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Enforcement of Corporate Governance Rules

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Session 2: Mechanisms for the Enforcement of Corporate Governance Rules

Henry Schiffman
Consultant to International Financial Institutions

Mechanisms for the Enforcement of Corporate Governance Rules

I. Introduction

Enforcement in this paper is used in two senses: the commonly understood sense of compelling recalcitrant companies or officials to comply with applicable laws or regulations on corporate governance; and vigilance by stakeholders over corporate governance activities and communication by stakeholders with companies to urge them to follow the rules that are being violated.

Compliance by companies with corporate governance rules generally leaves much to be desired in Eurasian countries. Recurring problems in basic matters include failures of companies to: register share ownership; notify shareholders of annual meetings; disclose to shareholders the identity of other shareholders; pay declared dividends or pay dividends to all shareholders; police transactions of the company with related parties; issue annual reports; or have required external audits. Needless to say, most of the important governance reforms since 2002 resulting from the corporate misconduct in the West that could result in greater compliance with basic rules have not been adopted, like requiring independent directors, providing expanded authority for an audit committee of the board, or ensuring that the board receives adequate and timely information from management.

It must be noted that given the many inappropriate rules for corporate governance found in Eurasian countries' company laws, it is, ironically, fortunate that some rules cannot be enforced, for example, those that provide for shareholders to decide matters that should be the prerogative of management like approval of large transactions and opening branches or subsidiaries of companies as is provided in several such laws.

Since recent experience has shown that it is unrealistic politically to significantly improve company laws by amendment, consideration should be given to the adoption by companies of codes of corporate governance that enhance good corporate governance by supplementing existing laws and regulations. Such codes would not "enforce" corporate governance rules but rather reinforce weak company laws.

For codes of corporate governance to be effective, they should contain clear rules that are obligatory and can be enforced. However, codes can be too indefinite or by their terms voluntary rather than obligatory. For example, in February 2005 one Eurasian country, at the initiative of an association of financial companies, adopted a code of corporate governance that not only contains questionable rules but includes some provisions that say a company "should" rather than "must" take certain actions and is voluntary. Thus, if a company in that country declares that it has adopted that code of corporate governance, what does that mean? That the company will comply with all the code's provisions, some provisions, some provisions sometimes and other provisions at other times? Such a code is not very useful in promoting good corporate governance. Instead, it may deceive shareholders and prospective investors into thinking that something significant has been accomplished that will improve the governance of a company when it is highly questionable whether this will be the case.

However, there is really no adequate substitute for good corporate governance rules in law or regulation as distinguished from a code of conduct that is not legally binding. Good voluntary rules can be problematic. For example, take the situation where a code provides for quarterly publication of financial results when the law requires only annual financial disclosure. If a company reports in a calendar quarter that its revenue declined twenty percent and its share price

the next day declines by thirty percent, the company may be subject to a lawsuit by aggrieved investors in the company's shares who sustained a loss that subsequently proved to be perhaps unnecessary because annual revenue actually increased sharply over the previous year. Courts in Eurasian countries would entertain such lawsuit.

II. Shareholders

Shareholders in Eurasian countries have had relatively limited impact on enforcing corporate governance rules. They have had less effect than shareholders in countries with developed financial markets but even in those other countries shareholders' influence is necessarily limited. The reasons for limited effect in Eurasian countries are several: limited experience with shareholding in joint stock companies, lack of institutional investors, lack of trust in and therefore use of legal institutions of the bar and courts, and lack of advice by specialists as to appropriate shareholder action.

The fact that joint stock companies have a history of only about fifteen years in modern times in Eurasian countries means that experience of shareholders in mounting action to enforce corporate governance rules is in its early stages. There is no well established tradition yet of collective action by shareholders. Shareholders have sometimes taken legal action to enforce corporate governance rules, but it has not been as well coordinated as is necessary if it is to be successful. An example is the contest for control of Promstroi Bank in the Kyrgyz Republic in 2004 when shareholders individually initiated some twenty lawsuits to seek to secure their rights with generally disappointing results.

A practice in a few countries that could significantly enhance the ability of shareholders to enforce their rights is the class action lawsuit where one or a few shareholders initiate lawsuits on behalf of all shareholders who wish to be included. In countries with this tradition there are law firms that specialize in these actions. Their compensation is contingent on the success of the case and they receive a percentage of any monetary awards received in the lawsuit. In some countries these contingent legal fees are considered unethical and are not permitted. Eurasian countries will have to determine whether they wish to permit such actions that could aid shareholders. Such collective action could be particularly important in Eurasian countries where shareholders are not permitted to know the identity of other shareholders and therefore the possibility of collective action is precluded. If class actions were permitted, rights of all who wished to be included would be represented, even if their identity were not revealed to other shareholders.

In countries with developed financial markets, shareholders' enforcement of corporate governance rules is principally by institutional investors—pension funds, insurance companies and public or private investment funds. They have significant financial stakes in governance of companies in which they have investments and are therefore vigilant and proactive. However, in Eurasian countries institutional investors generally have relatively few investments in shares or debt of companies. Their principal equity investments are in foreign companies and their domestic fixed income investments are principally in government securities. Thus, they have very little incentive to become active in enforcement of corporate governance rules. However, as stock exchanges become deeper and more liquid in some Eurasian countries, institutional investors should play a more active role in enforcement of corporate governance rules.

For collective or even individual action by shareholders to be effective frequently requires trust in legal institutions of the bar and the courts which is largely lacking in Eurasian countries. This is often justified because of the lack of adequate skills of lawyers and the ineptitude or dishonesty of courts that means that the outcome of a lawsuit is often too uncertain. This situation is bound to improve over time however. Most Eurasian countries, with assistance from donors, have initiated projects for improvement of curricula in law schools, establishment of enforceable standards of

ethics, and improvement of transparency and efficiency of courts' operations that should benefit both the bar and judges and lead to greater recourse to the bar and the courts by shareholders when appropriate.

The most important action shareholders can take to seek to ensure that the governance rules are complied with is to elect competent and honest boards—both supervisory boards and management boards for countries that have these two boards or a board of directors where there is one board. However, shareholders have limited powers to nominate board candidates and often limited knowledge of the qualifications of candidates. In countries with developed financial markets there are specialized companies that advise institutional shareholders on how to vote on matters for shareholders' decision, including candidates for positions on boards. These institutional investors normally control the voting at annual and special meetings of the boards of directors. In the absence of specialized advisors and use of such advisors, shareholders in Eurasian countries must generally rely on their separate uncoordinated actions that have limited effect.

However, in the case of privatized companies where shares that provide effective control of voting are still held by employees and former employees of the privatized companies, there is a potential for cohesive action since these shareholders usually live and work in proximity and can communicate with each other relatively easily. But there is a lack of evidence that this occurs with any frequency with respect to corporate governance rules. Corporate action in these as well as other companies in Eurasia is still dominated by directors and management with respect to important corporate governance rules.

III. Directors

Especially in countries where effective shareholder action has limitations, as indicated above, companies' directors should be the primary fiduciaries to ensure that the rules for corporate governance are followed. However, the composition and responsibilities of directors in many Eurasian countries are not conducive to proper exercise of fiduciary responsibilities. For companies that have two tier boards, the supervisory board has great potential for enforcing corporate governance rules that are violated by management. The composition of these boards is of persons who do not work full time in the company that they serve as directors that is highly desirable to give them the proper perspective to exercise fiduciary responsibilities. However, very frequently the board is dominated by a principal shareholder's representatives and this impairs the ability of directors to take objective decisions in accordance with the law rather than in accordance with the dictates of a principal shareholder.

The interests of principal shareholders and those of other shareholders are often the same but not always and in important situations. For example, if there is a prospect of selling a company to another company or investors at a price that would represent a significant profit for shareholders, the principal shareholder may block action because the principal shareholder does not wish to relinquish control. And control may be desirable for the wrong reasons, for example, because the company purchases goods or services or financial assets from another company controlled by the same principal shareholder at prices that are excessive.

It would therefore be desirable to have on the supervisory board persons who are independent of both principal shareholders and management. A majority of the board composed of such person would be the ideal but at least certain key functions should be entrusted to independent directors like recommending to the full board the appointment of an independent auditor and the compensation of the company's highest officers. Where a company has only one board, that board should include independent directors.

The explicit functions of the board of directors should also include those that seek to ensure that important corporate governance rules are enforced. Some company laws merely state that the board is responsible for the management of the company. Rules of corporate governance are stated but no explicit responsibility for the rules is assigned. Given the widespread violation of even basic rules in many Eurasian countries, the supervisory board or sole board should have one or more committees that is concerned with corporate governance rules. For example, the committee should examine whether shareholders are given notice of shareholders' meetings, whether dividends that are declared are paid to all shareholders in accordance with their stated rights, whether candidates for a company's boards are qualified and independent, whether the company has an adequate system of internal audit and controls, whether transactions of a company with related parties are disclosed and fair to the company, whether annual reports are being communicated to shareholders, and whether compensation paid to the highest company officials is appropriate in light of their performance and compensation paid in comparable companies. When there are violations of corporate governance rules, the directors should take action to remedy those violations.

IV. Government regulators

Government regulators have an important role to play in enforcing corporate governance rules especially given the weaknesses in the enforcement capacity of the courts and other stakeholders. However, in most Eurasian countries the company law, as distinguished from the securities law, does not assign an enforcement role to a governmental authority. The main enforcer of company law and corporate governance rules in these laws has been the securities commission or consolidated financial sector regulator. However, this is often only for companies that have publicly issued securities and not for others. Therefore Eurasian countries should consider whether it would be appropriate to provide for supervisory responsibility for enforcement of the company law to a government body, probably most appropriately the agency responsible for enforcement of the securities law.

The actions of regulators in Eurasia has been varied. Most seem to concern themselves with minutiae rather than systemic or major issues, often for the wrong reasons—to exact rents from companies. The record of enforcement has also been mixed and often not the most appropriate. The most common enforcement mechanism has been the imposition of fines. This could be effective if the fines were known in the corporate community and acted as a deterrent to violations by other companies. However, this is often not the case. There is very limited use of what is more efficacious and often used in enforcement in countries with developed financial markets—a consent agreement. Such enforcement tool may include providing restitution to shareholders damaged by a violation or remedial action by the company to seek to ensure that the violation does not occur again. This latter element goes to the root of the problem rather than merely punishing the company by imposing a fine.

Regulatory agencies in Eurasia have usually had insufficient resources to hire and train qualified staff. There are usually no codes of ethics for regulatory agency staff, as distinguished from rules of ethics for all civil servants that are often too general and hardly ever enforced. Several Eurasian regulators are strengthening their activities and once there are more qualified and ethical staff, their enforcement role should increase in importance.

V. Stock Exchanges

In the past four years several stock exchanges in countries with developed financial markets such as those in the United Kingdom, Hong Kong, Thailand and the United States have considerably strengthened corporate governance requirements for companies to list on these exchanges. These include requirements for independent directors on companies' board of directors and requirements for a committee of the board to be established, usually called an audit committee, that has broad responsibilities to ensure compliance by companies with corporate governance rules.

Since stock exchanges in Eurasian countries, with one notable exception, usually have listed the largest and most economically significant companies in their countries, exchanges could have a significant impact on the quality of corporate governance in their countries. Stock exchanges could enforce corporate governance rules if they establish corporate governance requirements for listings. Alternatively, if there is a code of corporate governance in a country and it was appropriate, stock exchanges could make such codes obligatory for listed companies. However, one of the most important stock exchanges in Eurasia, while endorsing voluntary codes of conduct, did not wish to enforce the code for its listed companies. Exchanges in some Eurasian countries are financially weak and could be reluctant to impose stringent corporate governance requirements for fear that such rules would discourage new listings and that listed companies would abandon the exchange. This has happened in some countries with developed financial markets.

VI. Courts

Of the three branches of government, the judicial branch has been the most problematic in Eurasian countries and therefore generally cannot be counted upon to enforce rules of corporate governance. Most courts are still not suited to judge cases involving modern market economy issues and corporate governance issues can be among the more complex. The fact that most judges are also subject to undue influence by parties to a case further disqualifies courts from being enforcers of corporate governance rules. A basic precept of rule of law is predictability—similar outcomes for similar cases--and many court decisions on economic and financial issues in Eurasian countries are incomprehensible.

However, efforts are underway in all countries to develop honest and capable judiciaries. There are some twenty elements required for a competent, honest and efficient judiciary that will require several years to attain in Eurasian countries. A more expeditious solution to enforcement of governance rules is discussed in the section below.

VII. Ad hoc Arbitration

Even in countries with competent and honest courts, ad hoc arbitration is frequently used in commercial disputes since it often provides more expeditious and expert resolution of disputes. This is not to be confused with "arbitrage courts" in the former Soviet Union and courts in Eurasia that still use that appellation. Ad hoc arbitration is the determination of a dispute by one or three arbiters appointed by the parties to the dispute and the decision is legally binding.

In Eurasia some countries recently enacted laws that authorize such arbitration. This can be used for enforcement of corporate governance rules if the company law or the company charter state that disputes under the company law can be so decided. While judicial reform is a long tem proposition, there are now in Eurasian countries competent and honest lawyers and others who

are knowledgeable about corporate governance and could properly enforce corporate governance rules by their decision.

A key issue is whether the law that authorizes arbitration for final settlement of disputes has too wide criteria for reversal of arbitral awards by the courts. The grounds for this should be extremely narrow and exceptional. Arbitration works best between serious companies who are inclined to accept an award. In the case of corporate governance disputes, if authorized in the company law or company charter, the company should abide by an arbitral decision. If is does not, under the arbitration law the award would be enforceable by the courts. Again, however, the inherent weaknesses in Eurasian courts present a potential impediment.