

Chapter 6

Corporate Governance*

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6.1. Introduction

This paper addresses corporate governance¹ as one of the policy areas for inclusion in the *Policy Framework for Investment* (PFI) under the OECD Initiative on Investment for Development. It provides background both on the relationship between corporate governance and a sound investment environment, and on some of the key corporate governance issues that policy makers should consider in this context. This document will serve as the basis for one of the ten policy chapters to be developed for inclusion in the *Policy Framework for Investment*, each setting out key questions and issues for policy-makers' consideration in the context of promoting an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to society.² Importantly, the questions presented in this report are not intended and should not be seen as a substitute for the work by the OECD Steering Group on Corporate Governance to develop a methodology for assessing the implementation of the *OECD Principles of Corporate Governance*.

The OECD has actively worked to promote good corporate governance since first adopting the *Principles of Corporate Governance* in 1999, recognising their importance in contributing to financial stability, investment and economic growth. Following their adoption, they have become recognised as an international benchmark for policy-makers, investors, corporations and other stakeholders worldwide. The OECD in co-operation with the World Bank Group has undertaken an extensive programme to increase awareness and understanding of the *Principles* and encourage their use that has involved more than 80 countries (OECD and non-OECD) around the world. The Financial Stability Forum identified the *Principles* as one of 12 key standards important to achieving sound financial systems. The World Bank also uses the *Principles* as the underlying basis for country corporate governance reviews that have been carried out in more than 40 developing countries over the last four years, known as Reports on Observance of Standards and Codes (ROSCs). The UN's Monterrey Consensus Declaration also cited the importance of corporate governance as a factor in promoting a stable and predictable environment for investment and development. The Declaration suggested that "special efforts are required in such priority areas as economic policy and regulatory frameworks for promoting and protecting investments, including in the areas of human resource development, avoidance of double taxation, corporate governance, accounting standards and the promotion of a competitive environment."³

The *OECD Principles* were revised in 2004 based upon an extensive review of experience both within OECD countries and with non-OECD countries through Regional Roundtables on Corporate Governance in Asia, Eurasia, Latin America, Russia and Southeast Europe, as well as through consultations also involving countries from Africa, the Middle East and the Caribbean. The Roundtables have held more than 30 meetings since the *Principles* were first adopted, and each region, using the *Principles* as a reference, has developed consensus-based conclusions, recommendations and priorities summarized in Regional White

Papers, as well as in the 2003 OECD report, *Experiences from the Regional Corporate Governance Roundtables*. This paper draws particularly upon Roundtable experience, as well as the *Survey of Corporate Governance Developments in OECD Countries*, in identifying some of the issues that have emerged as priorities. One of the strongest underlying motivations for adopting these Roundtable recommendations and for continuing to pursue their implementation is that each region has recognised the important link between good corporate governance and investment.

This paper is intended to support discussion of some of the key aspects that policy-makers and others concerned with corporate governance should take into consideration, as one element of a sound environment for investment, but does not aim to be comprehensive and should not be considered as the basis for a review of corporate governance practices in a particular jurisdiction. The *OECD Principles* themselves (available at www.oecd.org/daf/corporate/principles) should continue to serve as the main reference for policy dialogue.

In addition, the OECD is currently carrying out much more detailed and comprehensive work, under the responsibility of the Steering Group on Corporate Governance, to develop an overall methodology for review of country experience and corporate governance policy dialogue, based upon the *OECD Principles of Corporate Governance*. The Steering Group requested that this work support efforts to update the methodology for corporate governance Reports on Observance of Standards and Codes (ROSCs) that the World Bank carries out to reflect the 2004 revision of the *Principles*, as well as to serve as a basis for future OECD policy dialogue to strengthen corporate governance in member countries. The draft methodology closely follows the *Principles*, setting out likely practices to be considered, and “essential criteria” to be taken into consideration. In addition, the draft methodology stresses the importance of considering how different elements of the corporate governance framework may be complementary or interdependent in achieving the objectives of the *Principles*, while avoiding a “check-list” approach.

6.2. The role of corporate governance in achieving an attractive investment environment

Corporate governance reform is an important aspect of broader reform programmes aimed at securing an environment attractive to both domestic and foreign investors and that enhances the benefits of investment to society. As the Preamble to the *OECD Principles* states, “The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for investment decisions. Of particular relevance is the relation between corporate governance practices and the increasingly international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors. If countries are to reap the full benefits of the global capital market, and if they are to attract long-term ‘patient’ capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles. Even if corporations do not rely primarily on foreign sources of capital, adhering to good corporate governance practices will help improve the confidence of domestic investors, reduce the cost of capital, underpin the good functioning of financial markets, and ultimately induce more stable sources of financing.”

The corporation is at the very heart of the investment process, requiring a constant search for the most efficient ways to combine all the different resources needed to produce those goods and services that meet market demand. Of special interest for a discussion on corporate governance is the economy's ability to match commercially viable projects with the financial resources that are required to actually turn an idea into a profitable enterprise. To be sure, capital is only one among several important inputs that are needed to build a competitive company. Skilled labour, managerial talent and intermediary goods and services are also vital. But, while access to capital is not a sufficient condition, it is for all practical purposes a necessary one. This is particularly true for equity financing, which allows companies to increase their exposure to risks that are associated with long term and forward looking undertakings such as the opening up of new business lines, corporate re-structuring, research activities, product development and market expansion.

But it is not only the absolute *amount* of available capital that will determine the ability to increase economic welfare through capital formation. Equally important is the effectiveness with which it is *allocated* among alternative investment opportunities and, not least, how well the corporation's final use of it is actually *monitored*. If household savings and available corporate funds for some reason do not reach their best possible use, society will undoubtedly forego opportunities that would have generated additional economic welfare. Under such circumstances, entrepreneurs will not find appropriate funding for profitable projects; existing companies will not be able to expand their operations; potentially profitable innovations will never be commercialised, etc. Moreover, necessary re-structuring of individual companies and entire industries will be impaired, and productive assets will be locked into underperforming activities.

These three steps in the investment process – to mobilise capital, to allocate capital among alternative ends, and to monitor the use of the invested capital – are among the key functions of the financial system. In market economies, they are carried out by a multitude of individual investors and the overall outcome will to a large extent depend on their individual skills and incentives. But the result will also be highly dependent on the institutional framework of laws, regulations and business practices that shape and affect the interactions between equity investors and the corporation, that is to say, the corporate governance framework.

By specifying the distribution of rights and responsibilities among the different participants to the corporation, the quality of the corporate governance framework influences the outcome at all stages of the investment process. A few examples may help to illuminate this point:

- At the first stage of the investment process, secure methods of ownership registration and the opportunity to obtain legal redress for violation of shareholder rights are just two examples of corporate governance provisions that will facilitate the mobilization of capital. If investors cannot be assured that the assets they invest in are properly recognised and protected, their savings will remain idle, hidden away or instantly consumed, instead of being employed in productive uses.
- At the second stage of the investment process, reliable and transparent accounts of corporate operations and their financial situation are essential to make informed decisions about the allocation of financial resources among alternative uses.
- At the third stage, the procedures for corporate decision-making, the distribution of authority among company organs, the design of incentive schemes and workable lines

of accountability are all obvious corporate governance issues that have to be in place in order to ensure that companies actually use their resources effectively.

Looking at these relationships, it is evident that the importance of good corporate governance goes far beyond the interests of shareholders in an individual company. It is a public policy concern. A weak corporate governance framework will severely impede all stages of the investment process and hence the economy's overall prospects to maintain a strong private sector basis for economic growth. Poor corporate governance will damage the capacity to mobilise savings, hinder efficient allocation of financial resources, and prevent proper management of corporate assets.⁴

6.3. Key elements of a corporate governance framework

The following section, drawing extensively from the OECD Principles, the Survey of Corporate Governance Developments in OECD Countries and the OECD report on Experiences from the Regional Corporate Governance Roundtables, highlights a number of key questions for policy-makers to consider as they seek to develop sound national frameworks for good corporate governance. The Principles (not including the Preamble or Part II annotations) are provided for reference as an annex. It also includes questions related to governance of state-owned enterprises, drawing upon the OECD Guidelines on Corporate Governance of State-Owned Enterprises adopted by the OECD Council in April 2005.

What steps have been taken to ensure the basis for a corporate governance framework that promotes overall economic performance and transparent and efficient markets? Has this been translated into a coherent and consistent regulatory framework, backed by effective enforcement?

An effective corporate governance framework requires an effective legal, regulatory and institutional foundation, which all market participants can rely upon when they enter into their multitude of contractual relations. This legal, regulatory and institutional foundation typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that are the result of a country's specific economic circumstances, history and traditions. The desirable mix between legislation, regulation, self-regulation, voluntary standards, etc. will therefore vary from country to country. As new experiences accrue and business circumstances change, the content and structure of this framework might need to be adjusted. In this process, it is essential to assess the quality of the domestic framework in light of international developments and requirements.

The regulatory and legal environment within which corporations operate is of key importance to overall economic outcomes. Policy makers have a responsibility to put in place a framework that is flexible enough to meet the needs of corporations operating in widely different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources. To achieve this goal, it is important that policy makers remain focused on the ultimate economic outcomes from interventions. When considering different policy options, it is also useful to undertake an analysis of the impact on key variables that affect the functioning of markets,

such as incentive structures, the efficiency of self-regulatory systems and dealing with systemic conflicts of interest.

Corporate governance requirements and practices are typically influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, insolvency law, contract law, labour law and tax law. Under these circumstances, there is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to improve corporate governance. When looking at the legal and regulatory framework, it is therefore important to be aware of this risk and take measures to limit it.

In each of the Regional Corporate Governance Roundtables, the need for effective enforcement and implementation has emerged as a key priority. This reflects a view that a sound legal framework for corporate governance, while important, is not sufficient for ensuring the effective functioning of the capital markets. Laws and regulation but also most private arrangements designed to protect the rights of shareholders and ensure equitable treatment of different shareholders and stakeholders derive their strength from the broader implementation and enforcement environment. If existing institutions are weak, implementing and enforcing private agreements as well as laws and regulation becomes more difficult. A corporate governance framework must therefore include both a set of policies and a regulatory/institutional framework to ensure its implementation.

While enforcement is a general problem of development, it particularly affects firms seeking external financing, as well as impacting on the valuation of shares of existing, listed firms. Financial contracts involve the commitment of the firm to adhere to certain obligations, in particular to share its profits by paying an appropriate rate of return to the providers of external financing. A weak enforcement environment therefore has a negative impact on share value, and makes it more difficult for firms to commit to honour financial contracts and attract new financing as well.

A number of elements of enforcement are addressed in subsequent questions in this paper. Among other things, it should be noted that effective enforcement requires that the allocation of responsibilities for supervision, implementation and enforcement among different authorities is clearly defined so that the competencies of complementary bodies and agencies are respected and used most effectively. Overlapping and perhaps contradictory regulations between national jurisdictions is also an issue that should be monitored so that no regulatory vacuum is allowed to develop (i.e. issues slipping through in which no authority has explicit responsibility) and to minimise the costs for corporations to comply with multiple legislative systems.

How does the corporate governance framework ensure the equitable treatment of shareholders? Do national characteristics of the corporate ownership and control structures call for strengthening any particular aspects of the corporate governance framework?

In the developing and emerging market economies that participate in the Regional Roundtables on Corporate Governance, as well as in many OECD countries, major shareholders control most companies, in some cases through differential voting rights or

complex ownership and control structures that allow them to maintain control with relatively little equity. In many of these countries, most of these controlling shareholders are individuals or families. Controlling groups may also play a role, and less commonly, a foreign multinational or major bank. In other cases, ownership is controlled by the state, raising additional governance challenges which are touched upon under the last three questions of this chapter.

The ownership structure has important implications for the corporate governance framework. Controlling shareholders have strong incentives to closely monitor the company and its management, and can have a positive impact on the governance of the company. However, their interests may also conflict with the interest of other shareholders – minority shareholders. This conflict is most destructive when the controlling shareholders extract private benefits at the expense of minority shareholders. Thus, while the *OECD Principles* are intended to apply to the full range of ownership structures found in listed companies, and are also considered useful for non-listed companies, certain aspects of the *Principles*, such as protection of minority rights and equitable treatment of all shareholders, may receive increased attention in economies where majority control is dominant, especially through techniques which involve little equity.

Minority shareholders are not the only victims of poor corporate governance. Controlling shareholders themselves pay the cost of poor corporate governance in the form of lower valuations, restricted access to equity finance, and difficulties with respect to succession planning and accessing outside talent. And the economy pays through reduced productivity, as scarce investment funds are allocated less efficiently. To reduce these costs, some controlling shareholders take voluntary measures to improve their own corporate governance and improve their reputations with other shareholders. The creation of institutions like special stock market tiers and voluntary corporate governance codes can facilitate these voluntary measures by allowing companies to credibly signal markets that they have high standards of corporate governance. However, there are limits to what voluntary actions can achieve. In the long run, controlling shareholders may actually benefit from legally binding and effectively enforced measures to improve investor protection.

This should include protection of certain property rights. For example, an equity share in a publicly traded company can be bought, sold or transferred, and entitles the investor to participate in the company's profits. It also provides a right to obtain information about and influence the company, primarily by voting at shareholder meetings. All these rights carry an intrinsic economic value. In order for investors to buy equity they therefore need to be confident that their entitlement to these and other rights that they have purchased are properly recognised and protected.

What are the procedures and institutional structures for legal redress in cases of violation of shareholder rights? Do they function as a credible deterrent to such violations?

One of the ways in which shareholders can enforce their rights is to initiate legal and administrative proceedings against board members and management (particularly

executive management serving on the board). Experience has shown that an important determinant of the degree to which shareholder rights are protected is whether effective methods exist to obtain redress for grievances at a reasonable cost and without excessive delay. The confidence of minority investors is enhanced when the legal system provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. The provision of such enforcement mechanisms is a key responsibility of legislators and regulators.

There is some risk that a legal system, which enables any investor to challenge corporate activity in the courts, can become prone to excessive litigation. Thus, many legal systems have introduced provisions to protect board members against litigation abuse in the form of tests for the sufficiency of shareholder complaints, so-called safe harbours for board member actions (such as the business judgement rule) as well as safe harbours for the disclosure of information. In the end, a balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation, which may also cause management and boards to become excessively risk averse. Many countries have found that alternative adjudication procedures, such as administrative hearings or arbitration procedures organised by the securities regulators or other regulatory bodies, are an efficient method for dispute settlement, at least at the first instance level.

The great majority of countries that participate in the Regional Roundtables on Corporate Governance have laws and regulations that seem to offer strong protection to shareholders. Yet these shareholders, including not only smaller investors but also large institutional investors such as pension funds and international investment firms, still have their rights violated, in large part because the procedures and institutional structures for legal redress often result in ineffective enforcement of these laws and regulations. Without the appropriate institutional framework, new laws, whether they are transplanted or domestically developed, may simply be ignored or in a few cases, create new difficulties.

An effective judiciary is essential for providing a credible deterrent to abuse of shareholder rights. In countries with a weak judiciary, lengthy legal processes with unpredictable outcomes undermine the incentives for shareholders to pursue their rights. As mentioned above, some countries place greater emphasis on use of alternative mechanisms for resolving disputes in order to reduce reliance upon the courts. However, an unaccountable regulator can be the source of other abuses. The securities regulator should not only ensure transparency in financial markets, but its own transparency as well. The regulator should explain and publish its rulings, and develop new regulation in an open manner. Even as national securities regulators seek to enhance the efficiency and effectiveness of enforcement of shareholder rights through their own enforcement and due process systems, checks and balances to ensure equitable treatment under the law remains important. Thus, strengthening the courts' ability to effectively address corporate disputes will remain critical.

What measures are in place to monitor and prevent abusive related party transactions and inhibit other ways for corporate insiders and controlling owners to extract private benefits?

Certain types of corporate activities involve inherent conflicts of interest on the part of the participating parties, for example managers, board members and controlling shareholders. It is therefore important for the market to know if such activities are carried out with due regard to the interests of all shareholders. Abusive self-dealing involving persons who exploit their close relationships to the company to the detriment of the company and investors, as well as insider trading entailing manipulation of the capital markets should be prohibited and enforced. To this end, it is also essential that companies fully disclose material related party transactions to the market, either individually, or on a grouped basis, including whether they have been executed at arms-length and on normal market terms. In discussing the content and coverage of such measures, consideration should of course be given to a workable definition of related parties. It will also be necessary to address the individual's responsibility for announcing a conflict of interest and the role of the board of directors in assessing the material implications of such a conflict.

An inquiry about the quality of the regulatory framework with respect to related party transactions would benefit from a special discussion about transactions that involve major shareholders (or their families), either directly or indirectly. It should also address the obligation of shareholders to report transactions and the nature of the transactions with related parties, grouped as appropriate.

What procedures and institutions are in place to ensure that shareholders have the ability to significantly influence the company? For example, are there sufficient notification procedures for general shareholders meetings and adequate procedures for proxy voting to effectively allow voting for those unable to directly participate?

Participation in general shareholder meetings is a fundamental shareholder right that is critical to their ability to influence the company and the quality of corporate governance. It is during these meetings that decisions about key issues, such as dividends and the election of the board of directors, are made. In order for shareholders to be able to participate effectively in decisions made at the shareholders' meeting, either directly or by proxy, they need to be informed about the meeting in a timely and orderly fashion. Also, the rules and procedures for casting votes must be designed with an aim to facilitate and encourage shareholder participation in the decision-making process at a reasonable cost.

In this context, it is of particular importance to consider the timeliness and the quality of any information that is distributed with the purpose to inform shareholders about the issues that will be discussed and decided at the shareholders' meeting. Does content and procedure provide the background and time that is required for them to inform themselves and consult on the issues that will be discussed and decided?

Access to information and reliable proxy procedures are particularly important in the case of foreign investors who often hold their shares through chains of intermediaries. Shares are typically held in accounts with securities intermediaries, that in turn hold accounts with other intermediaries and central securities depositories in other jurisdictions, while the listed company resides in a third country. Such cross-border chains often give rise to special challenges with respect to determining the entitlement of foreign

investors to use their voting rights in order to influence key decisions, such as the election of directors, and the process of communicating with such investors. The obvious risks are of course that information from the company doesn't reach the ultimate shareholder and that the opinion of the ultimate shareholder does not reach the shareholder's meeting. It is therefore important to address to what extent the legal and regulatory framework clarifies the duties and procedures for informing about the shareholders' meeting, and the procedures for voting of shares that are held by foreign owners.

More generally, the requirement for delegating voting rights to custodians should be regulated in some detail. When shaping such rules, special attention should be given to those situations where financial institutions, such as banks and brokerage firms, hold shares in custody for investors.

By what standards and procedures do companies meet the market demand for timely, reliable and relevant disclosure, including information about the company's ownership and control structure?

A strong disclosure regime that promotes real transparency is a pivotal feature of a market-based corporate governance system that allows shareholders to exercise their ownership rights on a fully informed and equal basis. It underpins confidence in the stock market and is a powerful tool for influencing the behaviour of companies and for protecting investor rights.

Present and potential shareholders require access to regular, reliable and comparable information in sufficient detail for them to assess the stewardship of management, and make informed decisions about the valuation, ownership and voting of the company's shares. Insufficient or ambiguous information will hamper the ability of the markets to function. It will increase the cost of capital and result in a poor allocation of resources.

Arguably, failures of governance can often be linked to the failure to disclose the "whole picture", particularly where off-balance sheet items are used to provide guarantees or similar commitments between related companies. It is therefore important that a discussion about the quality of disclosure standards also take into account how transactions relating to an entire group of companies are treated and how information about contingent liabilities, off-balance sheet transactions and special purpose entities are disclosed.

A discussion about the content of disclosure standards and the dissemination procedures will naturally address numerous trade-offs that relate to the completeness, quality and cost of establishing and disseminating the information. In order to determine what information should be disclosed at a minimum, many countries apply the concept of materiality. Material information can be defined as information whose omission or misstatement could influence the economic decisions taken by users of information.

A particular transparency issue in many markets relates to the complex ownership and control structures. Transparent reporting regarding ownership is essential in order to curb, among other things, abusive transactions among related parties. The OECD template on Options for Obtaining Beneficial Ownership and Control Information serves as a reference for improving the availability of such information.

In the course of developing a strong disclosure regime, it should always be kept in mind that the channels, timing and procedures for disseminating corporate information can be just as important as the content of the information itself. There is no use in issuing material information if it doesn't reach the market and the concerned authorities in a predictable and timely fashion. While the disclosure of information is often provided for by legislation, filing and access to information can be cumbersome and costly. Filing of statutory reports has been greatly enhanced in some countries by electronic filing and data retrieval systems. Some countries are now moving to the next stage by integrating different sources of company information, including shareholder filings. The Internet and other information technologies also provide the opportunity for improving information dissemination.

How does the corporate governance framework ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and its shareholders? Does the framework also recognise the rights of stakeholders established by law or through mutual agreements, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises?

While board structures and procedures vary across countries, the board everywhere should play a central role in the governance of the company. Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance (and replacing it if necessary), and achieving an adequate return for shareholders. It should also monitor and manage potential conflicts of interest of management, board members and shareholders and ensure the balancing of competing demands on the corporation.

Controlling shareholders are frequently in a position to choose all members of the board. These board members may be quite effective at furthering the interest of the controlling shareholders, perhaps even seeing themselves as the delegate for the controlling shareholder. In turn, minority shareholders have demanded to have their own delegates on the board.

However, the *Principles* assert that regardless of how they are chosen, in order for boards to effectively fulfil their responsibilities, they must be able to exercise informed, objective and independent judgement, acting as representative of all shareholders. Important board responsibilities include overseeing systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. These are normally formalised as a duty of care and loyalty, and it is important that these concepts are firmly anchored in law and jurisprudence, and in the understanding and practices of the board members themselves. In some countries, companies have found it useful to explicitly articulate the responsibilities that the board assumes and those for which management is accountable.

The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Corporations should recognise that the contributions of stakeholders constitute a valuable resource for building competitive and

profitable companies, contributing to the long-term success of the corporation. The rights of stakeholders as established by law or mutual agreement should be respected. Observance of environmental and social standards is relevant in this context (also see Chapter 7 on Responsible Business Conduct).

Examples of specific reforms include clarification of board member duties in the law; requiring greater numbers of “independent” board members; encouraging the use of specialized committees, especially audit committees; developing the infrastructure for the ongoing training of board members; and in some cases making greater use of cumulative voting, which may strengthen the representation of board members considered independent of the controlling shareholder.

What has been done and what more should be done in terms of voluntary initiatives and training to encourage and develop a good corporate governance culture in the private sector?

In dealing with corporate governance issues, countries use a varying combination of legal and regulatory instruments on the one hand, and voluntary codes and initiatives on the other. The *Principles* do not prescribe a single approach, and country experience varies widely depending in part on history, legal traditions, efficiency of the courts, the political structure of the country and the stage of enterprise development. Many countries, hoping to minimize compliance costs and to provide greater flexibility within a market framework, have developed and sought to promote greater use of voluntary codes and initiatives to improve their corporate governance. Suggesting that a “one size fits all” approach is not efficient, some countries have sought to implement their codes through “comply or explain” provisions that do not require compliance, but require an explanation when the provision is not followed. In some countries, such codes are implemented by stock markets through listing requirements. However, while such measures can play an important role in improving corporate governance arrangements, they might leave shareholders and other stakeholders with uncertainty concerning their status and implementation. When codes and principles are used as a national standard or as an explicit substitute for legal or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.

Corporate governance institutes or institutes of boards of directors have also sprung up in many countries, increasingly in the last five years, with an aim to promote awareness and to train directors to better understand corporate governance objectives and requirements. Increasing the supply of competent directors and improving the quality of their supervision has been a particular concern. Some institutes have also engaged in media training programmes as another means for increasing public understanding of corporate governance.

Has a review been undertaken of the national corporate governance system against the OECD Principles of Corporate Governance? Has the result of that review been made public?

The World Bank has completed 48 corporate governance reviews of some 40 developing and transition economies, known as Reports on Observance of Standards and Codes (ROSCs), using the *OECD Principles* as the reference for these exercises. Subject to the agreement of the country's government to have the review publicly disclosed, the World Bank publishes these ROSCs on their Web site at www.worldbank.org/ifa/rosc_cg.html. In addition, the OECD, as part of its work to develop an updated methodology for such reviews, has undertaken a pilot review of an OECD country's experience with implementation of the *Principles*. While participation in and public disclosure of these reviews are voluntary, their disclosure, and better yet, public discussion of these reviews, can provide a useful basis for building awareness of and support for changes needed to strengthen the corporate governance framework and overall environment for investment.

Policy dialogue among the range of policy-makers, institutions and stakeholders concerned with improving corporate governance has proven to be an effective way of building consensus for corporate governance improvements on a national and regional basis. The Regional Roundtables on Corporate Governance (in Asia, Eurasia, Latin America, Southeast Europe and Russia), which have been meeting since the year 2000, are continuing to meet regularly to promote implementation of White Paper recommendations setting out action plans for change. These and other regional policy dialogue programmes (in Africa, the Middle East and North Africa, and the Caribbean), with the strong support of the Global Forum on Corporate Governance and local partners, co-founded under a partnership agreement between the World Bank and OECD, have helped to build consensus for regional and country-based action, and for follow-up on implementation. Participation in such regional policy dialogue can provide a means for accessing international expertise and building capacity for change.

6.4. Corporate governance of state-owned enterprises

The *OECD Principles of Corporate Governance* apply to state-owned enterprises, particularly to listed SOEs, but the *OECD Guidelines on Corporate Governance of SOEs* have been developed because of a number of specific challenges associated with the state's role in governing SOEs.⁵ SOEs indeed often suffer from passive ownership by the state, or on the contrary, from undue political interference. SOEs in many cases are also notorious for having a soft budget constraint, being largely protected from the takeover and bankruptcy threats that are essential tools for monitoring management in private sector corporations. More fundamentally, SOEs have a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly and easily identifiable principals. Structuring this complex Web of accountabilities in order to ensure efficient decisions and good corporate governance is a challenge.

Moreover, globalisation in most industries and technological changes and liberalization in many infrastructure sectors and network industries, traditionally dominated by SOEs, have also made necessary certain readjustments or restructuring of the state sectors. In order to promote overall investment and economic development, the state should ensure that the private sector may compete on a level playing field with SOEs, including safeguarding against conflicts of interest between the state as owner and as market regulator within the same sectors. In a few cases, severe financial difficulties of highly visible SOEs, with the resulting heavier budgetary burden, subsidisation and indebtedness, have triggered strong reactions and a demand for the reorganisation of the exercise of ownership rights by the state.

To face these specific challenges and to respond to these difficulties and even backlashes, a number of governments have undertaken significant reforms in the way they exercise their ownership rights. This is true for the OECD countries, but is also true for a number of non-OECD countries where, in many cases, state ownership is even more prevalent. How SOEs are run is crucial to the economic efficiency and competitiveness of the countries where they are based. Poor corporate governance practices in SOEs have a series of serious consequences. Badly governed SOEs may have unclear objectives and take decisions which impair their efficiency and development potential. This will have an impact on the quality of services and products delivered to citizens, in turn impacting on the economic infrastructure and general development capacity of the countries concerned. This also leads to decreased profits or even losses that tend to be borne by the public budget, thus increasing the general fiscal burden and indebtedness. Frequent undue political interference in the management of SOEs and lack of transparency on both their objectives and performance also contribute to the general poor public governance. Moreover, SOEs are widely recognised for being an important source of corruption, particularly in weak institutional environments.

While the *Guidelines* provide more comprehensive background on addressing the challenges mentioned above, the questions below touch upon a few of the key considerations to be addressed.

How is the ownership function of state-owned enterprises structured to ensure a level playing field, competitive market conditions and independent regulation? What are the processes in place to enable the state to act as an active and informed owner, while not interfering in day-to-day management of SOEs?

How the ownership function of the state is organised – that is, the functioning of the entities responsible for establishing and implementing the state’s ownership policies – can influence the overall investment environment. In particular, it is important that the ownership function is clearly identified and separated from other state functions, including regulatory oversight. This helps to ensure a level playing field for all investors, especially with regard to compliance with laws and regulations.

The organisation of the ownership function within the state administration varies from one country to another. The ownership function might be centralised within one ownership entity, shared between two ministries or entities, or decentralised over the different sector ministries concerned. To reinforce the ownership function and ensure its clear identification, the *Guidelines* recommend at least to set up a strong co-ordinating entity or, more appropriately, to centralise this ownership function. Such centralisation helps in clarifying the ownership policy and ensures a more consistent implementation of this policy. Moreover, it could also facilitate “pooling” together relevant expertise on key matters.

The objective of the ownership entity is to implement the ownership policy as developed by the government. This ownership policy typically defines the overall objectives of state ownership and describes the state role in the corporate governance of SOEs. It also explains how the state plans to implement its ownership policy.

It is the role of the ownership entity to develop an appropriate framework to ensure that the state exercises its ownership rights actively and in an informed manner. The state's primary responsibilities as an owner are as follows: i) to be represented in the general shareholders meeting and to vote the state shares; ii) to establish a well-structured and transparent board nomination process; iii) to set up reporting systems allowing regular monitoring and assessment of SOE performance; iv) when possible to maintain continuous dialogue with external auditors and state control organs; v) to ensure that remuneration schemes for SOE board members are adequate.

While being an active and informed owner, it is crucial that the state does not interfere in the day-to-day management of SOEs and let their boards carry out their responsibilities. In this case, SOEs enjoy full operational autonomy to realise their defined objectives.

What are the processes in place to ensure that SOE board members are nominated in a transparent manner and based on their competencies and experience, so that they may effectively carry out their role of strategic oversight, rather than to serve as a conduit for undue political pressure?

In order to carry out their role, SOE boards should actively i) formulate, monitor and review corporate strategy within the framework of overall corporate objectives; ii) establish appropriate performance indicators and identify key risks; iii) monitor the disclosure and communication processes, ensuring that the financial statements fairly present the affairs of the SOEs and reflect the risks incurred; iv) assess and follow management performance; v) develop effective succession plans for key executives. To underline the board's responsibilities, a Directors' Report should be provided along with annual statements, and should give information on the organisation, financial performance, material risk factors, significant events, relations with stakeholders, and the effects of directions from the co-ordinating or ownership entity. The board should also develop, implement and communicate compliance programmes for internal codes of ethics based on country norms and in conformity with broader codes of behaviour, including the OECD Guidelines for Multinational Enterprises.

In view of this wide range of responsibilities, it is crucial that SOE boards have adequate authority, the necessary competencies and sufficient objectivity to effectively carry out their functions of strategic guidance and monitoring of management. Experience in most countries reveals that often SOE boards do not bear the responsibility for SOE performance and are not fully accountable to the owners. Political influence in the nomination process is strong in a number of countries, with the process often degenerating into political interference. This is often identified as a main weakness of SOE governance.

A crucial task for the ownership entities is thus to set up a structured and transparent nomination process for SOE boards. The objective is to ensure that board members are selected based on their competencies and experience and that they are independent enough to carry out their fiduciary duty. If employees from the ownership entity or other civil servants are elected on SOE boards, they still need to meet the required competence level for all board members and in no case should they act as a conduit for undue political

influence. In this regard, it is also important to insist on the fiduciary duty of SOE board members. They should carry out their duties in an even-handed manner with respect to all shareholders, acting in the best interests of the company as a whole. They should not act as individual representatives of the constituencies that appointed them.

How are SOEs effectively held accountable to the government, the public, and in the case of listed SOEs, to other shareholders, including through adequate reporting by the ownership entity and SOEs themselves?

Another challenge regarding the corporate governance of SOEs is to improve their transparency. Adequate reporting on SOE objectives and performance both by the SOEs themselves and by the ownership entities allows the media, the Parliament and the public to have a clear idea about how the state fulfils its ownership function. To ensure adequate transparency requires that SOEs are subjected to the same high-level accounting and auditing standards as listed companies. This also requires that SOEs develop efficient internal audit procedures and are subject to an annual independent external audit based on international standards.

Adequate disclosure of material information as described in the OECD Principles is also often a weak point in SOE governance practices. The Guidelines more particularly draw attention to specific areas of concern: i) the company objectives and their fulfilment; ii) the ownership and voting structure; iii) risk factors and any measures taken to manage such risks; iv) any financial assistance received from the state and commitments made on behalf of the state; v) any material transactions with related entities. These later transactions are often an important source of abuses, particularly in weak institutional environments, and it is crucial to consider closely the procedures in place to control and disclose such transactions.

Finally, consistent aggregate reporting by the ownership entity is instrumental in ensuring accountability to the public and the media on SOE performance. A growing number of countries are publishing annually an aggregate report on SOEs, focusing on their financial performance and their valuation, and giving an overview of their evolution. Such reports might also provide a general statement on the state ownership policy and on how it is implemented. Information on the organisation of the ownership function and on SOE boards is often included, as well as changes in these boards.

The Guidelines also call for reinforcing the accountability of the ownership entities *vis-à-vis* representative bodies such as the Parliament. However, it is important to fine-tune the accountability mechanisms to ensure that they do not unduly restrict the ownership entities or SOEs' autonomy and to provide reasonable guarantees regarding confidentiality issues. This is often a delicate balance to be struck.

Notes

1. Corporate governance, as set out in the Preamble to the *OECD Principles of Corporate Governance*, refers to a set of relationships between a company's management, its board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are

set, and the means by which attaining those objectives and monitoring performance are determined.

2. For background information on the *Policy Framework for Investment*, see DAF/INV/TF(2006)1. In addition to corporate governance, the policy areas in the *Framework* include investment policy; investment promotion and facilitation; trade policy; tax policy; competition policy; policies for promoting responsible business conduct; human resource development; infrastructure and financial sector development; and public governance.
3. See the Declaration of heads of state and government, “Confronting the challenges of financing for development: a global response”, issued on 22 March, 2002 at the UN Financing for Development conference in Monterrey, Mexico.
4. The above section is largely excerpted from an article by Mats Isaksson, OECD Corporate Affairs Division Head, “Corporate Governance and Public Policy” (2004) published in *The Future of Corporate Governance*, Corporate Governance Forum, Stockholm.
5. These Guidelines are primarily oriented to SOEs using a distinct legal form (i.e. separate from the public administration) and having a commercial activity (i.e. with the bulk of their income coming from sales and fees).

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ANNEX 6.A1

The OECD Principles of Corporate Governance

I. Ensuring the basis for an effective corporate governance framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

- A.** The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.
- B.** The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.
- C.** The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.
- D.** Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

II. The rights of shareholders and key ownership functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

- A.** Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation.
- B.** Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company.

- C.** Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:
1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
 2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
 3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.
 4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.
- D.** Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.
- E.** Markets for corporate control should be allowed to function in an efficient and transparent manner.
1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.
 2. Anti-take-over devices should not be used to shield management and the board from accountability.
- F.** The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.
1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.
 2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.
- G.** Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.

III. The equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

- A.** All shareholders of the same series of a class should be treated equally.
 1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.
 2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.
 3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
 4. Impediments to cross border voting should be eliminated.
 5. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.
- B.** Insider trading and abusive self-dealing should be prohibited.
- C.** Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

IV. The role of stakeholders in corporate governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

- A.** The rights of stakeholders that are established by law or through mutual agreements are to be respected.
- B.** Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.
- C.** Performance-enhancing mechanisms for employee participation should be permitted to develop.
- D.** Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.
- E.** Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.
- F.** The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.

V. Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

- A.** Disclosure should include, but not be limited to, material information on:
1. The financial and operating results of the company.
 2. Company objectives.
 3. Major share ownership and voting rights.
 4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.
 5. Related party transactions.
 6. Foreseeable risk factors.
 7. Issues regarding employees and other stakeholders.
 8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.
- B.** Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.
- C.** An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.
- D.** External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.
- E.** Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.
- F.** The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.

VI. The responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

- A.** Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
- B.** Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
- C.** The board should apply high ethical standards. It should take into account the interests of stakeholders.

- D.** The board should fulfil certain key functions, including:
1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
 2. Monitoring the effectiveness of the company's governance practices and making changes as needed.
 3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
 4. Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
 5. Ensuring a formal and transparent board nomination and election process.
 6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
 7. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
 8. Overseeing the process of disclosure and communications.
- E.** The board should be able to exercise objective independent judgement on corporate affairs.
1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.
 2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.
 3. Board members should be able to commit themselves effectively to their responsibilities.
- F.** In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.