in 1996.[5] The dataset includes information on the board committees to which a director belongs, board affiliation, demographic characteristics and other information.

Descriptive results

Table 9.1 summarizes the IRRC directors database. It shows the number of firms, directorships and unique directors. Because the number of director

Table 9.1 Firms and directors in the IRRC dataset

IRRC dataset	1998	1999	2000	2001	2002	2003
Firms	1,772	1,807	1,759	1,800	1,439	1,472
Director Positions	17,048	17,420	16,675	16,669	13,499	13,792
Unique Directors	12,930	13,312	12,937	13,020	10,681	10,959

Note: The table summarizes the IRRC directors' database, showing the number of firms, directorships, and unique directors. 'Firms' is the number of firms surveyed in a given year. 'Director Positions' is the total number of places on the boards of directors for all firms surveyed. 'Unique Directors' is the number unique persons who fill all places on the boards of directors for all firms surveyed. Because Unique Directors is less than Director Positions, this implies that there are persons who serve as directors on more than one board.

positions is greater than the number of unique directors, this indicates that a director often fills more than one director position. Such board interlocks, when boards create ties between each other due to a shared directorship, are a feature of US corporate governance (Davis and Greve 1997 and Davis et al. 2003). The table shows that each director has about 1.32 directorships in 1998 falling to 1.26 in 2003, indicating that the amount of interlocks has been decreasing.

Table 9.2 shows board composition for firms by year. The IRRC classifies a directorship as 'Employee', 'Linked', or 'Independent'. The IRRC defines a linked director as 'a director who is linked to the company through certain relationships, and whose views may be affected because of such links', for

Table 9.2 Types of directors in the IRRC dataset

Director type on board of directors	1998	1999	2000	2001	2002	2003
Director type = Employee (%)	22.3	21.9	21.8	21.3	19.7	18.4
Director type = Linked Affiliated (%)	17.4	17.3	16.6	15.7	13.9	12.8
Director type = Independent (%)	60.3	60.8	61.6	63.0	66.4	68.8
Total	17,048	17,420	16,675	16,669	13,499	13,792

Note: The table shows the composition of the board of directors for firms by year. A director is considered an employee if he/she is currently working for the firm, considered linked if he/she is affiliated with the company in such a way that his/her views may be biased and unfavourable to shareholders (see Appendix 9A for more details), and considered independent if he/she is elected by shareholders, having no affiliation with the firm.

Table 9.3 Compensation committee composition

Directors on the compensation committee by director type	1998	1999	2000	2001	2002	2003
Director type = Employee (%)	1.4	1.7	1.4	1.3	0.7	0.4
Director type = Linked (%)	12.8	12.8	11.9	11.5	9.4	7.7
Director type = Independent (%)	85.8	85.6	86.7	87.2	90.0	91.9
Total number of directors on compensation committee	6,238	6,375	6,088	6,165	5,085	5,188

Note: The table includes only members of the board of directors who are part of the compensation committee (therefore firms without a compensation committee are excluded), showing the percentage of each director type comprising compensation committees.

example a former employee. Appendix 9A provides a detailed explanation of what constitutes a linked directorship. A director is 'independent' if elected by the shareholders and not affiliated with the company. In 2003, 18 per cent of directors are employees, 13 per cent are linked directors and 69 per cent are independent directors. The percentage of independent directors has been increasing annually, coinciding with a decrease in the number of employees and linked persons on boards of directors.

Table 9.3 focuses on those members of the board of directors who are part of the compensation committee; therefore, it includes only firms with a compensation committee. The trend is the same as that of Table 9.2, with independent members continuing to increase. This indicates an improvement in the composition of compensation committees from the perspective of shareholders, as preferential compensation practices towards CEOs have likely decreased.

Table 9.4 includes only data from those firms having compensation committees. We define affiliated directors as directors who are either employees or linked directors. In 2003, 78 per cent of firms have zero affiliated directors on the compensation committee; 17 per cent have one affiliated director and the distinct of minority of firms (5 per cent) have more than one affiliated director on the committee. Between 1998 and 2003, the percentage of firms with affiliated directors on the compensation committee has decreased.

Table 9.5 shows the size of firms' compensation committees by year. In 2003, the modal committee size is three, with a range from zero to nine. Across years, the modal committee size remains constant, while the number of

Table 9.4 Affiliated directors of the compensation committee

Number of affiliated directors on the compensation committee	1998	1999	2000	2001	2002	2003
No affiliated directors (= 0) (%)	64.2	65.2	67.9	69.2	73.5	77.8
Affiliated directors = 1 (%)	24.8	23.1	21.8	21.4	18.9	16.9
Affiliated directors = 2 (%)	8.0	8.2	6.9	6.7	6.2	4.2
Affiliated directors = 3 (%)	2.3	2.5	2.7	2.0	1.1	0.6
Affiliated directors ≥ 4 (%)	0.7	1.0	0.7	0.7	0.3	0.5
Total number of firms	1,743	1,780	1,732	1,774	1,423	1,461

Note: The table includes only data from firms with compensation committees. An affiliated director is defined as a director who is either an employee or who is linked.

firms without compensation committees has decreased. Significantly, a few companies do not have compensation committees. One such company is the Burlington Coat Factory (BCF). The NYSE listing rule specifies that firms must have a compensation committee comprising independent directors. Such committees adopt a written charter explaining the committee's purpose, its duties and responsibilities, and its annual performance evaluation (see section 303A.00 'Corporate Governance Standards'). Because Burlington is a controlled company,[6] a compensation committee is not required. Monroe G. Milstein, the founder and chairperson of Burlington, determines executive compensation, receiving advice from other principal executive officers. The company bases compensation decisions chiefly on an executive's performance, however, stock owned and an executive's family ties to Milstein are

Table 9.5 Compensation committee size by year

Size of compensation committee	1998	1999	2000	2001	2002	2003
Committee size = 0 (%)	1.6	1.1	1.5	0.7	1.1	0.8
Committee size = 1 (%)	1.1	0.6	1.0	1.2	0.9	0.9
Committee size = 2 (%)	14.5	15.4	16.9	17.9	13.3	12.8
Committee size = 3 (%)	38.6	37.5	38.5	38.5	40.4	41.8
Committee size = 4 (%)	25.1	27.1	24.1	25.2	26.5	25.8
Committee size = 5 (%)	12.2	12.5	11.7	11.1	11.4	12.4
Committee size ≥ 6 (%)	6.9	5.8	6.3	5.4	6.4	5.5
Total number of firms	1,772	1,799	1,759	1,786	1,439	1,472

considered as well. Executives who fall into the last two categories often receive a lower compensation than do other individuals in a similar position. Burlington stands by this philosophy, as the salary of Monroe G. Milstein has remained the same for the past three years. In fact, it is 'approximately $72,000 less than his 1983 salary, the year of the Company's initial public offering' (BCF 2003).

Similarly, National Presto Industries has chosen to forgo a compensation committee. The board of directors makes decisions regarding executive compensation, with salaries and bonuses reviewed at the end of each fiscal year. Over the years, executive salaries have been below that of salaries paid to executives at comparable firms. Historically, the company has not relied on stock incentives as an integral part of its compensation programme. Instead, National Presto Industries believes that total salary and bonus compensation given are appropriate for the firm and its officers (National Presto Industries 2003).

Another firm, Loews, did not have a formal compensation committee before 2003, but rather a group called the Incentive Compensation Committee. In January 2003, however, the company redesignated its Incentive Compensation Committee as its compensation committee. Before 2003, the Incentive Compensation Committee managed and awarded grants under the Incentive Compensation Plan and Loews Stock Option Plan. Currently, and before 2003, the purpose of Loews's executive compensation policy is to encourage a high level of performance by executives. The company has used the Loews Stock Option Plan to motivate executives further. Under the Incentive Compensation Committee, salary levels were mainly based on salaries received by executives in a similar position as a company with comparable revenues (salaries were set between the 50th and 75th percentiles of salaries at these firms) (Loews 2002). After 2003, the compensation committee has consisted solely of independent directors. The compensation goal remains the same, yet it seems, besides market practices, there is more focus on 'an individual's level of responsibility, experience, [and] performance' (Loews 2004).

Table 9.6 shows the ways in which a director may be classified as affiliated, indicating the type of link that makes the status such. Linked categories include former employee, supplier of professional services, designated director status, customer or supplier, interlocking director, relative, recipient of charitable funds, or other affiliation. The IRRC relies primarily on proxy disclosure to determine conflicts that may arise due to affiliation, though it considers direct and indirect services supplied to or by the firm of interest as well. We report the percentage of aforementioned links for each year. Values do not total 100 per cent because a linked director may be affiliated in multiple ways, fitting into more than one of the categories. For example, a director may be both a former employee and provide professional services to the firm.

Table 9.6 Types of linked directorship

Types of linked directors	1998	1999	2000	2001	2002	2003
Former employee (%)	29.3	31.5	32.0	33.9	36.0	38.2
Professional Services (%)	41.5	37.0	39.1	41.5	44.2	38.9
Designated Director (%)	19.4	19.1	20.8	19.2	9.4	10.1
Customer or Supplier (%)	19.8	20.2	21.2	20.5	16.4	19.3
Interlocking (%)	9.9	8.7	7.8	6.2	5.9	4.4
Relative (%)	11.7	9.5	9.0	10.9	7.4	8.6
Charity (%)	0.2	0.3	0.3	0.3	0.7	1.0
Other (%)	0.9	0.5	0.01	0.3	0.2	0.4
Total number of links	2,968	3,013	2,779	2,609	1,875	1,769

Note: This table shows in what way linked directors are associated with the firm. Values do not total 100 per cent because a linked director may be linked in multiple ways. A Former Employee previously worked either for the firm of interest or for a majority-owned subsidiary. Professional Services indicates that services, such as legal or financial, have been provided by the director personally or by his employer. A Designated Director is one who is a significant shareholder or a 'documented agreement by a group', for example, a union. A Customer or Supplier is defined as such unless the transaction was deemed 'not material' in the firm's proxy materials. Interlocking is defined as a situation in which two firms each have a director who sits on the board of the other. Relative status indicates that a director is a family member of an executive officer. Charity indicates that the director is a member of a company that receives charitable giving from the firm of interest. Other encapsulates any other affiliation that may bias a director to overlook the interests of shareholders.

In all years, the most common forms of affiliated directors are former employees or a member of a firm that supplies the firm of interest with professional services (for example, law or consulting firm). For instance, in 2003, 38.2 per cent of affiliated directors were former employees of the firm and 38.9 per cent of affiliated directors supplied professional services to the firms.

Regression results

We estimated the effect of affiliated compensation committees on CEO compensation. We define two right-hand-side variables. The first is a binary variable if the compensation committee contains any affiliated directors; zero otherwise. The second is the proportion of the compensation committee comprising affiliated directors or insiders. The measures are consistent with previous research (for example, Daily et al. 1998; Anderson and Bizjak 2003). The compensation committee data comes from the IRRC dataset described in the previous section. CEO compensation data is drawn from the ExecuComp dataset. Previous executive pay research has extensively used ExecuComp (see Murphy 1999). We measure CEO compensation as salary, bonus, long-term incentive payouts, total value of stock options granted (using

Black–Scholes), and other cash payments (includes compensation such as signing bonuses, benefits, tax reimbursements, and above market earnings on restricted stocks).[7] This is consistent with other research reviewed in Core et al. (1999, 2003) and Murphy (1999).

Our regression equations contain a set of control variables. First, firm size is an important predictor of executive compensation. Larger firms demand more talented CEOs to run complex firms, and consequently, these CEOs are paid more (Rosen 1982; Core et al. 1999). We measure this as the log of market value. We include firm performance to reflect potential alignment between manager and shareholder interests and the incentives (Conyon and Peck 1998; Core et al. 1999). We use a market-based measure, the three-year return to stockholders. Our regressions also contain a set of industry and year dummy variables to filter out sector effects and macroeconomic shocks.

Table 9.7 contains descriptive statistics of the variables and shows that the average percentage of directors on compensation committees who are affiliated is approximately 10 per cent, whereas about 28 per cent of firms have at least one affiliated director as a committee member. Table 9.8 contains the regression results. We performed both ordinary least squares regression (OLS) and fixed effects panel data regressions (FE) on the data, with log of total compensation being the dependent variable in all cases. All regressions used

Table 9.7 Descriptive statistics for variables in the regression model

Variable	Mean	Median deviation	Standard
Total Compensation ($000s)	5,729.66	2,602.74	15,995.62
Market Value ($millions)	8,185.16	1,596.36	26,957.92
Stock Return (%)	8.24	6.66	27.27
Has Affiliated Compensation Committee (yes = 1)	0.276	0	0.447
Percentage of Affiliated Directors on Committee	10.60	0	19.77
S&P 500 Firm (yes = 1)	0.347	0	0.476

Note: The table contains the variables of interest used in the regressions. The sample consists of 7,000 annual observations of 1,500 firms between 1998 and 2003. The compensation data is derived from ExecuComp and the compensation committee data from IRRC. Total compensation is the sum of salary, bonus, other cash, restricted stock grants, Black–Scholes grant value of options. Market Value is the value, in millions of dollars, at the end of the fiscal year. Stock Return is the three-year total return to shareholders, including monthly reinvestment of dividends. Has Affiliated Compensation Committee is a binary variable that is 1 if the firm has one or more affiliated directors on its compensation committee and 0 if the firm's compensation committee is composed of all independent directors. Percentage of Affiliated Directors on Committees is the percentage of compensation committee members who are affiliated. S&P 500 Firm is a binary variable that is 1 if the firm is a member of the S&P 500 and 0 otherwise.

Table 9.8 Regression results

Dependent variable = log (Total Compensation)	OLS	OLS	Fixed effects	Fixed effects
Has Affiliated Compensation Committee (= 1)	-0.15^{**}		-0.0087	
	(0.026)		(0.032)	
Percentage of Affiliated Directors on Committee ($\times 10^{-2}$)		-0.37^{**}		-0.048
		(0.059)		(0.079)
Log (Market Value)	0.40^{**}	0.39^{**}	0.34^{**}	0.34^{**}
	(0.011)	(0.0114)	(0.029)	(0.029)
Stock Return ($\times 10^{-3}$)	0.34	0.37	1.37^{**}	1.37^{**}
	(0.47)	(0.47)	(0.52)	(0.52)
S&P 500 Firm	0.24^{**}	0.24^{**}		
	(0.036)	(0.036)		
Mining/Manufacturing	0.093^{**}	0.090^{**}		
	(0.023)	(0.029)		
Utilities	-0.53^{**}	-0.54^{**}		
	(0.048)	(0.048)		
Finance	0.039	0.032		
	(0.037)	(0.037)		
Time effects	Yes	Yes	Yes	Yes
Observations	7,294	7,295	7,155	7,155
R^2	0.36	0.36	0.74	0.74

Note: ** significant at 1%; * significant at 5%; + significant at 10%.
The table summarizes the coefficients for each regression model. In all regressions, the dependent variable used is log (Total Compensation). The first five independent variables are defined in Table 9.7. The variables Mining/Manufacturing, Utilities, and Finance are binary variables equal to 1 if the firm is of that industry type and zero otherwise. Column 1 includes coefficients for the OLS model with Has Affiliated Compensation Committee as the variable of interest, whereas in column 2, Percentage of Affiliated Directors on Committee is the variable of interest. Note that the affiliation-related coefficients for both OLS models are negative and significant. Columns 3 and 4 have the same variable of interest as columns 1 and 2, respectively, but were calculated using time-series cross-section regression. Though the coefficients are negative, in this case they are insignificant.

approximately 7,000 observations from about 1,500 firms over a six-year period (1998–2003).

Overall, the results show that there is no relationship between a firm having affiliated directors on its compensation committee and the total compensation of the CEO. Two OLS regressions were performed: one with Has Affiliated Compensation Committee and the other with Percentage of Affiliated Directors on Committee as the variable of interest. Independent variables that are the same for both OLS models include log of Market Value (at the end of the fiscal year), Stock Return (three-year total return to shareholders, in per cent), S&P 500 Firm (binary variable – 1 if firm is a member of S&P 500, zero otherwise), and industry variables, including Mining/Manufacturing, Utilities, Finance, and Other (1 if the firm is the firm type of interest, zero otherwise). Additionally, binary variables for each year, 1998–2003, were included in the OLS models. Results of the OLS regressions show that the coefficients Has Affiliated Compensation Committee and Percentage of Affiliated Directors on Committee are both negative and significant, controlling for firm size, performance and sector effects. This implies that if a firm has affiliated directors on its compensation committee, the committee is likely to award the CEO with a compensation package *lower* than that which a CEO in a comparable firm with no affiliated directors on its compensation committee would receive. This contradicts the hypothesis that firms with affiliated directors on its compensation committee will award its CEO higher compensation. The control variables show that CEO compensation is greater in larger firms,[8] firms with better stock returns, and S&P 500 firms. This is consistent with previous research (see the review by Murphy 1999).

Two FE models were estimated, one with Has Affiliated Compensation Committee and the other with Percentage of Affiliated Directors on Committee as the variable of interest. The log of Market Value and Stock Return were the only additional independent variables included in the regression. Results of the FE model, however, show both coefficients of interest as negative and insignificant. This indicates that there is no relationship between the composition of a firm's compensation committee and the total compensation its CEO is awarded. Using an FE modelling procedure allows us to draw stronger conclusions than the OLS regressions, because we can cater for time-invariant firm-specific heterogeneity. Additionally, the R^2 value for this model is more than twice that of OLS (0.74 versus 0.36). We reject the hypothesis that a firm with affiliated directors on its compensation committee will award greater CEO compensation. In this sample, the composition of the committee has no bearing on CEO pay. The results are consistent with the findings of Anderson and Bijack (2003) and Daily et al. (1998) who also find no relation between measures of CEO compensation and the composition of the compensation committee.

Conclusions

In this chapter, we have reviewed the existing literature on the effectiveness of compensation committees and provided new evidence on the relation between CEO pay and committee composition. Our research adds to existing studies by presenting new evidence on pay-setting institutions in US firms and examining the effect of compensation committees on CEO pay during the period from 1998 to 2003.

What are the effects of compensation committees? The studies reviewed in this chapter reveal a complex pattern of results. Executive pay is greater in firms with compensation committees, not lower (Main and Johnston 1993; Conyon and Peck 1998). However, Conyon (1997) shows that the growth in pay is lower in firms adopting compensation committees. The composition of the committee does not seem to cause agency concerns. Studies show that executive pay is not significantly greater if compensation committees contain affiliated or inside directors (Daily et al. 1998; Newman and Mozes 1999; Anderson and Bizjak 2003; Vafeas 2003). Compensation committees, though, have mixed effects on executive incentives. Anderson and Bizjak (2003) and Vafeas (2003) find no evidence that CEO incentives are lower when affiliated directors are on the compensation committee. However, Newman and Mozes (1999) conclude that pay for performance is more favourable to the CEO when the compensation committee contains insiders. In addition, Conyon and Peck (1998) show that the link between pay and performance is greater in firms adopting compensation committees.

The new results in this chapter suggest that compensation committees in the United States have become more independent between 1998 and 2003. The fraction of affiliated directors on compensation committees is falling. We also found that the composition of a firm's compensation committee has no effect on the total compensation awarded to its CEOs. This runs contrary to the widely expected hypothesis that having affiliated directors on compensation committees would result in greater CEO pay. Warren Buffett was worried that compensation committees contained too many Chihuahuas (affiliated directors) and not enough Dobermans (independent directors). It turns out not to matter, at least for the level of CEO compensation during this time-period and for this set of firms. We should offer some caveats to our analysis, though. First, we have examined only the effect of affiliated compensation committees on CEO pay. We have not considered their effect on CEO incentives. It is well known that stock options in the US have become an important part of CEO pay. Although committee structure seems not to influence the level of pay, it might affect its composition, namely, the amount of options and other equity granted to the CEO. This is an important avenue of future research. Second, our econometric models were parsimonious. We would recommend estimating more expansive models and that the different contexts where compensation committees may exert influence be investigated. For instance, do committees have different effects in regulated compared to non-regulated sectors? Despite these limitations, we believe that the review of the extant literature and the new results on compensation committees are an important addition to the corporate governance literature.

Appendix 9A: Linked director

The following definition of an affiliated director is given by the IRRC at: www.irrc.com/resources/glossary.htm.

The IRRC generally considers any director affiliated who is a former employee; is an employee of or is a service provider, supplier, customer; is a recipient of charitable funds; is considered an interlocking or designated director; or is a family member of a director or executive. More specifically, an affiliated director is:

- A former employee of the company or of a majority-owned subsidiary.
- A provider of professional services – such as legal, consulting or financial – to the company. The services may be provided either personally by the director or by the director's employer.
- A customer of or supplier to the company, unless the transaction occurred in the normal course of business and was explicitly deemed 'not material' by the company in proxy materials.
- An employee of an affiliate of which the company owns less than 50 per cent. (An employee of a subsidiary that is 50 per cent or more owned by the company, is considered an employee director.)
- A designee under a documented agreement by a group (such as a union) or significant shareholder. Majority holders (or employees of majority holders) are assumed to be designated.
- A family member of an executive officer.
- A part of an interlocking directorship whereby a director and executive of the company sits on a board of another company that has an executive and director who also sit on the original company's board.
- A recipient of the company's charitable giving, if this is disclosed in the proxy statement.
- Any other type of affiliation that may compromise the ability or incentive of a director to perform oversight duties in the best interests of shareholders.

Notes

1. See the complaint: http://news.findlaw.com/hdocs/docs/nys/nygrasso52404cmp.pdf.
2. See the New York Stock Exchange corporate governance rules at www.nyse.com/pdfs/section303A_final_rules.pdf.
3. These were selected from two separate overlapping samples, the top 500 companies as ranked from ELC International Britain's 1000 Largest Companies in 1991 and the top 500 companies in the Charterhouse Top Management Remuneration Sample for the years 1989 and 1990. They required also that these companies were listed on the London Stock Exchange and were available in DataStream.
4. Visit the IRRC's website at www.irrrc.org. The site contains the following statement about the goals of IRRC: 'IRRC is the leading source of high quality, impartial information on corporate governance and social responsibility. Founded in 1972, IRRC provides proxy research and analysis, benchmarking products, as well as proxy voting services to more than 500 institutional investors, corporations, law firms, foundations, academics and other organizations. IRRC is unique in the industry, as it does not advocate on any side of the issues it covers. Clients can be assured that IRRC data and analyses are objective and unbiased'.
5. Data on the composition of the committee start in 1998, hence the time frame of our study.
6. The NYSE defines a controlled company as a company in which an individual, group, or other company holds over 50 per cent of the voting power. If this is true, a company is not

obligated to meet the terms of Sections 303A.01 (majority of independent directors), 303A.04 (fully independent nominating committee), or 303A.05 (fully independent compensation committee). A company that chooses to rely upon these exemptions must disclose this information in its annual proxy statement or in Form 10-K filed with the SEC. If a company meets the controlled company guidelines, it is required to have an audit committee composed solely of independent directors and of three persons, at minimum. 'If a controlled company ceases to be controlled, it is required to have at least one independent director on its nominating and compensation committees as of the date it ceases to be controlled; a majority of independent directors on those committees within 90 days after it ceases to be controlled; and fully independent nominating and compensation committees and a majority independent board within one year' ('NYSE Listed Company Manual Section 303A Corporate Governance Listing Standards Frequently Asked Questions').
7. This is variable TDC1 in the ExecuComp dataset.
8. The elasticity of CEO compensation is estimated in the range 0.33 to 0.40. This has been found in other CEO pay studies.

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10 The development of corporate governance in Australia

Geof Stapledon

Introduction

From the mid-1980s until the end of the 1990s, issues of corporate governance received sporadic attention in Australia. Government, business, institutional investors, professional advisers, consultants, academics, the Australian Stock Exchange (ASX) and the media took an interest in governance issues mostly during periods of economic decline. All this changed with the major corporate collapses and scandals of 2001 and 2002 – which included not only Enron, WorldCom, HealthSouth, Global Crossing and other companies based in the United States, but also five publicly traded Australian companies: a telecoms company (One.Tel); a general insurer (HIH); a retailer (Harris Scarfe); and two mining companies (Pasminco and Centaur). Since the corporate collapses, corporate governance has remained a front-page issue in Australia.

This chapter reviews the current state of corporate governance in Australia, with emphasis on key trends and developments. The approach adopted is to look at several corporate governance 'mechanisms'; that is, mechanisms that play a role in decreasing the divergence between managers' and shareholders' interests that Jensen and Meckling articulated in their famous 1976 article. The mechanisms reviewed are:

- market forces (particularly the market for corporate control and product market competition);
- legal environment protecting investors;
- share ownership structure (including ownership by large blockholders, institutional investors and directors);
- monitoring by non-executive directors;
- disclosure rules and governance codes;
- independent audit; and
- incentive remuneration for senior executives.

The chapter's focus is the publicly listed sector. More than 1,700 companies are listed on the ASX, although the 100 largest companies account for more than 90 per cent of the market's value. Market capitalization is around A$990 billion (US$740 billion). This represents 106 per cent of GDP, and ranks the Australian stock market listed sector the 11th largest in the world.[1]

Market forces

There are several market forces that can operate as a discipline on a company's managers. These include the threat of a hostile takeover (known as the market for corporate control), the product market, the market for managerial talent and the capital market. The first two of these are reviewed below.

Market for corporate control

The threat of a hostile takeover offer being made for the shares in the company they manage can serve as an incentive to senior executives to run the company efficiently. If they do not do so, and such a bid materializes and is successful, the executives run the risk of being fired.[2]

The likelihood of a suboptimally managed company becoming a target of a hostile bid is likely to be a factor, partly, of the *efficiency* of the market for corporate control in the company's country of domicile. Australia has a reasonably efficient market for control, by comparison with most other developed economies. Dignam (2005) found that, in the 10 years from 1992 to 2001, there were 401 completed mergers and acquisitions (M&A) transactions involving Australian listed companies as targets, of which 75 (18.7 per cent) were hostile. Comparing Australia to the United Kingdom and the United States, Dignam concluded that Australia's market for corporate control was comparatively weak. He found that only 29 of the 401 M&A transactions (7.2 per cent) were *successful* hostile bids, compared to just over 20 per cent for the UK during 1988–98,[3] and 21 per cent for the US during 1980–94.[4] None the less, contrasted with most other developed economies, such as Japan and the countries of continental Europe, it is clear that Australia's incidence of hostile bids overall, and of those that succeed, places the country at the upper end of the scale in terms of a developed market for corporate control.[5]

Competition in the product market

The market or markets in which a company operates – selling its goods or services – can serve as a disciplinary force on the company's senior executives. A company which is managed inefficiently may lose market share to other firms in the same industry, which are operated more efficiently, provided that the market is competitive.

During much of the twentieth century, Australian firms were heavily protected from foreign competition. By the early 1970s, tariff levels in Australia were higher than in any developed economy besides New Zealand.[6] However, protective barriers were reduced dramatically during the 1980s and

1990s, to the point where Australia now has one of the lowest levels of trade protection among developed nations.

In terms of competition among domestic players, a broadly – but not entirely – similar pattern emerges. Until the mid-1970s, Australia did not have genuine anti-trust laws. Empirical studies conducted during the 1960s showed that Australian business people were prepared to admit to the existence of cartels, and even to attempt to justify them.[7] But the Trade Practices Act, introduced in 1974, banned price-fixing, market sharing and other cartel behaviour; use of market power for anti-competitive purposes; certain 'vertical' arrangements between, for instance, manufacturers and distributers; and anti-competitive mergers. The act is generally regarded as well-enforced by a well-resourced regulator (the Australian Competition and Consumer Commission). On the other hand, three decades after competition laws were enacted, several industries are highly concentrated in Australia, including building materials, ports services, telecommunications, domestic air travel and supermarkets. Some industries are virtually duopolies.

This evidence on factors affecting competition between Australian companies and their foreign and domestic rivals indicates that the product market is functioning as a more effective corporate governance mechanism today than 20 or 30 years ago, but also that in some instances it is probably a blunted instrument.

Legal environment protecting investors

The well-known series of papers by La Porta, López-de-Silanes, Shleifer and Vishny (LLSV) contend – and provide some evidence consistent with the proposition – that the strength of a country's investor-protection laws should be related to the depth of the capital markets in that country, the dispersion of share ownership and the value of listed equities.[8] LLSV suggest that strong investor-protection rules lead to (that is, cause) capital markets to develop and share ownership to disperse, although the empirical data seems to leave open the possibility that causation flows in the opposite direction: that capital markets develop for some unrelated reason or reasons, and that it is the resulting constituency of widely dispersed investors who then lobby for better investor-protection rules.[9]

The LLSV methodology rates Australia quite high on the scale of investor protection.[10] Rightly so. Australia has a common law system, and has well-developed legal principles governing the duties of company directors and executives, and the rights of shareholders and creditors; a relatively accessible court system; and a corporate regulator that has been active in pursuing breaches of directors' and officers' duties for the past 15 years.

There have been some recent statutory reforms and common law developments that have bolstered the investor-protection regime in Australia.

Shareholders were given a statutory right to bring 'derivative' proceedings with court approval, in 2000.[11] Several other statutory reforms have related to disclosure and auditors, and are discussed under those headings below. Effective from 2005, shareholders have an 'advisory' (that is, non-binding) vote on the Remuneration Report in the company's annual report.[12] This initiative was borrowed from that introduced in the UK in 2003. And in terms of common law, the standard of care expected of non-executive directors has increased materially in recent years.[13]

Share ownership structure

Particular patterns of share ownership can be regarded as a significant corporate governance mechanism in publicly listed companies. This is not always obvious to those schooled on Berle and Means's picture of share ownership in listed companies – where, based on US data from the late 1920s, many companies had a mass of diffuse small holdings.[14] But in a market like Australia where large percentage shareholders ('blockholders') are common, and where institutional share ownership levels are also high, use of ownership rights as a means of reducing agency costs is a reality.

Blockholders

Compared to smaller shareholders, blockholders have greater incentives to monitor managers. This is because as the ownership stake of a shareholder increases it has, *ceteris paribus*, a greater incentive to increase firm value – and monitoring management is one avenue to achieve that.[15] Apart from the incentive to monitor in order to increase firm value, a blockholder will also have an incentive to monitor if the blockholding represents a significant part of the holder's wealth, and if – as would often be the case – the blockholder has a less diversified portfolio than an institutional investor.

To the extent that blockholders conduct more monitoring than smaller shareholders, there is a 'shared' benefit of control. Shared benefits of control are those improvements to firm value that are brought about by the blockholder, but are enjoyed as much by minority shareholders as by the blockholder. Besides the blockholder's role in monitoring management, shared benefits may also result from improving the flow of information from inside the firm to capital owners,[16] and making value-enhancing implicit contracts with employees, suppliers and other non-shareholder stakeholders.[17] Also, in the case of blockholders that are themselves corporations, the block ownership may align the incentives of both firms if they are involved in product market alliances or joint ventures. Contracting and monitoring costs may thereby be reduced – to the benefit of all shareholders.[18]

But not all benefits of control are shared. Private benefits – as the name suggests – are those benefits of control that a blockholder enjoys to the exclusion of other shareholders. These include misappropriating corporate assets at the expense of minority shareholders – for instance, through a business transaction between the firm and the blockholder on non-arm's-length terms that are significantly advantageous to the blockholder. However, not all private benefits are harmful to minority shareholders. A blockholder that is itself a corporation could generate not only shared benefits (as outlined above) but also private ones; for example, if the blockholder is able to obtain synergies in production or asset complementarities for its own business that are not enjoyed by the firm in which it has its large holding. Also, non-pecuniary private benefits (such as the 'amenities' associated with controlling a firm that owns a professional sports team, or a media business, for instance) do not necessarily have a negative impact on minority shareholders.[19]

The empirical evidence shows that blockholders are prevalent in Australia. Lamba and Stapledon (2001) studied the ownership structure of 240 listed Australian companies as at 1998, drawn from the entire population of approximately 1,200 listed companies. The sample companies consisted of 80 'large' companies (drawn from the companies ranked 1 to 100 by market capitalization), 80 'medium-sized' companies (drawn from the companies ranked 101 to 500 by market capitalization) and 80 'small' companies (drawn from the companies ranked 501 to 1,200 by market capitalization).

Of the 240 sample companies, 235 had at least one 'substantial holder', that is, a person or entity with a disclosable (5 per cent or greater) interest in the company's equity. In 185 of these cases, the largest or only substantial holder was a non-institutional investor, that is, a 'Family', 'Corporate', 'State' or 'Miscellaneous' holder. In the remaining 50 cases, the largest or only substantial holder was an institutional investor holding the shares as a portfolio investment for clients.

Tables 10.1–4 provide a summary of the blockholdings of non-institutional investors, as revealed in Lamba and Stapledon's study. As Table 10.1 shows, 72 per cent of the sample companies had a 10 per cent or larger blockholder and 52 per cent had a 20 per cent or larger blockholder. As shown in Table

Table 10.1 Incidence of Australian companies with a controlling shareholder, 1998

Control threshold	No. of companies	% of total
10% or larger blockholder	173	72.1
15% or larger blockholder	153	63.8
20% or larger blockholder	125	52.1
25% or larger blockholder	108	45.0

Source: Lamba and Stapledon (2001).

Table 10.2 Breakdown of blockholdings (non-institutional holdings)

Range of blockholdings	No. of companies	% of total
0–4.9%	55	22.9
5–9.9%	12	5.0
10–14.9%	20	8.3
15–19.9%	28	11.7
20–24.9%	17	7.1
25–29.9%	21	8.8
30–34.9%	16	6.7
35–39.9%	10	4.2
40–44.9%	10	4.2
45–49.9%	12	5.0
50% +	39	16.3
Total (rounded)	240	100.0

Source: Lamba and Stapledon (2001).

10.2, 16 per cent had an absolute controlling shareholder (that is, a 50 per cent or larger blockholder). In terms of blockholder categories (Table 10.3), 'Family' blockholders were by far the most prevalent: accounting for 70 per cent of all blockholders,[20] followed by 'Corporate' blockholders which accounted for a further 24 per cent. Table 10.4 reveals a considerable difference between the large sample companies on the one hand, and the medium-sized and small sample companies on the other hand, in terms of the number having a blockholder and also the type of blockholder. Less than half (46 per

Table 10.3 Categorization of blockholders

Type of 10%+ blockholder	No. of companies	% of total*
Family	121	69.9
Corporate	42	24.3
State	4	2.3
Miscellaneous	5	2.9
Unknown	1	0.6
Total	173	100.0

Note: * The percentages in this column are of the 173 sample companies with a 10 per cent or larger blockholder.

Source: Lamba and Stapledon (2001).

Table 10.4 Categorization of blockholders: breakdown by company size

	Large companies		Medium companies		Small companies		All companies	
Type of 10%+ blockholder	No.	%[a]	No.	%[b]	No.	%[c]	No.	%[d]
Family	15	40.5	48	69.6	58	86.6	121	69.9
Corporate	18	48.6	16	23.2	8	11.9	42	24.3
State	2	5.4	2	2.9	0	0.0	4	2.3
Miscellaneous	2	5.4	2	2.9	1	1.5	5	2.9
Unknown	0	0.0	1	1.4	0	0.0	1	0.6
Total	37	100.0	69	100.0	67	100.0	173	100.0

Notes:

a. Percentage of the 37 large sample companies with a 10 per cent or larger blockholder.

b. Percentage of the 69 medium-sized sample companies with a 10 per cent or larger blockholder.

c. Percentage of the 67 small sample companies with a 10 per cent or larger blockholder.

d. Percentage of the 173 sample companies with a 10 per cent or larger blockholder.

Source: Lamba and Stapledon (2001).

cent) of large sample companies had a blockholder,[21] whereas 86 per cent of medium-sized sample companies, and 84 per cent of small sample companies, had a blockholder. The most common type of blockholder for large companies was a 'Corporate' holder – accounting for 49 per cent of all blockholders[22] in those companies, with 'Family' blockholders accounting for a further 41 per cent. 'Family' blockholders dominated in the medium-sized and small companies – accounting for 70 per cent of all blockholders in medium-sized companies and 87 per cent in small companies.

Lamba and Stapledon conducted a regression analysis in an effort to determine the drivers of the different ownership patterns summarized above. They found that:

1. Regardless of which threshold for 'control' was used, there was a high statistically significant relationship between ownership structure and the level of related party transactions (a proxy for private benefits of control). The relationship was positive – that is, consistent with the authors' hypothesis that the larger the level of private benefits, the more likely the company was to have a controlling shareholder.
2. Company size appears to be an important explanatory variable – larger companies were less likely than medium-sized and small companies to have a controlling shareholder.
3. Mining sector companies were more likely to have a controlling blockholder than were other types of companies.
4. Several other variables lacked a statistically significant relationship with ownership structure. These were industry (in terms of financial and non-financial companies), the firm's age (in terms of the number of years the company had been listed on the stock exchange), the market-to-book ratio (a proxy for a company's growth prospects), and standard deviation of returns (a measure of risk).

Many US empirical studies have investigated whether there is a link between the presence or absence of a large non-institutional shareholder and corporate performance. The results have been mixed.[23] Several studies indicate that significant share ownership by senior management is associated with enhanced corporate performance.[24] In a widely cited study, Anderson and Reeb (2003) found that S&P 500 firms with founding-family blockholders perform better and are more valuable than non-family firms. The relation between founding-family holdings and firm performance was found to be non-linear, with performance first increasing as the level of family ownership increased but then decreasing with increased family ownership. They also found that when families are actively engaged in firm management (that is, a family member is CEO), firm performance is better than if an outsider is CEO.

On the other hand, one US study found that sample companies having other companies as significant (but less than 50 per cent) shareholders were likely to exhibit relatively poor share price performance.[25] The study's authors were attracted by the possible explanation that large corporate shareholders are able systematically to transfer wealth from other shareholders by means of 'inter-corporate "perquisites" – financial and product market transactions at favorable terms to the [large corporate shareholder]'.[26]

There is currently only limited Australian evidence on the relationship between large non-institutional share ownership and corporate performance. Farrer and Ramsay (1998) have investigated the connection between directors' share ownership and corporate performance in listed Australian companies.[27] Their study produced inconclusive results. The relationship differed according to the performance measure used (Tobin's Q, shareholder returns or growth in earnings per share), whether director share ownership was measured by dollar value or a percentage of the company's shares, the size of the company, the type of director (executive or non-executive), and the industry in which the company operated.

Share ownership by institutional investors

Institutional share ownership is at a lower level in Australia than in, for instance, the United Kingdom. Among the 240 sample companies studied by Lamba and Stapledon, it was only in 50 (or 21 per cent) that the largest or only substantial holder was an institutional investor holding the shares as a portfolio investment for clients. Overall, institutional shareholdings account for about 45–50 per cent of the Australian share market, compared to about 70 per cent in the United Kingdom.[28] Table 10.5 provides a breakdown of the substantial holdings of institutional investors in the 200 largest listed Australian companies as at 2004. It reveals that significant holdings, well above 5 per cent, are not uncommon.

Before 1990, institutional investors' role in corporate governance in Australia was confined largely to tendering – or not tendering – their shares to hostile takeover bidders. Since 1990, however, institutional shareholders have played a steadily increasing role in mitigating agency costs. They have produced and promoted best-practice guidelines covering board structure and composition, executive and director remuneration, auditor independence and a range of other matters; participated actively in debates about corporate and securities law reform; intervened occasionally at particular companies, for instance through behind-the-scenes pressure to shake up an underperforming board, or through a public campaign for greater investor protection; and shown a greater propensity to exercise their voting rights since the late 1990s.[29] But Australian institutional investors are not monolithic. Although they share similar views on some matters of general principle, different institutions

Table 10.5 Institutions' substantial shareholdings, 2004

Institution	Number of S&P/ASX 200 companies in which a substantial shareholding was held, by size of holding					
	5–8%	8–11%	11–14%	14–17%	17–20%	20%+	Total
Commonwealth Bank of Australia	21	14	6	1	1	1	44
Barclays Group	26	3	–	–	–	–	29
Perpetual Trustees	9	10	6	3	–	–	28
AMP	16	3	1	1	–	1	22
Maple Brown Abbott	12	7	2	–	–	–	21
National Australia Bank	16	–	1	1	–	–	18
Capital Group Companies	11	3	2	–	–	–	16
Perennial	10	5	–	–	–	–	15
Deutsche Bank	7	4	–	1	1	–	13
UBS	9	2	–	–	–	–	11
Lazard Asset Management	7	3	–	–	–	–	10
ING Australia Holdings	8	1	–	–	–	–	9
Investors Mutual	5	2	1	1	–	–	9
Schroder Investment	5	2	–	–	–	–	7
Westpac Banking Corporation	6	–	–	1	–	–	7
Goldman Sachs JB Were Group	4	2	–	–	–	–	6
452 Capital	6	–	–	–	–	–	6
Concord Capital	3	2	–	–	–	–	5
Merrill Lynch	3	1	1	–	–	–	5
Franklin Resources	3	1	–	–	–	–	4
GMO Australia	4	–	–	–	–	–	4
Macquarie Bank	2	1	–	–	–	–	3
Caledonia Investments	2	1	–	–	–	–	3
Delaware International Advisers	1	2	–	–	–	–	3
Fidelity Group	1	–	1	1	–	–	3
Others	25	12	5	1	1	–	44
Total	222	81	26	11	3	2	345

Source: ISS Australia: www.issproxy.com/about/offices/australia.jsp.

commonly take different approaches to corporate governance issues. This reflects the fact that they are fierce competitors in the investment management industry.

Where there is a large non-institutional blockholder on a company's share register, the scope for institutional investors to minimize agency costs is reduced. The unsuccessful intervention by institutional shareholders at Darrell James Limited provides a good illustration.[30] Four institutions and one large private investor, collectively representing 30 per cent of the equity, requisitioned an extraordinary general meeting (EGM) at which it was proposed to make changes to the company's board. At the time of the requisition, the chairman and his family controlled 33 per cent of the equity. However, prior to the EGM, the chairman's family company bought a further 3 per cent of the shares in the market (taking their stake to 36 per cent), and a private investor loyal to the chairman purchased 1 per cent to take his holding to 6.75 per cent. Prior to the EGM, the chairman also organized a slate of five new non-executive director candidates to stand against the requisitionists' nominees; and, significantly, secured the support of an institutional shareholder holding 4 per cent of the equity. At the EGM, over 90 per cent of the equity was voted, with 54 per cent supporting the existing board and 38 per cent supporting the dissident institutions. The chairman's five nominees were elected to the board, and the institutions' resolutions were not passed. Nevertheless, institutional investors' exercise of voting rights, together with corporate law and stock exchange listing rules that prohibit related parties from voting on transactions in which they are interested,[31] have an important role to play in ensuring that the interests of minority shareholders are not ignored by the blockholder.[32]

Monitoring by non-executive directors

The use of independent non-executive directors to monitor the performance of the executive management is a widely recommended practice in corporate governance guidelines around the world. Australia is no different: the three main sets of guidelines all recommend that a board of a listed public company should contain a majority of independent directors.[33]

The most recent study of board composition in large Australian companies (the 100 largest measured by market capitalization) found that, on average:

- The board consisted of nine directors (ranging from four to 15).
- Executive directors made up 21 per cent, and non-executive directors 79 per cent, of the board.
- About 65 per cent of the non-executive directors (and therefore about 51 per cent of all directors) satisfied an 'independence' standard, with the remaining 35 per cent of non-executive directors having some form of business, advisory or substantial ownership affiliation with the company.

- The board chair was a non-executive director in 89 per cent of cases – in 47 per cent of cases an *independent* non-executive, and in 42 per cent of cases an *affiliated* non-executive. The positions of CEO and chair were combined in only 3 per cent of sample companies, and there was a CEO and a separate executive chair in 8 per cent of cases.
- All companies had an audit committee, 98 per cent had a remuneration committee and 83 per cent had a nomination committee.[34]

Quite a number of studies have explored the relationship between board composition (for example, the proportion of independent or non-executive directors) and corporate performance. Many of the studies have used US data. Most do not find consistent evidence of a statistically significant link between board composition and corporate performance.[35] A number of factors may limit monitoring of managers by independent directors. These include limited time available to independent directors, lack of detailed knowledge of the company's business by independent directors, and there being too few independent directors on a particular board to be effective.[36]

A similar pattern is emerging from the small number of studies using Australian data. Two Australian studies have looked at the relationship between board composition and company performance, focusing simply on the executive and non-executive split on the board;[37] that is, ignoring the fact that some non-executive directors are independent while others have affiliations with the company and/or its management. Neither study found a statistically significant relationship between the proportion of non-executive directors on the board and share-price performance. Lawrence and Stapledon (1999) classified the Top 100 companies' directors (as at 1995) as executive directors, affiliated non-executive directors and independent non-executive directors, and tested whether different board composition was related to different corporate performance – both in terms of share-price performance and various accounting measures of performance. On the whole, their tests produced no solid evidence that the proportion of independent directors – or of other types of directors – influences corporate performance.

Using more recent data (for 1998) and a sample drawn from a broader group of companies (Top 500 rather than Top 100), Fleming and Stellios (2001) found that Australian companies with a relatively low proportion of non-executive directors tended to pay their CEOs excessively.

Disclosure rules and governance codes

The last decade has seen significant increases in disclosure requirements for publicly traded companies in Australia. For example, the interpretation and enforcement of continuous disclosure rules has toughened over the past five years.[38] Corporate law reforms introduced in 1998 require listed companies to provide extensive disclosure about director and executive remuneration, including a detailed breakdown of pay, component by component, for all directors and the five highest-paid executives below board level.[39] Another recent disclosure enhancement is a rule requiring companies to place on a public register the results of any 'tracing' they do about holders of interests in their shares.[40]

In 1996, ASX Listing Rule 4.10.3 was introduced – requiring companies to disclose their corporate governance practices. Listing Rule 4.10.3 was strengthened in 2003 when it was transformed into a UK-style 'comply or explain' rule. All companies listed on the ASX must disclose by reference to the benchmark set of standards published by the ASX Corporate Governance Council. The Council, formed in August 2002, consists of representatives of Australian peak bodies that represent directors, executives, superannuation (pension) funds, fund managers, auditors, company secretaries, investment bankers, lawyers and other key stakeholders and advisers. The Council's mission was to develop and deliver an industry-wide, supportable and supported framework for corporate governance which could provide a practical guide for listed companies, their investors, the wider market and the Australian community. In March 2003, the Council published its *Principles of Good Corporate Governance and Best Practice Recommendations*. The ten principles relate to the following: top management and board members' responsibilities, effective board composition, ethical decision making, independent verification of financial reporting, timely and balanced (both positive and negative) disclosure, shareholder rights, risk management, encouraging top management and board member best performance, remuneration, and legal and other legitimate obligations to shareholders.

Several groups that address corporate governance issues were formed during the early 1990s. The Australian Investment Managers Association (AIMA) became an influential group in corporate governance, eventually merging into a new organization: the Investment and Financial Services Association (IFSA). IFSA is the peak industry body representing fund managers. The Australian Council of Superannuation Investors (ACSI) is the peak industry body representing the interests of superannuation (pension) funds in their capacity as equity investors. Both IFSA and ACSI have detailed corporate governance guidelines. The Australian Shareholders Association (ASA) represents retail investors, and has a reasonably high media profile in the governance area.

IFSA's main set of guidelines, *Corporate Governance: A Guide for Fund Managers and Corporations*, is known as the Blue Book. The fifth edition was published in October 2004. Among the Blue Book's recommendations are that boards should include a majority of independent directors, the chairman should be an independent director (and, if not, a 'lead director' should be appointed from among the independent directors), the audit committee should consist solely of independent directors, and that boards should appoint nominating and remuneration committees composed of a majority of independent directors. The Blue Book advocates that independent directors meet separately on a regular basis to review the performance of the board and management, and that boards should disclose remuneration policies. Other policies call for unbundling multiple items into single resolutions and subjecting all major corporate changes to shareholder votes.

IFSA also has detailed sets of guidelines on executive share option plans (and other long-term equity incentive plans) and employee share plans. The guidelines on long-term equity incentive plans include that options be granted at no less than the prevailing market price, that vesting periods be significant, that challenging performance hurdles be incorporated, and that dilution be capped at 10 per cent for all plans aggregated.

ACSI published a detailed set of governance guidelines in 2003, and a second edition in August 2005: *Corporate Governance Guidelines: A Guide for Superannuation Trustees to Monitor Listed Australian Companies*. The ACSI recommendations are broadly similar to those of the ASX Corporate Governance Council and IFSA, but are more detailed and demanding in relation to executive remuneration. For instance, ACSI has detailed guidance on termination payments, including a recommended maximum payout of 12 months' base salary.

Independent audit

As was the case in the US, the UK and elsewhere, the independence of auditors became the focus of great attention in Australia in the aftermath of the major corporate collapses and scandals of 2001. The federal government commissioned a major inquiry,[41] which ultimately led to a raft of reforms.[42] Interestingly, one potential inhibitor of auditor independence – the provision of non-audit services to an audit client – has not been subjected to anywhere near as strict a response in Australia as it has in the US (where many non-audit services are effectively banned).[43] The Australian response on this issue has been closer to the British response,[44] involving enhancement of disclosure rules and revision of professional codes of conduct.[45] This is despite the fact that, over the decade to 2002, the average audit fee paid by an S&P/ASX 100 company increased by 9 per cent, while the average non-audit fees paid to the auditor increased by 230 per cent.[46]

Incentive remuneration for senior executives

An executive's compensation package can be structured with a view to aligning more closely the interests of that executive with the interests of the company's shareholders. This would typically involve tying some components of the executive's compensation to corporate performance. If a proportion of an executive's compensation is placed 'at risk' in an appropriate fashion, the executive's rewards should move broadly in line with shareholders' returns.

In practice, the two components of executive compensation which are usually contingent on some aspect of company performance are (i) the short-term incentive, and (ii) the long-term incentive. A short-term incentive is an extremely common component of the compensation package of senior executives of Australian publicly traded companies. Most often, the short-term incentive is described as the 'annual bonus', and is paid in cash. Most large publicly traded Australian companies use performance measures other than share price and dividends in determining the short-term incentive for their senior executives. The performance measures are often related to 'internal' performance and accounting performance (for example, earnings per share) rather than share price performance.

The most popular form of long-term incentive among the S&P/ASX 200 companies (the 200 largest publicly traded Australian companies by market capitalization) is the traditional option. This is an option which has an exercise price equal to the market price of the company's shares at the time the option is granted. As at the end of 2004, 56 per cent of long-term incentive plans at S&P/ASX 200 companies provided for the issue of traditional options.[47]

Another popular type of long-term incentive used by Australian companies is the zero exercise price option (ZEPO). ZEPOs are usually described as 'performance rights', 'performance award rights', 'performance shares', 'allocation rights', 'deferred shares' or something similar. In contrast to traditional options, the executive pays nothing to the company when exercising ZEPOs. Under a typical ZEPO plan, the executive is granted conditional rights to acquire shares from the plan trustee. If the plan's performance hurdles are met and the executive is still employed by the company at the end of the vesting period, the executive will become unconditionally entitled to the shares – and will be able to sell them and make some money. The amount of money made will depend on how the company's share price has performed since the ZEPOs were granted. But even if the company's share price has fallen since the grant date, the executive stands to make something.

As at the end of 2004, 34 per cent of long-term incentive plans at S&P/ASX 200 companies provided for the issue of ZEPOs.[48] ZEPOs have become increasingly popular, with several companies publicly abandoning traditional options and replacing them with ZEPOs.[49]

Traditional options have a 'natural' performance hurdle, in that the executive will rationally only exercise the options if the share price at the vesting date is greater than the exercise price. ZEPOs do not share this feature. Given that an executive who holds ZEPOs can still make money even if the share price at vesting date is lower than it was at grant date, it is not surprising that performance hurdles are *de rigueur* for ZEPO plans used by publicly traded companies in Australia. All 21 ZEPO plans that were voted on by shareholders in S&P/ASX 200 companies during 2003 incorporated at least one performance hurdle.[50]

The most common hurdle among S&P/ASX 200 companies relates to total shareholder return (TSR) – which is in essence the growth in the company's share price plus dividends paid (and assumed to have been reinvested) during the year. As at the end of 2004, 45 per cent of long-term incentive plans (whether using traditional options or ZEPOs) at S&P/ASX 200 companies referenced TSR in their principal or only performance measure.[51] The next-most-common performance measure (24 per cent of cases) was earnings per share. Next (12 per cent) was a hurdle that required appreciation in the share price above the market price at grant date.

In terms of an empirical relationship between executive pay and performance, three Australian studies have all found no statistically significant relationship.[52] This was the case regardless of whether performance was measured in terms of share price or various accounting measures. Each study found a positive relationship between company size and CEO pay – which lends some support to the managerialist theories that managers have incentives to maximize firm sales rather than profits.[53] However, these studies all have methodology issues that could at least partly explain the lack of a correlation between remuneration and corporate performance.[54]

Conclusion

The major corporate collapses and scandals that occurred in the US during 2001 and 2002 had counterparts in Australia. As a result, corporate governance has received as much attention in the media and the public arena generally, in Australia, as it has in other developed capital markets in recent years.

This chapter illustrates that while many aspects of the corporate governance regime in Australia are similar to those in countries like the US and the UK, there are some features of the Australian regime that distinguish it; for example, the incidence and role of large blockholders. But, fundamentally, Australia has a relatively well-developed capital market, and its governance environment is generally reflective of shareholder primacy.

Notes

1. ASX Limited, *Fact File 2005: Statistics to 31 December 2004*, Australian Stock Exchange, Sydney, 2005, p. 1.
2. Manne (1965); Jensen and Ruback (1983).
3. Citing Cosh and Guest (2001, p. 36).
4. Citing Schwert (2005, p. 2599).
5. In Germany, for instance, there were only three hostile bids between 1945 and 1998: Franks and Mayer (1998).
6. Ville and Merrett (2000, p. 26); Cheffins (2002, p. 30).

7. Brunt (1994, pp. 486–491).
8. See La Porta et al. (1997, 1998, 2002).
9. Cheffins (2001); Coffee (2001).
10. Australia's legal regime is even more protective of minority shareholders than indicated in the LLSV papers. For instance, Australia is recorded in LLSV as not mandating 'one share, one vote'. In fact, there is a rule requiring one share, one vote for Australian publicly listed companies. The requirement is contained in Rule 6.9 of the ASX Listing Rules. An acknowledged limitation of the LLSV dataset is that they confine their source of shareholder protective rules to statutes. Stock exchange listing rules and securities regulators' rules are not taken into account. In addition, in relation to creditor protection, Australia is recorded as (i) having an 'automatic stay on assets' mechanism in corporate reorganizations, barring secured creditors from enforcing their security; and (ii) allowing management to stay in place during a corporate reorganization. Neither of these is correct. In relation to (i), although there are some restrictions, a typical large secured creditor of a company that has gone into voluntary administration can enforce its security: Corporations Act 2001 (Cth), sections 441A to 441K, 444D. In relation to (ii), management will stay in place during a voluntary administration only if the company's creditors vote in favour of that. Therefore, the level of shareholder and creditor protection in Australia is considerably greater than indicated in LLSV.
11. Corporations Act 2001 (Cth), Part 2F.1A.
12. Corporations Act 2001 (Cth), section 250R.
13. See, for example, *Daniels v Anderson* (1995) 16 ACSR 607; *Gamble v Hoffman* (1997) 24 ACSR 369; *ASIC v Rich* (2003) 44 ACSR 341.
14. Berle and Means (1968).
15. Shleifer and Vishny (1986); Daniels and Halpern (1995); Holderness (2003).
16. Stein (1989).
17. Shleifer and Summers (1988).
18. Allen and Phillips (2005).
19. Demsetz and Lehn (1985); Barclay and Holderness (1989).
20. Defined using the 10 per cent threshold.
21. Defined using the 10 per cent threshold.
22. Defined using the 10 per cent threshold.
23. See the studies summarized in Ramsay and Blair (1993, pp. 160–62).
24. See the studies summarized in Holderness (2003, pp. 58–9) and Black (1992, pp. 917–24).
25. Rosenstein and Rush (1990).
26. Ibid. (p. 50).
27. See also Crasswell et al. (1997).
28. Stapledon (1999, pp. 19–20).
29. See generally, Stapledon (1996, chs 7, 8); Ramsay et al. (2000); ACSI (2003); IFSA (2004).
30. See McIlwraith (1991a, p. 16; 1991b, p. 64; 1991c, p. 21); Owen (1991, p. 43).
31. See Corporations Act 2001 (Cth), Chapter 2E ('Related party transactions'); ASX Listing Rules, Chapter 10 ('Transactions with persons in a position of influence').
32. The possibilities for abuse of minority shareholders by controlling corporate shareholders in Australian companies are illustrated well by the Independent Resources litigation: *Re Spargos Mining NL* (1990) 3 ACSR 1; *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539.
33. ACSI (2003, p. 4); ASX Corporate Governance Council (2003, Recommendation 2.1); IFSA (2004, para. 11.4).
34. ISS Australia (2005).
35. See the review in Stapledon and Lawrence (1997); see also Millstein and MacAvoy (1998).
36. Stapledon and Lawrence (1997, pp. 158–60).
37. Grace et al. (1995); Calleja (1999).
38. ASX Listing Rule 3.1; ASIC (2000, 2004).
39. Corporations Act 2001 (Cth), section 300A.
40. Corporations Act 2001 (Cth), section 672DA.
41. *The Independence of Australian Company Auditors* (2001).
42. The legislative reforms were introduced into the Corporations Act 2001 (Cth) by the

Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Cth) (known as the CLERP 9 reforms).
43. Public Company Accounting Reform and Investor Protection Act of 2002 ('Sarbanes–Oxley Act'), section 201.
44. Companies (Audit, Investigations and Community Enterprise) Act 2004 (UK), section 7.
45. Corporations Act 2001 (Cth), section 300(11B)–(11E).
46. Institutional Analysis (2002).
47. Data provided to the author by ISS Australia: www.issproxy.com/about/offices/australia.jsp.
48. Ibid.
49. See, for example, 'Corporate Governance in the Commonwealth Bank of Australia' (2002).
50. Equity Strategies Pty Ltd (2004, p. 4).
51. ISS Australia, see n. 47 above.
52. Defina et al. (1994); Izan et al. (1998); Fleming and Stellios (2001).
53. See, for example, Baumol (1967).
54. Stapledon (2004).

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PART V

CORPORATE GOVERNANCE: ADDITIONAL DIMENSIONS

11 Turkey, corporate governance at the crossroads

Melsa Ararat and Mehmet Ugur

Introduction

Turkey is a rapidly growing emerging market and the largest economy lined up to join the European Union (EU). During its long march for integration with Europe, a high degree of volatility, underpinned by recurrent economic crises, has been a well-documented aspect of Turkey's macroeconomic performance. Ararat and Ugur (2002) examined the corporate governance (CG) framework in Turkey until 2001 and arrived at an unequivocally pessimistic conclusion. Throughout the 1980s and 1990s, the Turkish CG regime was characterized by opacity and was prone to corrupt practices. The capital market was characterized by low liquidity, high volatility, high cost of capital (low firm valuation) and limited new capital formation. Controlling shareholders maintained large stakes and have leveraged cash flow rights due to privileged shares and pyramidal ownership structures. In addition, shortcomings in the legal and regulatory framework were contributing substantially to the risks of investing in equity markets in Turkey. These deficiencies affected adversely not only the flows of foreign direct investment but also the development of an equity market into which both foreign and domestic savings could be channelled.

In a follow-up article, Ugur and Ararat (2004) argued that the economic policy reforms that followed the 2001 crisis can be expected to induce improvements in CG standards for two reasons. First, the transition to a rule-based economic policy would increase the credibility of the statutory CG reforms. Second, the macroeconomic stability that seemed to follow the economic policy reform would encourage voluntary improvements in CG standards as equity finance becomes a more viable option. The research led to the conclusion that the statutory CG standards in Turkey have improved, but highly concentrated ownership structures and the inadequacy of the enforcement framework would continue to constitute serious obstacles.

In this chapter, we examine new evidence to ascertain the extent to which the quality of CG standards can be related to the emergence of a rule-based economic policy framework and the subsequent reduction in macroeconomic instability. The analysis below suggests that the positive impact of the change in the economic policy framework is still evident, but there is still significant resistance to change in a number of areas.

Setting the scene: economic policy developments in Turkey

During the last three decades, macroeconomic instability has gone hand in hand with liberalization, which started in 1980. Policy choices of populist and unstable coalition governments led to three financial crises (in 1994, 2000 and 2001). Inflation reached 106 per cent in 1994 and remained above 60 per cent until 2001. While macroeconomic instability undermined the credibility of the government as a rule setter and as an enforcer, corporations opted for low-quality CG practices in order to counterbalance the risks arising from macroeconomic instability and to secure an artificial competitive edge against their competitors. Disclosure remained limited, pyramidal structures proliferated, intra-group transactions and fund diversions became evident and boards remained dominated by insider owner/managers. These factors weakened investor confidence in the market and caused the share of foreign direct investment to remain low in relation to Turkey's economic fundamentals.

Macroeconomic instability and poor CG standards were related to the heavy involvement of the state in the economy, which led to two undesirable consequences. On the one hand, it fostered a political culture in which the legitimacy of the state was a function of the 'rents' that the government could distribute rather than its ability to provide 'public goods' such as a stable macroeconomic environment, a transparent regulatory system, social conflict resolution mechanisms, and so on. On the other hand, the state's heavy involvement increased 'private risks'. Therefore, it induced private economic agents to pressure the government of the day to compensate at least part of their risks – irrespective of whether such risks have been due to government action or the private actors' own actions. This second tendency combined with the first and led to persistent favouritism, corruption practices, opacity, and so on (Ugur 1999: ch. 3).

It is important to note here that macroeconomic instability in the 1990s was observed during a period when the role of external anchors such as the EU or the International Monetary Fund (IMF) was limited. The EU did not emerge as an effective anchor in the 1990s because it was not prepared to provide Turkey with the prospect of membership. In fact, while the Central and Eastern European countries have upgraded their relations with the EU and signalled firm commitment to policy reforms as well as macroeconomic stability, Turkey's relations with the EU have deteriorated since the rejection of its membership bid in 1989. The deterioration was evident until the Helsinki Council decision of 1999, which granted Turkey an official candidate status. The EU's reluctance to admit Turkey was largely due to lack of commitment to integration on the part of Turkish governments. However, in the absence of an EU anchor in the form of Copenhagen criteria tied to the prospect of eventual membership, policy makers' attempts at reforms and stabilization remained largely non-credible – hence the anchor/credibility dilemma analysed in Ugur (1999).

Similarly, the IMF did not emerge as an effective anchor either. The IMF intervened twice (in 1994 and 1999) with a credit package in return for structural reforms and stabilization. However, policy makers made only half-hearted attempts to comply with IMF conditionality. This lack of commitment has been underpinned by policy makers' preference for discretion, which was necessary for maintaining clientelistic/populist policies. It was only after the crisis in 2001 that the IMF was able to secure a firm commitment to stabilization and economic reforms. The weakness of the external anchors until the end of the 1990s has contributed to the persistence of macroeconomic instability in Turkey thereby reducing the probability of introducing CG reforms (Ugur and Ararat 2004).

Turkey's efforts to achieve macroeconomic stability under an IMF standby agreement delivered tangible results. Fiscal discipline has been restored and inflation has been reduced to single digits from persistently high levels above 60 per cent. In addition, 18 vulnerable banks have been taken over by the Banking Regulation and Supervision Agency (BRSA) at a total cost of US$47.2 billion – after it had been established that these banks were unviable because of either non-performing loans or outright tunnelling. These developments were anchored by an IMF standby agreement signed in 2001. In addition, Turkey has made significant progress in complying with the EU's Copenhagen criteria. Initial reforms undertaken by the coalition government between 2001 and 2002 were accelerated by the new government that was elected in November 2002. On 6 October 2004, Turkey received a qualified go-ahead from the European Commission, which recommended that the EU should begin accession negotiations. According to the Commission, high inflation had come down to historic lows, political interference had been reduced and the institutional and regulatory framework had been brought closer to international standards. Thus, an important change towards a stable and rule-based economy had taken place (EU Commission 2004: 70).

The public sector reforms focused on accountability and transparency, leading to improvements in the audit capacity and framework and in the efficiency of tax regulations. In addition, important markets such as electricity, telecommunications, sugar, and tobacco and alcohol were liberalized, leading to the gradual disappearance of administrated prices and subsidies. The third standby agreement with the IMF, still pending signature, foresees further improvements in the public sector by (i) deepening of structural reforms (ii) implementing public expenditure management, and (iii) strengthening public sector governance including implementation of the national anti-corruption strategy.

Rule-based economic policy and improved CG standards I: regulatory framework reforms after 2002

Despite its long history and large-scale securities trading in the past (see Tanor 2000, Vol. I, pp. 18–28), the modern capital market has only a 20-year history. From 1980s onwards, there was a continuous increase in the number and size of joint-stock companies that opened up their equity to the public. The Capital Markets Law (CML) was enacted in 1981 and the Capital Markets Board (CMB) was established as the sole independent regulatory authority at the end of 1985. Secondary market operations, initially limited to equity trading, started in 1986 with the foundation of the Istanbul Stock Exchange (ISE). In 1992, with amendments to the relevant legislation, the CMB's powers were increased to allow it to define new instruments in response to rapid market developments. The small amd medium-sized enterprise market, gold exchange, and options and derivatives market were opened later in 2003 and 2004.

After a decade of successful performance until 2000, market activity declined with the economic crises. The decline started in 2000 with a loss of 31.8 per cent of market value in 2001. Market capitalization went down to 20 per cent of the GDP from 35 per cent in 2000. Based on the closing values of the last trading day of 2001, the total market capitalization decreased to US$47.69 billion compared to the year-end figure of US$69.5 billion in 2000. There were almost no initial public offerings (IPOs) after 2000 – when a record of US$2.8 billion was raised through IPOs of 35 firms. A weak primary market was conducive to a combination of high trading and high-price volatility. This, in return, was conducive to gains on speculative trading evidenced by a high incidence of capital market abuse.

From 2003 onwards, the picture started to improve significantly in line with the progress in achieving macroeconomic stability. While the 'public sector' was putting its house in order and implementing a strategy to fight corruption, which was frequently blamed by the private sector as the main obstacle to corporate governance reforms, the CMB issued a number of significant directives and recommended a Corporate Governance Code in July 2003. The 'Corporate Governance Principles' (CMB 2003) are presented as the road map for future regulations by the CMB. In the preface to the Principles, which are based on OECD guidelines, the CMB states very clearly that their voluntary nature should not be taken lightly. The CMB is keen to ensure that explanations concerning implementation or non-implementation, conflicts arising from incomplete implementation, statements on future plans for the company's governance practices and so on 'should all be included in the annual report and disclosed to the public' (Ugur and Ararat 2004).

At the end of 2004, market capitalization recovered to US$98.3 billion and reached 37 per cent of GDP with the inclusion of 12 IPOs. Average free float was around 35 per cent as of the end of the year, up from 22 per cent in 2001. Also, the share of the 25 most heavily traded companies in total trading fell from 72 per cent in 2002 to 66 per cent at the end of 2004 – reflecting a moderate increase in the trading of other stocks. Balance of securities traded by foreign institutional investors increased from US$12.9 million in 2002 to US$18.9 million in January 2005 and the total transaction volume by foreign institutional investors increased from US$1.96 billion to US$3.6 billion. At the end of 2003, there were more than one million individual equity investors and two million mutual fund investors. In addition, 288 mutual funds and 81 audit firms were registered with the CMB. As of March 2005, the total market capitalization of the ISE had reached US$115 billion with an average daily trading volume of US$913 million. Nevertheless the market is still shallow, as the total number of companies remains low (307 companies, 22 of which are investment partnerships) and activities are still concentrated around financial institutions. In addition, the market capitalization of the 10 largest companies (3.3 per cent) represented 58 per cent of the total market capitalization (see ISE, www.ise.gov.tr and CMDB, ww.spk.gov.tr).

The CMB, the ISE and Takasbank (Settlement and Custody Bank) are the major institutions involved in the capital market. The CMB regulates the operations of the ISE. Transactions are carried out on the basis of continuous auction trading by an electronic system. As a body, the CMB is appointed by the Council of Ministers for six years and it is capable of directly imposing penalties – including suspension and cancellation of licences and putting the companies on a ‘watch list’ for non-compliance. Securities of such companies can only be traded for 30 minutes a day and transactions are closely monitored. However, the CMB could not take cases to court directly as this right is granted to public prosecutors only. The latest amendments in 1999 strengthened the powers of the CMB and enhanced the institutional infrastructure for the market by establishing new institutions under the CML, such as the Association for Securities Dealers, the Securities Investor Protection Fund, and the Accounting Standards Board. The ISE’s board and its chair are appointed by the government from among the nominees submitted by the CMB for a five-year term. It is governed by a general assembly attended by its trading members licensed by the CMB. Recent history shows that both the CMB and the ISE have been responsive to market needs and that their structural fundamentals do not impose any problems for performing an effective role.

The primary sources of corporate governance regulations are the Turkish Commercial Code of 1956 (CC), CML as amended in 1999 and regulations issued by the CMB. Currently, the CC is undergoing a radical amendment – with the explicit objective of aligning it with European directives on company and capital market laws. The CMB has also announced a major review of the

CML in March 2005 and invited market participants for consultation. A new banking law is in the process of being enacted after a few months of public consultation, with substantial provision regarding the governance of credit lending institutions. All these changes will substantially improve the legal and regulatory framework for corporate governance but the most important improvements will be brought in by the changes in the CC.

The draft banking law which is expected to be enacted by parliament at the end of 2005 sets the ground for dissolving the financial and industrial arms of family-owned conglomerates by ensuring reduction in connected lending and limiting shareholding of banks in non-financial institutions to a maximum of 15 per cent of its own funds. The draft gives ample powers to the BRSA and holds the board and senior managers liable, jointly and severally, for the repayment of credits extended in violation of the act. In addition to general technical requirements for prudent banking (in areas such as accounting, risk management, internal control, bad loan provisions, capital adequacy, elimination of full state guarantee on deposits, and so on) the draft banking law provides for alignment with international best practice and sets strict criteria concerning the personal integrity of general managers, assistant general manages and board members. It authorizes the BRSA to issue mandatory corporate governance rules, including a component of board independence assured by statutory approval of independent member nominations. (See Table 11.1.)

In addition to laws and regulations, the Corporate Governance Principles issued by the CMB in July 2003 and amended in 2004, provide further guidelines for listed companies' governance on a 'comply or explain' basis. They are based on the OECD's Corporate Governance Principles and consist of four parts. Part one includes the principles on shareholders' rights and their equal treatment. In part two, the principles for disclosure and transparency concepts are covered in detail. Part three is mainly concerned with stakeholders defined as the company shareholders and its employees, creditors, customers, suppliers, various non-governmental organizations, the government and potential investors who may decide to invest in the company. Part four includes issues such as the functions, duties and obligations, operations and structure of the board of directors and the committees to be established for supporting the board operations. All listed companies are mandated to report their compliance with these principles in their annual report, starting from 2004. According to the CMB's announcements, to encourage companies to adopt high CG standards, a separate CG index will be set up in the ISE. To qualify, companies should achieve a minimum of 6 out 10 points in an independent rating of their compliance with the CMB's CG guidelines. According to a press release issued by the ISE in March 2005, the index will be calculated as soon as five companies meet the minimum requirements. The ISE has also

Table 11.1 Recent improvements in Turkish corporate governance standards

Year	Reform/improvement
Improvements to the regulatory framework	
2003	The Commercial Code of 1956 comes under review, with a view to making it compatible with EU company and capital market legislation
2003–05	Work on the banking law, which would restrict connected lending and empower the BRSA to issue mandatory corporate governance codes for banks
2003 (July)	The CMB issues the Corporate Governance Code. The code provides for various standards on a 'comply or explain' basis for listed companies
2005 (March)	The CMB announces a major review of the CML
Improvements to the disclosure framework	
2004 2005	Introduction of inflation-adjusted accounting standards (IFRS) are the mandatory standard
2004–05	New internal auditing standards are introduced. 'Audit committees' headed by a non-executive director have to endorse and be held responsible for financial reports
2004–05	External auditing standards are improved, by tightening the regulatory oversight of auditing firms and requiring rotation of auditors every 5 years
2004–05	Separation of audit and consultancy companies
2004–05	Work towards introducing the public disclosure system, which will employ digital certificates and electronic signatures

announced that listing fees for companies qualified to be included in the CG index will be discounted by 50 per cent. A new decree regarding rating agencies regulates the credit rating and CG rating activities. Rating companies can only be set up as joint-stock companies with adequate capital; they are subject to the new regulation with respect to their independence and competence separately for credit and corporate governance ratings.

Given the evidence above, the post-2002 reforms and changes expected in the near future in the legal and regulatory framework constitute significant steps towards the establishment of good CG standards. In that sense, they are steps in the right direction and may contribute to the emergence of an effective capital market. In this process, the CMB emerges as a significant actor, which is committed to ensure full compliance with EU and IOSCO (International Organization of Securities Commission) principles by the end of 2005 (president's speech in March 2005, www.spk.gov.tr). From an analytical perspective, these developments imply that the transition to a rule-based economic policy framework and the macroeconomic stability that followed have induced CG reforms. The improvement in regulatory standards in the last few years either followed or was contemporaneous with economic policy reform and macroeconomic stability. As the government adopted a rule-based approach to economic policy, the statutory rules of the game in the area of corporate governance are now being redefined. In addition, the corporate sector is now more willing to upgrade its CG practices as equity finance becomes a relatively more feasible option under macroeconomic stability.

Rule-based economic policy and improved CG standards II: improvements in the disclosure standards

The disclosure infrastructure for listed firms has been strengthened in the last few years through new decrees issued by the CMB on auditing and accounting standards and as a result of improvements in the technological infrastructure. A major missing component of international standards, namely inflation adjusted consolidated reporting, was adopted in 2004. A vast majority of ISE-30 companies had been issuing annual reports and quarterly statements based on the International Accounting Standards (IAS) voluntarily for some time. In 2004, the IFRS was an optional standard accepted by the CMB and finally, as of 2005, it has become the mandatory standard, putting Turkey ahead of many EU countries in adopting international standards.

New regulations have also been adopted in harmony with international audit standards. Listed companies have to establish an 'audit committee', headed by a non-executive director, and officers have to sign off the financial reports with the statement that the information reflects the financial position and operating results of the company and that the reports do not include unfair, misleading or deficient explanation. External audit standards have been substantially improved in the process by strengthening the regulatory oversight of audit companies, requesting rotation of auditors every five years and mandating the separation of consulting and auditing activities. Audit companies are approved by the CMB and they are subject to civil action if their statement misleads the investors. However, the quality of the majority of the audit firms is questionable. The Independent Audit Association founded in 1988 does not have a statutory position to self-regulate the profession.

Public disclosure is facilitated by means of a prospectus and circulars, financial statements and reports and public disclosure of material events. As a general rule, public companies are required to disclose any changes that may affect the company's market value. Specially mentioned by the CMB are changes in ownership and management, fixed assets through sales or purchases, business activities, investments and the financial situation of the company. In the case of subsidiaries, changes in the parent company are also required to be disclosed. Irregularities and non-compliance can be subject to criminal law.

The CMB's information infrastructure is currently being upgraded to a high standard in order to combat capital market abuses and ensure effective surveillance of market transactions as well as timely disclosure. The public disclosure system will employ digital certificates and electronic signatures. All public disclosure will be disseminated electronically via the internet. The system has been running for a trial period since November 2004 and it is expected to be fully operative in 2006, eliminating paper-based reporting completely.

Although the picture for listed companies is looking rather rosy, it is much less so for unlisted firms. Furthermore, unregistered economy and corruption are still posing serious threats for the efficient functioning of the market. There is no set of generally accepted accounting principles that applies equally to all companies operating in Turkey – other than the general rules that govern aspects of accounting in the Tax Procedures Code and the Uniform Chart of Accounts which prescribe a code of accounting and a format for the presentation of financial statements. The new CC is expected to change the situation by adopting the IAS for all joint-stock companies above a certain size and mandating an annual external audit.

During the crisis years, the role played by civil society against corruption and in monitoring corporations was extremely limited. First of all, restrictions imposed upon the civil society organizations coupled with a highly monopolized media and the tradition of opacity exacerbated the information asymmetry between society on the one hand and the state and the private sector on the other. Second, corruption was legitimized in the eyes of the civil society due to the moral void (Ararat 2004). With the ongoing democratization reforms, this picture is expected to change but the monopolistic structure of media will continue to pose a problem. An S&P/CGFT Transparency and Disclosure (T&D) Survey recently conducted by S&P and Sabanci University's Corporate Governance Forum evaluated disclosure practices of 52 companies listed on the ISE. The survey also compared these companies with companies in other markets, which are surveyed by S&P/IFC Global Index (International Finance Corporation), using the same methodology. The survey results reveal that Turkey compares with Emerging Asia, is better than Latin America and slightly worse than Asia Pacific (S&P and CGFT 2005).

The survey indicates that Turkish companies score higher in financial transparency but the disclosure on board and management structure and

Table 11.2 Comparison of transparency and disclosure scores (out of 100)

	Composite score	Ownership structure	Financial disclosure	Board structure and processes	No. of companies
UK	70	54	81	70	124
Europe	51	41	69	41	227
US	70	52	77	78	500
Japan	61	70	76	37	150
Asia-Pacific	48	41	60	42	99
Latin America	31	28	58	18	89
Emerging Asia	40	39	54	27	253
Turkey	41	39	64	20	52

Sources: S&P (2002); S&P and CGFT (2005).

processes is significantly worse than the rest of the world. This evidence, as was the case above with respect to the regulatory framework, suggests that the transition to a rule-based economic policy has been followed by some improvements in CG standards concerning transparency and disclosure. However, the evidence also indicates that Turkey is still at the beginning of a lengthy catching-up process – as can be seen from the difference between Turkish and developed-country standards.

Resistance to change

Despite the positive trends examined above, there are still significant obstacles to sustained improvement in CG standards. These obstacles are evident in the following areas: enforcement/implementation; shareholders' rights and investor protection; board structure and processes; and corporate ownership structure. In what follows, we shall examine the nature of resistance to change in these areas.

Enforcement

Throughout the 1990s, there were severe operational problems with the legal process and law enforcement. First, ministers and members of parliament enjoyed extensive immunity against corrupt practices, which included permissive supervision, lenient law enforcement and distribution of rents in return for political support (see Ugur 1999: 68–75). Second, the process was complicated, slow and costly; or it was unpredictable due to heavy reliance on decrees. Third, the general inefficiency of the legal process and the weaknesses in law enforcement compromised the institutions that were introduced to supervise listed corporations. Since 2000, the CMB has filed complaints to the office of public prosecutors for around 100 CML violations every year.

Only one case in each year has reached decree absolute, with the rest resulting in dismissals and adjournments. The average time between the CMB's appeal and the first verdict (excluding decisions on adjournment and dismissal) was 12 months. The public prosecutor had not acted on files concerning 26 cases in 2001 and half of the cases in 2002. The result is that only 1 per cent of all complaints ended up with any punishment. (www.spk.gov.tr). However, in line with our argument that macroeconomic stability provided incentives for improvements in corporate governance, we have observed some improvement in compliance. This is reflected in a decrease in the number of cases taken to the public prosecutors by the CMB – from 165 in 2003 to 50 for the first eight months of 2004. In addition, the enforcement and rule of law are now considered as the most important issues by corporate actors – as reflected in a conference organized by the Istanbul Chamber of Commerce in May 2004.

Shareholders' rights and investor protection

The CML applies to all joint-stock companies with more than 250 shareholders whether listed or not. In 2004 there were approximately 700 companies subject to CML; however, the regulatory regimes are different for each group, for example, cumulative voting is mandatory for unlisted joint-stock companies with more than 500 shareholders. In general, fundamental rights of shareholders include participation and voting in general assemblies, electing the board, receiving dividends, requesting information from the corporation, submitting the company to audit, challenging resolutions of the general assembly and filing civil actions against directors who fail to perform their duties. Minority rights start at 5 per cent in public companies and 10 per cent in non-public companies. Minority shareholders can veto the release of management, demand that the company or statutory auditors take legal action against the directors who have violated CC, demand that special statutory auditors be appointed, call an extraordinary general meeting or add items to the agenda and demand postponement of discussions on the balance sheet for one month. A recent addition to this list is the right to elect directors by the use of 'cumulative voting', provided that the articles of association have provisions to this effect. CG Principles have additional provisions that are voluntary. Cumulative voting is recognized and commended by the CMB but implementation requires a change in the articles of association of the company.

With the exception of a mandatory public announcement of the agenda and venue and making the documents available for shareholders at company premises 15 days before the assembly, provisions regarding general assemblies are vague. CC provisions regarding the right to participate in discussions are also unclear and subject to board discretion. Unless required for quorum purposes, institutional shareholders are requested to abstain from voting.

Transfer of shares may be problematic; shareholders are required to register their ownership in the share register maintained by the board in the case of transfer of nominee shares that are not traded on the stock market, despite the decree that sets Takasbank records as the primary source for ownership of shares registered by the CMB. In addition, 23 per cent of companies listed on the ISE are reported to have provisions imposing limitations on transfer of shares in their articles of association (CMB 2004). This is probably associated with the controlling shareholders' desire to maintain control.

Privileged shares are allowed subject to shareholder approval but CC requires all shares to have at least one vote. A unique exemption is usufruct shares (or dividend right certificates) which give additional cash-flow rights to founders without voting rights. Usufruct shares are not included in the share capital and they can also be issued to the public after the incorporation. CG principles recommend 'one share, one vote' but allow non-voting shares if provisions exist in the articles of association. Preferred shares are different from privileged shares and give rights to the owners to receive dividends before the shareholders of common stocks. Common stocks can be classified and assigned different privileges. The most common privilege is nomination rights. The CMB (2004) notes that 42 per cent of the listed companies have privilege shares with nomination rights. This is understandable since board nomination is a right given only to the shareholders and to be used only during the general assembly. The use of shares with nomination rights or keeping control rights are alternative means used by corporations to prevent chaotic assemblies. Other common privileges include multiple voting rights, a predetermined dividend rate or allocation priority in the case of liquidation.

The CMB issues mandatory minimum dividend rates every year but there is no requirement to disclose the dividend policy. Shareholders are granted pre-emptive rights, but the CC allows shareholders to restrict those rights by a majority vote. Authority to restrict pre-emptive rights can be delegated to the board, but in any case restrictions can only be applied equally to all shareholders. In practice this authority is used for new issues. Share buybacks or treasury stocks are not allowed, although the amendments to the CC are expected to change this situation.

Insider trading is a criminal offence punishable with fines and imprisonment. The CMB is responsible for monitoring and investigating cases and application to the public prosecutors, however provisions are vague and monitoring capabilities are limited. The CML also regulates 'disguised profit transfers' in the case of related party transactions and requires disclosure of related parties. Tunnelling and transfer pricing are unlawful and carry criminal liabilities, although the detection and monitoring of such transactions have not been very efficient in the past. Taboglu (2002) reports that 362 'real persons' or legal entities were prohibited from trading in stock markets in 2002 and notes that a high percentage of suspected cases are not prosecuted because of the difficulty in providing a prima facie case in the absence of effective surveillance and technical capacity. While the penalties are clear, the procedure to follow and the disclosure requirements are not. There is no definition of ‘related parties’ in law. In most cases, the CMB instructs the company to remedy the situation within 30 days.

Neither class nor derivative action exists under Turkish law, however the shareholders who opposed decisions or who approved the decisions but were misinformed, may ask the courts to nullify the decision if the decision is proven to be contrary to the law. They may take further civil action against the directors and statutory auditors under certain conditions.

Shareholder rights are uniformly applicable to both foreign and local shareholders. Procedures concerning the incorporation of foreign companies have been changed and most of the red tape has been eliminated with recent amendments in the foreign investment law.

A survey of websites of ISE-50 companies shows that only 11 companies have posted their articles of association, the most important document on shareholders’ rights, on their website. Only nine companies disclose any information at all about the backgrounds of their directors and only five companies disclose their Code of Ethics (‘Iyi Şirket’ 2005).

Board structure and processes

Boards usually consist of representatives of controlling shareholders which in most cases are members of a family. Day-to-day operations are delegated to a professional manager and usually one member of the board is designated to be in charge of execution with the oversight of the general manager on behalf of the board. Even when the manager is included and given the title ‘CEO’, his/her authority is limited. The designated director, who is usually a family member (*murahhas aza*), represents the board and has extensive powers.

In a survey conducted by the CMB, listed companies are asked to report on their level of compliance with the CG Guidelines (CMB 2004). According to the survey only 9 per cent of the companies had established a CG committee. Some 78 per cent of the boards include non-executive members (ibid.) but in most cases they are either the members of the controlling family or they are not independent. The CMB reports no acknowledgement of truly independent members as this would require a change in the articles of association of companies and hence filing with the CMB.

The CMB (ibid.) reports that only 4 per cent of the boards are compensated on the basis of company performance. Anecdotal evidence suggests that in many cases boards are not compensated since members are also the owners. The CC allows the board to receive up to 5 per cent of the profits with the approval of the general assembly, provided that the company pays dividends to all shareholders. A directorship fee for board attendance is also defined in CC but is rarely used.

In the S&P/CGFT T&D survey, preliminary results reveal that disclosure about the functioning of the board is significantly poorer than financial or ownership disclosure. This may be considered as less important since the traditional agency problems are less significant in 'insider' systems, but it may be an indication of informality/lack of professionalism in the functioning of the board. The fact that only 50 per cent of the listed companies have a mission or vision statement disclosed to the public (CMB 2004) may be indicative of this lack of formalism. Indeed, Aksu and Kosedag (2005) report, using the S&P/CGFT T&D survey data, that between the extreme quartiles of lowest and highest scores, companies with higher scores especially in the category of board structure and management processes disclosures, have higher returns and accounting measures of profitability.

The board does not have to meet physically unless it is deemed necessary, and in most cases matters for discussion are circulated among the members together with the proposed text of the resolutions. The decisions become binding once they are written in the minutes and duly signed by the members. Anecdotal evidence suggests that board meeting tend to be short and important decisions are made by the controlling families. Employees of parent companies frequently sit on the boards of subsidiaries, mainly for financial oversight. Often these employees are trusted members of the extended family and the number of boards they sit on may be in excess of 20.

Ownership structure

The fourth area where inertia is evident relates to corporate ownership structure and consequences. In his work on corporate ownership structures and corporate performance of 305 listed Turkish companies owned and controlled primarily by families under a pyramidal ownership structure, Yurtoglu (2000, 2003) classifies Turkey as an 'insider' country, with insiders being the country's richest families. Yurtoglu's research shows that companies with deviation of control rights from cash-flow rights are systematically undervalued by the market.

Families directly or indirectly control 80 per cent of all companies (242 of 305 companies). In a substantial majority of the companies, ownership and management overlap. Holding companies own the largest stake in 121 companies with a mean of 47 per cent of outstanding shares. Financial and nonfinancial companies own 39 and 57 companies with stakes close to 50 per cent. Overall, the five largest shareholders owned about 64 per cent of the equity in the ISE in 2001 (Yurtoglu 2003). This figure is not expected to be very different based on the scarcity of new issues since then. The CMB survey (2004) notes that only 36 per cent of companies disclose their ultimate ownership structure.

Investment companies or funds are closed-end partnerships based on contract law. Trust or open-ended company models are not allowed under Turkish law. The consequence of this situation is that outside investors have no voting rights – leading to increased volatility since the only option available to investors is to exit. Most funds, including pension funds, are managed by portfolio management companies belonging to a family-owned group. Portfolios are populated by companies cross-invested by groups on friendly terms. The ‘relationship-based’ nature of the financial markets even in the case of equity investments makes new entries difficult.

Conclusions

Our findings suggest that Turkey’s legal and institutional framework for corporate governance has improved over the past few years. In addition, transparency and disclosure standards are comparable to those in other emerging markets, and recent legislation can be expected to have further positive effects. In terms of structural reform, the most notable change has taken place in the financial sector reforms and in improved supervision of the banking sector. This is followed by the CMB’s CG Principles, which provide a reference point for voluntary improvements.

These findings are in line with those of the research indicating that country characteristics are highly significant in shaping the CG system in less-developed countries. If we focus on economic and financial development and the prospect for economic growth as two country characteristics, we can state with some confidence that the change in these characteristics has been positive and that has had a positive effect on Turkey’s CG standards. However, country characteristics also include ownership structures of the firms and legal systems of the country in which the firms operate. When these characteristics are taken into account, we can see that there is still significant resistance to change. Therefore, the recent improvements in CG standards are still serving as a basis to fill the gap between the law and the desired corporate behaviour. This state of affairs is clearly visible in a number of areas (such as implementation, investor protection, ownership structures, and so on) where the effectiveness of recent reforms remains limited.

There are two obstacles to further improvement in Turkish CG practices. The first is related to the trends in capital flows favouring developed Anglo-Saxon markets and consequential decrease in the significance of emerging market companies in strategic portfolio investments. In fact, when these companies are included in foreign investors’ portfolios, liquidity tends to be the most significant selection criterion even though liquidity is not known to be a proxy for performance. One explanation for the relative lack of investor interest in emerging markets could be lack of information on CG quality where it matters most. In developed markets, the indicators of CG quality are relatively better established and the data are more readily available from public disclosures. In emerging markets with lower standards of public disclosure, disclosure data may be non-credible. In this context, the finding by Aksu and Kosedag (2005) for the ISE provides sober reading: disclosure, widely accepted as the leading indicator of CG quality, does not have an explanatory power in explaining firm value since the variation between companies is small.

The second obstacle is highly concentrated ownership and low flotation rates, both of which deter investors from entering the Turkish market. The CMB's new regulations requiring at least 25 per cent flotation in the IPOs is a positive step in the right direction but is not sufficient to make a significant difference in the near future. The most important injection of capital to the stock market was expected to be realized by privatizations, but privatization remains one of the areas in which the current government seriously underperforms. Hence with 120 brokerage houses and only 307 listed companies with an average flotation of around 25 per cent, the market remains prone to excessive volatility.

Most research on corporate governance treats ownership structure as exogenous with the exception of early work by Demsetz and Lehn (1985). However, recent empirical research on emerging markets and business groups suggests that ownership structures may be an equilibrium outcome of private benefits expected from group control (Khanna and Palepu 2000; Chang 2003; Dyck Zingales 2004; Kim et al. 2004). Korean experience in dismantling business groups through regulatory enforcement provides useful insights into how ownership structures can be influenced by policy choices. The draft banking code is expected to play a similar role in Turkey although to a lesser extent. We also expect the predicted acquisitions of Turkish banks to help the further dilution and dismantling of group structures.

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12 Corporate governance in South Africa*

Philip Armstrong with Nick Segal and Ben Davis

> I am an African. I owe my being to the hills and the valleys, the mountains and the glades, the rivers, the deserts, the trees, the flowers, the seas and the ever-changing seasons that define the face of our native land. (Thabo Mvuyelwa Mbeki, President of the Republic of South Africa)

Introduction

Corporate governance has been a reasonably well-developed concept in South Africa since the establishment of the King Committee on Corporate Governance in 1992, at the instigation of the Institute of Directors of Southern Africa (IoD) and the release of the first King Report in November 1994, which took its name from the Chairman of the Committee, Mervyn King, a prominent businessman and former High Court Judge. It was not stimulated by any significant crisis in the corporate sector at that time; rather it concerned the competitiveness of the South African private sector following the readmission of the country to the global economy following its transition to a fully-fledged democracy after the collapse of apartheid.

The first King Report drew attention to the importance of a properly functioning board of directors as a key ingredient of good corporate governance. It advanced many of the standards and principles advocated in the plethora of national codes that were adopted, particularly in the Commonwealth countries, following the release of the Cadbury Report in the United Kingdom in 1992. The King Report was distinguished by its integrated approach to good governance with regard to financial, social, ethical and environmental practice, to serve the interests of a wide range of stakeholders. This probably reflected the considerable role that business has played in South Africa in both social and economic issues, especially during the period leading up to the political transition from a white minority-dominated system to a democratically elected black majority government.

South Africa's economy before 1994

Since the discovery of precious mineral deposits in the late nineteenth century, the private sector has been central to the country's economic performance.

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Even today, over three-quarters of South Africa's productive capacity rests in the hands of private business. However, the public sector is also a significant factor in the South African economy. State-owned enterprises account for about a quarter of the country's capital stock, and generate approximately a third of all savings in the country (on a gross basis). This means that the public sector plays a critical role in the allocation of capital in the South African economy, which has considerable implications for corporate governance standards in the country.

Until the early 1990s, the South African economy was dominated by a small number of mining finance houses that controlled diverse activities and investments. They operated primarily in South Africa (on account of the stringent exchange control regulations and the political isolation of the economy) although some international trade was carried out *sub rosa*. In consequence, the proper functioning of market mechanisms and the cultivation of a sound corporate culture of transparency and disclosure were largely stifled. These shortfalls were accompanied by excessive rent seeking both by government and private sector management, often at the expense of employees and shareholders generally. This state of affairs was secured through preferential ownership arrangements, such as pyramids or low/non-voting shares, and was usually characterized by control blocs, intra-group transactions and other similar mechanisms that gave rise to a range of conflicting interests. At the same time, the capital and money markets, though mature and well developed by emerging market standards, were dominated by a small number of large insurance and pension funds. These had mutual ownership structures in which the same private sector institutions were central. Again, utilities, infrastructure industries and strategic sectors of the economy fell under the control of state-owned enterprises, where the rationale for government involvement was overtly political. In none of these was serious thought given to issues of governance.

Overall, economic enterprise – whether in the private or public sectors – featured a lack of accountability for performance. It was also severely constrained by inadequate governance structures which hindered the proper functioning of market mechanisms.

Political and economic transformation

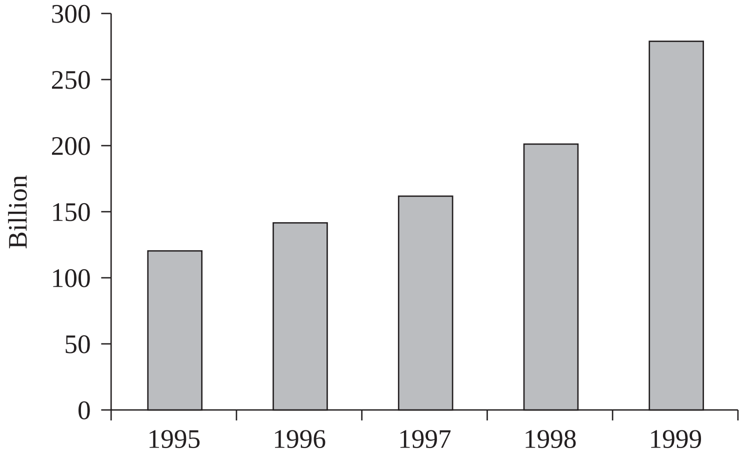
The dismantling of the racially-based political system brought about a profound change in the socio-economic fabric of South Africa. By 1994, South Africa's economy was in an advanced state of decline owing to political isolation, inward-looking economic policies and the legacy of racial exclusion. The weak state of the economy was manifested by stagnant gross domestic product (GDP) growth, declining savings and investment rates, falling formal sector employment and a resultant drop in per capita GDP. The economy was also vulnerable to external forces because of insufficient net inflows, in turn a result of the unattractive investment climate.

In contrast, the new government has adopted a policy of economic liberalization, with special emphasis on capital market development and corporate renewal. Macroeconomic reforms have resulted in the stabilization of major aggregates such as a reduced budget deficit as a percentage of GDP, a decline in inflation and real interest rates, improved transparency in, and predictability of, monetary and fiscal policies, and the successful reintegration of South Africa into the global economy. The creation of sound macroeconomic fundamentals has made more-targeted microeconomic reforms possible, to generate sufficient economic growth to address South Africa's policy goals. Corporate governance has very much been a feature of this process.

While South Africa's GDP is by far the largest on the African continent at \$160 billion, this is a fraction of the global GDP of approximately \$36,000 billion, making South Africa the 29th largest economy in the world in GDP terms. In respect of sub-Saharan Africa, South Africa makes up a significant part of the total GDP of \$417 billion.[1] This presents both challenges and obligations to South Africa in relation to the rest of the continent. Examples of South Africa's efforts to meet these are its prominent role in the New Partnership for Africa's Development (Nepad), and the conduct of South African business interests that are operating in other countries on the continent.

Notwithstanding South Africa's prominence and the acknowledgement of its relatively advanced economic system in the context of emerging markets, it has not been a significant recipient of foreign direct investment (FDI), which remains a cause for concern for the government and the business sector. In 2001, South Africa received approximately \$6.5 billion in FDI on account of an unbundling of cross-shareholdings by the London-listed company Anglo American and its subsidiary, De Beers, but this was an exception: the figure has remained at around \$1 billion or less annually, a fraction of the total global FDI flows of \$735 billion reported in 2002.[2]

South Africa's economy is inextricably linked to that of the Southern African region, and to Africa as a whole, and it is an important focus point in this country's global economic strategy. Hence the economic recovery of the African continent through the Nepad initiative is crucial to South Africa's long-term planning. However, Western Europe remains the largest source of inward investment for South Africa, and accounts for almost half of the country's total foreign trade. Seven of South Africa's top ten trade partners are located in Western Europe, led by the UK, given the historical and political links between that country and its former colony, and is closely followed by Germany. Other partners outside Western Europe are the US, another major source of trade, mainly in unprocessed and semi-beneficiated material; and Japan in the Far East.



Sources: South African Reserve Bank and Statistics South Africa, 2004.

Figure 12.1 Real level of portfolio investment in South Africa since 1994 (in constant 2000 prices)

While historically the bedrock of the South African economy has been the export of commodities derived from the mining and agricultural sectors, the manufacturing sector has become increasingly significant as a result of active official policy interventions. The secondary sector, buoyed by the strong growth in construction spending, has also become a factor in the country's economy. The development of the financial services sector has been particularly pronounced; it is now the largest contributor to GDP (18.8 per cent in 2003), having eclipsed the manufacturing sector in 1998 (17.2 per cent in 2003). This growth was achieved despite the currency crises in 1998 and 2002, and the economic uncertainty resulting from the political and social changes that occurred throughout the 1990s.

South Africa's financial system has emerged as a sophisticated and well-developed sector of the economy, comparable with those of the major financial centres of the developed world. In terms of size relative to GDP, private sector lending and the equity market rank among the deepest in the world. The increasing importance of financial services to the economy, and the role these play in the asset allocation process, have increased investor activity on the local stock market, both by local and international investors, together with market reforms necessary to improve transparency and efficiency. Foreign investors in particular have played a catalytic role by applying pressure for market reform, and for higher corporate governance standards. Adding further emphasis to the need for higher standards has been South Africa's admission to the World Trade Organization (WTO) and its participation in a number of other important multilateral arrangements and accords. These have given further impetus to a series of domestic regulatory initiatives directed towards fostering a market-orientated corporate culture.

Corporate governance reform

The first King Report was instrumental in raising awareness of what constitutes good governance, both in the private and public sectors. It offered to companies, and state-owned enterprises, for the first time, a coherent and disciplined governance framework that was relevant to local circumstances and offered practical guidance. The King Committee has no official mandate (unlike nearly all the other similar initiatives in other countries), and thus its recommendations are self-regulatory. However, it has made an important contribution to the significant progress South Africa has made towards corporate governance reform since the political transition in the mid-1990s. The breadth and sophistication of these reform measures must place South Africa in the top rank of emerging market economies, and in some cases even on a par with some of the more developed markets.

Some of the more significant measures that reinforced the corporate responsibility issues highlighted in the first King Report included the Labour Relations Act (1995), the Basic Conditions of Employment Act (1997), the Employment Equity Act and the National Environmental Management Act (1998). The listings requirements of the former Johannesburg Stock Exchange (JSE), now known as JSE Securities Exchange South Africa, were comprehensively revised, first in 1995 and again in 2000, to incorporate the King Report to ensure that these rules remained in line with international best practice. A number of amendments to the South African Companies Act recommended in the first King Report have also been promulgated, *inter alia*, compelling disclosure of the identity of beneficial owners of shares held by nominees. The Insider Trading Act, introduced in 1998, provides for rigorous supervision and monitoring of insider trading. For the first time in South African legislation, the act extended beyond criminal sanction to embrace civil remedies.

Running parallel with these developments was the introduction of the Public Finance Management Act (PFMA) in 1999, which introduced much more rigorous standards for reporting and accountability by adopting an approach to financial management in public sector institutions that focuses on performance in service delivery, and economic and efficient deployment of state assets and resources. It was also followed by a government policy protocol that laid down comprehensive guidelines for good corporate governance in public sector institutions. This emphasized the government's own requirements for high standards of accountability and good governance in public institutions falling under its direct control and supervision.

The second King Report followed a review of the developments that had taken place in the South African economy and in the global markets since 1994. Again, it was not driven by any major crisis in the corporate sector. However, as it happened, coincident with this assessment a number of crises in both private and public sector companies came to light, which provided additional reasons for the review.

Four primary guiding principles were established for the committee's assessment process. The first was to review the first King Report and evaluate its currency in terms of developments, both local and international, since 1994. The second was to extend the integrated approach to embrace the interests of a wider range of stakeholders, without subverting the primary interests of shareholders as enshrined in South African corporate law. Another was to consider matters of risk and internal controls assurance; and the fourth was to recommend provisions for effective enforcement of good corporate governance standards and of the existing rules and regulations. The review was conducted by five task teams that covered the areas of boards and directors; accounting and auditing; internal audit, control and risk management; integrated sustainability reporting; and compliance and enforcement. The task teams were deliberately structured to include a wide range of interests. Their members were recruited from the private and public sectors and represented institutional and investor interests, civil society, government and regulators. This was to ensure a wide reference framework for the investigation and consideration of the recommendations arising out of the review. The King Committee itself is composed of leading proponents of corporate governance and representatives of significant professional, private and public sector institutions. The IoD plays an important facilitative role, and provides secretariat support.

Extensive consultation took place locally and internationally, from the inception of the review in August 2000 until the final release of the second King Report in March 2002 (IoD 2002). Members of the task teams were required to seek endorsement of the King recommendations in their respective constituencies, and contact was made with various experts and institutions at international level to discuss key aspects of corporate governance. The review procedure was led by a principal convenor, selected from among the King Committee members, who was responsible for the coordination of the process and much of the structure and content of the final document.

The second King Report was designed to elaborate on the practices of good governance as defined in law. It was not intended to offer a substitute for, or in any way make good the legal deficiencies in the current regime governing corporations in South Africa. To the extent that legal deficiencies were identified, recommendations were made for consideration by the relevant authorities.

Little progress in addressing these shortcomings has been made thus far at the legislative level, pending the introduction of the government's corporate law reform programme. However, urgent consideration has been given to strong provisions to detect and sanction director delinquency and to introduce legal requirements for accounting standards likely to be promulgated in 2005. That the King Committee relied on the public relevance of its recommendations and on those directly involved in the review process to raise the issues with the regulators is probably a shortcoming.

A particular emphasis in the second King Report was on the qualitative aspects of good corporate governance. In other words, it was not designed as a regulatory instrument, but as a tool to identify core areas of good practice for boards, directors and companies, which extended beyond the existing legal and policy framework to embrace a number of aspirational principles. The review was noteworthy for bringing into this framework the societal obligations of companies, in this way indirectly reinforcing the expectations of government and the wider community that the corporate sector will contribute to the country's transition and development. Given the difficulties of applying the guidelines across the entire South African economy, the recommendations of the second King Report focus primarily on companies quoted on the JSE, banks and financial institutions, and public sector enterprises and agencies at both national and provincial levels. These fall within a structured and more readily regulated environment in which the standards of corporate governance can be more easily identified and measured. Public interest issues and investor rights and interests are also more likely to be affected by the behaviour of these particular categories of organizations.

There are a multitude of unquoted private companies, close corporations and other forms of corporate entities that fall outside the structures above. They do not fit easily into a framework that allows for supervision of their corporate governance practices. There is no easy way to include them, given the limited capacity for enforcement that South Africa currently possesses, although it is desirable that they should fall within the ambit of good business practice.

The King Code

The Code of Corporate Practices and Conduct, which enshrines the core principles in the second King Report, deals with the following key components of corporate governance.

Board structure

The board is identified as the focal point of the corporate governance system because it is ultimately accountable for the performance and affairs of the company. This calls for a unitary board structure (common to countries falling, broadly speaking, under the Commonwealth system of law) that requires a balance between executive and non-executive directors. A majority of the non-executive directors should be independent of management.

The need for a proportion of independent board members as a counterbalance was largely derived from the more rigorous requirements of international investors. It was directed at the tight-knit nature of the South African business community, and at the importance of opening up boards to consider a wider pool of candidates for directorships. It has allowed particular emphasis to be paid to issues of diversity, both in terms of gender and race (which have been highlighted as a strategic imperative for companies wishing to remain relevant in the South African business environment).

The appointment of independent directors has given rise to the need for a more effective induction process for directors, and strategies to enable them to develop further, to ensure that companies in both the private and public sectors remain competitive, with all directors well versed in their duties and obligations. The IoD has been particularly prominent in instituting training programmes for directors, whether inexperienced or experienced. Some 5,000 individuals have passed through the IoD's programmes over the past four years, following the interest stimulated by the second King review.

The requirement that directors and boards undergo regular evaluation, preferably from an independent facilitator, to ensure the effectiveness of the board and the continuing suitability of individual directors standing for re-election, has allowed the more sophisticated aspects of board governance to come into play. Given the shortage of skills in South Africa, it was not considered appropriate to prescribe age limits or constraints on the length of service of board members. Both are problems that are difficult to address among the many other demands on boards in South Africa at present.

While no recommendations as to the size of boards were made in the King Code, institutional investors and regulators have raised the issue. As a result a number of boards have seen fit to reduce their size, to conform with corporate governance norms.

The code requires that the roles of chair and chief executive officer are separate, a ruling which has since been reinforced by the JSE, banking and financial markets regulators, and the regulations governing public sector companies. Furthermore, the position of chair should be held by an independent non-executive director. Companies across a wide spectrum have taken steps to address this requirement.

The length of executive director service contracts is restricted to a maximum term of three years. Any extension should be subject to shareholder confirmation. Extensive disclosure of individual director (executive and non-executive) remuneration and benefits is now enforced by all of the regulators mentioned above.

Detailed guidelines are provided in relation to the requirements for audit, remuneration and nomination committees. The code places a strong emphasis on the role of independent non-executive directors in this process. Board committees, too, are required to undergo regular independent evaluation.

The second King Report calls for extensive disclosure. As a result, directors have become much more concerned about their ability to fulfil their obligations. They are also more aware of the implications of accepting invitations to serve on a company board.

Risk management and internal control assurances

Effective risk management and internal control systems are essential in a successful corporate governance system. The King Code provides clear-cut guidelines which emphasize the board's responsibility for the total process of risk in the business.

The guidelines also charge the board with developing risk strategy policies, setting the company's risk tolerance level, and assessing its risk profile on the basis of various categories including credit, market, operational, human resources, regulatory and legal risks. Boards are also required to introduce an appropriate whistle-blowing process in the company. This supplements recent legislation on the same subject.

Companies quoted on the JSE are required to provide a comprehensive annual statement on risk and internal control. Although this has been a feature of the banking and financial sectors for some time, the code has made these requirements more stringent. Rigorous provisions are now also in force in the public sector.

The code emphasizes the importance of organizational integrity. Each company is expected to demonstrate its commitment to probity by drawing up an ethical code or statement of business principles, the implementation of which should be monitored by the board and management.

Accounting and reporting

The second King Report makes a number of recommendations with regard to accounting and auditing issues, paying particular attention to the role of the audit committee. This calls for companies to disclose any consulting services rendered by the same audit firm, so that it can be examined for any potential conflict of interest. It also calls for efficient audit processes using a combination of the external audit with an effective internal audit function and further requires that the audit committee should be chaired by an independent non-executive director, not the board chair, and that its members should have experience in financial matters.

The need for an effective internal audit function is emphasized, and the efficacy and relative independence of the audit team assigned to the external audit should be checked on a regular basis.

A particularly important provision is that boards should examine regularly the basis for considering the company a 'going concern' for the year ahead. This generates serious deliberation in board meetings, bearing in mind the liabilities that inappropriate assessment or misreporting of the company's financial position could incur.

The guidelines provided in the second King Report reflected the broad compatibility between the Generally Accepted Accounting Practices (GAAP) and those of the International Accounting Standards (now known as the International Financial Reporting Standards – IFRS). It is useful to note that steps have been taken by the accounting regulators in South Africa to ensure that local standards are compatible with international reporting standards, and that they will be in full alignment with the updated IFRS in 2005.

Integrated sustainability reports

Stakeholder rights, as previously observed, are addressed through specific laws providing for affirmative action and addressing historical racial imbalances in the workplace, employee skills development, labour and employee rights, the prevention of discrimination and harassment across a broad spectrum of issues and circumstances, and so on. The second King Report goes further in requiring that every company should report at least once annually on the nature and extent of its social, transformational, ethical, safety, health and environmental management policies and practices. This extended brief envisages companies going beyond the legal requirements and treating these aspects of their activities as strategic issues.

The more inclusive policy requirements are probably what most distinguish the South African guidelines from similar codes worldwide. These requirements should take the form of an integrated approach to the overall business strategy of companies, and should be designed as part of its economic profile. They should also be recognized as another dimension of risk, as previously noted.

Relations with shareholders

The second King Report did not deal with relations between the board and its shareholders extensively, given the rights conferred on the latter in the South African Companies Act. However, it recognized that this remains a serious area of concern that requires review because of the high cost and impractical nature of the remedies available to minority shareholders in the current South African system.

Companies are encouraged to enter into a dialogue, based on constructive engagement and the mutual understanding of objectives, with institutional investors. Clearly, this debate should also comply with regulatory and other directives governing the dissemination of information by companies and their directors and officers.

Proxy voting without significant restrictions or constraints is permitted, although the inefficiency of the system gives rise to concern (as it does in most systems worldwide). While the second King Report makes no explicit reference to the issue of one share, one vote, this is largely assumed under the terms of the Companies Act. Disproportionate voting rights (which were common at one time in South Africa) are now prohibited for companies quoted on the JSE.

It would be unrealistic to anticipate that the second King Report on its own, given the voluntary nature of compliance with its recommendations, would of itself generate a significant transformation in corporate governance standards and practices in South Africa. It is acknowledged that other interventions will be necessary to create the climate necessary to ensure adherence to these guidelines. Therefore, the King Committee came to the conclusion that in so far as principles of corporate governance coexist with established legal principles, no new sanctions or remedies were necessary. However, the second King Report recorded its particular concern over the current lack of enforcement of existing rules and regulations.

Recent reform measures and developments

The development of corporate governance has manifested itself in a number of interesting ways.

Foremost among these has been the relocation of the primary listings of some of South Africa's major companies to international financial centres such as London and New York.[3] This has not been so much a reflection of any dissatisfaction at prevailing governance structures in South Africa, but rather has had more to do with issues of international expansion and the need to access capital in an arguably more stable currency environment. A major effect, however, has been a growing appreciation in these companies of the high standards of governance required to operate with credibility in international markets, and the consequent importation of those standards into their operations in South Africa. A clear illustration is provided by the withdrawal by Telkom of its majority-owned mobile telephone operator, Vodacom, from the Nigerian market because of doubts relating to the integrity of certain local business dealings. (Telkom is a former parastatal – with government retaining a substantial interest – which was floated on the New York Stock Exchange in 2003, and thus subject to the US Securities and Exchange Commission (SEC) rules.)

The JSE has undertaken yet another comprehensive revision of its listing rules, which makes a number of the recommendations under the second King Report mandatory and applies the 'comply or explain' principle with respect to conformity with the remaining guidelines. An interesting feature of the JSE is that its market capitalization stands at approximately 1.65 times GDP (excluding cross-holdings). This is higher than that of many developed countries such as the UK, France, Germany and even the US. While there has been a marked shrinkage of listings on the JSE, falling from 668 companies in 1998 to 426 in January 2004 (sometimes attributed to its more onerous listings requirements and the accompanying corporate governance rules), the reason is probably corporate consolidation and the declining demand for new equity issues in the domestic market.

Various elements of the recommendations in the second King Report have been incorporated into legislation and regulations relating to financial markets on the grounds that these support prudential conduct. Other reasons were probably the credibility and relevance of the King guidelines, and the cumulative effect of the wide participation of different interest groups, including representatives of the regulatory and supervisory agencies in both the private and public sectors, in the process.

The banking regulator went even further, in calling for an enquiry into the corporate governance of South Africa's major banks, more to validate their governance systems and processes than to suggest any impropriety.[4] This investigation resulted in a number of recommendations, which have given rise to significant amendments to the Banks Act. These introduced a number of mandatory provisions of a governance nature, and codified the duty of care expected of a bank director and certain categories of executive (including those associated with the bank's holding company) in relation to shareholders and depositors.

At pretty much the same time, the regulations accompanying the PFMA were comprehensively altered to conform with a number of recommendations contained in the second King Report. This was followed by a completely revised Protocol on Corporate Governance for State-owned Enterprises, which replaced the earlier policy protocol. The new protocol incorporated more comprehensive and rigorous guidelines for public sector institutions. More recently, government has introduced the Municipal Finance Management Act, which imposes extensive governance obligations on officials and executives associated with municipal financial administration. This is a clear signal from policy makers that corporate governance has been identified as a matter of national significance.

Within the policy environment, new and more rigorous legislation continues to be promulgated. A series of statutory interventions and regulations have been introduced to combat money laundering and support stricter anti-corruption measures. These are not only in line with the priority accorded to good governance, but advertise South Africa's intention to observe international conventions and standards so as to add credibility to the country's international standing. A cause for concern, however, is South Africa's low ranking in the global corruption perception index. (This may have been caused in part by the arms scandal.[5])

With the advent of a truly democratic dispensation, South Africa has been able to boast an active and free media. Corporate governance has been closely monitored by the press, which has given considerable attention to the conduct of directors, boards and companies, and has made little distinction between malfeasance in the private and public sectors. This may have helped to stimulate a level of shareholder activism not previously observed in the South African market. None the less, despite some well-publicized examples of poor governance, the general public profile of institutional investors and fund managers has remained low.

Issues of enforcement and prosecution

South Africa has had its fair share of Enrons and Worldcoms. While these have reached nowhere near the magnitude of some of the spectacular corporate collapses in the US and Europe, they have had devastating effects on many minority shareholders and creditors. Examples of corporate failures include Macmed, a healthcare company which collapsed in 1999, losing some R986 million ($158 million).[6] Furthermore, it has come to light that the company secretary of Macmed was an unrehabilitated insolvent. Leisurenet, a lifestyle and health fitness company, had a board comprising some of South Africa's most respectable non-executive directors. The company collapsed in 2000, allegedly because of fraud committed by the two key executives and part-owners, losing some R1.2 billion ($173 million).[7] Disturbingly, a number of corporate governance debacles have also occurred in the financial sector, resulting in the collapse or absorption of a number of second-tier banks.

The main source of concern, at least from an international investor's perspective, has been the length of time that it has taken to investigate and prosecute such cases of corporate malfeasance. This has not been caused by unwillingness on the part of the authorities, but by the sheer capacity constraints facing an economy that is in transition and at the same time is attempting to meet all its international obligations and establish itself as a market of integrity.

Until 1994, the judiciary and the prosecution machinery were largely weighted by political considerations. With the transition to a proper political democracy, the focus has now shifted to the high levels of serious crime in the country, which includes economic offences. Given that South Africa's corporate laws were constructed some 40 years ago, many of their provisions are either outdated or out of kilter with the current capacity for practical enforcement.

After a series of delays, largely caused by other policy priorities, the government has finally announced that South Africa is to embark on a major overhaul of its corporate law regime, starting with a review. This is likely to be guided by a number of developments internationally, most notably in the UK. From the initial announcements, it appears that the new legislation will focus on a series of corporate law reforms that offer a wider range of mechanisms for enforcement and redress, and possibly give greater emphasis to civil remedies as opposed to the prosecution of criminal offences (which predominates in the existing Companies Act).

The review aims to address institutional requirements to ensure simplicity, effective and consistent enforcement, and the clarification of roles and responsibilities in relation to agencies for, and measures of enforcement. It will identify the fundamental rules governing the procedures for company formation, corporate finance law, corporate governance, mergers and acquisitions, the closing down of a company and the administration and enforcement of the law. It will also consider the relationship between company law and other rules and measures for the protection of the interests not only of shareholders, creditors and employees, but the state, the environment, consumers and black economic empowerment. Some of the observations contained in this chapter are similar to those made in the government policy statement announcing the review, in particular that company law should promote the competitiveness and development of the South African economy by:

- encouraging entrepreneurship and diversity of enterprise by simplifying the formation of companies and reducing the costs associated with the formalities of forming a company and maintaining its existence, thereby contributing to the creation of employment opportunities;
- promoting innovation and investment in South African markets and companies by providing a predictable and effective regulatory environment that allows for flexibility in the formation and management of companies;
- promoting the efficiency of companies and their management;
- encouraging transparency and high standards of corporate governance and recognizing the broader social role of enterprises in South Africa; and
- ensuring compatibility and harmonization with best practice internationally.[8]

Weak enforcement of rules and regulations has been a perennial concern for investors in emerging markets. It is often cited as a major problem in discussions concerning South Africa. Clearly from what has been stated above, this is recognized by the South African authorities. Probably the main reason for the negative perception is not so much a general lack of enforcement, as might be the case in other emerging markets, but erratic enforcement.

In some areas it is of a high standard, but in others it is almost absent. This inconsistency might be exacerbated by the fragmented nature of South Africa's regulatory system, and the propensity for regulatory arbitrage that has resulted. The high cost that effective regulation would entail places an immense burden on South Africa's democratic government, especially in the light of equally significant financial priorities in the areas of housing, health, social welfare and education, among others.

That the government has achieved so much in the short space of ten years is as much a miracle as was the peaceful transition to political democracy that took place in 1994. South Africa today is naked to the world in terms of what it does and how it does it. Its performance is increasingly measured against global standards, and the country's policy makers are no doubt aware of it. Globalization is a fact of life, and to engender foreign direct investment South Africa needs to demonstrate that it is a secure haven for overseas investors. Therefore the measures taken to improve corporate governance need to be embraced, rather than challenged and hindered by claims that they represent over-regulation.

Steps to consider and developments in the regulatory system

There is a need to look at more effective means of regulation that stimulate the market to respond to such interventions. This in turn might encourage a measure of peer oversight and sanctioning of non-compliance. For South Africa, that means considering some of the following ways in which corporate governance measures could be reinforced:

- A more synchronized system or structure of regulation could bring about an increased level of coordination in mandatory measures and enforcement. There has already been some debate over the desirability of a single regulatory oversight authority (which, if it were ever to be adopted, might lead to a rationalization of regulatory agencies, and so address the current fragmentation of regulation).
- Another step might be to look at the role of pension fund trustees in South Africa, and to examine their obligations in relation to the funds placed in their care. South Africa has a large private retirement fund sector and a long-term insurance industry. There is also a significant quantum of retirement funds that lie in the public sector. Domestic institutional investors dominate the JSE, and account for around 40 per cent of the total market capitalization. Since exchange control restrictions regulate the investment of domestic funds to a large extent, issuers quoted on the JSE essentially operate in a captive domestic market.

  While it is an issue complicated by many factors such as the training of the employee and union nominees that must comprise 50 per cent of pension fund trustee boards, a greater sense of awareness and accountability needs to be developed among pension fund trustees. This might stimulate a more rigorous process for selecting institutional fund managers. It might require some level of regulatory intervention (along the lines proposed in the UK currently and already practised in the US and Australia). South Africa's pension funds legislation is under review, and corporate governance issues have been accorded a high emphasis. This could, in turn, place pressure on institutional fund managers in South Africa to pay more attention to the votes of beneficiaries in respect of the investment of pension fund money placed under their control. If properly constructed, regulatory intervention would also draw attention to some of the conflicts among institutional investors that occur in this market. These are often closely aligned with the banking system and thus present additional structural and behavioural impediments to any activism on the part of shareholders, in that a number of the more prominent institutional investors are closely linked or owned by some of the major commercial banks. Also, institutional investors rely considerably on transactions with private sector companies. This makes it difficult for fund managers to retain these funds on the one hand, if on the other their analysts are aggressively challenging management. This in turn therefore leads to a level of mutual cohabitation for reasons of convenience.

  These institutions could also be required not only to publicly disclose their voting policies, but also what their voting decisions on material issues have been.

- The role of analysts in the corporate governance process requires more clarity and, perhaps, a level of market regulation. This is not an issue unique to South Africa. What requires investigation is the level of pressure applied to boards and executives to meet targets set by investment analysts, who themselves are often acting out of self-interest. This is a particularly tricky area of corporate governance. No doubt international developments will eventually inform South Africa's own response to this issue.
- The accounting profession in South Africa currently operates under a self-regulatory structure which, like those of other major international markets, has been under review and significantly restructured under the accounting professions bill.[9]

All incorporated bodies in South Africa, both foreign and domestic, are required to register with the Companies Office responsible for the administration of the Companies Act. This institution falls under the Ministry of Trade and Industry. The banking sector is regulated by the Registrar of Banks, who is located in the South African Reserve Bank, while the financial markets sector, covering long- and short-term insurance, collective investment schemes, pension and retirement funds, and so on, is supervised by a self-financed independent statutory body, the Financial Services Board (FSB). The FSB, in turn, is accountable to the minister of finance. The institutions falling into the banking and financial markets sectors are also governed by international conventions and accords to which South Africa has subscribed.

As previously indicated, South Africa is committed to the implementation of the Basel II accord and the IFRS. This puts it well ahead of many markets in the developed world. At the same time, perhaps in response to some of the observations above, the FSB has consolidated a number of securities-related legislative instruments into the new Securities Services Act, which includes even more exacting insider trading restrictions. One visible area of success within the South African enforcement regime has been the prosecution of insider dealings. Since the promulgation of this legislation in 1999, 164 cases have been registered for investigation. Legal action so far has been sought in 21 cases, and in 19 instances, the targeted individuals settled the matter out of court (or a total in the region of R47 million – $7 million).[10] No criminal prosecutions have yet taken place, although a landmark case is ready for submission to the courts.

Another significant regulatory instrument, the Securities Regulation Code (based on the takeover code in London), which was introduced in 1990, has played an important role in the South African market. By emerging market standards its application has been relatively successful. Again, like the insider trading directorate, it is a self-funded body. Budgetary constraints therefore impose certain limitations. However, the South African takeover code is also under review, with the aim of introducing more effective and stringent measures, particularly where the existing concessionary measures are considered too permissive for prevailing requirements. Lessons learned from the hostile Goldfields/Harmony transaction will likely inform some of the revisions.

Black economic empowerment

No discussion of corporate governance in South Africa would be complete without considering the issue of black empowerment. While ownership by black business and individuals of shares on the JSE has been nominal as a factor of market capitalization, it is an area that has gained greater traction recently. A number of very significant transactions have been concluded in the banking and financial services sector in particular. Empowerment has been assisted by statutory intervention in the form of the Broad-based Black Economic Empowerment Act (2003), and various self-regulatory sectoral accords, such as those reached in the mining and finance sectors. A number of others have been agreed more recently. Although these measures are designed to address historical socio-economic imbalances, this reasoning and its political and economic significance in the South African business landscape is not sufficiently well understood in the international markets.

In pure governance terms, though, some of the steps taken to bring about black economic empowerment might even be seen to be regressive in their construction. However, the understandable commitment of government to accelerate the pace of black economic advancement, more specifically to generate a greater level of ownership of businesses by black people, has introduced new pressures that are potentially problematic for corporate governance. This is because the process of building a capitalist class on the basis of artificial financing structures can, all too readily, lead to business ventures with shareholding structures that transgress the principles of good governance. Such enterprises have taken root in South Africa since its transition to a political democracy. Balancing best business practice and this type of affirmative action is a delicate task that requires careful juggling of priorities, but has many strategic merits.

The commendable progress achieved by policy makers since 1994 will have to be sustained by a certain level of vigilance on their part, to ensure that important developments towards the development of a black business class do not circumscribe the drive for good corporate governance. Perhaps symptomatic of this need for caution are the substantial donations made by companies in the private sector to political parties, and the lack of any regulations on this issue, although these exist in countries like the UK by virtue of institutional investor concerns.

Quo vadis corporate governance in South Africa?

At the heart of many of these issues lies the question of ethics in the business and commercial environment (as is very much the case in any other market). Corporate governance is essentially concerned with common sense, ethics, business integrity and reputation.

Therefore, while the policy makers and regulators can take the formal requirements of corporate governance to a certain point, it still devolves on the boards of South African companies in the private and public sectors to ensure that corporate governance as a guide to actual practice remains a priority issue. This is an economic imperative, given the global competition for international capital which is unrelenting in demanding sound corporate governance standards and the highest levels of accountability and probity.

South Africa's democratic dispensation is now well established, following three successful national elections. The authorities remain under pressure to improve the standard of living of the general population rapidly, through higher employment and expanded social services. In order to achieve higher economic growth, South Africa will need to increase both domestic and foreign capital, and use it more efficiently.

Notwithstanding the ambitious goals set by the policy makers to ensure good corporate governance, a perverse consequence (which is typical of most emerging markets) has been to raise doubt as to the institutional capacity of South Africa to implement the high standards desired. By and large neither the structures nor the financial resources to carry out this mandate have been forthcoming. Consequently, the admirable objectives set by the authorities are sometimes undermined by the lack of capacity for full and proper enforcement of the regulations.

Connected to this, but even more important, is to ask whether the country can afford high governance standards in practical terms. Nowhere is this more apparent than in the small business sector, where the country's performance internationally is very weak. At the same time this is a key area for ensuring that the economy has a prosperous future. There is also a concern that the country's First World approach to corporate governance, regulation of the business sector and economic policy generally has imposed costs on the economy that may have held back the rate of economic growth. However, it is not necessarily the content of these measures that is in question, but rather the basis on which they can more effectively be implemented. Sober consideration of the economic benefits that ought to be derived from such measures is required. Possibly alternatives should be investigated: perhaps there is a 'smarter' way of achieving the same ends. It is a difficult dilemma that is not unique to South Africa, but perhaps it illustrates the perverse consequences of adopting high-level global standards that do not always accommodate the difficulties facing emerging markets like South Africa's.

All the same, the policy makers are likely to continue their commendable promotion of measures designed to ensure sound corporate governance, in both the private and public sectors. South Africa is therefore likely to continue to pursue sophisticated measures to ensure that it holds its place as a prominent and desirable emerging market destination for investors.

Lessons for Africa

Notwithstanding the merits of advocating high global standards of corporate governance and regulation, these should be carefully measured against the capacity of countries to absorb such requirements, bearing in mind their other policy priorities, which are often of a social nature. This dilemma is particularly acute in Africa.

Also, many issues in corporate governance assume the existence of a well-developed capital market, which is not the case in many parts of Africa. Therefore other measures should be sought to foster appropriate levels of good corporate governance. An obvious example would be the continuing influence of state-controlled activities in the commercial sector, notwithstanding the widespread privatization that followed the implementation of structural economic adjustment programmes during the 1990s. Well-functioning state-owned enterprises, following internationally accepted standards of good corporate governance that are appropriately designed for their particular structure of state ownership and control, would provide an immense boost to national standards. However, this implies a measure of political will that is often absent in governments. It also assumes that a country has appropriate institutions for credible director training and development, and readily available accounting and auditing skills.

Again, ensuring that regulations are enforced and that the country can provide a framework for prosecution of economic offences that is independent of political interests is extremely difficult in developing states.

However, none of these obstacles is insurmountable. What countries need to identify, perhaps with the objective assistance of initiatives such as Nepad, is where improved corporate governance would contribute to greater economic effectiveness. Then, taking other policy priorities into account, they could make well-considered advances in critical areas. The idea would be to introduce regulatory and other incentives that would encourage companies to adopt good governance standards and practices, but would be partly self-regulatory in nature.

Self-regulation is, of itself, a subject for extensive discussion. Instead of adopting complex securities laws and systems that are not essentially representative of the economic structure, it might be better, instead, to promote corporate governance practices that are more appropriate to the level of development of the economic system and which can often provide remedies of a more basic nature that are more easily capable of implementation and monitoring given limited resources or capacity. Introducing proper measures of public accountability and proper director selection and training for state-controlled commercial operations would also likely create a series of positive responses across the economy. These would improve the quality of service and commercial efficiency, and have a positive influence on the conduct of customers and suppliers.

As these small advances gather momentum, other, more sophisticated, measures could be considered. The timing should depend always on the capacity of the economy to absorb such measures and the costs of adopting and implementing them. The overall aim should always be to avoid compromising the country's financial and economic stability within the demanding requirements of the wider implications of the global economy.

Notes

1. World Bank, *World Development Indicators, 2003,* www.worldbank.org/data/databytopic/GDP.pdf.

2. UNCTAD (2002).
3. Anglo American, BHP Billiton, Telkom, Old Mutual, SABMiller, Sasol.
4. The enquiry was conducted under the leadership of Advocate J.F. Myburgh SC, a former high court judge.
5. The South African government has committed to a multimillion dollar refurbishment of its defence force equipment, based on a series of counter trade arrangements that would facilitate investment in the industrial sector of the South African economy. Allegations have subsequently arisen relating to facilitation payments, bribery and corruption and other similar activities that are in the process of investigation and prosecution.
6. *Sunday Times*, www.suntimes.co.za/2004/02/15/business/companies/comp06/asp. Currency converted at average rate for 1999 of R6.11 to the dollar.
7. *Business Report*, www.busrep.co.za. Currency converted at average rate for 2000 of R6.11 to the dollar.
8. *South African Company Law for the 21*st *Century*, Guidelines for Corporate Law Reform announced by the Minister of Trade and Industry, May 2004.
9. This follows the findings of an enquiry commissioned by the minister of finance, under the leadership of Dr D. (Len) Konar, an expert in accounting and corporate governance and a prominent board adviser and board member.
10. A presentation given to the press by the Financial Services Board, 4 August 2004. Currency converted at average rate for the first six months of 2004 of R6.74 to the dollar.

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13 Corporate governance developments in India

Shri Bhagwan Dahiya

> Profits earned by hook or crook can not be the sole criterion for judging the success of a business. The success of liberalization requires the steady development of a new corporate ethic. (Prime Minister Atal Bihari Vajpayee, 15 August 2001 address)

Introduction

The corporate sector in India is governed by the Companies Act of 1956 which aims to ensure adequate protection of the interests of creditors and shareholders and regulates the issue, transfer and allotment of securities; the Securities Contracts (Regulation) Act of 1956 which covers all aspects of securities trading and regulates the operations of the stock market; the Securities and Exchange Board of India (SEBI) Act of 1992 which protects the interests of shareholders and promotes and regulates the securities markets; and the Sick Industrial Companies (Special Provision) Act (SICA) of 1985 which deals with the financial reorganization (including bankruptcy procedures) of distressed companies.

India's corporate sector consists of private limited and public limited companies. On 31 March 2004, there were in all 646,906 companies, of which: 77,380 were public limited companies and 564,132 were private limited companies; only 496 were companies with unlimited liability; 3,244 were limited by not-for-profit guarantees and associations; 1,654 were foreign companies; and the government corporate sector consisted of 1,309 companies, of which 702 were public limited and the remaining 607 were private limited (GOI 2005). The public limited companies account for almost two-thirds of the book value of equity. The government corporate sector, while consisting of a mere 0.20 per cent of the total number of companies in India, accounts for almost 39 per cent of paid-up capital. Although India has 22 stock exchanges, Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) together account for more than 99 per cent of the total turnover (SEBI 2005). In recent years, there has been a structural change in the brokering industry with an increase in the number of corporate brokerage entities floated by the institutions. The number of corporate brokers on 31 March 2005 was 3,773 out of a total of 9,128 registered brokers in the country. In addition, there were 13,684 sub-brokers.

The number of foreign companies in India was 772 on 31 March 1997. Since then, this number has been steadily increasing; it was 1,045 on 31 March 2000 and 1,654 on 31 March 2004. With regard to the country of incorporation of these foreign companies, 359 companies were incorporated in the USA, 288 in the UK, 125 in Japan, 88 in Germany, 74 in Hong Kong, 68 in France, 49 in the Netherlands, 41 in Australia, 33 in Italy, 29 in Canada, 28 in Switzerland, 18 in Belgium, 17 in Sweden, 13 in UAE, 10 in Panama, 9 in Thailand, 9 in Bangladesh, 5 in Pakistan, and 4 in Nepal and the remaining 387 countries (GOI 2005).

The Indian corporate sector has seen substantial and significant changes since 1993 when the phrase 'corporate governance' came to prominence (Dahiya and Gupta 2003). Since then, a series of legal and regulatory reforms have transformed the corporate governance framework and improved the level of accountability and responsibility of insiders, fairness in the treatment of minority shareholders and stakeholders, board practices and transparency.

Over the last few years, a series of corporate governance committees were appointed by the Confederation of Indian Industry (CII), the Department of Company Affairs (DCA) and the SEBI.

CII's Code of Corporate Governance (CII 1998)

In 1996, the Confederation of Indian Industry, India's largest industry and business association, took the first institutional initiative to develop and promote a code for corporate governance to be adopted and followed by Indian companies. This initiative was due to increasing public concern about the protection of investor interest, promotion of transparency, disclosure of information, and the need to move towards international standards. The CII set up a National Task Force to examine corporate governance issues and recommend a voluntary code of best practice. The Task Force presented the draft guidelines and the Code of Corporate Governance in April 1997 at the CII's National Conference and Annual Session. The draft was then publicly debated in workshops and seminars. A number of suggestions were received for the consideration of the Task Force, which then released 'Desirable corporate governance: a code' in April 1998.

With regard to the functioning of boards of directors, the code recommended that there should be 'professionally competent, independent, non-executive directors, who should constitute at least 30 per cent of the board if the chairman of the company is a non-executive director, or at least 50 per cent of the board if the chairman and managing director is the same person'; no single person should hold a directorship in more than 10 listed companies; and the non-executive directors should become active participants on boards, such as that of the audit committee, and have clearly defined responsibilities within the board. They should have an understanding of balance sheets, profit and loss accounts, cash-flow statements and financial ratios, and have some knowledge of various company laws. Companies should pay the non-executive directors a remuneration over and above the fee for the professional input. As a general practice, any director who has not attended as many as 50 per cent of the meetings should not be reappointed. Key information to be reported to the board must include annual operating plans and budgets, capital budgets, manpower and overhead budgets, detailed quarterly results, internal audit reports, details of any joint venture or collaboration, substantial transactions concerning goodwill, brand equity, or intellectual property, recruitment and remuneration of senior officers, and so on. Any listed company with either a turnover of more than Rs 1 billion or a paid-up capital of Rs 200 million should set up an audit committee consisting of at least three members, all drawn from the company's non-executive directors, and with clearly defined terms of reference. The code also made recommendations with regard to disclosure of various aspects of company performance and staff, including the rating received from all credit rating agencies.

Kumar Mangalam Birla Committee (SEBI 1999)

The second major corporate governance initiative was taken by SEBI on 7 May 1999 through the appointment of a Committee on Corporate Governance under the Chairmanship of Kumar Mangalam Birla to promote and raise the standards of corporate governance (SEBI 1999). The terms of the reference of the committee were to suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and any other measures to improve corporate governance standards in the listed companies, in areas such as continuous disclosure of material information, both financial and non-financial, manner and frequency of such disclosures, and responsibilities of independent and outside directors; to draft a code of corporate best practice; and to suggest safeguards to be instituted within the companies to deal with insider information and insider trading.

The primary objective of the committee was to view corporate governance from the perspective of the investors and shareholders and to prepare a code to suit the Indian corporate environment. The committee divided its recommendations into mandatory and non-mandatory categories. Those recommendations which were absolutely essential for corporate governance and which could be defined with precision and enforced through the amendment of the listing agreement were classified as mandatory. Others which were either desirable or which required a change in the law were classified as non-mandatory. These recommendations were to be applied to all listed private and public sector companies.

The committee recommended that 'the board of a company have an optimum combination of executive and non-executive directors with not less than

50 per cent of the board comprising non-executive directors. . . . If a company has a non-executive chairman, at least one-third of the board should comprise independent directors and if a company has an executive chairman, at least half of the board should be independent'. Independent directors were defined as 'directors who apart from receiving a director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect their independence of judgement'. A director should not be a member of more than 10 committees or act as chair of more than five committees across all the companies in which he/she is a director. Board meetings should be held at least four times a year, with a maximum time gap of four months between any two meetings. A board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressing of shareholder complaints. There should be a separate section on corporate governance in the annual reports of companies, with a detailed compliance report on corporate governance. Disclosures must be made by the management to the board relating to all material financial and commercial transactions, where they have a personal interest that may have a potential conflict with the interests of the company at large.

In order to enhance the credibility of the financial disclosures of a company and to promote transparency, the committee recommended that a qualified and independent audit committee should be set up by the board of a company. The audit committee should have a minimum of three members, all non-executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge. The chair of the committee should be an independent director. The audit committee should meet at least three times a year.

Narayana Murthy Committee (SEBI 2003)

Towards the end of 2002, the SEBI Committee on Corporate Governance was constituted under the chairmanship of N.R. Narayana Murthy. The terms of reference of the committee were 'to review the performance of corporate governance; and to determine the role of companies in responding to rumour and other price-sensitive information circulating in the market, in order to enhance the transparency and integrity of the market'.

The committee submitted its report on 8 February 2003 and recommended that it should be obligatory for the board of a company to lay down the code of conduct for all board members and senior management of a company. All board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect, signed by the chief executive officer (CEO) and the chief financial officer (CFO).

There should be no nominee directors. Where an institution wishes to appoint a director on the board, such appointment should be made by the shareholders. An institutional director, so appointed, should have the same responsibilities and shall be subject to the same liabilities as any other director. A government nominee on public sector companies should be similarly elected and should be subject to the same responsibilities and liabilities as other directors.

The committee defined the term 'independent director' as a non-executive director of the company who apart from receiving a director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holdings company, its subsidiaries and associated companies; is not related to promoters or management at the board level or at one level below the board; has not been an executive of the company in the immediately preceding three financial years; is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years; is not a supplier, service provider or customer of the company; and is not a substantial shareholder of the company, that is, owning 2 per cent or more of the block of voting shares.

All compensation paid to non-executive directors may be fixed by the board of directors and should be approved by shareholders at the general meeting. Limits should be set for the maximum number of stock options that can be granted to non-executive directors in any financial year and in aggregate. The stock options granted to the non-executive directors shall vest after a period of at least one year from the date such non-executive directors have retired from the board of the company. Companies should publish their compensation philosophy and statement of entitled compensation in respect of non-executive directors in their annual report. Companies should disclose on an annual basis details of shares held by non-executive directors, including on an 'if-converted' basis. Prior to their appointment to a listed company, non-executive directors should be required to disclose their stock holding in the company.

The committee further recommended that the audit committees of publicly listed companies should be required to review the financial statements and draft audit report; the management discussion and analysis of financial conditions and results of operations; reports relating to compliance with laws and to risk management; management letters/letters of internal control weaknesses issued by statutory/internal auditors; and records of related party transactions. All audit committee members should be 'financially literate' and at least one member should have accounting or related financial management expertise. All audit committee members should be non-executive directors. A statement of all transactions with related parties including their bases should be placed before the independent audit committee for formal approval/ratification.

Since it is important both for corporate boards to be fully aware of the risks facing the business and also for shareholders to know about the process by which companies manage their business risks, the committee recommended that procedures should be in place to inform board members about the risk assessment and minimization procedures. These procedures should be periodically reviewed to ensure that the executive management controls risk through means of a properly defined framework. Companies raising money through an initial public offering ('IPO') should disclose to the audit committee, the uses/applications of funds by major category (capital expenditure, sales and marketing, working capital, and so on), on a quarterly basis. On an annual basis, the company should prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus. This statement should be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the board to take action on this matter.

The provisions relating to the composition of the board of directors of the holding company should also apply to the composition of the boards of subsidiary companies. At least one independent director on the board of the parent company should be a director on the board of the subsidiary company. The audit committee of the parent company should also review the financial statements, in particular the investments made by the subsidiary company. The minutes of the board meetings of the subsidiary company should be available for review at the board meeting of the parent company. The board report of the parent company should state that it has also reviewed the affairs of the subsidiary company.

The committee further recommended that the mandatory recommendations made in the Naresh Chandra Committee's report, relating to corporate governance (GOI 2002), be implemented by the SEBI. These recommendations included that the management should provide a clear description in plain English of each material contingent liability and its risks, which should be accompanied by the auditor's clearly worded comments on the management's view; and that for all listed companies, there should be a certification by the CEO and the CFO.

Department of Company Affairs

The Department of Company Affairs has been making necessary changes in the Companies Act, 1956 and the rules made thereunder to keep pace with the globalization process. The provisions relating to 'nomination facility for shareholders and deposit-holders', 'buy-back of securities', 'relaxation in norms relating to inter-corporate loans and investments', 'setting up of an Investor Education and Protection Fund', 'allowing sweat equity' and 'compliance of accounting standards in preparation of annual accounts' were important provisions introduced through the Companies (Amendment) Act, 1999 to provide initiatives and safeguards for improved investor protection and better corporate governance. The Companies Act, 1956 has again been amended: the Companies (Amendment) Act, 2000 provides for a postal ballot, an audit committee, a directors' responsibility statement, debenture trustees, a secretarial compliance certificate, a reduction of time for payment dividend, a tenfold increase of fines, an option for the election of a director by small shareholders and so on.

Sanjeev Reddy Committee (GOI 2002)

Through the Department of Company Affairs and the Ministry of Law, Justice and Company Affairs, on 15 May 2000, the government set up a study group, under the chairmanship of P.L. Sanjeev Reddy, 'to examine and operationalise the concept of corporate excellence on a sustained basis to sharpen India's global competitive edge and to further develop corporate culture in the country'. The committee submitted its report on 20 November 2000. The recommendations of the committee were grouped into two categories: (i) essential, to be introduced immediately by legislation; and (ii) desirable, to be left to the discretion of the companies and their shareholders. It was recommended that a model governance code incorporating both the essential and desirable measures should be drafted and included as a table in the Companies Act, to be adopted optionally by the companies. Given the challenges of managing change, the committee recommended phased implementation of the essential measures, depending upon the size and capabilities of the companies on the one hand and on the other, the requirements of the marketplace.

The committee recommended that there should be a minimum of five directors in the case of listed companies, and three for unlisted companies. Apart from this, the size of the board should be left to the discretion of the company and its shareholders. The board of a listed company should at all times have a majority of independent non-executive directors. Independence was defined to mean absence of any material pecuniary or other relationship that could impair the person's exercise and freedom of judgement in all matters relating to the company.

Every listed company should be required to set up an audit committee and a compensation committee consisting of a minimum of three members, all of them independent non-executive directors. The chair of the audit committee should be a person with knowledge (by qualification or experience) of finance and accounting. Executive directors such as managing directors and other full-time directors of listed companies should be barred from taking up any other position as an executive director, managing director, or full-time director in any other company, whether listed, unlisted or private. Subject to the prior approval of the board (with all directors concurring), they may accept other non-executive directorships in no more than two other listed companies, be a board chair in no more than one such company, be a member of no more than two committees and shall not accept chairmanship of either the audit committee or the compensation committee of such other companies.

The audit committee of a listed company shall have the authority to seek and obtain from the statutory auditors and the cost auditors, and such auditors shall be obliged to provide upon such request, an account detailing all relationships between the auditors on the one hand, and on the other, the company, its subsidiaries, its promoters or dominant shareholders in management control, and any associates or subsidiaries controlled by such promoters or dominant shareholders. The auditors should also affirm their independent status.

Subject to shareholder approval and within the prescribed overall ceiling on aggregate directorial and managerial remuneration as a percentage of profits, listed companies shall have complete discretion to fix rewards and remuneration, and methods and periodicity of payments, to their executive and non-executive directors to attract and retain the services of the right kind of people to serve in such a position. The CEO and the CFO of all public companies, listed and unlisted, should provide a statement in the annual report to shareholders, (i) acknowledging responsibility for the financial statements and confirming that they have been prepared in accordance with accepted accounting standards and practices, and detailing with reasons any deviations from such standards or practices; (ii) confirming compliance with all legal and regulatory requirements, and detailing with reasons and without admission of any default, any instance of non-compliance; and (iii) to the effect that all statutory formalities have been complied with, all statutory dues have been paid and to the best of their knowledge and belief there were no illegal transactions or payments during the period to which the report relates.

Naresh Chandra Committee (GOI 2002)

On 21 August 2002, the Department of Company Affairs appointed a high level committee, under the chairmanship of Naresh Chandra, to examine various corporate governance issues. The terms of reference of the committee were to examine the entire gamut of issues pertaining to the auditor–company relationship with a view to ensuring the professional nature of the relationship; to examine measures required to ensure that the management and auditors present a true and fair statement of the company affairs; to examine whether the present system of regulation of the profession of chartered accountants, company secretaries and cost accountants is sufficient and has served well the concerned stakeholders, especially small investors, and whether there is any advantage in setting up an independent regulator (along the lines of the recently passed Sarbanes–Oxley Act of 2002 in the United States) and, if so, what form the independent regulator should take; and to examine the role of independent directors, and how their independence and effectiveness can be ensured.

The committee submitted its report on 23 December 2002 and recommended that the minimum board size of all listed companies, as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs 10 crores and above, or turnover of Rs 50 crores and above should be seven – of which at least four should be independent directors. No less than 50 per cent of the board of directors should consist of independent directors.

The committee defined an independent director of a company to be a non-executive director who apart from receiving a director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies; is not related to promoters or management at the board level, or one level below the board; has not been an executive of the company in the last three years; is not a partner or an executive of the statutory auditing firm, the internal audit firms that are associated with the company, and has not been a partner or an executive of any such firm for the last three years; is not a significant supplier, vendor or customer of the company; is not a substantial shareholder of the company; and has not been a director of the company for more than three terms of three years each.

The Committee further recommended that audit committees of all listed companies, as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs 10 crores and above, or turnover of Rs 50 crores and above, should consist exclusively of independent directors. In line with international best practice, the committee recommended an abbreviated list of disqualifications for auditing assignments, which includes prohibition of any direct financial interest in the audit client; prohibition of receiving any loans and/or guarantees from or on behalf of the audit client; prohibition of any business relationship with the audit client; prohibition of personal relationships; prohibition of service or cooling-off period; and prohibition of undue dependence on an audit client.

It was also recommended that the accounting and bookkeeping services, internal audit services, financial information systems design and implementation, including services related to information technology systems for preparing financial or management accounts and information, actuarial services, brokers, dealers, investment advisers or investment banking services, outsourced financial services, management functions, including the provision of temporary staff to audit clients, any form of staff recruitment, and particularly the hiring of senior management staff for the audit client, and valuation services and fairness option should not be provided by an audit firm to any audit client.

Before agreeing to be appointed, the audit firm must submit a certificate of independence to the audit committee or to the board of directors of the client company certifying that the firm, together with its consulting and specialized services affiliates, subsidiaries and associated companies are independent and have an arm's-length relationship with the client company; have not engaged in any non-audit services listed and prohibited; and are not disqualified from audit assignments by virtue of breaching any of the limits, restrictions and prohibitions.

Naresh Chandra Committee Part-II (GOI 2003)

The government appointed another committee, under the chairmanship of Naresh Chandra, on 10 January 2003. The terms of reference of the committee were to suggest a scientific and rational regulatory environment, the hallmark of which is the quality, rather than the quantity, of regulation, and to make recommendations in this regard with reference particularly to the Companies Act, 1956 and the Indian Partnership Act, 1932. The committee submitted its report on 8 July 2003 and made certain recommendations to amend these acts.

Subsequently, the Ministry of Company Affairs has decided to undertake a comprehensive review of the Companies Act, 1956, with a view to revising it in order to develop an appropriate framework and institutional structure for regulating the corporate sector in tune with the emerging economic scenario, encouraging good corporate governance and protecting the interests of the stakeholders and investors, including small investors.

Current status

The most recent development in corporate governance is the SEBI's amendment in Clause 49 of the Listing Agreement. The major changes include amendments/additions to provisions relating to: the composition of the board; non-executive directors' compensation and disclosures; the code of conduct; the audit committee, its power and role; subsidiary companies; disclosures; and CEO/CFO certification of financial statements. It was initially proposed that the amended Clause 49 be effective from 1 April 2005 for listed companies, but this was extended to 31 December 2005.

Under the amended clause, the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than 50 per cent of the board of directors comprising non-executive directors. If the chairman of the board is a non-executive director, at least one-third of the board should comprise independent directors and if he is an executive director, at least half of the board should comprise independent directors. Further, the clause defines independent directors as those who, apart from receiving a director's remuneration, do not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect the independence of the director; is not related to promoters or persons occupying management positions at the board level or at one level below the board; has not been an executive of the company in the immediately preceding three financial years; is not a partner or an executive or was not a partner or an executive during the preceding three years, of any statutory audit firm or internal audit firm associated with the company, or the legal and consulting firm(s) that have a material association with the company; is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect the independence of the director; and is not a substantial shareholder of the company, that is, owning 2 per cent or more of the block of voting shares.

All fees/compensation, if any is paid to non-executive directors, including independent directors, shall be fixed by the board of directors and shall require the previous approval of the shareholders at the general meeting. The shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

The audit committee is clearly the most important of the board committees. It is supposed to oversee the financial reporting process, besides the accounting quality, risk management function, and internal control system. The amended Clause 49 further directs that a qualified and independent audit committee shall be set up; that the committee shall have a minimum of three directors as members; that two-thirds of the committee members shall be independent directors; and that all members of the committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

A separate section on corporate governance in the company's annual reports containing a detailed compliance report is also made mandatory under the amended clause.

Most recently in the year 2005, the Ministry of Company Affairs, in partnership with the CII, the Institute of Company Secretaries of India (ICSI) and the Institute of Chartered Accountants of India (ICAI), has set up the National Foundation for Corporate Governance (NFCG) with the goal of promoting better corporate governance practices. The NFCG would focus, among other things, on creating awareness of the importance of implementing good corporate governance practices both at the level of individual corporations and for the economy as a whole; working to instil a commitment to corporate governance reforms; and cultivating international linkages and maintaining the evolution towards convergence with international standards and practices for accounting, audit and non-financial disclosure.

Conclusion

A detailed statutory framework of corporate governance in India has been defined primarily by the Companies Act. The provisions contained therein have been further supplemented by the SEBI. Basic shareholder rights are reasonably well protected by the Companies Act, whereby all shareholders are treated equitably and the law does not make any distinction among different shareholders holding a given class or type of shares. Indian law fully protects the shareholders from any misuse of power by the custodians. A recent amendment to the Companies Act makes it mandatory to ascertain voters' preferences in certain matters only through the postal-ballot system, including electronic methods.

The SEBI regulates the stock exchanges, stockbrokers, share transfer agents, merchant banks, portfolio managers, other market intermediaries, collective investment schemes and primary issues. It prohibits fraudulent and unfair trade practices, and regulates the substantial acquisition of shares and takeovers. It is an autonomous body established by an act of parliament. Investor grievances against listed companies falling within the purview of the SEBI are related to non-receipt of dividends, shares, debentures, non-receipt of a letter concerning an offer for rights or interest on a delayed payment of refund orders, and complaints concerning collective investment schemes. Investor complaints pertaining to mutual funds and dematerialization of shares and complaints against market intermediaries are also taken up by the SEBI. The redress rate of the SEBI in resolving complaints has improved over the years from 21 per cent in 1991–92 to 95 per cent since 1999–2000.

The market for takeovers has become active during the last few years. Deregulation and competition have encouraged trends in favour of mergers, acquisitions and restructuring. The majority of acquisitions have been 'friendly', and the SEBI has worked out a takeover code. Until recently, insider trading was not considered illegal, but now the SEBI has formulated insider trading regulations. Disclosure standards are reasonably satisfactory. The Companies Act stipulates the format in which annual accounts are to be presented. The SEBI has mandated large listed companies to disclose summary results on a quarterly basis, and other companies on a half-yearly basis. As per the recent amendment to the Companies Act, non-executive directors are now considered to be officers of the company, and are made fully accountable for any lapses on the part of the company.

In its assessment report comparing the observance of corporate governance in India with the OECD Principles of Corporate Governance, the World Bank (2004) finds that in India 10 of the 23 OECD Principles are observed, six are largely observed, six are partially observed, and only one is materially not observed. The 10 principles that were found to be observed were: protection of basic shareholders' rights; right to participate in fundamental corporate decisions; shareholders' AGM rights; functioning of markets for corporate control; respect of stakeholders' rights; a performance enhancement mechanism for stakeholder participation; stakeholders' participating in the corporate governance process to have access to relevant information; fair and timely dissemination of information; compliance with applicable law; and board members' access to accurate, relevant and timely information. The six principles which were found to be largely observed were: disproportionate control disclosure; disclosure standards; high-quality standards of accounting, financial and non-financial disclosure, and audit; boards to act with due diligence and care in the best interests of the company and the shareholders; boards to treat all shareholders fairly; and boards to fulfil certain key functions. The partially observed principles relate to the equal treatment of all shareholders; prohibition of insider trading and abusive self-dealing; disclosure interests of members of the board and managers; effective redressal for violation of stakeholder interests; annual audit by an independent auditor; and the boards' ability to exercise objective judgement on corporate affairs independent from management. The only principle which was found to be materially not observed relates to shareholders', including institutional investors', consideration of the costs and benefits of exercising their voting rights, as 'pension funds seldom exercise voting rights, instead they exert influence through nominee directors on the board of their portfolio companies'.

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Index