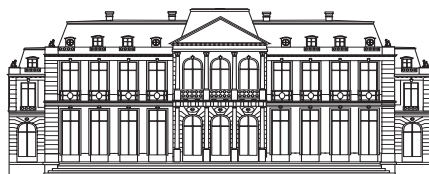


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**“CORPORATE GOVERNANCE IN RUSSIA”**

***Mr Mats Isaksson***

*Senior Consultant, Directorate for Financial, Fiscal and Enterprise Affairs  
OECD*

**“Investment, Financing and Corporate Governance:  
The Role and Structure of Corporate Governance  
Arrangements in OECD Countries”**

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Mr Mats Isaksson  
OECD

**Investment, Financing and Corporate Governance:  
The Role and Structure of Corporate Governance Arrangements in OECD Countries**

*Summary*

The significance of good corporate governance goes far beyond the interests of the shareholders in an individual company. For the economy as a whole it has a profound impact at all stages of the investment process, affecting the ability to mobilise, allocate and monitor the use of productive resources. Today, the importance of good corporate governance is reinforced by some of the most pervasive contemporary trends in the global economy, notably the growing role of the private sector, increased internationalisation, and rapidly changing competitive circumstances for investors and corporations. In their efforts to fully benefit from these developments, policy-makers and business practitioners in OECD countries have over the last decade taken important steps to improve corporate governance practices in listed companies. These reform initiatives have addressed perceived shortcomings of both the “insider approach” and “outsider approach” to corporate governance, and have gradually produced a set of commonly agreed elements that enhance good corporate governance. These elements can be summarised in: transparent ownership and company structures; enabling informed shareholder participation; effective minority protection; and high quality corporate information. Increased emphasis has also been given to shape an enforceable institutional framework of rules, regulations and accepted business practices that are supervised by competent authorities that can assure compliance. This emerging consensus among OECD countries does not imply victory of one governance approach over another. It should rather be seen as a possibility to provide investors and companies with more choice. An efficient structure of ownership and control should ultimately reflect the needs of the particular investors and corporations involved than any overriding “system”. Building on a growing consensus about the basic requirements for effective corporate governance the future policy challenge in OECD countries is to delineate flourishing avenues for different governance strategies that will prove their specific merits in competition with other practices. In order to be successful, and accepted by global capital markets, such reform efforts have to be undertaken within a well-understood, credible and enforceable regulatory framework.

### ***1. Financing Investment and the Role of Corporate Governance***

One of the most salient relationships in economic life is the positive link between investment and economic growth. By constantly adding to the quality and quantity of fixed capital and human skills, OECD economies have for more than a century experienced an unprecedented increase in real income per capita. This development has in turn made it possible to improve the quality of life dramatically for all citizens.

At the very heart of the investment process is the corporation and a constant search for the most efficient ways to combine all the different resources that are required 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 under-performing 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. This institutional framework is often summarised in the term corporate governance.

Corporate governance is the system by which business corporations are directed and controlled. And by specifying the distribution of rights and responsibilities among the different participants to the corporation the corporate governance framework comprise elements that are essential for a successful outcome at all stages in the investment process.

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At the first stage, credible and enforceable provisions for property protection, secure methods of ownership registration and the opportunity to obtain effective legal redress are elements that will facilitate the *mobilisation* and inter-mediation of capital. At the second stage, reliable and transparent accounts of corporate affairs and their financial situation is essential to make informed decisions about the *allocation* of financial resources among alternative uses. At the third stage, proper procedures for internal corporate decision-making, the distribution of authority among company organs, operative incentive schemes and established lines of accountability are important for executing effective *monitoring*.

From an economic policy perspective we can therefore conclude, that the importance of good corporate governance goes far beyond the interests of shareholders in an individual company. A weak corporate governance framework will severely impede all stages of the investment process and hence the economy's overall prospects to build a strong private sector basis for economic growth. Poor corporate governance will damage the capacity to mobilise savings, it will hinder efficient allocation of financial resources, and it will prevent proper monitoring of corporate assets. These are among the core concerns that have driven and nurtured the policy-discussions on corporate governance in OECD countries.

### ***2. The Growing Importance of Corporate Governance***

Because of its critical role in economic life corporate governance has for a long time, and certainly before the term itself came into swing, been an important item on the agenda of policy makers and practitioners. The central elements, for example the distribution of rights and responsibilities among different participants to the corporation, have been elaborated in a sequence of successive reforms, and today they form an integral part of such regulatory domains as company law, securities legislation and insolvency provisions. Also stock exchanges, accounting associations and similar professional organisations have over the years been undertaking considerable work to improve the self-regulatory underpinnings for corporate governance.

This said, it is also evident that the last decade has brought about an unprecedented public awareness of corporate governance. Today, discussions in OECD countries are no longer limited to business circles, lawyers, financial experts and regulators. The topic has become everyday headlines. There are numerous journals, newsletters, web-sites, consultants and university courses that now specialise in corporate governance -- and a wide range of different interests take part in the debate.

One important explanation for this growing interest is a number of high-profile cases of governance failure and misconduct. This was certainly what inspired the work of the British Cadbury Committee in the early 1990s, and similar initiatives that later followed in other countries, including Canada, Australia, the Netherlands and France. Another occurrence that more recently has ushered corporate governance to the front pages is the financial turmoil in some emerging market economies. But important as they are, these events do not by themselves explain why corporate governance has come to attract so much attention. The interest in corporate governance didn't disappear once the Cadbury Committee submitted its report. It was around well before the Asian financial crisis arrived -- and it will prevail long after it is gone.

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The reason is that the issues that corporate governance deals with are intimately linked to some of the most pervasive contemporary developments in OECD countries. While these developments haven't necessarily changed the fundamental governance questions themselves, they have in many cases placed corporate governance in a new context and certainly amplified its importance for our economies and societies as a whole.

Among the most important developments to be mentioned in this respect are: a) the growing role of the private sector; b) increased internationalisation; c) new competitive circumstances for companies.

*a) The growing importance of the private sector as the basis for wealth creation*

The business-corporation has become an increasingly important vehicle for wealth creation worldwide. More than a decade of capital market liberalisation, improved competition policy and privatisation programs in OECD countries has played an important role for developing and strengthening the private sector basis for economic growth. We trust corporations to create jobs, to generate tax income and to furnish the markets with goods and services. Increasingly, economies also make use of the private sector institution's ability to more effectively manage savings, assess investment opportunities and secure retirement income.

In order to meet expectations and successfully fulfil their increasingly important economic function it is imperative that companies and investors are governed in a way that keep them focused on their objectives, competitive in the operations and accountable for their actions. If not, countries will not only be deprived of substantive economic values, but will also experience a growing public mistrust in market institutions. For these reasons, it has been imperative that market oriented reform efforts in OECD countries have been accompanied by an unambiguous commitment to sound business practices. Good corporate governance is not only a safeguard against waste of corporate assets. It is also seen as a guarantee for the financial transparency, corporate accountability and investor responsibility that is necessary in order to preserve long term public legitimacy of market institutions.

*b) Growing international interdependence, particularly in the financial sector*

In OECD countries, most investors are no longer limited to make equity investments only in domestic companies. In their constant search for the most profitable opportunities they can now allocate their investments on a global scale. While this certainly allows for better diversified investment portfolios, it has also created new opportunities for all those future oriented enterprises around the world who are now able to raise money from a much larger pool of investors. Commercially viable business opportunities should no longer have to be impelled by the lack of domestic capital sources.

Ambitions to ripe the full benefits of these new opportunities have triggered a need among investors and corporations alike to better understand different business cultures and corporate governance arrangements. For investors to actually allocate money abroad on a long term basis, and for companies to open up to overseas ownership, they need to appreciate, and have well founded confidence, in the rules of the game.

In today's world characterised by international interdependence, the ability to communicate and understand different corporate governance practices becomes an increasingly important factor for companies and countries who want to attract internationally mobile capital, be it domestic or foreign. And

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at a more general level, it will be an important vehicle for improving the effectiveness of global capital allocation.

*c) New competitive circumstances for companies*

Many of today's fast growing and highly successful enterprises within the OECD differ quite radically from the traditional image of a smokestack blue-chip corporation. Not only do they differ in terms of market conditions, the character of their products, etc. In many cases they are also equipped with a different asset base. They are often more human capital intensive and highly dependent on intangible assets such as brand names, patents, strategic agreements and organisational know-how. They may also operate under more flexible contracts with employees, business partners and other constituents.

While these enterprises are highly successful, future oriented and attractive to many investors, their internal structures and the character of their operations often provoke their own genuine challenges in terms of corporate governance. Investors for example, are faced with new evaluation problems and the corporations themselves often struggle very hard trying to communicate the intrinsic potential of the company without disclosing any commercially sensitive information or making investors subject to insiders status. Other governance issues that frequently announce themselves in these enterprises are how to recruit, keep and motivate highly qualified staff, such as scientists and top management, and not least, how shareholders should monitor and evaluate managers that have unique entrepreneurial talents and almost exclusive insights about future business opportunities.

Since the success of these companies is of critical importance to the renewal of a country's industrial base, these challenges are far from trivial. And it is not surprising that we have already started to see the market's responses to some of them. This is perhaps most obvious in the areas of venture capital financing and in the private equity industry where new governance techniques are constantly being engineered. Experiences that, in turn have triggered an interest to improve and customise corporate governance arrangements also in larger and more established companies that exhibit similar characteristics. In fact, the ability to match evolving corporate characteristics with the most appropriate governance arrangements will for many modern enterprises be an important part of their competitive edge. If a country's regulatory framework doesn't enable such adaptability at company level, it will most probably impede the emergence of new industries and business opportunities that are not well served by more traditional arrangements.

### ***3. The Institutional Framework for Corporate Governance***

Current efforts to improve corporate governance in OECD countries are strongly driven by the business community, and its own interest in establishing efficient and credible relationships between key resource providers to the company. Both suppliers and receivers of capital share this interest and a wide range of corporate governance issues are constructively resolved in a process of private negotiations among market participants

Since corporate circumstances vary and since investors differ with respect to incentives, risk-attitude and investment strategies, the actual outcome of this process is of course a variety of corporate governance practices. A rapidly expanding high-risk enterprise that primarily rely on human capital may very well arrive at different governance arrangements than a cash-rich, mature and fixed-capital based corporations, operating under relatively stable market conditions.

*Despite obvious differences at company level, it is equally clear that the choice and the structure of corporate governance arrangements in OECD countries do not emerge in a vacuum. In addition to company specific circumstances and investor preferences a corporation's governance arrangements are greatly influenced by the laws, regulations and accepted market practices that constitute a country's institutional framework for corporate governance. At the very core of this framework is a set of statutory provisions but the importance of generally accepted practices and established business culture should by no means be under-estimated.*

*In no OECD country are all aspects of corporate governance arrangements determined by any single body. On the contrary they depend on a web of different influences, including legislators, regulatory agencies, courts, self-regulating bodies, norm setting private associations, interest groups, and individuals. The responsibilities and importance assigned to different actors may also differ among countries. Some tend to rely more heavily on self-regulation and private contracting than others. To make the best possible use of the many complementary institutions that influence corporate governance practices and arrive at an efficient division of responsibilities between them is an important step when developing an efficient corporate governance framework.*

*A country's institutional corporate governance framework can be described by the following main elements:*

- *Statutory law and regulations*
- *Voluntary standard contracts and self-regulation*
- *Implicit rules, social norms and business culture.*

#### *Statutory law and regulations*

Statutory law and regulations belongs to the public policy domain, and in that context corporate governance it is generally regarded as a means to advance the private sector basis for economic growth for the benefit of society as a whole. Without second-guessing the market, the prime regulatory objective in OECD countries has been to support the emergence of efficient business practices by providing a credible and enforceable legal foundation. This legal bedrock serves the indispensable function of outlining the basic rights and responsibilities of different parties; clarify the operation of the law; define pre-established procedures for legal redress; and assure compliance.

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One of the most important legislative domains for the design of corporate governance arrangements is *company law*. The main distinction between OECD countries is between civil law countries and common law countries. As some elements of company legislation in civil law countries has been seen as fairly rigid in comparison with the legal regimes that govern companies in common law countries, several attempts has been made to allow for greater choice and flexibility. Such initiatives are pursued along two main lines: the introduction of new legal forms; and by taking deregulatory measures for existing corporate forms. Examples along the first avenue include the recent French initiative to introduce the Société par Actions Simplifiée (SAS) with a less regulated governance structure than the ordinary Société Anonyme. The ambition to increase flexibility within existing corporate forms can be illustrated by the recent Marini report presented to the French Senate, and German initiatives to enact a number of deregulatory measures for small stock companies. Along the same lines it is also worth mentioning the recent ruling of the German Federal Supreme Court, which allowed a GmbH to serve as general partner in a Kommanditgesellschaft auf Aktien (KGaA). This option has increased the possibilities for family owned businesses to meet the company's capital needs through issuance of shares in the capital market.

Many countries have in recent years also used company law as a vehicle to improve transparency and the protection of shareholder's rights. Such concerns were behind for example the German Act on Control and Transparency of Enterprises which entered into force last year, as well as changes in the Japanese Commercial Code facilitating shareholder litigation and mandating the appointment of an outside auditor.

At a more general level, the company law debate in many OECD countries has more and more come to focus on the economic implications of the legal setting. Examples of initiatives that embrace such an approach include the ongoing "Corporate Law Economic Reform Program" in Australia and the recently started company law review in the UK, which goes under the title "Modern Company Law For a Competitive Economy".

*Securities legislation* is another area with profound impact on corporate governance practices. Some commentators even hold securities legislation to be the most important force in setting the standards for internationally acceptable practices. This is particularly true as more and more countries within the OECD have the ambition to develop their equity markets. While the US Securities and Exchange Commission for a long time has played an important role, a range of other countries have more recently taken steps to empower independent supervisory bodies for their securities markets. One of the most recent examples comes from Italy where the parliament last year adopted reforms which in parallel with increased disclosure standards and increased protection of minority shareholders also strengthened the regulatory powers of the Italian securities regulator, CONSOB. Also in other countries, including France, have the recognised importance of securities regulation contributed to increase the profile and presence of supervising authorities.

Beyond provisions that explicitly aim at minority protection, transparency, insider trading, etc. securities legislation can also affects the availability and use of different financial instruments, for example the use of stock options as an incentive tool for management. Securities legislation may also impact the monitoring function through provisions that regulate shareholder actions. One much discussed example in this respect is the US debate over the risk of potential liabilities for shareholders wishing to take collective action against a company. Commentators have argued that such restrictions may unnecessarily discourage active ownership and limits the possibility of shareholder influence.

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Since the demarcation line between securities legislation and corporate law sometimes is rather vague the two legal domains often complement each other. When assessing their influence on corporate governance it is therefore necessary to take their combined effect into account. As the US standard company law model for example is often accused of being quite weak on shareholder protection, shareholder rights has increasingly become the preserve of the quite powerful Securities and Exchange Commission.

Another set of regulations with an impact on corporate governance is *investment regulations* that can affect the investment choices of institutional investors. While much has been done to liberalise investment opportunities for institutions, many are still limited as to the composition of their portfolios and the size of equity stakes they can hold in a single company. As institutional investors rapidly are becoming the dominating owners of public equity, regulations that may stifle competition, curb governance incentives and restrict specialisation for this category of investors are increasingly considered also from a corporate governance perspective. It is important to underline that any initiatives to improve their role in corporate governance must be compatible with the institution's ultimate responsibilities and fulfilment of its fiduciary duties vis-à-vis the beneficiaries.

Other legal domains that to a greater or lesser extent may affect corporate governance arrangements include insolvency legislation, court practices and procedures, and tax legislation.

*Voluntary standard contracts and self regulation*

From a corporate governance perspective, the single most important step in a corporation's life is probably if it chooses to list at a recognised stock exchange (or move from one stock exchange to another). Since listing is not mandatory, "going public" can be seen as entering a voluntary standard contract. At the core of this contract are the listing requirements. These requirements are often linked, and build on, other regulations such as securities legislation. But stock exchanges also play an independent role. In their efforts to advance the market place and attract investors their ambition is generally to make sure that those companies that are allowed to list also comply with governance standards that meet market requirements. This ambition has inspired several stock exchanges to issue separate corporate governance codes or guidelines. The best known example is probably the Cadbury Code that after completion became part of the listing requirements at the London Stock Exchange. Following this example, other stock exchanges have adopted similar documents.

Many countries also have independent self-regulatory or norm setting bodies supervising and giving recommendations in relation to public trading. A prominent example is the British Takeover Panel monitoring the City Code on Takeovers and Mergers, which explicitly does not seek to have the force of law. Failure to comply with the code can still have very serious effects on the companies "depriving them of future opportunities to take advantage of the facilities of the securities markets in the UK". From this

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perspective it is not surprising that few, if any, market participants have ever challenged the Code or the rulings of the Takeover Panel.

Accounting is another area where self-regulation has become an important force for improving the corporate governance framework. Under the ultimate supervision of some regulatory body, many countries have found it effective to delegate to recognised self-regulatory bodies to actually develop and maintain standards for the practical application of accounting rules.

### *Implicit Rules, Social Norms and Business Culture*

As corporations and investors always form part of a wider social context their interactions are always influenced by prevailing implicit rules, social norms and business culture. While the immediate and exact impact of such value-systems may be hard to measure, their importance for evolving corporate governance practices is increasingly recognized. Their existence may in fact be an important explanation why technically similar legal frameworks may result in quite different corporate governance outcomes.

An often referred to example is the public perception of the mission of the corporation. In some countries, corporations are often expected to serve a range of social functions that in other countries has become the responsibility of the public sector. Such implicit commitments may concern job tenure, education and training. Implicit liabilities are sometimes expected to go also outside the actual workforce and include such services as providing for apprenticeship positions.

Value-systems also affect the business culture. Much has been said about the important role of trust and fairness for the long-term and stable development of the market economy, and the same arguments are often used in relation to corporate governance. Corporate governance can be no better than the quality of the legal framework in which companies operate, but in the absence of commonly embraced ethical and social norms it can indeed be worse. Although the City of London has sometimes been accused of nurturing too much of club mentality it has also been used as an example of the impact of shared norms.

Today, many different interests participate in the shaping of the value-systems for tomorrow's corporate governance practices. Shareholder associations, investor groups, individual companies, trade unions and politicians are some of them. As so many other aspect of corporate governance today, also this dialogue is increasingly conditioned upon the opportunities and challenges that follow from growing international interdependence. Under such circumstances it may indeed be the case that also the implicit norms and value systems that influence corporate governance practices will become more streamlined around the globe and across different constituents.

#### ***4. Corporate Ownership and Governance Arrangements in OECD Countries***

It has already been pointed out that companies in OECD countries display a variety of corporate governance arrangements. Such differences do not only exist between companies of different national origin, but also among companies within the same country. This multifaceted landscape would make a systematic and comprehensive description of company level practices extremely complex. For a more conceptual discussion about the principal approaches to corporate governance in OECD countries, and the policy concerns they provoke, it might therefore be useful to rely on a certain degree of generalisation. A

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common way to achieve that is to distinguish between the so-called “outsider approach ” and the “insider approach” to corporate governance. Again, and since elements of both these approaches exist in most OECD countries, this distinction between two stylised models should not primarily be seen as a classification of countries. Its main advantage is rather as a useful point of reference for a more principal discussion about historical influences, present developments and reform priorities.

The most distinguished feature of the outsider approach to corporate governance is probably its origin in well-developed and highly liquid equity markets. For this reason, the outsider approach is sometimes also called the market-based model of corporate governance. The relative importance of the public equity market in some major OECD countries is illustrated in Table 1. The table demonstrates marked differences between countries, both in terms of the number of quoted companies and the size of the stock market relative to GDP. The most striking difference is between UK and US on the one hand and France and Germany on the other hand. In 1996, the total market value of all domestic listed companies was four times higher in the UK than in Germany, and while both Germany and France are larger economies than the UK, the number of listed companies in these countries were considerably fewer. There were for example three times as many listed companies in the UK as in Germany. This is also reflected in the fact that only a small fraction (some 3.600) of all German companies are incorporated as stock companies (Aktiengesellschaft), while the vast majority of companies (600.000) are incorporated as GmbH, whose stock can not be subject to public trading.

**Table 1: Total market capitalisation in relation to GDP (1996) and number of domestic listed companies (1997)**

	<u>MV/GDP</u>	<u>Number of listed companies</u>
Germany	28%	700
France	38%	740
Japan	67%	1 805
United Kingdom	143%	2 046
United States	112%	7 304 <sup>1</sup>

The importance of the equity market can also be illustrated by looking at its role in capital formation. Table 2, shows the amount of new capital raised over the public stock market in relation to total national Gross Fixed Capital Formation. Again it is possible to detect a sharp difference between the Anglo-American equity markets and those of the other countries represented in the table. In the US for example the portion of new capital raised over the stock market was almost four times as high as in France. This difference is also reflected in the relative dependence on bank lending. Over the period 1980 to 1990, the ratio of credit financing to GDP averaged 42% in the UK against 82% in France and 86% in Germany.

Table 2: New Capital Raised as share of Gross Fixed Capital Formation, 1996

NCR/GFCF

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<sup>1</sup> Of which, NYSE, 2,271 and NASDAQ 5033

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Germany	3.6%
France	5.0%
Japan	1.4%
United Kingdom	17.8%
United States	19.4%

Still another indicator of the role that public equity markets play in corporate life is that British companies that go public tend to do so at an earlier stage of their life cycle than companies in Germany. The median age of firms who make an initial public offering is 8 years in the UK as against 40 years in Germany. There is also a considerable difference in terms of size, where the average size for a company being listed in the UK is \$16 million against \$60 million in Germany.

The outsider approach to corporate governance, rooted as it is in a long tradition of well- developed stock markets, relies heavily on the capital market as a means of evaluating performance and influencing corporate behaviour. This function is facilitated by a regulatory framework, which is characterised by strong disclosure requirements. In order to make it possible for a highly fragmented market to evaluate risk- and return prospects, material corporate information is expected to be disseminated in a timely fashion with equal access for all present and potential shareholders. In practice, disclosure requirements make no difference between the actual shareholders of the company and the stock market as a whole. Information is directed to the market place and any exclusive access to information by individual shareholders is highly regulated with recipients usually becoming subject to trading limitations. Together with securities regulators, stock exchanges play an important role for setting the standards and overlook compliance.

In countries where public equity markets traditionally have played a less important role for corporations and investors, the range of financial instruments tends to be narrower and banks often dominate most forms of financial intermediation. As for disclosure, such relationships often rely on confidentiality as information is shared between the bank and its corporate client. If the lending bank is also a shareholder in the company, exclusive access to such information can be seen to contradict the spirit of the market based emphasis on strong requirements for public disclosure.

The large listed companies that operate in the market-based system generally exhibit a dispersed ownership structure. The shareholder is widely recognised as the ultimate beneficiary of corporate proceeds, and the legal framework is designed to assure equal and fair treatment of all shareholders, including minority holders and foreign investors. Individual shareholders have typically viewed themselves as pure “outside” investors operating at arm’s length distance from the corporation and with no other relationship to the company except their financial investment. The absence of large visible and involved owners in the “outsider model” has paved the ground for a great degree of management discretion over corporate affairs, including the composition of the board of directors. The negative effects that may follow from this separation of ownership from control has been at the centre of the corporate governance discussion in market based systems.

While direct ownership by households still amounts to almost 50 percent of all listed US stock; institutional investors have over the last couple of decades become the fastest growing and most influential category of owners. The presence of institutional investors is even more marked in the UK where they presently hold more than 80 percent of all listed stock. In the US, the dominating institutional investors are pension funds and the rapidly growing mutual funds, while in the UK also insurance companies play an important role. It should be noted that the dominating role of a limited number of large institutional shareholders in the UK has resulted in an increasingly concentrated ownership structure at aggregate level, where, across the top 300 listed companies, 24% of their shares are now controlled by just five institutions.

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In companies that operate in countries with traditionally less developed equity markets, the ownership structure, also in listed companies, has tended to be more concentrated and complex. Companies are often relatively closely held and controlled by a few owners who tend to be engaged in long-term “insider” relationships with the company. The owners are frequently represented on the board of directors and may even serve as executive managers of the company. If a company has more than one large shareholder, these owners sometimes operate in a network, which makes communication and concerted action on corporate affairs relatively easy.

While the presence of large and often controlling shareholders usually facilitate direct monitoring of management, the insider approach is sometimes associated with less transparent ownership and corporate structures that can be used to detriment of minority shareholders. One prominent example of this is cross-shareholdings that can be used by management or significant shareholders within corporate groups to attain corporate autonomy and diminish the influence by non-controlling investors. Such structures have generally discouraged broad public ownership and created concerns among investors that are accustomed to more transparent ownership and control structures. If management is totally dependent on a single large shareholder, the insider approach may also give rise to undue preferential treatment of the majority owner. Such abuse can take many different forms and in the absence of strong disclosure requirements and transparent accounts, the mere risk of such practices has often deterred minority participation.

Institutional ownership plays an important role also in the insider model, but the nature of such ownership differs significantly from what is typically found in the outsider model. The dominating institutional owners in Japan, Germany and France have traditionally been banks, investment companies and industrial groups; owners that in the US and UK rarely, if ever, appears as significant shareholders in large listed companies. These institutions also tend to entertain much closer relationships with the company. In some cases, like the Japanese Keiretsu, they may even form part of a rather well defined formal or informal group.

Bank ownership, for example, has for a long time been a distinct feature of both the German and Japanese corporate governance landscape, and much attention has been given to its role in corporate governance. In Japan, bank influence is mainly pursued through the, so-called, “main banks” which is at the centre of the Keiretsu, while bank influence in Germany is exercised via the so-called universal banks.

Some commentators have argued that the long term and very close relationships that banks are able to develop in their capacity as creditors makes them well positioned to assess company performance, participate in strategic decision making and monitor management for the good of all shareholders. The combined role of creditor and shareholder is viewed as an effective way to internalise some of the central corporate governance problems. The question has been raised however, what performance variables the banks actually give priority to when they influence and evaluate corporate objectives. Critics have pointed out that fixed income claimants, such as debt holders have quite different monitoring incentives than equity holders. The potential effect of this discrepancy is particularly relevant when the bank’s voting power mainly stem from their ability to vote the shares that they administer on behalf of their clients. If this is the case and the banks main income source from the company is in the form of fixed income, they may use their influence to impose corporate strategies that prevent the company to pursue risks that would be beneficial for the shareholders and society as a whole.

Complex ownership structures, personal links and limited exposure to capital market influences have also raised concern that the insider approach impedes the ability to formulate, pursue and evaluate clear corporate objectives. The legal framework may also give limited guidance when it comes to identifying distinct lines of fiduciary duty. Many insider oriented companies operate in countries where legal provisions or strong public perceptions holds that the ultimate purpose of the corporation is to serve the interests of multiple constituents, including shareholders, employees and the public good.

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### 4.1 The reform agenda in OECD countries

Under the influence of increased market competition, globalised financial markets and much more widespread familiarity with equity investments, OECD countries have experienced a range of initiatives aiming to improve corporate governance practices. These initiatives have aimed at both the insider model and the outsider model. The main objective in insider oriented countries has been to reconcile the strengths of traditional governance practices with the recognised economic advantages that stem from corporate access to developed equity markets. In countries that primarily have relied on the outside approach the ambition has been to overcome the incentive and collective action problems related to dispersed ownership by promoting shareholder visibility and participation. The following two sections are by no means a complete account of public and private initiatives. Rather, they are intended to indicate some important steps and the general thrust of various initiatives.

#### 4.1.1 Promoting shareholder participation

While shareholder supremacy has been seen as the hallmark of the outsider model, the reality is that the emergence of very dispersed ownership structures usually left them with little influence over corporate affairs. This observation, which dates back to the 1930's, is the very origin of the modern corporate governance debate. The profound separation of ownership from control gave increasing discretionary power to hired management who could not always be expected to act in the best interest of the company and its shareholders.

Although this development was widely recognised as a genuine problem, it was also assumed that the lack of direct shareholder monitoring through voting and board representation could be compensated by the stock market's ability to discipline management behaviour. This argument builds on the assumption that if management can take care of the company, strict disclosure requirements in combination with liquid stock markets will take care of the stock. If shareholders are able to trade a company's stock on the basis of high quality information they will also be able to evaluate and sanction management performance. If they have reason to believe that management is under performing, shareholders will sell their stock; the price will fall and eventually pave the way for a take-over bid aiming to realise the fundamental values of the company. Such take-overs, which are triggered when management is not able to make the best possible use of company assets will typically result in a change of management and therefore serve as an ultimate check on their ability to shirk. The best protection for managers against this fate would be to keep stock prices up by running the company in the interest of the shareholders.

But managers of many companies, particularly in the US, were soon to find other, and less market oriented means to protect themselves. During the take-over boom in the 1980's a range of different take-over defences were introduced. The list of such devices as poison pills, shark repellents and golden parachutes can be made extensive as they come in many shapes and forms. But from the managers perspective they all serve the same purpose, namely to make unwanted take-overs impossible. Strong opposition against these instruments gave rise to a vivid debate about the need for a well functioning take-

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over market that operates in a transparent and fair manner. The movement against shareholder unfriendly defence tactics was in the 1980s an important part of the agenda for many institutional investors, such as CalPERS. The slogan was to use their voting rights and “just vote no” to proposals that aimed at introducing poison pills. While these campaigns certainly had an effect on the use of protective measures, some commentators claim that legislators and courts in the US still give too much room for the use of shareholder unfriendly defence tactics.

Exclusive reliance on the exit mechanism as a disciplining factor has also been mitigated by the presence of large institutional investors that hold a large portion of their assets in the form of indexed portfolios. Such an investment strategy often makes investors less flexible when it comes to selling the shares in an individual company. This has in turn triggered the search for alternative corporate governance strategies among several large institutions, notably the US public pension funds. With limited possibilities to exit specific companies, the principal governance-avenue has been to “move the heard” or “lift all boats”. The main tool to achieve this has been to identify a set of governance safeguards, which are assumed to minimise the risk of abuse, waste and moral hazard, and then request all portfolio companies to comply with these pre-established standards. Common elements of such standards include board practices, disclosure provisions and the character of compensation schemes. To gain additional leverage, some institutional investors also publish “black-lists” of companies that lag in performance and acceptable corporate governance practices. While this governance strategy can still be considered as basically arm’s length (and many institutional investors remain even less active) its influence on the general debate and on the overall governance culture should not be underestimated. This is particularly true in the area of board practices. In the outsider model, the board of directors has more and more come to be viewed as an efficient surrogate for more direct shareholder involvement. Also building on the Cadbury Code the Blue Ribbon Report from the US National Association of Corporate Directors there is now broad consensus that more professional and independent boards is a viable way to improve corporate governance in the outsider model. Some countries have also embarked on legal reform to improve regulations on director’s duties in relation to corporate governance.

In the US, the problem of collective action among dispersed shareholders has partly been tackled by the Securities and Exchange Commission. In 1992 they allowed for easier communication among those shareholders not seeking control. This provision has, according to some analysts, made corporations more willing to engage in direct communication with important shareholders. While in general agreement, other commentators argue that regulators should further reduce potential sources of liability for groups of institutional investors and other shareholders wishing to engage in collective monitoring. The SEC has also promoted shareholder participation by a proposal that would allow substantial shareholders who have held stock for a prescribed period of time to have a short statement with their views on management quality mailed with the proxy statement. Steps are also taken to facilitate voting practices, for example by the use of electronic means.

In addition, or rather as an alternative, to pre-established governance standards in individual companies some large institutions, notably in the UK, describe their ownership strategy as relational investing. These investors (still holding fairly small stakes in individual companies) prefer to influence the company through direct and informal discussions with the directors or the management. For investors with large and diversified portfolios such a strategy may indeed be very time consuming and for this reason it may become the case that such focused ownership will be carried out by specialised departments or subsidiaries.

During the last decade, market oriented countries have also experienced a surge in more “hands on” governance strategies designed to deal with specific information, monitoring and incentive problems. Such strategies are typically pursued by an intermediary owner, which pools capital from various sources in order to acquire large ownership stakes in a limited number of companies. Private equity partnerships and buy-out funds are examples of such specialised governance owners. In their search

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for competitive rates of return, many large institutional investors, including major US pension funds, have over the last years substantially increased their participation in such targeted and less liquid investment ventures.

The intermediary governance owner operates in active and ad-hoc collaboration with the entrepreneur and other insiders. The strategy focuses on maximising shareholder returns via customised contracts aiming at a more complete sharing of risks and better alignment of interests among the participants. This governance technique should not be confused with the traditional insider approach. Ownership structures and fiduciary obligations are clearly defined and the contractual rights, including exit possibilities, of different parties are thoroughly elaborated and explicit.

Traditionally used in small and mid-size companies in the high-tech industry, increased familiarity with more “hand’s on” governance techniques has made it an interesting strategy for ownership also in larger companies, not least as an efficient tool during restructuring. Commitment to this ownership strategy typically requires practical business experience, which is then transferred to the company in very concrete forms. The owners will certainly provide competent candidates for the board of directors, select the executive and if necessary form part of the management team. When carried out across borders, this ownership strategy does not only include transfer of financial capital but also of industrial know-how, management skills and business networks.

### 4.1.2 Promoting minority rights, transparency and high quality financial information

While much attention has been given to corporate governance in the market based system, companies, stock exchanges, regulators and controlling investors are seriously beginning to tackle those aspects of the insider model that creates obstacles to outside investment or hamper corporate dynamism. Unlike in the outsider model, the central problem in the insider model is not the separation of ownership from control. The main areas of concern are instead: a) effective protection of minority shareholder’s rights; b) more transparent corporate structures, and;

c) Market access to high quality financial information.

Reform initiatives are pursued at several levels and in several areas, some of which are mentioned in section 3. Additional examples include a set of recent changes to German law, specifically addressing issues of corporate governance. The German act on Control and Transparency of Enterprises (KonTraG), which entered into force on May 1, 1998 include measures to strengthen the position of shareholders, increase transparency and improve the quality of audit. It also addresses the role of banks in corporate governance. While some commentators find the steps rather modest, many still see them as an important vehicle in the process of attracting outside capital.

Among other provisions, the KonTraG puts further limitations on the use of voting rights related to cross-shareholdings. Listed stock corporations will no longer be allowed to exercise these voting rights for the election of the supervisory board members in the other company; something that will probably make abusive cross-shareholdings less attractive in Germany. In addition, German companies may no longer

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create caps on voting right. By limiting the number of votes an individual shareholder can cast, the main objective of such voting caps has been to prevent take-overs that are not approved by management.

Abusive use of cross-shareholdings has also been seen as a complicating factor in French business, and it is worth noting that the French corporate sector for some time has been in the process of unwinding such arrangements. From 1993 to 1997 inter firm shareholdings declined from 59 percent to less than 20 percent of total market capitalisation. During the same period foreign investments at the Paris stock exchange has surged and now counts for about 30 percent of total market capitalisation.

Along similar lines, tighter oversight has been imposed on other cross-company provisions such as interlocking directorates. Directors in, for example, French, German and Italian listed companies have in recent years become subject to limitations, as regards the number of board seats they can occupy in different corporations.

The German KonTraG also stipulates rules to improve the efficiency of the supervisory board and its role in auditing. The supervisory board of a parent company must for example, not only scrutinise its own annual accounts, but also the consolidated accounts of the group. Also in Japan steps have been taken to improve the quality of financial reporting by mandating the election of an external auditor.

As for the influence by banks, new Germany legislation now clarifies that banks must submit proposals on how they want to exercise their customer's voting rights and design such proposals in accordance with the interests of the average customer. They must also take organisational measures to ensure that the bank's own interests will not influence such proposals. The bank must appoint a board member to be responsible for compliance with these rules. This board member must also supervise the final exercise of the voting rights. A more substantial amendment to the German Stock Corporation Act states that a bank may not exercise the voting rights of its customers in stock corporations in which the banks itself holds more than five percent, unless it has explicit instructions from the customers to do so, or the bank does not exercise its own voting rights.

Japan (and more recently Korea) has allowed the formation of holding companies. Commentators have argued that these holding companies, if properly structured, could take over and actually improve some of the monitoring roles presently carried out by the main banks. A pure holding company, that would govern each of its subsidiaries more independently than banks usually tend to view their "own" Keiretsu companies, could conceivably have more disciplinary power and promote managerial efficiency.

Even more important perhaps (and independent of regulatory measures) is that banks themselves in many countries are reassessing the bottom line merits of their traditional role in corporate governance. Facing increased competition some of their ownership engagements are seen as hampering their ability to develop their core businesses of financial intermediation. Germany's two largest banks have recently shifted their long term equity holdings into separate companies while the parent banks are now expected to focus on financial services. This initiative is by some observers seen as a first step to divestiture.

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Reportedly, in Japan the traditional ties between banks and industrial companies are loosening. Companies are more inclined to go directly to the international capital market for financing while banks in the recent banking restructuring have been seeking to disentangle themselves from non-financial affiliates.

Other areas where substantial progress is underway to reconcile the advantages of the traditional insider approach with the ambition to attract widespread public ownership include improved mechanisms to facilitate shareholder participation in annual meetings, for example by proxy voting. Several insider-oriented companies have also made attempts to introduce compensation systems that better align the interests of management with those of the company's shareholders.

In these as well as other efforts independent groups and professional organisations, such as accounting boards, shareholder's associations, business roundtables and stock exchanges play an increasingly important role. In areas where the mutual benefits from reform are becoming evident consensus about the basic principles of good corporate governance seem to be forming. Over the last few years several organisations and committees have been issuing national corporate governance guidelines and codes of best practice, including in Japan, France, Germany, Spain and the Netherlands. Such initiatives to improve the corporate governance culture have also been sponsored by highly recognised business organisations in non-OECD countries, including India, South Africa and Malaysia. Considering their broad backing and high level recognition, the spirit of these voluntary initiatives should over time be expected to influence not only common practices but also the structure and content of new laws and market regulations.

Other developments that can be expected to influence actual practices include overseas listings and co-operation agreements between stock exchanges. Both these avenues will expose the investment community and the corporate sector to new demands in terms of corporate governance arrangements.

### ***5. Concluding Remarks***

During the last decade, considerable efforts have been undertaken in all OECD countries to tackle the perceived shortcomings of both the outsider and the insider approach to corporate governance. Despite the fact that this task has been approached from different historical and cultural traditions, there now seem to be general agreement on the necessary ingredients of good corporate governance in public companies. These core elements consist of: a) transparent ownership and corporate structures; b) enabling informed shareholder participation; c) effective minority protection, and; d) high quality corporate information. There is also a broad consensus that policy-makers and self-regulatory bodies have an important responsibility for creating an efficient legal and regulatory framework that supports the emergence of good corporate governance. In this process, the presence of competent authorities that effectively can monitor compliance with existing rules, has proven to be a critical factor if well-intended initiatives are to become more than hollow aspirations.

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This common understanding does not mean victory of one model over the other. It should rather be seen as a possibility to provide investors and companies with more choices. In fact, an efficient pattern of ownership and control should ultimately correspond more to the needs and characteristics of the particular investors and corporations involved than to any overriding “system”. Companies should also have the possibility to move smoothly from one regime to another as their needs and circumstances changes. It is worth underlining that this need for pluralism and flexibility by no means runs contrary to a set of commonly agreed standards. On the contrary, any innovative efforts to improve corporate governance practices can be successful and accepted only if they are undertaken within a well-understood, credible and enforceable institutional framework.

Under the influence of fierce competition in financial intermediation, and an emerging consensus about the basic requirements for effective corporate governance, investors can be expected to pursue two main governance strategies in the future: a) an “arm’s length” approach that relies on pre-established governance standards to minimise risk, and; b) a “hand’s on” opportunity maximising approach characterised by customised governance arrangements in combination with transparency and full contractual clarity.

From the investor’s perspective, the two approaches represent different ways to deal with the often complex information, monitoring and incentive problems in modern companies. The two strategies are of course stylises models and in reality many investors manage their equity holdings with varying doses of pre-established standards and hand’s on monitoring. Many institutional investors however, already hold dual portfolios, which include assets that are managed under either principle in relatively pure form.

Private innovations and policy reforms to develop and improve these two governance approaches are complementary. Pursuing them will lead to a more complete set of options in each country and facilitate for both investors and companies to put in place the most effective and best-adapted governance practices. Both strategies require a solid judicial framework, and if that is in place, global market competition, investor preferences and company specific circumstances will demonstrate the merits of different approaches and their most suitable applications.

In instances where reform requirements for the two governance strategies may conflict, the policy challenge ahead for OECD countries is to strike a proper balance and delineate flourishing avenues for both approaches, without permitting efforts along one line to impede initiatives along the other. Experiences from the last two decades of public debate, private sector innovations and policy reform in the area of corporate governance will greatly facilitate this task.