Introductory note

The PFI User’s Toolkit project responds to a need for specific and practical implementation guidance revealed from the experience of the countries that have already used or plan to use the PFI.

Development of the Toolkit has entailed a process, involving government users, cooperation with other organisations, OECD Committees with specialised expertise in the policy areas covered by the PFI and interested stakeholders.

Against this background, this document offers guidance relating to the corporate governance chapter of the PFI.

The PFI User’s Toolkit is purposely structured in a way that is amenable to producing a web-based publication. A web-based format allows: a flexible approach to providing updates and additions; PFI users to download the guidance only relevant to the specific PFI application being implemented; and a portal offering users more detailed resources and guidance on each PFI question. The website is accessible at www.oecd.org/investment/pfitoolkit.
Corporate governance

Corporate governance reform is an important aspect of broader reforms 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 of Corporate Governance 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.”

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 do not reach their best possible use, society will forgo 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, and potentially profitable innovations will never be commercialised. Moreover, necessary re-structuring of individual companies and entire industries will be impaired, and productive assets will be locked into underperforming activities.

The 9 PFI questions on Corporate Governance relate to:

- Legal, regulatory and institutional framework
- Equitable treatment
- Protecting shareholder rights
- Shareholder influence
- Disclosure
- The role of the board and the rights of stakeholders
- Voluntary private initiatives
- National reviews
- State-owned enterprises

These questions provide a brief introduction to some of the key corporate governance issues that policymakers and others should address to promote a sounder environment for investment. For a more complete assessment, policymakers should turn to the OECD Principles of Corporate Governance and its assessment methodology, or visit www.oecd.org/daf/corporateaffairs.
Legal, regulatory and institutional framework

6.1 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?

Key considerations

An effective corporate governance framework requires a sound legal, regulatory and institutional foundation, upon which all market participants can rely when they enter into contractual relations. This framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices, with the balance among them determined by a country’s specific economic circumstances, history and traditions. The framework is also dynamic: as new experiences accrue and business circumstances change, the content and structure 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 corporate form of organisation of economic activity is a powerful force for growth. The regulatory and legal environment in which corporations operate is therefore crucial for overall economic outcomes. Policymakers 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. This requires a focus on the ultimate economic outcomes from interventions. When considering different policy options, it is also useful to undertake an analysis of how key variables affect the functioning of markets, such as incentive structures, the efficiency of self-regulatory systems and the way systemic conflicts of interest are dealt with.

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.

Effective enforcement and implementation A sound legal framework for corporate governance, while important, is not sufficient for ensuring the effective functioning of the capital markets. Laws and regulation, as well as 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, implementation and enforcement 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 influencing 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 negatively affects 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 PFI questions. Effective enforcement requires allocating responsibilities for supervision, implementation and enforcement among different authorities in a clearly defined way so that the competencies of complementary bodies and agencies are respected and used most effectively. Overlapping and perhaps contradictory regulations between national jurisdictions should also 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.

Further resources

Section I of the OECD Principles of Corporate Governance addresses how to ensure the basis for an effective corporate governance framework.
Equitable treatment

6.2 How does the corporate governance framework ensure the equitable treatment of shareholders?

Key considerations

Equity investors are entitled to certain property rights. 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.

The ownership structure has important implications for the corporate governance framework. In many economies, 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 other cases, ownership is controlled by the state, raising additional governance challenges (see question 6.9). Controlling shareholders have a strong incentive to monitor closely the company and its management, with beneficial effects on the governance of the company, but their interests may also conflict with the interests of minority shareholders. In worst cases, controlling shareholders extract private benefits at the expense of minority shareholders.

All shareholders pay the cost of poor corporate governance in the form of lower valuations, reduced access to equity finance, and difficulties with respect to succession planning and accessing outside talent. Moreover, the economy pays through reduced productivity, as investment funds are allocated less efficiently. To reduce these costs, some controlling shareholders take voluntary measures to improve their own corporate governance and to improve their reputation 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 signal credibly to markets that they have high standards of corporate governance. Such measures can play an important role in improving corporate governance arrangements, but they also 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. In the long run, controlling shareholders may actually benefit from legally binding and effectively enforced measures to improve investor protection.

Further resources

Section III of the OECD Principles of Corporate Governance concerns the equitable treatment of shareholders.
Protecting shareholder rights

6.3 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? What measures are in place to monitor and prevent corporate insiders and controlling owners from extracting private benefits?

Key considerations

Certain types of corporate activities involve inherent conflicts of interest among participants. Such activities should be carried out with due regard to the interests of all shareholders and include effective methods to obtain redress for grievances. The confidence of shareholders and potential investors is enhanced when the legal system provides mechanisms for shareholders to bring lawsuits at a reasonable cost and without excessive delay. A balance must be struck between allowing investors to seek remedies for infringement of ownership rights and avoiding excessive litigation, which may cause management and boards to become excessively risk averse.

An effective judiciary is also 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 and discourage potential investors. Another dimension for the redress of abusive violations of shareholder rights is through prevention. To this end, companies should fully disclose material related-party transactions to the market, including whether they have been executed at arm’s-length and on normal market terms. In discussing the content and coverage of such measures, consideration should 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.
Shareholder influence

6.4 What procedures and institutions are in place to ensure that shareholders have the ability to influence significantly the company?

Key considerations

Participation in general shareholder meetings is a fundamental right of all shareholders, both foreign and domestic, that is critical to their ability to influence the company. The procedures for notification of shareholder meetings and for casting votes should be designed to facilitate and encourage participation. This requires, inter alia, timely notification and voting systems that enable shareholders to engage in the decision making process at reasonable cost.

Access to information and reliable proxy procedures is a particular challenge in the case of foreign investors who hold their shares through chains of intermediaries. This can give rise to special challenges with respect to determining the entitlement of foreign investors to use their voting rights and the process of communicating with such investors. The obvious risks are that information from the company does not reach the ultimate shareholder and that the opinion of the same shareholder does not reach the shareholder’s meeting. Both the extent to which 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 need to be addressed.

Further resources

Section II of the *OECD Principles of Corporate Governance* concerns the rights of shareholders and key ownership functions.
Disclosure

6.5 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?

Key considerations

Actual and potential shareholders require access to regular, reliable and comparable information in sufficient detail for them to exercise their ownership rights on a fully informed and equal basis. A disclosure regime that promotes transparency is thus a pivotal feature of a market-based corporate governance system. It underpins confidence in the stock market and is a powerful tool for influencing the behaviour of companies and for protecting investor rights. Insufficient or ambiguous information will hamper the ability of the markets to function, increasing the cost of capital and discouraging investment.

A discussion about the content of disclosure standards and the dissemination procedures will naturally address numerous trade-offs related 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.

In the course of developing a strong disclosure regime, the channels, timing and procedures for disseminating corporate information can be just as important as the content of the information itself. Material information needs to reach the market and the concerned authorities in a cost-effective, easily accessible, 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 can also help to improve information dissemination.

Further resources

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.

Section V of the OECD Principles of Corporate Governance concerns disclosure and transparency.
The role of the board and the rights of stakeholders

6.6 How does the corporate governance framework ensure the board plays a central role in the strategic guidance of the company, the effective monitoring of management, and that the board is accountable 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?

Key considerations

The board should play a central role in the governance of the company. It performs the following functions:

- guiding corporate strategy
- monitoring managerial performance and replacing managers if necessary
- ensuring that the corporation obeys the applicable laws
- establishing a code of corporate ethics
- overseeing systems to achieve an adequate return for shareholders
- monitoring and managing potential conflicts of interest of management, board members and shareholders

Boards have a duty to act in the best interests of the company and its shareholders, while dealing 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 by mutual agreement should be respected.

Regardless of how the board members are chosen, in order effectively to fulfil their responsibilities, they must be able to exercise informed, objective and independent judgement, acting as representative of all shareholders. Some of their responsibilities are formalised as a duty of care and loyalty, and it is important that these concepts be 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 articulate explicitly the responsibilities that the board assumes and those for which management is accountable.

Further resources

Section VI of the OECD Principles of Corporate Governance concerns the responsibilities of the board, and Section IV the role of stakeholders.
Voluntary private initiatives

6.7 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?

Key considerations

In dealing with corporate governance issues, countries use a varying combination of legal and regulatory instruments, voluntary codes and initiatives, 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 minimise 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. Some countries have also 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, stock exchanges have imposed corporate governance requirements through their listing requirements. Corporate governance institutes or institutes of boards of directors have also been established in many countries, with an aim to promote awareness and to train directors to understand better corporate governance objectives and requirements. Some institutes have also engaged in media training programmes as another avenue for increasing public understanding of corporate governance.

Further resources
National reviews

6.8 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?

Key considerations

A PFI assessment is not a substitute for a full review of a country’s corporate governance system, and countries should consider undertaking a full review against the OECD Principles of Corporate Governance. The World Bank has completed corporate governance reviews for over 100 countries, known as Reports on Observance of Standards and Codes (ROSCs), based on the OECD Principles. Subject to the agreement of the country’s government, the World Bank publishes these ROSCs on its website. The OECD also initiated a pilot review of an OECD country’s experience in implementing the Principles, as part of its work to develop a consistent methodology for such reviews. Public discussion and disclosure of these reviews can provide a useful basis for building awareness of, and support for, improvements in the corporate governance framework and environment for investment.

Policy dialogue among the range of policymakers, institutions and other concerned parties has proven to be an effective way of building consensus for corporate governance improvements on a national and regional basis. In cooperation with the World Bank, the OECD Regional Roundtables on Corporate Governance (in Asia, Eurasia, Latin America, Southeast Europe and Russia) have used the Principles for policy dialogue to promote regional corporate governance reforms. This activity has resulted in regional White Papers which develop common policy objectives and highlight recommendations for policy action. The Regional Roundtables continue 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 support of the Global Corporate Governance Forum (GCGF) and local partners, have helped to build consensus for regional and country-based action, and for follow-up on implementation. Participation in such regional policy dialogue helps to access international expertise and build capacity – and political will – for change.

Further resources

The Practical Guide to Corporate Governance: Experiences from the Latin American Companies Circle (IFC/OECD/GCGF 2009) highlights the challenges, priorities and tangible benefits of adopting leading corporate governance practices in the region. It offers a first look at Latin American company results during the recent period of financial crisis showing that firms recognised for better corporate governance practices suffered less than average listed companies.

Resource library
State-owned enterprises

6.9 How is the ownership function of state-owned enterprises (SOEs) structured to ensure a level playing field, competitive market conditions and independent regulation? What are the processes in place to ensure that the state does not interfere in day-to-day management of SOEs and that board members may effectively carry out their role of strategic oversight, rather than to serve as a conduit for undue political pressure? How are SOEs effectively held accountable to the government, the public, and to other shareholders (if any)?

Key considerations

How the ownership function of the state is organised can influence the overall investment environment. This function needs to be clearly identified and separated from other state functions, including regulatory oversight to help ensure a level playing field for all investors, especially with regard to complying with laws and regulations. It also helps to ensure that the state, while being an active and informed owner, does not interfere in the day-to-day management of SOEs, leaving their boards with full operational autonomy to realise their defined objectives and fulfil their function of strategic guidance and monitoring of management. Board members should be nominated through transparent processes, based on competencies and experience and should act in the best interests of the company as a whole, rather than as individual representatives of the constituencies that appointed them.

Transparency and accountability go hand-in-hand with autonomy. They reassure investors that government agencies, including SOEs, exercise their powers responsibly and help to instil confidence that investors entering new markets compete on an equal basis. Following some basic corporate governance principles, including the same accounting and auditing standards as for listed companies, can help SOEs to raise their standards of accountability and transparency. SOEs should develop efficient internal audit procedures and be subjected to an annual independent external audit based on international standards. Adequate disclosure of material information is also important to foster accountability, in particular relating to any financial assistance received from the state, commitments made on behalf of the state and any material transactions with related entities. Such transactions are often an important source of an uneven playing field for investors, particularly in weak institutional environments. Publishing annually an aggregate report on SOEs, focusing on their financial performance and their valuation, and giving an overview of their evolution also helps to ensure public accountability of SOEs.

Further resources

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.

Several other OECD publications consider state ownership and corporate governance issues. See www.oecd.org/daf/corporateaffairs/soe
Resource Library

OECD

The OECD Principles of Corporate Governance (2004) provide specific guidance for policymakers, regulators and market participants in improving the legal, institutional and regulatory framework that underpins corporate governance, with a focus on publicly traded companies. They also provide practical suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance.

The Methodology for Assessing the Implementation of the OECD Principles of Corporate Governance (2006) is intended to underpin an assessment of the implementation of the Principles in a jurisdiction and to provide a framework for policy discussions. The ultimate purpose of an assessment is to identify the nature and extent of specific strengths and weaknesses in corporate governance, and thereby underpin policy dialogue that will identify reform priorities leading to the improvement of corporate governance and economic performance.

Applying RIA to Policymaking in the Area of Corporate Governance (2009) looks at a study within the OECD of the application of regulatory impact analysis in the field of the regulation of corporate governance. Noting that the requirement to undertake RIA is an established part of the regulatory systems of OECD members, this paper examines examples of the application of RIA by financial services regulators to strengthen their evidence-based policy-making, drawing on the experience of OECD member countries. It looks at how regulators have dealt with some of the challenges to effective RIA which include; defining the problem, undertaking effective consultation, and identifying and measuring costs and benefits.


Options for Obtaining Beneficial Ownership and Control Information (2002).

The Guidelines on Corporate Governance of State-Owned Enterprises (2005) are the first international benchmark to help governments in improving the corporate governance of SOEs. They are based on, and fully compatible with, the Principles but are explicitly oriented to issues that are specific to the corporate governance of SOEs.


Global Corporate Governance Forum (www.gcgf.org)

The Global Corporate Governance Forum is an International Finance Corporation (IFC) multi-donor trust fund facility co-founded by the World Bank and the OECD in 1999. The Forum sponsors regional and local initiatives that address corporate governance weaknesses in middle- and low-income countries in the context of broader national or regional economic reform programmes.

The Practical Guide to Corporate Governance: Experiences from the Latin American Companies Circle (2009) highlights the challenges, priorities and tangible benefits of adopting leading corporate governance practices in the region. It offers a first look at Latin American company
results during the recent period of financial crisis showing that firms recognised for better corporate governance practices suffered less than average listed companies.

Within its mandate to support developing and emerging markets in their corporate governance reform efforts, has launched global and regional initiatives focusing on capacity building. The Forum is developing a series of corporate governance reform toolkits to ensure effective implementation of corporate governance reform at the country level, including (1) Building Director Training Organisations; (2) Developing CG Codes of Best Practice; and (3) CG Board Leadership Training Resources Kit.

**World Bank**

[Reports on the Observance of Standards and Codes](#) (ROSCs)