CENTER FOR INTERNATIONAL PRIVATE ENTERPRISE

Corporate Governance Framework Overview

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Issues to Cover...

- What is corporate governance?
- Why is it important?
- What are the linkages between corporate governance reform and institutional development?
- How do you approach corporate governance reforms? What are the strategies?
- What are CIPE’s lessons learned?
- Examples of successful programs

Some Background Information

- Adolf Berle and Gardiner Means "The Modern Corporation and Private Property" (1932)
  - Concerned with performance of modern corporations and efficient use of resources
  - Issues associated with separation of ownership and control. How do you hold managers accountable?
    - What are the potential problems?
    - How can you address those problems?

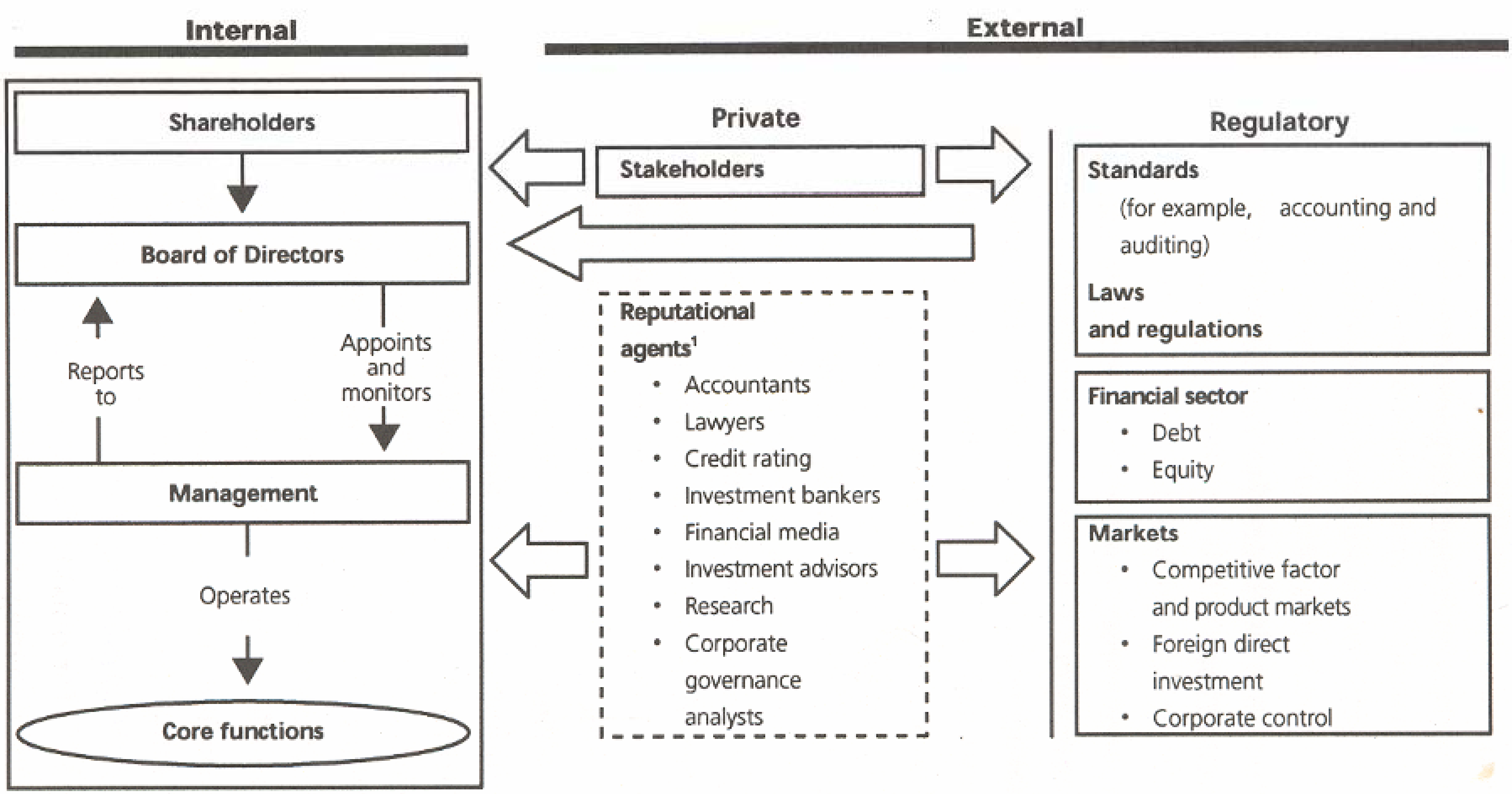
Family Firms Dilemma

- Owners and managers in family firms are one and the same – so is corporate governance still relevant?
  - Access to capital
  - Succession planning
  - Transparency in decision-making
  - Company image in the community
  - Legal compliance
  - Anti-corruption tools
  - Etc.

Basic Model

- Shareholders elect directors who represent them.
- Directors vote on key matters and adopt the majority decision.
- Decisions are made in a transparent manner so that shareholders and others can hold directors accountable.
- The company adopts accounting standards to generate the information necessary for directors, investors and other stakeholders to make decisions.
- The company's policies and practices adhere to applicable national, state and local laws.

Figure 1: Modern corporations are disciplined by internal and external factors



1. *Reputational agents* refer to private sector agents, self-regulating bodies, the media, and civic society that reduce information asymmetry, improve the monitoring of firms, and shed light on opportunistic behavior.

Source: The World Bank Group

Emphasis on Market Institutions

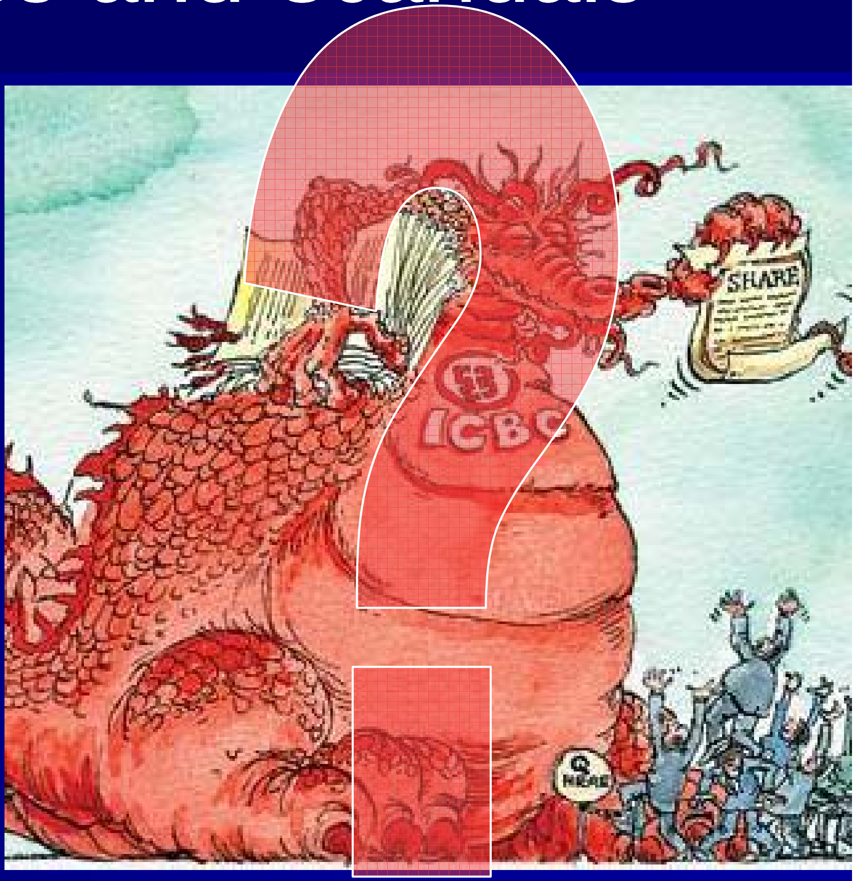
OECD Principles of Corporate Governance

1. Ensuring the Basis for an Effective Corporate Governance Framework*
2. The Rights of Shareholders and Key Ownership Structures*
3. The Equitable Treatment of Shareholders
4. The Role of Stakeholders in Corporate Governance
5. Disclosure and Transparency
6. The Responsibilities of the Board

* 2004 additions after the revision process

Drivers of Corporate Governance
Dealing with Failures and Scandals

- Chile Financial Crisis 1970s
- Asian Financial Crisis 1997
- Russian Financial Crisis 1998
- Impact of governance failures on:
    - Companies
    - Societies
    - Economies
- Challenges today: Who is next?

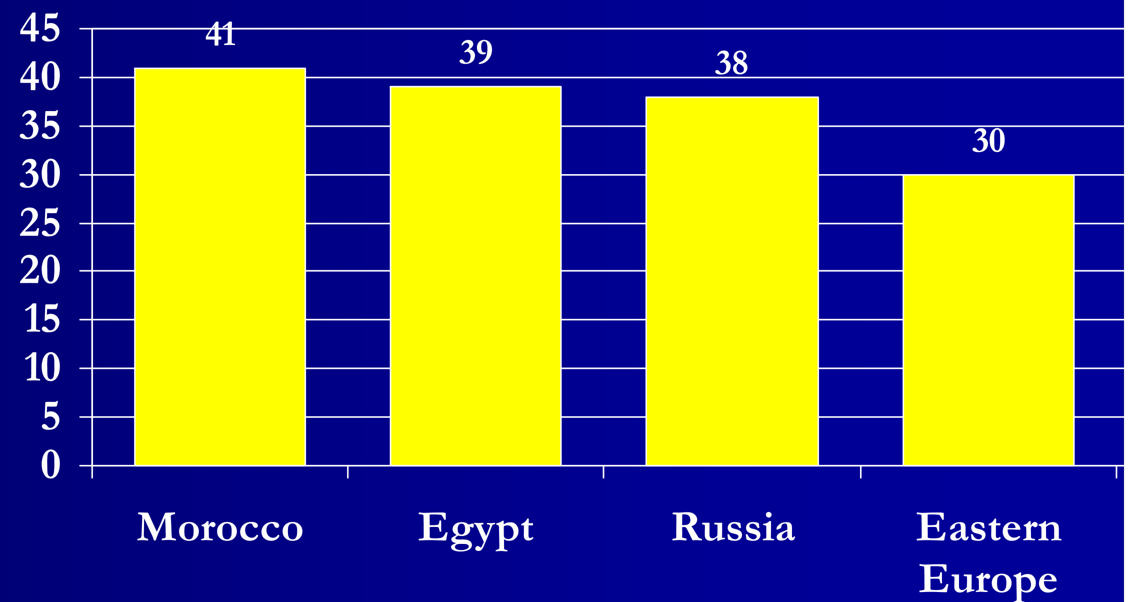


Questions remain in regards to China's underlying financial health despite impressive growth figures

Drivers of Corporate Governance
In Search of Benefits

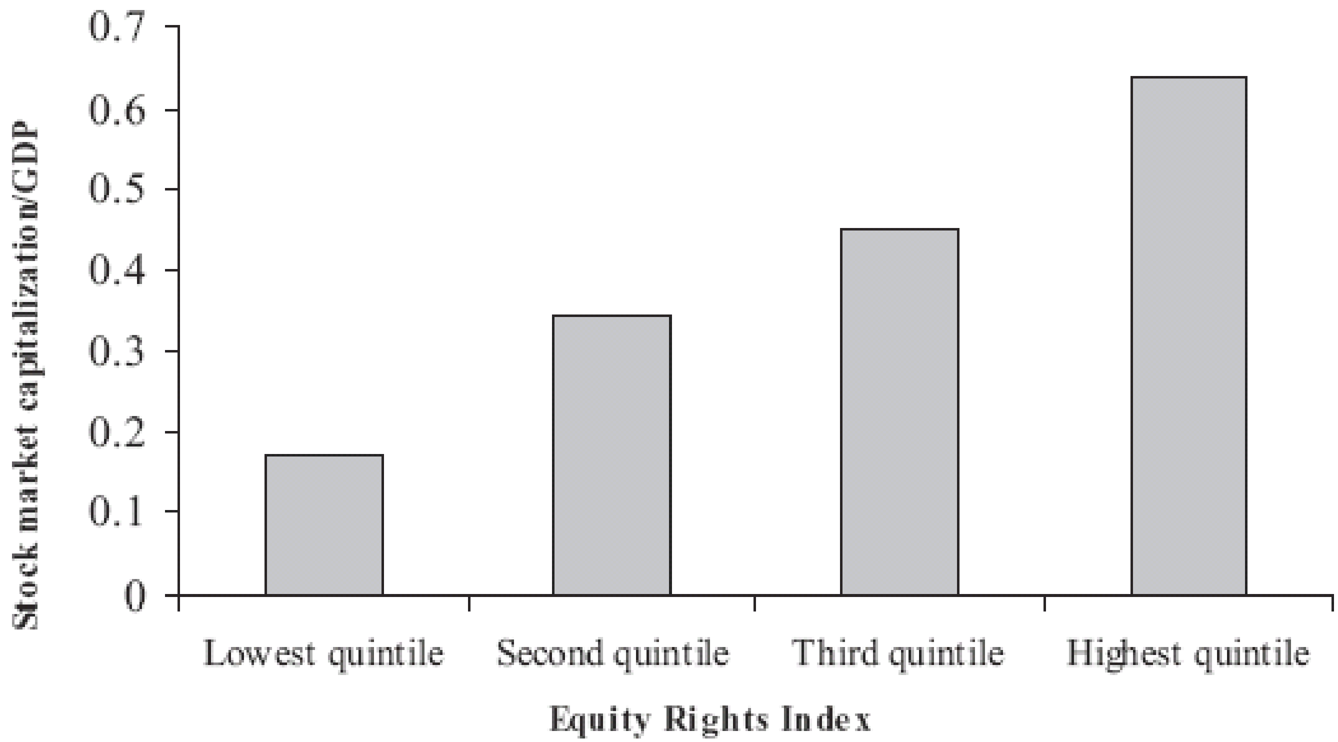
- Search for investment (FDI trends)
- Cost of capital
- Privatization
- SOE reform
- Competitiveness pressures
- Sustainability

The premium investors would pay for a well-governed company (McKinsey)



Corporate Governance and Competitiveness

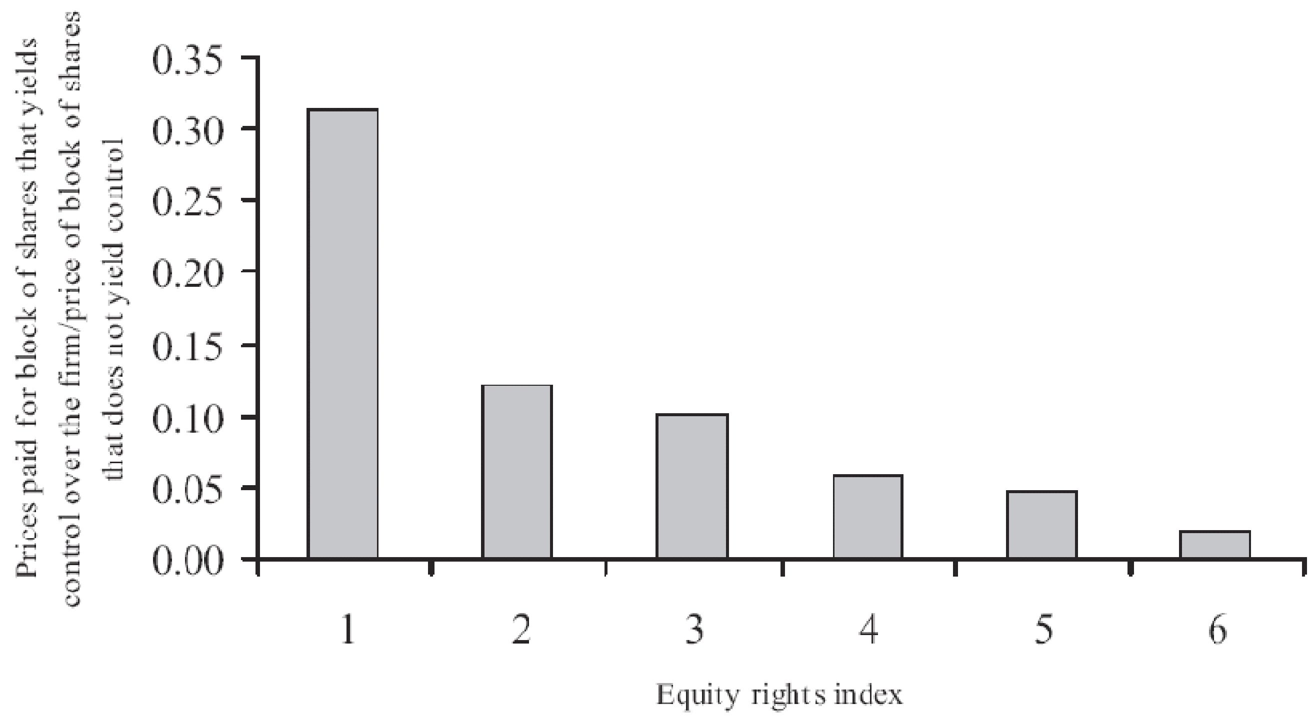
Stronger Shareholder Protection=Larger Stock Markets



Source: La Porta and others (1997).

Corporate Governance and Competitiveness

Stronger Corporate Governance=Lower Cost of Capital



Source: Dyck and Zingales (2004) and Nenova (2003).

Corporate Governance and Competitiveness

Higher Equity Rights=Higher Returns on Investment

Note: Figure depicts the marginal rates of return on new investment adjusted for the cost of capital calculated using Tobin's Q model.

Source: Data on returns come from Gugler, Mueller, and Yurtoglu (2004), who use data from Worldscope. The index on equity rights is from La Porta and others (1998).

Corporate Governance **Business Ethics**

Structure of decision-making

Guide for behavior

CORE VALUES

Transparency

Fairness

Accountability

Responsibility

Ethical Behavior Matters

- Why does it matter?
  - Concept of *caveat emptor* no longer valid
  - Ethical business practices = ability to retain existing customers, gain new ones
  - Positive impact on employees - management
  - Supply chains, global market opportunities
  - Corporate citizenship and the role of business in society

Applying ethics

- Bright lines vs. values
- Ethics as a set of evolving guidelines
- Ethics and responsible decision-making by the Board

Board of Directors

Fundamentals:

- Duty of care
- Duty of loyalty
- Business judgment rule

Internal Controls and Ethics

TI's Business Principles for Countering Bribery

- Political and philanthropic contributions, gifts, hospitality, etc.
- Facilitation payments!

Implementing the principles requires that:

- Boards of directors take formal responsibility
- Effective whistle-blowing channels exist
- Embedded internal control measures
- Formal accounting procedures set up that check for bribery
- Internal communication and training

Institutions Matter!

Functioning Markets

Better Environment for Doing Business

Property Rights

Good Governance

Market Entry

Rule of Law

Access to Information

Corporate Governance: Key Institutions Must Function Well

- Procedures for bankruptcy
- Property rights
- Contract enforcement – Judicial system
- Enforcement mechanisms
- Securities markets
- Free press – financial press
- Ratings agencies et al.
- Other checks and balances

Ownership Forms

- Dispersed Ownership
- Concentrated Ownership
- Family Firms
- State-Owned
- Cooperatives

Different Ownership Models

Concentrated	Dispersed
Control through shares/voting rights	Shareholder model
Strong interest in long-term performance	Short-term interests
Possible abuse of minority shareholders rights	Greater involvement of independent directors
Possibilities for colluding with managers, board members	Can lead to lack of swift decision-making
Possibilities for non-economic decision-making, asset stripping, etc.	Lack of incentives to monitor board members
Owners often hold board positions	More regulatory pressures

Private Sector and Corruption: Different Views

Private sector as a __________ corruption

- Victim of
  - Direct – extortion, costs of doing business
  - Indirect – loss of competitiveness, weak market institutions
- Source of
  - Public procurement
  - Private-private corruption
  - Gaining unfair competitive advantage
- Solution to
  - Mobilizing private sector for reform
  - Say “No” to corruption
  - Reform company (internal) and country (external) institutions

The Corruption Dilemma

Dilemma

- Although corruption is bad for business, individual companies that engage in corruption receive a short-term advantage

Approach

- It is important to set up a system that makes it hard for companies to engage in corruption, even if corruption seems desirable

In other words...

- Corporate governance as one antidote to corruption

Corporate Governance as an Antidote to Corruption

Effective corporate governance means that:

- Board members exercise good judgment
- Transparency values are present
- Investors receive timely and relevant information
- Decision-making is not done behind closed doors
- Decision-makers are held accountable for their actions
- Managers act in the interest of a company

The bottom line: effective corporate governance makes it hard for companies to provide bribes or other company resources to government officials in exchange for services.

Corporate Governance and Development

- **Democracy** - changing the nature of the relationship between business and state, transparent business participation in public policy
- **Democratic governance** – the relationship between public and private governance
- **Institutional reform** - importance of institutions to the functioning of corporate governance (property rights, enforcement, legal reform, etc.)
- Contributions to the **poverty alleviation** agenda – investment, business development, SOE reform, job and wealth creation.
- **Anti-corruption** – corporate governance as an effective supply-side anti-corruption tool – makes it more difficult to give and conceal bribes

Corporate Governance Dilemma

Benefits of having corporate governance mechanisms in place

Business costs of too much corporate governance regulation

Strategy for Corporate Governance Reform

1. Initial Assessment
2. Outreach and Education
3. Develop and Institute Corporate Governance Mechanisms
4. Capacity-Building, Enforcement, and Follow-up

1. Initial Assessment

- Assess corporate governance failures, challenges, opportunities, etc.
- Rate country standards vs. international best practices
- OECD principles/guidelines and local realities

2. Outreach and Education

- Identify stakeholders
- Build awareness: business leaders, policymakers, society
- Create broader public demand for reform
- Public education campaigns

3. Develop and Institute Corporate Governance Mechanisms

- Develop corporate governance codes and internal control mechanisms
- Foster shareholder activism
- Improve regulatory and enforcement frameworks
- Create corporate governance networks including regulatory bodies, business leaders and organizations, and other civil society groups

4. Capacity-Building, Enforcement, and Follow-up

- Training and certification programs for managers and directors
- Establishment of Institutes of Directors
- Create corporate governance ratings systems for investors
- Training for financial intermediaries
- Broader legal and institutional enforcement: ex. Judicial systems

Institutions and Corporate Governance

What does it mean for countries?

- Initial conditions matter
- Need to recognize that there is a cross-section of countries, approaches, and capacities
- Set own reform goals and priorities
- Strike the right balance between international best practices and local needs, priorities, and experiences
- Share lessons learned – knowledge management
- Focus on processes rather than outcomes
    - How you develop CG mechanisms and how they function vs. what you are trying to develop