

The State of Corporate Governance: Experience from Country Assessments

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World Bank Policy Research Working Paper 2858, June 2002

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Abstract

Corporate governance deals with the ways in which the rights of outside suppliers of equity finance to corporations are protected and receive a fair return. Good practices reduce the risk of expropriation of outsiders by insiders and thus the cost of capital for issuers. Capaul and Fremond review the experience of the preparation of 15 corporate governance country assessments across five continents. The assessments have been prepared under the umbrella of the joint World Bank/IMF initiative of the “*Reports on the Observance of Standards and Codes*” (“ROSCs”). The assessments focus on the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the duties of the board of listed companies and use the OECD Principles of Corporate Governance as benchmark. The paper gives an overview of the actual and potential contribution of the assessments to policy dialogue, diagnostic and strategic work, lending and non-lending operations and technical assistance and capacity and presents the unfinished agenda.

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Executive Summary

This paper reviews the experience of the preparation of 15 corporate governance country assessments across five continents.¹ These were conducted under the umbrella of the joint IMF/World Bank “Reports on the Observance of Standards and Codes (“ROSC”) and “Financial Sector Assessment Program” (FSAP) initiatives. The assessments focus on the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the duties of the board of listed companies. They do not address the corporate social responsibility agenda.

Section I summarizes the history and the rationale of the FSAP and ROSC programs. Section II focuses on the assessments themselves. It includes a review of the Organization for Economic Co-Operation and Development (OECD) Principles of Corporate Governance, the standard against which countries are benchmarked. A discussion of the reports, including an analysis of the framework of the policy recommendations and a summary of the key findings, is also presented. Section III gives an overview of the actual and potential contribution of the assessments to policy dialogue; diagnostic and strategic work, lending and non-lending operations and technical assistance and capacity building – which can be carried out by international financial institutions, bilaterals, local policy makers, and the private sector. Section IV presents the unfinished agenda.

Corporate governance is about the definition of property rights of shareholders and the mechanisms of exercising such rights. Equity rights are complex property rights. The right to participate in the profits of the company is conditional on the company generating a profit. If there is a profit, the next question is how the profit will be distributed. Corporate governance deals with the ways in which the rights of outside suppliers of equity finance to corporations are protected and receive a fair return if there is any.² Good practices reduce the risk of expropriation of outsiders by insiders and thus reduce the cost of capital for issuers and countries. Corporate governance deals with the market for corporate control; privatization is about the market for corporate control for government owned firms. Property rights need to be well established and defined if this market is to function efficiently. Hence good corporate governance can enhance the likelihood that privatized corporations will generate the efficiency gains expected from the disengagement of the state.

Empirical evidence suggests that good corporate governance increases the efficiency of capital allocation within and across firms, reduces the cost of capital for issuers, helps broaden access to capital, reduces vulnerability to crises, fosters savings provisions, and renders corruption more difficult. Corporate governance is also relevant to the regulation

¹ Brazil, Croatia, Egypt, Georgia, India, Latvia, Lithuania, Malaysia, Morocco, Philippines, Poland, Romania, South Africa, Turkey, Zimbabwe.

² Source: Andrei Shleifer and Robert W. Vishny. A survey of corporate governance, The Journal of Finance, (Vol. LII, number 2, June 1997).

of off-shore financial centers and vehicles, which can be used for money if not regulated properly.

The World Bank's corporate governance country assessments are a diagnostic instrument. They assess the laws, rules, regulations and practices governing the rights and obligations of listed companies, intermediaries and investors in a given country. They are most relevant to middle income countries, but they are also a useful instrument for transition economies, where mass privatization has created a large pool of listed companies with thousands of shareholders, and for low income countries seeking to attract international portfolio investors.

The assessments are a tool for communication between policy makers and domestic and international investors to reach a common understanding in an environment where countries are grappling with the establishment of a market for corporate control and are competing to attract capital. They do not advocate a single model of corporate governance. The assessments promote choice for issuers and investors.

The key findings of this paper are:

- None of the assessed countries comply with the OECD Principles in all respects. Yet all countries surveyed have undertaken or are currently undertaking reforms to bring their legal and regulatory frameworks in compliance with the OECD Principles. In most countries surveyed, there is a growing interest towards improving corporate governance practices. As of January 2002, over 43 countries have developed their own corporate governance codes of best practice, including Brazil, Croatia, Romania and the Philippines. The World Bank corporate governance assessments have also been a catalyst to trigger interest and reform.
- Generally, there is a discrepancy between the letter of the law and actual practices. The enforcement of shareholders rights and equitable treatment of shareholders need strengthening. In most countries surveyed, business transactions have traditionally taken place on the basis of relationships and trust and little attention has been paid to publicly available information. Corporate governance reform is a way to extend this trust to all market participants via enforcement of shareholders rights.
- The OECD Principles assume that countries have an efficient legal and regulatory framework in place and that securities regulators have the means and capabilities to enforce the rules and regulations of their capital markets. However, experience from the countries surveyed demonstrates that this is often not the case. Typically courts are under-financed, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt. Moreover, securities regulators have little direct power to enforce penalties. Enforcement of prevailing rules and regulations is mostly the responsibility of the courts. This leads to poor enforcement of the rules and regulations underlying corporate governance. In countries with weak regulatory environments, concentrated enforcement through the market regulators may be preferable to enforcement through the courts.

- A “menu of option” approach to corporate governance standards provides a means for issuers and investors to choose the markets and the companies that are most appropriate to their specific risk profile. At the same time, standardization of options is desirable to lower transaction costs for issuers and investors alike. In addition, choice in the form of different corporate governance options offered to issuers is an effective mechanism to facilitate reform.

I. The ROSC/FSAP Initiatives

I. A. The role of standards in the international financial architecture

In the wake of the international financial crisis of the 1990s, the international community embarked on a range of initiatives to strengthen the international financial architecture. The objective of these initiatives is crisis prevention, mitigation and resolution. The agenda focuses on weaknesses in the international financial system that potentially contribute to the propensity for and magnitude of global instability, hence requiring collective action at the international level.

There is widespread recognition that global financial stability rests on robust national systems and hence requires enhanced measures at the country level. In a world of integrated capital markets, financial crises in individual countries can imperil international financial stability. This provides a basic “public goods” rationale for minimum standards which benefit international and individual national systems.

The Financial Stability Forum, the G7, the G20 and the G22³ have emphasized, in particular, the role of minimum standards and codes in strengthening the international financial architecture. At the international level, standards enhance transparency. They identify weaknesses that may contribute to economic and financial vulnerability. They foster market efficiency and discipline. At the national level, standards provide a benchmark to identify vulnerabilities and guide policy reform. To best serve these two objectives, the scope and application of such standards need to be assessed in the context of a country’s overall development strategy and tailored to individual country circumstances. The IMF, the World Bank and other international financial institutions are undertaking the assessment of systemically important countries of the observance of 11 core standards relevant to private and financial sector development and macroeconomic stability⁴.

In this context, the Bretton Woods institutions have initiated the joint initiative on “*Reports on the Observance of Standards and Codes*” (“ROSCs”), which covers a set of eleven internationally recognized core standards relevant to economic stability and private and financial sector development. The individual standard assessments are collected as “modules” in country binders constituting the aforementioned “ROSCs”. Under this modular approach, the IMF takes the lead in preparing assessments in the areas of data dissemination and fiscal transparency. Modules for the financial sector (monetary and financial policy transparency, banking supervision, securities market regulation, payment systems, deposit insurance) are mostly derived from the *Financial*

³ G7: Canada, France, Germany, Italy, Japan, UK, USA. G20: G7 plus Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, EU. IMF and World Bank participate in the discussions. G22: G7 plus Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand.

⁴ The full list of the 11 standards is set out in Appendix A. Money laundering, a potential 12th standard, is currently under consideration for inclusion in the ROSC exercise.

Sector Assessment Program (“FSAP”). The World Bank takes the lead in three areas: (i) corporate governance, (ii) accounting and auditing, and (iii) insolvency regimes and creditor rights.

Box I: Chronology of the ROSC initiative

July 1998: IMF Executive Board indicates that the official sector should play a larger role in strengthening incentives to implement standards, including through monitoring the extent to which members observe standards in areas within the Fund’s direct operational focus.

October 1998: G-22 Taskforce Recommendations – the G-22 working group recommends that the IMF, in the context of its Article IV surveillance consultations, should consider preparing a report – a Transparency Report – that summarizes the degree to which an economy meets internationally recognized disclosure standards across a wide range of areas.

October 1998: G-7 endorses G-22 recommendation and calls on the IMF to “monitor in close co-operation with the standards-setting bodies the implementation of... codes and standards as part of its regular surveillance under Article IV”.

1999/2000: IMF Executive Board decides to undertake reports on international financial architecture issues to be called “Transparency Reports.” The World Bank joins the IMF in this exercise which is expanded to include other assessments and is now named the Reports on the Observance of Standards and Codes (ROSCs).

I. B. ROSC and FSAP assessments

The ROSC and the FSAP programs are tools to assess financial sector vulnerability and development needs. They provide input to the Fund for its surveillance activities and are useful instruments to support the policy dialogue of International Financial Institutions, policy makers and the private sector. They can contribute to the design of loans, assist in the preparation of key policy documents and provide benchmarks for the designs and monitoring of technical assistance and capacity building programs.

Countries volunteer for a ROSC or FSAP program. They can choose either or both of the programs. FSAP contains a section that remains confidential between the Fund/Bank and the assessed country. In contrast, ROSC assessments have a vocation to become public documents. The IMF and the World Bank have set up special purpose websites to disseminate ROSC assessments into the public arena. Publication is voluntary. Countries can either refuse the publication of an assessment; authorize its publication while exercising a “right of reply,” which gives them an opportunity to express their disagreement with the opinions of the IMF/World Bank; or authorize its publication as it stands. To remain useful, assessments of progress in implementing standards must be updated periodically.

II. The World Bank Corporate Governance Assessments

The first step in developing a methodology to assess the corporate governance system of a given country was the identification of a standard. In contrast to the World Bank team in charge of the Insolvency and Creditor Rights ROSC, which had to develop a standard, the corporate governance team of the Private Sector Advisory Services Department (PSAS) could use the OECD Principles as the benchmark. The OECD Principles were agreed upon by a large number of countries (29) of varied legal, economic and cultural traditions and after extensive consultation with the World Bank, the IMF, the Bank of International Settlements, and representatives of the business community from Japan, Germany, France, UK and the US, as well as international investors, trade unions and other interested parties. Consultations also took place with a number of emerging market governments. As such, they represent the minimum standard that countries with different traditions could agree upon, without being unduly prescriptive. In particular, they are equally applicable to countries with a civil and common law tradition, different levels of ownership concentration, and models of board representation.

II. A. The benchmark: the OECD Principles of corporate governance

The OECD Principles of corporate governance are general guidelines for regulating the entry, on-going obligations, and exit of companies to and from equities markets. According to the OECD Task Force that drafted them, the Principles were devised with four fundamental concepts in mind: responsibility, accountability, fairness and transparency. The Principles allow for diversity of rules and regulations.

The OECD Principles are primarily concerned with listed companies. They are organized into five sections, (1) the rights of shareholders, (2) the equitable treatment of shareholders, (3) the role of stakeholders in corporate governance, (4) disclosure and transparency and (5) the responsibilities of the board.

The IOSCO Principles deal with the regulators of financial markets, self-regulating organizations (SROs), enforcement, cooperation in regulation, collective investment schemes (investment funds), market intermediaries, secondary securities markets and issuers. The OECD Principles complement the IOSCO Principles of financial market regulation by focusing in more detail on disclosure and transparency of issuers and equitable treatment.

The OECD Principles state that board members are accountable to shareholders and to the company.⁵ Accountability to shareholders means equal treatment of majority and minority shareholders. Accountability to the company means that directors must ensure that the company complies with existing laws and regulations, such as tax, labor, health and safety laws, equal opportunity, environmental legislation, and competition law.

The Principles stress that stakeholders, in particular creditors, employees and consumers, play an integral part in shaping the decisions of a company. Principle III states that "...the corporate governance framework should encourage active co-operation between

⁵ Source: Preface to the OECD Principles

corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises”. The full social responsibility debate goes beyond the scope of this paper.

In particular, corporate governance deals with the checks and balances that need to be put in place to deal with the problem resulting from the separation of management and ownership in corporations. Board members and management need to have enough independence to manage the company’s affairs as they best see fit without undue interference from outsiders, as long as they do it prudently, with diligence and care, and in the interests of shareholders. Checks and balances are necessary to ensure accountability, since people are likely to manage their own affairs more carefully than those of others.

The OECD Principles are non-binding. They provide a framework for dialogue on country experience and identification of policy reform “without prejudice to the prerogative of each nation to find its own path to better corporate governance.”⁶ The aim is a common framework in which good corporate governance practices can develop, in consistency with national regulations and traditions.⁷

A process of consultation is currently being put in place to assess the effectiveness of the Principles as a policy tool and core standard. In line with the decisions taken at the 1999 OECD Council meeting at Ministerial level, preparatory work for an assessment of the OECD Principles will begin in 2002 with the intention of undertaking a full review in 2005. The first stage will consist of analytical reports on corporate governance complemented by research papers on current trends based on a questionnaire circulated among members countries. Since their publication, several new codes have been released, including the Combined Code in the UK and the King II Report in South Africa, which in some respects, are more prescriptive than the OECD Principles.

The Regional Roundtables on Corporate Governance, a joint OECD/World Bank initiative, follow the structure of the five chapters of the OECD Principles. The Roundtables were launched by the Memorandum of Understanding signed by President J. Wolfensohn and Secretary General D. Johnston in June 1999 to disseminate best practice in corporate governance and increase the ownership of reform in developing countries and transition economies. In addition, the World Bank and the OECD set up the Global Corporate Governance Forum, a multi-donor trust fund, to (a) disseminate best practice and raise awareness of the need for reform; (b) foster academic research; and (c) provide a source of finance for implementation of reform and capacity building.

II. B. Process and format

The template

To assess countries, the World Bank has produced a questionnaire in the form of a template (the “Template”). It is structured along the five chapters of the OECD

⁶ Source: OECD Principles

⁷ Source: *Ibid*

Principles. The objective of having the Template is to facilitate the gathering of information necessary to formulate a diagnostic of the institutional framework underlying corporate governance, as well as prevailing practices and enforcement. For each OECD Principle, a set of questions have been prepared to assess the compliance of the country under assessment. Questions have been drafted so that they can be answered by “yes” or “no” as often as possible, to allow benchmarking.

The Template includes a section on the ownership structure of the assessed country, since this is an important determinant of corporate governance practices. It endeavors to identify pyramid structures, cross shareholdings, and business groups and gathers information on the divergence between cash flow rights and voting rights. While the OECD Principles are mainly concerned with the rights of shareholders and stakeholders, disclosure and the responsibilities of insiders, the template also addresses the issue of institutional capacity.

A first Template was produced at the beginning of 2000 and revised in the same year. Consultation took place for the preparation of the second generation Template.⁸ In its current form, the Template is applicable mainly to non-financial enterprises. A third generation Template is currently in progress. The objective of this exercise is to focus on the assessment of banks and non-bank financial institutions, such as insurance companies and pension funds. The third generation Template will also include some more detailed questions on the governance of securities regulators in a manner complementary to the International Organization of Securities Commissions (IOSCO) principles.

The assessment

There are two ways of conducting corporate governance country assessments – as an “external” or as an “assisted” self assessment. While the World Bank is responsible for researching and drafting the assessment under the first approach and the country’s policy makers validate the findings, under an “assisted” self assessment the country is involved in all stages of the process. This approach works well when the authorities of the assessed country are committed to reform. In the “assisted” self assessment, the ability of the local authorities to provide complete and accurate information may be impaired by political considerations. For example, it may be difficult for a regulatory agency to acknowledge that the existing legislation is not properly enforced. However, if these constraints are not there, the “assisted” self assessment increases the degree of ownership of domestic policy makers and helps develop capacity.

The format of the reports complies with the operational guidelines for ROSC reports issued by the World Bank and the IMF. The content has evolved over time. It started with a 15-page narrative describing corporate governance practices of the assessed country, plus a matrix benchmarking the adherence to each OECD Principle. In a second phase, policy recommendations were added. The latest format attempts to differentiate between

⁸ Corporate governance experts from the World Bank Group, the OECD, the IMF, the Commonwealth Association, the US Securities Commission, as well as private sector experts of corporate governance from industrialized and developing countries, were asked to provide guidance and opinions.

compliance of the legal and regulatory framework and actual practices of market participants, and includes a chapter on institutional strengthening. It also reconciles the corporate governance modules for FSAPs and ROSCs.

The format of the assessments allows for systematic benchmarking across countries and regions. It is divided into four parts: (i) executive summary, (ii) capital market overview and institutional framework, (iii) principle by principle review including policy recommendations and, (iv) institutional strengthening.

Each OECD Principle is evaluated based on quantitative and qualitative standards. “Observed” means that all essential criteria are met. “Largely observed” means that only minor shortcomings are observed, which do not raise any questions about the authorities’ ability and intent to achieve full observance within a reasonable period of time. “Partially observed” means that while the legal and regulatory framework may be fully compliant with the OECD Principle, practices and enforcement diverge. “Materially not observed” means that, despite progress, the shortcomings are sufficient to raise doubts about the authorities’ ability to achieve observance. “Not observed” means that no substantive progress toward observance has been achieved.

The assessment is most useful when the country under assessment is committed to a reform agenda and agrees to the publication of the report through the World Bank ROSC website http://www.worldbank.org/ifa/rosc_cg.html.

The assessments are complementary to private sector rating activities. The World Bank assessments focus on country analysis, while some rating agencies have started to focus on companies. Standard & Poor’s and Moody’s have begun rating companies in emerging markets. Other similar exercises are carried out by specialized firms such as Pensions Investment Research Consultants in the United Kingdom or Deminor in Belgium and France. New rating companies for corporate governance have emerged in Russia and Korea.

II. C. Policy recommendations

Policy recommendations are suggestions for countries that want to compete for international portfolio capital. A “one size fits all” solution is not advocated. Examples are provided of how other countries have overcome similar problems. They provide choice for issuers, countries and investors alike. In the global market, both countries and issuers compete for capital. The driving principle is to encourage choice and let market forces pick the winners.

Choice enables reputational costs and benefits to play their role. If there is no choice, the benefit of complying with international best practice is difficult to capture. If there is choice, recipients of capital can signal to the market that they are different. This approach was recently followed by Brazil, as discussed in Box II. Over time, it is expected that governance regimes that are less transparent and provide less protection to minority investors, will find it more difficult and more expensive to attract capital.

Box II: The Brazilian Novo Mercado

In 2001, BOVESPA, the São Paulo stock exchange, launched a new market segment, the Novo Mercado, which aspires to international standards of corporate governance. The Brazilian approach is innovative. Traditionally, new segments have been introduced by stock exchanges to encourage small and medium size enterprises to become listed. Listing rules for the new segments have usually been watered down versions of listing rules on the main board. Not so in Brazil. The companies listed on the Novo Mercado will be prohibited from issuing non voting shares whilst companies on the main board can do so. They will have to abide by US or international accounting standards and their free float⁹ will be at least 25 percent. An arbitration panel has been created to settle shareholder disputes. As a result, some investment banks, such as Merrill Lynch, have put the Novo Mercado at the top of their rankings for minority shareholders rights and significantly above the main Brazilian board ranking.

The rationale for the creation of the Novo Mercado is to allow companies that want to abide by international best practice to differentiate themselves from the Brazilian main board. It is also expected that their adherence to the Novo Mercado listing rules will allow companies to attract quality domestic and international investors and ultimately lower their cost of capital. For example, Brazilian pension funds will be allowed to invest a higher proportion of their assets in companies listed on the Novo Mercado. Likewise, the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), the state-owned development bank, is offering more attractive lending terms to companies that list there.

The policy recommendations offer alternatives about how to comply with the OECD Principles through the effective enforcement of the existing legal and regulatory framework. Sometimes the recommendations include the modification of existing laws or rules or the adoption of new ones. The recommendations also focus on how companies can improve their internal governance structures. The endorsement and ownership of the reform program by the private sector is essential for corporate governance reform to be successful. Therefore, policy recommendations may include measures to encourage the development of private sector associations such as institutes of directors, non-for-profit shareholder associations or other business associations, which operate in parallel with existing public institutions and provide private solutions to information dissemination.

The policy recommendations should be construed as a set of interdependent measures that need to be implemented simultaneously to be effective. Take, for example, the concept of equitable treatment of shareholders. One obvious way of enhancing the

⁹ The free float is that portion of capital which is not held by controlling shareholders and can be easily purchased by portfolio investors.

protection of minority shareholders is to introduce the option of cumulative voting¹⁰ for the election of board members, so that minority shareholders have a chance of being represented on the board. However, this measure alone may not prove effective. The introduction of cumulative voting in the Philippines did not result in greater representation of minority shareholders on boards of directors, because in most instances, the number of minority shareholders present and voting at the Annual General Meeting was insufficient to win enough votes on one candidate. Complementary measures, such as proxy voting, voting by mail and the introduction of the concept of independent directors, are necessary to enhance equitable treatment. Each country's specific circumstances, priorities, and level of development should drive the sequencing of reform.

II. D. Key findings

For ease of reference, the discussion regarding key findings has been divided to correspond with the five sections of the OECD Principles. Each section highlights deviations from the OECD Principles or describes compliance. One major key finding is that the legal and regulatory frameworks of the assessed countries are largely compliant with the OECD Principles. However, practices are not. The difficulty of the assessments is to reflect the discrepancies between the letter of the law and compliance.

Table 1 sets out the consolidated matrix for 12 countries.¹¹ The consolidated matrix is the merger of two matrices. The first one was used to benchmark the first generation of assessments. It has three entries: "Yes," "No," and "Incomplete."¹² The second generation matrix was used until December 2001. It has four entries: "Observed," "Largely Observed," "Materially Not Observed" and "Not Observed."¹³ Therefore, the consolidated matrix has four categories: "Observed/Yes," "Partially Observed," "Not Observed/No" and "Not available." The column "Partially Observed" includes the scores "Largely Observed," and "Materially Not Observed," as well as the score "Incomplete" from the first assessments. In addition, it should be noted that the first generation matrix did not cover the stakeholders section and some other minor issues, as indicated by the entry "Not available."

¹⁰ Cumulative voting allows minority shareholders to cast all their votes on one single candidate. Suppose that a publicly traded company has two shareholders, one holding 80% of the votes and another with 20%. 5 new members of the Board need to be elected this year. If there is no cumulative voting rule in place, each shareholder will have to vote separately for each Board position. The majority shareholder will get all 5 seats, since he will outvote the minority shareholder each time by 80:20. With cumulative voting in place, the minority shareholder can decide how to place her votes. The optimal strategy for her would be to take all her votes (5 times 20%) and place them on one Board member. The minority shareholder will then win that seat, since she will have 100%.

¹¹ Latvia, Lithuania and South Africa are not finalized.

¹² "Incomplete" means that some provisions are in place, while others may not be.

¹³ As of January 2002, an additional score, "partially observed," has been introduced for cases when a principle is less than "largely observed," but better than "materially not observed."

Table 1: Summary Matrix

OECD Principles	Observed/ Yes	Partially observed	Not observed/ No	Not Available
Section I: The Rights of Shareholders				
<i>A. Basic shareholders rights:</i>				
(i) Ownership registration	*****	*****		
(ii) Share transfer	*****	*****		
(iii) Access to information	***	*****		
(iv) Participation and voting at AGM	*****	*****		
(v) Election of board	*****	*****		
(vi) Share in the profit	*****	*****		
<i>B. The right to participate in decisions on fundamental corporate changes</i>				
(i) Amendments to the statutes	*****	*****		
(ii) Authorization of additional shares	*****	*****	*	
(iii) Extraordinary transactions (resulting in sale of the company)	****	*****		
<i>C. The right to be adequately informed about, participate and vote in general shareholder meetings (AGM):</i>				
(i) Sufficient and timely information about AGM	*****	****		
(ii) Opportunity to ask question and place items on agenda	**	*****	*	**
(iii) Vote in person or in absentia	*	*****		
<i>D. Disclosure of capital structures and arrangements enabling control disproportionate to equity ownership:</i>	****	*****		
<i>E. Efficient and transparent functioning of market for corporate control:</i>				
(i) Clearly articulated and disclosed rules and procedures, transparent prices and fair conditions	**	*****	**	
(ii) No use of anti-takeover devices to shield management from accountability	**	*****	*	****
<i>F. Requirement to weigh costs/benefits of exercising voting rights</i>		**	*****	***
Section II: Equitable Treatment of Shareholders				
<i>A. Equal treatment of shareholders within same class</i>				
(i) Same voting rights for shareholders within each class. Ability to obtain information about voting rights attached to all classes before share acquisition. Changes in voting rights subject to shareholder vote.	*****	****		
(ii) Vote by custodians or nominees in agreement with beneficial owner.	****	**	***	***
(iii) AGM processes and procedures allow for equitable treatment. Avoidance of undue difficulties and expenses in relation to voting.	*****	*****		
<i>B. Prohibition of insider-trading and self-dealing</i>	*****	*****		
<i>C. Disclosure by directors and managers of material interests in transactions or matters affecting the company.</i>	**	*****		
Section III: Role of Stakeholders in Corporate Governance				
<i>A. Respect of legal stakeholder rights</i>	*	*****		*****

OECD Principles	Observed/ Yes	Partially observed	Not observed/ No	Not Available
<i>B. Redress for violation of rights</i>	*	*****		*****
<i>C. Performance-enhancing mechanisms for stakeholder participation</i>	*	*****		*****
<i>D. Access to relevant information</i>		*****		*****
Section IV: Disclosure and Transparency				
<i>A. Disclosure of material information</i>				
(i) Financial and operating results	*****	*****		
(ii) Company objectives	*	*****	*	****
(iii) Major share ownership and voting rights	*****	*****		
(iv) Board members, key executives and their remuneration	**	*****		
(v) Material foreseeable risk factors		*****	*****	**
(vi) Material issues regarding employees and other stakeholders		*****	***	***
(vii) Governance structures and policies	*	***	*****	**
<i>B. Preparation of information, audit, and disclosure in accordance with high standards of accounting, disclosure, and audit</i>		***** *		
<i>C. Annual audit by independent auditor</i>	**	*****		
<i>D. Channels for disseminating information allow for fair, timely, and cost-efficient access to information by users</i>	*****	*****		
Section V: Responsibilities of the Board				
<i>A. Act on an informed basis, in good faith, with due diligence and care, in the best interest of the company and shareholders</i>	**	*****		
<i>B. Fair treatment of each class of shareholders</i>	***	*****		
<i>C. Compliance with law and taking into account stakeholders' interests</i>	***	*****		****
<i>D. Key functions:</i>				
(i) Corporate strategy, risk policy, budgets, business plans, performance objectives, implementation and performance surveillance, major capital expenditures, acquisitions, divestitures		***** *		
(ii) Selection, monitoring, replacement of key management	**	*****		*
(iii) Key executive and board remuneration, board nomination	*	*****		*
(iv) Monitoring of conflict of interest of management, board members, and shareholders, including misuse of corporate assets and abuse in related party transactions.		*****	**	*
(v) Ensuring integrity of accounting and financial reporting systems, including independent audit, systems of control, compliance with law	*	*****	*	
(vi) Monitoring governance practices and making necessary changes	*	****	***	****
(vii) Overseeing disclosure and communication	***	*****	*	**
<i>E. Objective judgement on corporate affairs:</i>				
(i) Assignment of non-executive board members to tasks of potential conflict of interest (e.g. financial reporting, remuneration)	*	*****	**	*
(ii) Devote sufficient time to their responsibilities	*	*****	*	***
<i>F. Access to accurate, relevant, and timely information</i>	***	*****	*	***

Section I: The rights of shareholders

Registration of shares has historically been the responsibility of the company. This power vested in management created difficulties arising from agency problems between managers and shareholders. In some countries, e.g. Croatia, Morocco, and Turkey, companies can object to or block share transfer and ownership registration. In India, the transfer of physical shares often results in delays and increases the likelihood of fraud or theft. These are deviations from the right of shareholders to secure ownership registration. Most of the countries surveyed have created central depositories that speed up the process of share transfer and registration and make them more secure. This removes the power to register shares from insiders.

While voting is a basic right of ordinary shares in most countries, owners of bearer shares do not have the right to vote in Egypt. In Brazil, the majority of investors own shares without voting rights (the so-called PN shares¹⁴). On the other hand, shareholders who have paid up only 50 or less percent of the share issue price have full voting rights in Croatia, Morocco and Egypt.

In all assessed countries, fundamental corporate decisions are made with a supermajority of shares voting and present. Shareholders can delegate the authority to issue new shares to the board. This does not contradict the OECD Principles. However, the question arises whether there should be a ceiling on the amount of shares and time frame within which they can be issued. In Croatia, companies may receive authorization from shareholders (if approved by 75 percent of the shares at the meeting) to issue up to 50 percent of share capital for a period of up to five years. The law also allows the management board to increase the company's share capital by converting company bonds into new shares up to the amount of the share capital of the company. Finally, the law permits company statutes to waive existing shareholders' pre-emptive rights on new share issues.

As recommended under the OECD Principles, shareholders owning between five and ten percent of capital can convene a shareholder meeting or add resolutions to the agenda in most countries surveyed (Romania and South Africa are the exception). In none of the assessed countries is the revised agenda circulated at the expense of the company. On voting procedures and the right to vote in absentia, all countries allow physical proxies. In Latvia, efforts to introduce electronic voting are underway. India recently introduced a non-mandatory requirement to use postal voting for certain important resolutions such as mergers and acquisitions and buy-back of shares. Malaysia also permits voting by mail.

Disclosure of capital structures is generally in line with the OECD Principles in the sense that, if a shareholder wants to know the first level capital structure of a listed company, there is a way to gather this information. Typically, the annual report, the stock exchange, the registrar or the annual general meeting (AGM) will provide it. *Stricto sensu*, therefore, the country is in compliance with the OECD Principle. However, the

¹⁴ Non voting PN shares can constitute up to 2/3 of total share capital. The new corporate law lowers this limit to 50 percent.

information is often hard to get; and if there are pyramid structures and cross shareholdings as for example in Egypt and Morocco, or nominee owners, it is difficult to identify the ultimate controlling shareholder. In Romania, investors tend to protect themselves behind off-shore vehicles incorporated in Cyprus, where there are no requirements to disclose ownership. Consolidation is often not mandatory under national accounting rules. It is therefore impossible to detect pyramid structures and indirect cross shareholdings. Georgia is noticeable amongst the assessed countries for having introduced a requirement to disclose ultimate beneficial ownership beyond the five percent threshold.

The assessed countries are characterized by concentrated ownership structures. Ownership concentration implies that the corporate takeovers only take place in a friendly environment. Malaysia, Poland and India have takeover codes and mandatory tender offer rules. While a mandatory tender offer exists in Egypt, it does not extend to all shares. It is not common for corporate law to request a shareholder vote on the sale of substantial assets.¹⁵

The OECD Principle which states that shareholders should consider the costs and benefits of exercising their voting rights is based on the premise that positive financial returns can be obtained by exercising voting rights. This principle is not observed in any country surveyed, although Malaysia is taking steps in this direction. There is little shareholder culture, and the costs of exercising voting rights and the danger of upsetting incumbent management are deemed greater than the benefits in the short term. Also, pension funds are often not well developed, if they exist at all. However, it can be argued that this OECD Principle is even more important in developing and transition economies than in industrialized countries because in the latter investors can “vote with their feet”, i.e. sell their holdings if they are dissatisfied with the governance of their portfolio companies, whereas in the former investors cannot do so easily without moving the market. All countries surveyed require that shares be blocked from trading a certain time before the annual general meeting (AGM) for votes to count, except for Romania which has introduced a “date of record”. The introduction of a date of record for proof of ownership is one way to create incentives for institutional investors to vote, because it does not inhibit them from selling their shares after the date of record.

Section II: The equitable treatment of shareholders

The concept of protection of minority shareholders is not well developed in the countries surveyed as shown by the case discussed in Box IV below. Most countries comply with the requirement that shareholders should have timely and sufficient information about the annual general meeting, except for Georgia, Brazil and the Philippines where the notice periods are too short or are not well circulated and important agenda items can be omitted. In India, there are companies which opt to hold the annual general meeting in remote places, which makes it difficult and sometimes expensive for minority shareholders to attend. With regards to the exercise of voting rights by custodians or

¹⁵ defined as 25 percent or more of company assets

nominees in agreement with beneficial owners, it is impossible to track beneficial owners in Croatia, Georgia and the Philippines, while in Egypt the concept is now being introduced in the new Depository Law.

Despite the fact that insider trading and self-dealing are a criminal offense in all assessed countries, monitoring and detection remain a problem across the board. The securities regulators are generally not equipped to carry out their surveillance activities efficiently and depend on an often overburdened, weak or slow court system for enforcement. In addition, commercial tribunals do not exist in all countries.

Box III: Difficulties in enforcing equitable treatment of shareholders

A recent case illustrating the lack of equitable treatment in the market for corporate control was the acquisition of the Moroccan bank Banque Marocaine de l' Afrique Occidentale (BMAO) by a listed state-owned bank called Banque Nationale pour le Développement Economique (BNDE) in 2000. BNDE commissioned one of the big five consulting firms to do the valuation. BMAO's minority shareholders representing ten percent of capital objected to the buyout price and requested a second valuation. A press campaign was initiated against the dissenting shareholders, arguing the law should not allow just any shareholder to bring a transaction to a standstill. The minority stakeholders lost their case.

This example illustrates the conflicts that prevail in countries where the rights of minority shareholders are not well understood and where a shareholder culture does not exist. BMAO was widely known to have a balance sheet with serious problems. In consequence, the valuation might well have been favorable to minority shareholders. Nevertheless, this is not the point. The minority shareholders were not able to go through with their motion of a second valuation. It was not deemed acceptable that minority shareholders would question a decision of management/controlling shareholders.

Disclosure by directors and managers of material interests in transactions or matters affecting the company is less than fully observed in most countries. The regulatory framework usually includes rules and regulations for disclosing and monitoring related party transactions and self-dealing. However, disclosure is not always mandatory, or there are no clear rules. In Morocco, related party transactions must only be disclosed if they take place under "special conditions." There is a general concern that existing provisions are not consistently adhered to and cannot be enforced in environments often characterized by pyramid structures, cross shareholdings and a weak judicial system.

Section III: The role of stakeholders

Stakeholders are generally defined as all those who have a material relationship with the company that is not based on share ownership. These includes employees, creditors, customers, suppliers, local communities and even society at large.

The OECD Principles state that the corporate governance framework should recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Stakeholders are protected by contracts, competitive markets and through laws and regulation. Regulation is necessary, because markets are imperfect. They sometimes generate negative externalities, or fail to protect certain stakeholders of the firm adequately. For example, since contract law has been found to be insufficient to govern all aspects of the long-term relationship between workers and the firm, the law of labor contracting, pension law, health and safety law and anti-discrimination law have been developed. Similarly, since the firm has an incentive to embark on activities that may destroy the environment of the communities located near the enterprise, environmental legislation and the law of nuisance and mass tort have been developed. Likewise, to protect consumers, product safety regulation, warranty law, tort law governing product liability, antitrust law, and mandatory disclosure of product content have been introduced.

Other rules and regulations include tax laws, bankruptcy law, corporate law and securities law. These laws are necessary to protect the interests of states, creditors and minority investors. For example, corporate law and bankruptcy law protect creditors from shareholders that indulge in abusive behaviors. Corporate law includes rules for “piercing the corporate veil,” whereby creditors can hold shareholders liable beyond their limited liability when they have interfered with the running of the company in a manner that results in the company’s being unable to service its debt obligations. Similarly, creditors can block dividend distribution in the presence of inadequate capital.

Company boards must also ensure that adequate mechanisms are in place to provide familiarity and compliance with legislation related to the rights of stakeholders. Mechanisms are needed so that the firm and its officers understand and observe the legal rights of stakeholders. Companies need to consult and communicate with employees and other stakeholders.

While such a legal and regulatory framework may be in place in developing countries and transition economies, the lack of enforcement capability of the judiciary may result in insufficient protection of stakeholders. Consequently, additional protections –such as board representation– may be warranted. In addition, some companies have found it advantageous to take voluntary measures to foster good stakeholder relations.

Worldwide, stakeholders are seldom represented on the board. Exceptions are e.g. Germany, China, the Czech Republic, Austria, Egypt, Denmark, Norway and Sweden where employees have the right to elect representatives to the (supervisory) board. In transition economies, such as Poland, it is customary for creditors to sit on the board of the company they lend to. Their interest is thus protected by board representation.

The debate in transition economies on the role of stakeholders in corporate governance has been developing in a different context from the one prevailing in OECD economies and developing countries. The main concern of transition has been to move away from the model of the enterprise as a social unit towards an enterprise that is a profit-making entity based on clear property rights and capable of attracting capital.

In Romania, unions have a voice in corporate restructurings and collective bargaining. Employees have a right to be informed by companies and to conduct negotiations through employee representatives in cases of increase in charter capital, reorganization, liquidation and other key decisions that might impact on the deterioration of work conditions. Trade unions can also initiate such consultations. However, consultation and other labor rights contained in labor laws are not always observed in practice.

Bondholders are the stakeholder group that tends to be recognized in the legal framework and has access to relevant information, including the right to send a representative to the annual general meeting. Performance enhancing mechanisms, such as stock options, are used in some countries to align the interests of managers and employees with shareholders. In Morocco, share options were introduced in 2001. However, they have been issued at a discount to prevailing market price. As a result, the incentive for managers to improve performance and increase share price is significantly reduced.

Section IV: Disclosure and transparency

Material information encompasses that which should be known by investors to formulate a rational investment decision. Improving the disclosure of material information provides investors with information to adjust their risk/reward perception. Incentives shape the approach to information disclosure. In countries where business has traditionally been based on relationship and trust, corporate information is thought of as secret; and it is accepted practice to keep different sets of books, e.g. one for taxes, one for outside investors, and one for the majority shareholder.

Information needs to be disseminated in a fair, timely and cost effective manner. Most of the countries surveyed only partially comply with international financial reporting standards. The assessments follow the recommendation of the Financial Stability Forum to adopt International Accounting (IAS) and auditing standards. Only Croatia is in full compliance with IAS, while most other countries differ in material aspects, including consolidation and segment reporting. In addition, the notes to the accounts are often only available to the public in summary form, if at all. Companies in Morocco and Egypt limit themselves to the publication of summary financial statements (sometimes with partial notes) in the newspaper or legal gazette.

Non financial information includes (i) company objectives, (ii) off balance sheet commitments and litigation risks, (iii) the ownership structure of the company, (iv) the remuneration of board members and key executives, (v) material foreseeable risk factors, (vi) material issues regarding employees and other stakeholders, and (vii) information on governance structures and policies. Disclosure of non-financial information is a new concept in most developing countries and transition economies. In Turkey, layoffs of more than 20 percent of the workforce, as well as collective bargaining agreements, must be disclosed. Malaysia and India require the disclosure of governance structures and policies under the listing rules as part of their code of best practice. The remuneration of board members and key executives is generally set by the AGM in the aggregate. South Africa followed a gradual approach in disclosure of board remuneration. The first King report, published in 1999, recommended that aggregate compensation be disclosed in the

annual report of listed companies. The second King report, released in July 2001 calls for the disclosure of individual compensation.

Another set of issues relates to audit practices and the legal liability of auditors. The OECD Principles remain quite general on this point. In most of the countries surveyed, the legal and regulatory framework delegates the setting of accounting and auditing standards to the accounting association. Compliance is generally monitored by the securities regulator or, as in South Africa, to the stock exchange. Often these institutions do not have the necessary expertise to fulfill this obligation. The professional accounting and auditing bodies are in charge of monitoring members and their professional conduct. Generally, however, the monitoring is carried out by the same market practitioners that are being supervised. Also, professional associations often do not have the means to impose effective sanctions. A commendable exception to this rule is Morocco, although this is currently the subject of a dispute. On occasion, auditors have given unqualified opinions and certified that the accounts audited provide a fair and true picture, despite the fact that many defects were noted. The penalties for such behavior are low and enforcement generally lax. None of the countries surveyed has opted to set auditor liabilities at a high enough percentage of share capital to act as an effective deterrent.

While in theory most regulatory and legislative frameworks contain provisions defining auditor independence, this is often not standard practice. Independence signifies the absence of direct or indirect personal and business relationships, past or current, between the audit firm, its partners, the company, its director and all related parties. In the aftermath of the Enron scandal,¹⁶ it is likely that full disclosure of audit and all other fees paid to the audit firm will be adopted by a growing number of countries.

Section V: Responsibilities of the board

In most developing countries and transition economies, irrespective of their legal heritage, companies tend to follow a “parliamentarian model” of board representation, where directors represent the constituency that elected them. This model is not consistent with the four pillars of the OECD Principles.

In many countries, majority shareholders exercise significant influence over boards, directly as board members or indirectly through the appointment of board members who report to them. In this case it is difficult to hold the majority shareholder liable for his actions as a “shadow director.”¹⁷ Malaysia has attempted to subject shadow directors to statutory duties. The legal and regulatory frameworks in all assessed countries establish general duties for the board of directors. However, the prevailing legislation often does

¹⁶ In the fall of 2001, Enron, the US energy trading company, filed for protection from creditors under Chapter 11. It transpired that, with the connivance of its auditor, the company had used off balance sheet subsidiaries to hide the amount of debt that the company had accumulated. Such practices had prevented shareholders from gaining a full and fair picture of the company’s financial situation until it was too late.

¹⁷ “Shadow directors” are controlling shareholders or shareholders with significant influence over the control of the company, who exert influence over the board even though they are not de facto directors.

not spell out the key functions and there are no guidelines or procedures on how to fulfill these obligations. On the other hand, countries are beginning to introduce stiff penalties for board members without introducing the concept of the “business judgment rule.” This rule allows directors to make business decisions without worrying about violating the duties of care and diligence, if they have acted on an informed basis, in good faith, and in the honest belief that the decision taken is in the best interests of the company. In the absence of such rule, directors may be discouraged from taking necessary decisions in the ordinary course of business.

One of the recurring themes on the subject of board duties across all regions is the lack of training and the limited understanding that directors have of corporate governance issues. According to market surveys, nine-tenths of directors do not feel that they are adequately informed or knowledgeable about their duties and responsibilities as a board member. One possible remedy is the creation of Institutes of Directors for training, dissemination of best practice and issuance of guidelines regarding the size of boards, the constitution of committees, and other useful practices. Training for directors is already mandatory in Malaysia.

In addition to defining strategy, selecting, monitoring and overseeing management is the most fundamental function of the board. A board that cannot dismiss management is not an effective board. This function requires an independence from management and controlling shareholders that is generally lacking in developing countries and transition economies. In many countries with single tier board structures, the chief executive officer (CEO) is also the chairperson of the board. In developing countries where ownership is highly concentrated, this person is often also a representative of the majority shareholders. This set-up makes it virtually impossible for outsiders to replace management because it would mean firing themselves. Therefore, the board fails in this fundamental respect. To change this situation, it is tempting to recommend that the function of CEO be separated from the function of chairperson of the board. However, experience in Morocco suggests that policy makers should carefully weigh the costs and benefits of making such a recommendation. In Morocco, the business community supported the separation of CEO and chair for the wrong reason, namely because it diminished the personal legal liability of the chairperson.¹⁸ Under such circumstances, decoupling the two functions may be counterproductive. The accountability of board members to shareholders and stakeholders must first be firmly established. This may require legislative changes such as amending company law, or more vigorous enforcement of existing legislation. Then, decoupling is an option. Another approach to this problem is to set up a special purpose committee empowered to select and monitor key management.

While non-executive directors are frequent in the countries surveyed, very few are truly independent from the controlling shareholder or management. In contrast, the Kuala Lumpur Stock Exchange’s listing requirements go beyond the norm by defining independent directors as “directors who are not officers of the company, who are neither

¹⁸ For this reason a number of companies have opted for the two tier board structure.

related to its officers nor represent concentrated family holdings of its shares; who in the view of the company's board of directors, represent the interest of all public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment.”

Effective monitoring includes the detection and resolution of conflict of interests between management/board and shareholders/stakeholders, and prevention of any misuse of corporate assets and abuses in related party transactions. There is a growing consensus that board committees, such as recruitment, nomination, remuneration, risk management and audit committees with a minimum number of independent directors, can be useful to assure independence from management. In 11 out of 12 countries surveyed, the board does not effectively ensure the integrity of accounting and financial reporting systems, including oversight over the audit function. At this stage, there is no consensus as to what the optimal degree of independence should be. Some, like the Australian Institute of Directors, argue in favor of director expertise over independence: According to the Australian Institute, a majority of executive directors should be elected to key committees, such as the audit committee. Others, like the American National Association of Corporate Directors favor a majority of independent directors. In developing countries and transition economies, the pool of available financially numerate independent directors is often limited. The Australian approach is, therefore, perhaps more realistic. According to the OECD Principles, board members must have access to accurate, relevant and timely information, including management accounts and advice from outsiders. In most countries with unitary boards that were surveyed, access to information is assured since most board members are insiders. However, information is not always readily available in countries with supervisory boards. Directors should also devote sufficient time to their responsibilities. Board meetings are still often considered a formality and not convened with sufficient frequency. Directors do seldom adequately prepare themselves for board discussions, and boards are often too large to be effective. One possible remedy is to introduce a requirement in the listing rules that companies publish information on the frequency and attendance of their board meetings in their annual report.

III. Uses in Policy Dialogue and Implementation of Better Corporate Governance Practices

The corporate governance assessments have a number of applications for International Financial Institutions, policy makers and the private sector. They support diagnostic and strategic work, underpin policy dialogue and lending operations, and provide input to technical assistance and capacity building efforts. They are useful for companies who want to capture reputational benefits by improving their internal corporate governance structure.

III. A. Diagnosis, strategy and lending operations

The corporate governance assessments can be seen as building blocks for diagnostic work, such as investment climate assessments. They are useful inputs into key policy documents, such as sectoral strategies for the private and financial sectors or country wide development strategies. Their strengths lie both in the systematic standardized

coverage and in their benchmarking against an internationally recognized standard, and they provide an easy guide to policy dialogue and reform. The assessments complement the OECD/World Bank Regional Roundtables on Corporate Governance. The assessments provide country specific diagnostics, while the roundtables focus on regions.

In addition to their diagnostic and strategic value, corporate governance country assessments are valuable inputs into lending operations. In the World Bank, for example, the country program cycle has become the most important business model. Programmatic adjustment lending has been found to be a cost-effective vehicle for supporting the Bank's policy dialogue with its clients on the social and structural agenda and for partnering with other agencies. The country has replaced the project as the critical focus of implementation. The programmatic approach of the World Bank has four main steps¹⁹ – definition of the vision; diagnosis prepared and shared with clients and partners²⁰; programming; and monitoring. Corporate governance country assessments are useful for the definition of the vision (aspiration to comply with international standards). During the diagnostic phase, they provide critical and objective information on the strengths and weaknesses of the economy under review, including the functioning of the private sector and securities market. During the programming phase, the assessments provide valuable input into the design and sequencing of operations. During the monitoring, they provide clear progress benchmarks to monitor the outcome of the programs.

III. B. Technical assistance and capacity building operations

Corporate governance country assessments directly identify technical assistance and capacity building needs, which can be financed through operations from International Financial Institutions, bilaterals or the private sector. An example of a multi-donor trust fund is the World Bank/OECD Global Corporate Governance Forum, which is set up to disseminate best practice and raise awareness of the need for reform; foster academic research; and provide a source of finance for implementation of reform and capacity building.

Measures proposed in the assessments include setting up institutes of directors; training securities regulators and commercial courts' magistrates; introducing arbitration procedures; strengthening the association of accountants and auditors; assisting with the drafting of a code of best practice (see box); advising on the governance of the securities regulator and the stock exchange; training the financial press and setting up institutions that actively defend shareholders rights.

¹⁹ Source: Klaus Tilmes, Ivan Velez and Karim Gigler, May 2001. World Bank Documents: Programmatic Lending: Review of Recent Bank Documents.

²⁰ Due diligence and other diagnostic economic and sector work (ESW).

Box IV: Codes of best practice

A code of best practice is a useful tool to complement the existing legal, regulatory and institutional framework underpinning corporate governance. Codes have been issued by companies seeking to differentiate themselves from their competitors in terms of corporate responsibility (General Motors, Royal Dutch Shell), by stock exchanges, a special purpose commissions set up by the private and the public sectors. A number of countries have issued national codes of best practice for corporate governance inspired from the OECD principles. These include Brazil, India, Poland, the Czech Republic, Malaysia, Russia, and China, among others. While such codes are rooted in the OECD Principles, some of them go further. For example, India and South Africa require disclosure on individual emoluments of directors, including stock options – the OECD Principles do not. Likewise, in Brazil, the Novo Mercado requires issuers to adhere to the one-share-one-vote principle – the OECD Principles do not.

Codes of best practice are rules which go beyond the law. They are an instrument for improving behavior based on evolving best practice. They consist of guidelines concerning the selection, composition, and remuneration of the board of directors, the role and composition of board committees, the definition of “independence”, the treatment of shareholders and stakeholders, accounting standards, financial and non financial reporting and disclosure policies. Compliance with the code is usually voluntary. In Malaysia and Singapore, the securities regulator and/or stock exchange require issuers to disclose the extent to which they comply with the code in their annual report and explain divergences, or to publish a separate report on corporate governance. In countries such as India and Brazil some of the recommendations of the code have been picked up by the securities regulator or the stock exchange and made mandatory through the listing requirements (e.g. minimum number of independent directors).

The corporate governance assessments can improve the targeting of training by identifying areas where enforcement needs strengthening or capacity building is needed. Once the required training has been identified, the efficiency and targeting of training delivery can be increased by borrowing aspects of the "output-based" approach to financing service delivery - allowing suitable institutions to compete for the delivery of the required training, and linking the compensation of the trainers at least in part to the number of students successfully accredited in the required skills.

A summary of follow up operations with a corporate governance dimension in client countries of the World Bank is set out below (see Table 2).

Table 2: Summary of Follow-up Requests and Operations in Selected Countries	
Brazil	<ul style="list-style-type: none"> • Follow-up: programmatic financial sector adjustment loan with corporate governance issues embedded in the securities market thematic area has been negotiated. • Follow-up: TA project supporting implementation of the financial sector reform program by the Central Bank and the securities regulator (CDVM) negotiated.
Bulgaria	<ul style="list-style-type: none"> • Follow-up: <ul style="list-style-type: none"> ➤ PAL will likely include conditionalities related to revisions of the commercial and securities legislation. ➤ Approximately \$25,000 in PHRD is being used to finance international consultants on revisions to the commercial law.
Cambodia	<ul style="list-style-type: none"> • Follow-up: IDF grant to improve accounting standards and financial reporting.
China	<ul style="list-style-type: none"> • Request: TA for development of director training for securities commission and for establishment of a director institute. • Follow-up: legal reform program focusing on corporate law.
Croatia	<ul style="list-style-type: none"> • Follow-up: recommendations regarding revisions to the company law are to be included in the structural adjustment loan under preparation.
Czech Republic	<ul style="list-style-type: none"> • Request: World Bank to play role of facilitator to reconcile two separate codes of corporate governance.
Egypt	<ul style="list-style-type: none"> • Follow-up: IDF approval for \$247,000 for Institute of Directors (IoD).
Indonesia	<ul style="list-style-type: none"> • Request: TA for curriculum development, trainer training, and provision of guest trainers to the Indonesian Institute of Corporate Directorships. • Follow-up: <ul style="list-style-type: none"> ➤ advice to high-level national committee on corporate governance; ➤ support for new corporate law and identification of listing criteria for the Jakarta stock exchange; and ➤ project component to strengthen the capacity of commercial courts by training judges and staff.
Korea	<ul style="list-style-type: none"> • Follow-up: <ul style="list-style-type: none"> ➤ significant components on corporate governance and transparency reforms under SAL I and SAL II; ➤ ASEM grant (\$300,000) to the Korean Institute of Certified Public

Table 2: Summary of Follow-up Requests and Operations in Selected Countries	
	<p>Accountants to develop a CPE program and other educational material to improve auditing practices; and</p> <ul style="list-style-type: none"> ➤ PHRD Special (\$750,000) to support establishment of the Korean Accounting Standards Board and improve the effectiveness of FSS on supervision of disclosure and financial reporting practices.
LAO P.D.R.	<ul style="list-style-type: none"> • Follow-up: \$300,000 IDF grant on improving financial accountability under preparation.
Mauritius	<ul style="list-style-type: none"> • Request: TA for Institute of Directors (IoD).
Philippines	<ul style="list-style-type: none"> • Follow-up: <ul style="list-style-type: none"> ➤ Corporate governance issues will be addressed when an adjustment operation goes forward (CAS envisions adjustment loan in FY03); ➤ Sector specific issues will be handled under SCAL, SILS and APLS; and ➤ In economic and sector work, ongoing grant to support Institute of Directors (IoD).
Thailand	<ul style="list-style-type: none"> • Follow-up: <ul style="list-style-type: none"> ➤ significant component on corporate governance reform under EFAL I and EFAL II; ➤ ASEM grant (\$400,000) for development of course syllabus and materials for the Institute of Directors (IoD); ➤ IDF grant (\$350,000) to improve financial reporting and audit for listed companies. ➤ Significant component on corporate governance reform under the Country Development Partnership on Competitiveness; and ➤ PHRD Special (\$750,000) to improve application of new and improved accounting and auditing standards through a CPE and a CMA program, as well as to develop guidelines for financial reporting of SME.
Ukraine	<ul style="list-style-type: none"> • Follow-up: programmatic lending operation with corporate governance issues embedded as milestones and reform actions.
Vietnam	<ul style="list-style-type: none"> • Follow-up: IDF grant (\$300,000) on improving financial accountability.

IV Open Issues and Next Steps

To enhance the relevance of the OECD Principles for the developing countries and transition economies, the concept of choice and the problems associated with enforcement need to be debated.

Choice

One fundamental issue that arises from the corporate governance assessments is that choice, in the form of different corporate governance options offered to issuers, is an effective mechanism to facilitate reform. More generally, a “menu of options” approach provides a means for issuers and investors to choose the markets and the companies that are most appropriate for their specific risk profile. At the same time, standardization of options is desirable to lower transaction costs for issuers and investors alike.

Issuers

All over the world, companies have a choice when incorporating. They can decide to incorporate as partnerships, limited liability companies or other forms permitted under the law. Each form of incorporation carries different obligations. Depending on the amount and kind of outside financing needed, companies will choose the form of incorporation that is best adapted to their needs. Choice is therefore essential.

Choice is also desirable because it allows incentives for market participants to play their part. Issuers who want to attract portfolio investment have an incentive to adapt to norms that satisfy such investors. A stock exchange which allows listed companies to choose between different level of disclosure and corporate governance standards through several compartments, provides an opportunity for those companies opting for the compartment with the highest standards to signal to investors that they are different from the majority of listed companies in their country. Such companies may therefore be able to raise capital more easily, lower their cost of capital and attract high quality long term investors, such as pension funds, to become shareholders in their company. This approach is attractive because it provides a non-coercive mechanism for pulling the country’s corporate governance upward gradually by leveraging reputational costs and benefits. An example of such an approach is the recent introduction by the Brazilian stock exchange of a new compartment called the Novo Mercado, which is discussed in Box II. The companies listed on the Novo Mercado are prohibited from issuing non-voting shares, while companies on the main board may do so. They have to abide by US or international accounting standards, and their free float must be at least 25 percent. An arbitration panel has also been created to settle shareholder disputes.

At the other end of the spectrum, some companies may not be ready, willing and able to comply with the minimum standards of disclosure, transparency and accountability prescribed in the OECD Principles, let alone those required by the “top compartment” of the exchange; however, they may still wish to provide some limited liquidity to their shareholders. This objective can be achieved by introducing an Over the Counter compartment, which provides limited disclosure standards to investors but allows them to

offer their shares for sale through an organized market. This approach has been followed successfully by the Prague Stock Exchange.

Investors

Investors have different risk profiles. Some are attracted by high-risk/high returns investment opportunities; some are more risk averse. Investors are sometimes willing to invest their savings in a company where the degree of transparency is limited, because they have high confidence in the incumbent management team or because they perceive the sector in which the company operates to be bearing. Allowing different models of corporate governance to co-exist provides a “horses for courses” approach and permits investors with different risk profiles to choose the appropriate market and company to invest in and allows market forces to pick the winners.

In addition, some developing countries with dynamic capital markets such as Chile have liberalized their capital accounts, thereby allowing investors to invest their savings abroad. This approach may not be appropriate for all developing countries and transition economies. However, when this is possible, one of the main benefits of this approach is that it provides alternative means of promoting equitable treatment of shareholders and creates strong incentives for both issuers seeking capital, as well as national regulators that desire to promote overall economic fundamentals, to ensure that their financial systems comply with international financial standards.

Enforcement

In South East Asia and Latin America, firms are often organized in business groups. These groups grow internally, constructing a web of companies that support the group. At the apex of the group is a large enterprise controlled by a family which plays a corporate finance function for smaller companies by financing suppliers and new firms and cushioning financial downturns. In Latin America and the Middle East, a bank or an insurance company is often added to the group. Hence, there are cross-shareholdings to finance growth. This system of internal corporate governance, while not transparent to the market, substitutes for a weak external corporate governance framework, where the legislative framework is inadequate or enforcement of the law is weak. Business groups function on the basis of proprietary information. Further discussion is required to determine whether rules and regulations concerning the dissemination of information and disclosure and transparency need to be adapted to these circumstances. Similarly, in countries with weak regulatory environments, concentrated enforcement through the market regulators may be preferable.

In developing countries and transition economies, where the legal and regulatory framework is evolving, the question arises whether policy makers should rely on judges or regulators to enforce laws and contracts. At this stage of development, courts are often under-financed, unmotivated, unclear as to how the law applies, unfamiliar with

economic issues or even corrupt.²¹ Experience shows that in these circumstances the incentives of regulators to enforce the laws may be greater than those of judges. Judges are faced with a broader set of trade-offs and are less focused on issues of corporate governance than specific regulators for securities markets, or special courts for securities markets. It may therefore be more advantageous to rely on regulatory agencies until the judicial system becomes efficient. This only works, however, if the regulators can enforce sanctions without their verdicts being subject to automatic appeal. In Poland, strict enforcement of the securities law by a highly motivated regulator was associated with a rapidly developing stock market. In the Czech Republic, hands-off regulation and reliance on the court system was associated with a moribund stock market.²²

Other issues

There are some areas where the OECD Principles remain open to interpretation. In some of these, differences of opinion remain while in others there appears to be some convergence towards more precise definition.

The rights of shareholders to dividends

One example where the OECD Principle need clarification is the Principle stating that basic shareholder rights include the **right to share in the profits** of the corporation. In some countries who contributed to the drafting of the Principles (The USA or the UK, for example) and subsequently endorsed them, shareholders do not decide on profit distribution. This is the prerogative of the board of directors. Shareholders only have the right to approve the proposal of the board. They can lower the dividend proposed, but can neither increase it nor insist on a distribution if management decides to retain earnings for investments. The right to dividends is an economic right subject to the decision of management. In other countries, for example France, the shareholders assembly can impose a dividend distribution on the board of directors.

Shareholders' rights and capital increases

Another example where differences of opinion have emerged is the issue of **capital increases**. The OECD Principles state that shareholders should have the right to participate in fundamental corporate changes. They do not specify whether and how capital increases should be put to the vote of shareholders. It has been argued in some quarters that capital increases should require a supermajority (75 percent of outstanding shares) vote by shareholders. Others argue that such rule is impractical and restricts management in the exercise of its duties.

Disclosure of executive compensation

In the case of disclosure of **compensation for directors and executives**, the OECD Principles simply state that "sufficient information" should be disclosed to shareholders.

²¹ Coase versus the Coasians, Edward Glaeser, Simon Johnson, Andrei Shleifer (2001)

²² Ibid

Since their publication, there is a growing consensus that individual compensation packages should be disclosed in detail.

Equitable treatment

One of the benefits of equitable treatment of shareholders is that it fosters risk diversification for all shareholders. In a system where control rights of some shareholders ensure that they obtain a disproportionate share of the control premium, those who own shares with control rights have no incentives to diversify their investments. If on the other hand, there is only one single class of shares with the same voting rights and if the rules governing takeovers ensure that control premiums are distributed to all shareholders of the target company equally, the trade-off between concentration of voting rights and risk diversification is reduced. This is one argument in favor of “one share-one vote.” The OECD Principles do not prescribe one-share-one vote; they merely require disclosure when there is a deviation from this principle. Some quarters are vocal on this issue, insisting on a change of laws where multiple or non-voting shares are permitted. Others argue that the market should be left to penalize issuers that deviate from the one-share-one vote principle.

Other mechanisms to promote the equitable treatment of shareholders include mandatory tender offers for acquirers that obtain control of a company. This rule permits minority investors to participate in the control premium paid for acquiring control of a company. On the other hand, the imposition of a mandatory tender offer rule may make it easier to frustrate hostile bids in markets with weakly developed capital markets, thereby providing more power to the company’s directors at the expense of shareholders, and make it more difficult for *any* shareholder to realize a premium over the current price.

List of Standards and Codes Assessed by IMF and World Bank

Group A: Transparency Standards (assessed by the IMF, including under the FSAP)

- **Data Dissemination:** the Fund's *Special Data Dissemination Standard/General Data Dissemination System (SDDS/GDDS)*.
- **Fiscal Transparency:** the Fund's *Code of Good Practices on Fiscal Transparency*.
- **Monetary and Financial Policy Transparency:** the Fund's *Code of Good Practices on Transparency in Monetary and Financial Policies* (usually assessed under the FSAP).

Group B: Regulatory and Supervisory Standards (assessed under the FSAP)

- **Banking Supervision:** Basel Committee's *Core Principles for Effective Banking Supervision (BCP)* (usually assessed under the FSAP).
- **Securities:** International Organization of Securities Commissions' (IOSCO) *Objectives and Principles for Securities Regulation*.
- **Insurance:** International Association of Insurance Supervisors' (IAIS) *Insurance Supervisory Principles*.
- **Payments Systems:** Committee on Payments and Settlements Systems' (CPSS) *Core Principles for Systemically Important Payments Systems*.

Group C: Market Infrastructure Standards (assessed by the World Bank, including under the FSAP)

- **Corporate Governance:** OECD *Principles of Corporate Governance*.
- **Accounting:** International Accounting Standards Committee's *International Accounting Standards*.
- **Auditing:** International Federation of Accountants' *International Standards on Auditing*.
- **Insolvency & Creditor Rights:** World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*.

Group D: Market Integrity Standards (currently under consideration for ROSCs)

- **Money Laundering:** Financial Action Task Force (FATF) on Money Laundering *FATF 40 Recommendations* –preparation of ROSC modules under the aegis of the FATF currently under consideration.