OECD OCDE

International Experts Meeting on Corporate Governance of Non-listed Companies

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Hyatt Regency Istanbul Hotel
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SYNTHESIS NOTE

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I. Introduction

The International Experts Meeting on Corporate Governance of Non-listed Companies was held in Istanbul, Turkey, on 19-20 April 2005. The meeting was organised by the OECD with the support of the Government of Japan, and brought together a large number of policy makers, business leaders, and other experts to participate in a discussion on the policy implications of the on-going debate on corporate governance of non-listed companies. The presence of participants from 36 countries, many of which are non-OECD economies, from around the globe attests to the great interest in the subject. Their views constitute a unique contribution to the research on corporate governance in this area. This participation is a product of strong demand expressed by participants in the Regional Corporate Governance Roundtables[1] for the OECD to pursue work on corporate governance of non-listed companies.

In this kick-off meeting, participants addressed questions, from a range of standpoints, about the different ownership and control structures of non-listed companies, the role of professional management and transparency requirements, the corporate governance challenges in accessing outside capital, the corporate governance strategies for succession planning and conflict resolution, the role of legal and contractual mechanisms in the emergence of good corporate governance practices, and the task of policy makers to facilitate better corporate governance and business performance in non-listed companies. The discussions benefited greatly from the presentations, comments and insights from meeting participants, many of which are reflected in this synthesis note.

This note endeavours to set out the important policy issues that arose from the International Experts Meeting. It is divided into four parts, corresponding to the themes explored at the meeting: (*i*) the corporate governance characteristics of non-listed companies; (*ii*) the driving forces for improving corporate governance practices in non-listed companies; (*iii*) the role of a public policy framework in supporting good corporate governance of non-listed companies; and (*iv*) next steps.

II. Key issues discussed and preliminary conclusions

After the opening remarks of His Excellency Mr. Tomoyuki Abe, Ambassador of Japan to Turkey, and Mr. Dogan Cansizlar, Chairman and CEO of the Capital Markets Board of Turkey, Mr. Mats Isaksson, Head of the OECD Corporate Affairs Division, explained that the meeting would attempt to shed light on the relevance of the OECD Principles of Corporate Governance in countries where non-listed and often family/founder-owned companies play a pivotal economic and social role. He specified that the main focus of the meeting was to analyse and discuss the corporate governance challenges and opportunities for non-listed companies in the search for external capital. The starting point of the discussions was the experience from the Regional Corporate Governance Roundtables. The experiences on the implementation of the OECD Principles of Corporate Governance contain many important lessons for improving the business environment for non-listed companies. The adoption of professional training in corporate governance is needed to create professionalised companies in which communication channels between shareholders and managers are clear. For this purpose, attention must be given to succession planning in family-owned businesses to facilitate non-controlling shareholder involvement in these companies. Participants noted that banks and financial institutions should consider improving their monitoring of corporate governance in non-listed companies. There is also a need to build up experience and know-how on corporate governance in the

1. The Regional Corporate Governance Roundtables are organised by the OECD in partnership with the World Bank Group and local hosts in the following regions: Asia, Latin America, Russia, Eurasia, and Southeast Europe. Demand has also come from the OECD-Middle East and North Africa (MENA) Working Group 5 on Improving Corporate Governance.

courts. That said, improvement in the corporate governance environment could serve to facilitate protection of non-controlling shareholders from expropriation by controlling parties, which in turn may attract foreign direct investment in non-listed companies.

A. The corporate governance characteristics of non-listed companies

Participants stressed the importance of creating effective internal and external mechanisms for non-listed companies and the need for improved institutions to stimulate social welfare and economic growth. The discussion focused on the governance features and mechanisms that are characteristic of non-listed companies, such as: ownership and control; the role of professional management; transparency; and education and awareness. Naturally, corporate governance issues vary not only from business to business, but also across countries. For example, in the field of enforcement, some participants identified that the level and quality of the judiciary is variable. The meeting also pointed to the peculiar features of the lingering effect of the mass privatisation process that created, in a number of countries, a class of shareholders who are not fully cognizant of their responsibilities to other shareholders and the company. While the view was that privatisation in itself is a good opportunity to improve corporate governance, this point will not be taken up in this synthesis note as it is one of the central issues of OECD's programme on privatisation and corporate governance of state-owned enterprises.

The contemporary corporate governance debate

The debate on corporate governance[2] has mostly focused on listed companies particularly in countries with developed capital markets and companies with dispersed shareholdings. A leading corporate governance issue concerns the appropriate design of a legal, institutional and regulatory framework that helps to align the interests of shareholders and managers. Policy makers worldwide have looked to devise an effective framework that supplies proper incentives for the board and management to act in the interest of the company and its shareholders; and furnish investors with sufficient monitoring information. For example, one of the primary risks that non-controlling shareholders face – in both private and publicly listed companies – is that they will end up in a situation where the controlling shareholder may use his or her position to deprive the non-controlling shareholder of influence over major decisions; and/or any significant distribution of the business earnings. Many jurisdictions have legislation that can prevent abuse of non-controlling shareholders in both circumstances, and typically these measures apply to both non-listed companies and public companies.

Participants observed that in most countries around the world, both listed and non-listed firms typically operate as a closely held company with concentrated ownership. While there are substantial similarities in the problems and solutions devised for both types of companies, the typical organisational structure of non-listed companies seems to demand, in some instances, an approach different from the one used for listed firms. Shareholders in publicly held companies – unlike those in non-listed firms – are protected mostly by mechanisms aiming to constrain large shareholders due to

[2] Corporate governance is defined as the system by which business corporations are directed and controlled. Indeed, the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the company, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making and monitoring decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives and strategy are set, and the means of attaining those objectives and monitoring performance (OECD 2004).

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the presence of a market for transferable shares, and by reputational agents (*e.g*. accountants, rating agencies, and stock exchange watchdogs) who play an important role in both reducing information asymmetries and detecting fraud. Participants noted that, in absence of these external mechanisms, an alternative framework is needed to improve the performance of non-listed companies, a framework with varying levels of control and commitment to help these firms tailor the company structure to their particular preferences. According to participants, a corporate governance framework elaborated for non-listed companies could not only help to define the internal and external stakeholders' expectations *ex ante*, but also, and more importantly, assist judiciaries, auditors, lawyers and other professionals in solving problems *ex post*.

Corporate governance and the variety of non-listed companies

The general definition of "non-listed companies" used in the discussions is: closely held companies whose shares, unlike those of publicly held companies, do not trade freely in impersonal markets, either because the shares are held by a small number of persons or because they are subject to restrictions that limit their transferability (Hansmann/Kraakman, 2004). The profile of the target universe of companies is generally large companies (relative to the economy of countries where they are incorporated) that are by choice unlisted but that have financial stakeholders (equity and/or creditors) besides their controllers. This includes companies, partially or completely, under founder/family control, with professional management although the founder/family may continue to play an important governance/shareholder role. Also included are companies with experience in, or which seek to tap, private capital markets (including private equity), and understand what the corporate governance requirements are.

In the discussions on the challenges and opportunities for corporate governance of non-listed companies, participants distinguished a variety of non-listed companies, such as family-owned companies, state-owned companies, group-owned companies, private investor-owned companies, joint ventures, and mass-privatised companies. As the preponderance of non-listed companies is family-owned, these businesses attracted the most attention in the discussions. These firms are characterised by a smaller number of shareholders, no free market for the companies' shares, and substantial majority shareholder participation in the management, direction and operation of the company. Nevertheless, they do not fit into a single mould. It was clear from the discussions that non-listed companies avail themselves of different internal and external corporate governance mechanisms. Non-listed firms employ, for example, different legal business forms to structure their organisation, varying from partnership forms to limited liability companies and joint stock companies. As noted, the choice of organisation defines and determines to a large extent the internal corporate governance mechanisms. In some instances, the chosen legal business form allows for a governance structure in which the owners have joint management and control rights without a board. Other business forms require companies of a certain size to have a two-tiered system, consisting of a management board and a supervisory board. Again, this varies from country to country, as does the relationship between the two boards.

Participants noted that the effect of internal mechanisms, such as ownership and compensation regimes, also depend on how the business is financed. Most non-listed companies rely on family and bank financing for expansion and growth. However, companies that are unable to obtain bank finance because of the high risk they present, must usually attract private equity to develop their plans. Venture capital funds are a very important source of private equity capital. In the discussions that arose around this topic, participants explained the legal and non-legal mechanisms that venture capitalists usually employ to align the interests of investors, fund managers and entrepreneurs.

Internal and external mechanisms of good corporate governance

Participants identified a wide range of internal and external mechanisms that can be employed to solve the complex and costly contracting and governance problems of the firm. **Internal mechanisms** include ownership structure, the board of directors, managerial compensation, financial transparency, and adequate information disclosure. They usually arise from the nexus of relational contracts among the business participants, such as managers, shareholders and other stakeholders, which devise detailed contractual arrangements to align the parties' interests to reduce monitoring costs. For instance, companies' articles of association usually contain provisions on the composition of company boards, the internal structure and decision-making process of the company, and disclosure requirements. Incentive compensation is another mechanism often used to motivate managers to pursue risk-taking and avoid actions that are not in the interest of the company and its shareholders, creditors and other stakeholders. Compensation schemes, through which managers receive a substantial amount of their compensation from stock and stock options, provide managers with an incentive to benchmark their performance in accordance with the shareholders' expectations and to prevent overly risky actions and opportunism. Stock options, as distinct from fixed cash salaries, function as a contingent compensation that is linked to business performance. However, caution should be taken to put in place complementary institutions to make the options schemes effective.

External mechanisms, on the other hand, are market-based techniques designed to reinforce the internal governance structure of the firm. For instance, the market for corporate control furnishes shareholders of listed companies with an increased possibility to tender to a hostile offeror when the company under-performs. The threat of hostile acquisitions of the shares in under-performing companies can influence managers' incentives to forego actions that have a detrimental effect on the performance of companies. Below-market performance may facilitate equity transactions that are large enough to change control and replace management. Since there is no market for corporate control for non-listed companies, participants stressed that these would require a more complex mechanism to control abusive and under-performing managers and shareholders. They pointed to other external mechanisms, like trust and reputation concerns that are important to private equity providers. As these non-legal mechanisms can play a crucial role in preventing opportunism within companies, it was felt that extending these techniques to non-listed companies should be investigated. It was also noted that institutions, like independent registrars and chambers of commerce, could be created and existing ones strengthened to ensure that firms abide by the legal and regulatory corporate governance framework, thereby increasing trust in the market. Participants concluded that an effective system of corporate governance for non-listed companies depends on the presence of both internal and external mechanisms that are sufficiently responsive to the governance problems that occur in these companies.

Professional management

In the discussion on professional management, participants discussed different approaches to the composition and role of management on boards in non-listed companies. The need for strong board oversight was a dominant theme in the discussions. The role of independent non-executive directors, in particular, is a key issue. Independent directors were claimed to be an indispensable part of any good corporate governance framework. Some, however, pointed out that the creation of independent boards is problematic. In most non-listed companies, controlling shareholders retain the power to appoint and dismiss both the board and management of the company. Where the board remains exposed to the controlling shareholders' influence, participants argued that the effectiveness of adopting board independence rules is likely to yield few benefits. Since independence is a matter of subjective judgement rather than definition, it became clear that there are no simple solutions with respect to criteria for defining independence.

Participants also suggested that corporate governance problems could be minimised by the appointment of competent – rather than independent – professional outside directors. Another way is to foster professionalism and competency by providing training, education and support to incumbent directors. The latter approach also has the effect of strengthening self-discipline. Participants used real life experiences to show that such measures are likely to promote performance and good internal governance in a controlling shareholder system of corporate governance.

Transparency requirements

Imperfections in the financing of non-listed firms often arise because of information asymmetries between controlling and non-controlling shareholders: the controlling shareholder generally has much better information than the non-controlling investors. Participants believed that giving non-controlling shareholders full and timely access to information enhances the governance of both listed and non-listed companies. Disagreement arose, however, over the mandatory disclosure requirements for non-listed companies. In some European countries, companies are obliged to prepare and disclose to the register their annual reports and accounts but these obligations are much less demanding and informative than what is required for listed companies. Some participants were of the opinion that mandatory disclosure generates more costs than benefits due to loss of personal privacy, loss of competitive position, undermining of private property rights, direct compliance costs, and administrative costs. In their view, business participants have an incentive to avoid mandatory disclosure and incur restructuring costs because they are reluctant to disclose sensitive information. Another problem is that the information is not always timely and accurate. The usefulness of the disclosed information often depends on the experience and quality of the auditors. Discussants pointed to other means of gathering information. Venture capitalists, for instance, have developed contractual mechanisms that not only give them immediate access to the company's financial accounts, but also force the company to reveal performance problems and other essential information to the equity investors.

To be sure, shareholders may have other direct techniques for acquiring information about the performance and financial situation of the company. But corporate governance goes beyond the protection of shareholders. Companies should also aim at protecting the interests of other stakeholders, such as employees, suppliers, and creditors. The purpose of mandatory disclosure is twofold. First, stakeholders other than shareholders and managers will have access to information. Second, and perhaps more importantly, it encourages business participants, in particular managers, to analyse and understand the business. When they are used to communicating openly and clearly, the costs of mandatory disclosure will diminish significantly. It was also mentioned that the requirement for transparency could serve as a risk management tool. The distinction between internal and external transparency was further discussed. Further discussion is required, however, to clarify what exactly should be disclosed and to whom.

B. The driving forces for improving corporate governance practices in non-listed companies

Access to capital and implications for corporate governance

In the second part of the discussions on the challenges and opportunities for corporate governance in non-listed companies, participants concentrated on the driving forces for improving corporate governance practices. In particular, participants attempted to distil lessons from the ownership and financing structures of large non-listed companies. It appeared from the presentations and discussions that more research is needed. However, the preliminary research and theoretical work that was done for the Experts Meeting revealed some important conclusions, which are set out below.

The majority of non-listed companies are characterised by large or medium holdings of stock held by a family, industrial firm, or the state. Controlling shareholders in listed companies, in contrast, usually do not hold more than 50% of the total outstanding shares in a company. Empirical research indicates that the difference in ownership structure has a positive effect on company performance. Both listed and non-listed companies usually leave management in charge of the business plan and operations. But the controlling shareholder's closer levels of monitoring and cheaper intervention in the event of management failure seem to entail superior performance in non-listed companies. Increased information symmetry between the controlling shareholder and management in these firms arguably helps to create a more secure and stable environment for long-term investment strategies.

The financing structure of non-listed companies can also bring major benefits. Large controlling shareholders in non-listed companies typically prefer to finance business development with internal funds. In order to prevent dilution of the shareholder's controlling stake, non-listed companies tend to use bank finance when additional funding for expansion and growth is required. The basic structure of the debt contract gives managers a strong incentive to ensure the company's success and ability to meet the repayment requirements. As defaults on repayment would eventually deprive the managers from control, discussants argued that debt should be viewed as a disciplining device to align managers' and shareholders' interests. The policy implication is to guarantee strong creditor rights.

The role of institutional investors, particularly pension funds, banks and bondholders, was discussed. Participants noted that debt finance offers an additional advantage. Banks and credit rating agencies could help to implement good corporate governance by demanding that non-listed companies comply with best practice norms as part of the risk assessment process. Some participants noted that the Basel II accord[3], with its overriding aim of improved risk assessment procedures by individual banks, could speed up this implementation strategy for some large non-listed companies. This does not mean that private equity investors could not produce the same effect. Venture capital associations, for instance, promulgate principles that help to increase respect, integrity, transparency and confidentiality within the company. Participants noted that private equity investors encourage the implementation of these principles in articles of association and shareholder agreements before their decision to invest start-up and development capital.

Succession planning and conflict resolution

Participants stressed that since there is no real market for the shares of non-listed companies, a common concern is protecting non-controlling shareholders from expropriation by controlling shareholders. Case studies showed that it is imperative to take the interests of non-controlling shareholders into account in business decisions. This can be accomplished, for instance, by the formalisation of the board's decision-making process and the establishment of a family council. In non-listed companies, especially when personal family relationships are involved, it is of utmost importance that the directors are aware of potential conflict of interest issues. Decision-making procedures that reveal information to shareholders and increase the involvement of non-controlling shareholders prevent internal disputes. A family council, which protects and combines family and business affairs, is another mechanism for anticipating internal strife and disruption of the company's business operations before they occur.

Although there was broad consensus among participants on the importance of non-controlling shareholder protection in non-listed companies, discussants cautioned not to overemphasise the legal and regulatory protection of non-controlling shareholders. In family-owned businesses, non-

3. Bank for International Settlements issued in 2004 a new capital adequacy framework commonly known as Basel II.

controlling shareholders are often members of the second, third or later generation of the founding family. They do not participate actively in the business and leave the operations of the company to another controlling shareholder or manager. In these cases, dissatisfaction is usually associated with the reduction or expected reduction of dividends. It was clear to participants that frustrated non-controlling shareholders could be detrimental to the performance of the company. Different classes of shares may be an effective solution. Legal mechanisms that would help them to obstruct the operation of the business and make mischief for the other shareholders and family members may only exacerbate potential conflicts. According to most participants, competent and committed shareholders who recognise and understand their roles in the company are a prerequisite for the future growth and success of the company. It was stressed several times that careful and timely succession planning with a focus on training and education is crucial in a well-developed corporate governance system for family-owned firms. Also, participants discussed the need to develop efficient alterative dispute resolution mechanisms to solve conflicts within family businesses.

C. The role of a public policy framework in supporting good corporate governance in non-listed companies

Participants noted that the legal framework helps to define and determine the internal and external mechanisms of corporate governance. It was widely acknowledged that a proper legal framework can induce desired managers' and shareholders' behaviour.

In discussions about the legal and regulatory framework of corporate governance, participants examined the complex set of laws, regulations, policies, procedures, codes of best practices, plans, and other documents. It became evident that a primary source of corporate governance instruments is the company or corporation laws of individual countries. Participants pointed out the need of offering clear and simple legal rules to a firm's managers, shareholders, creditors and other stakeholders. For instance, company law plays an important role in protecting key shareholder rights. These rights enshrined in the company laws of most jurisdictions include: (*1*) attendance at annual general meetings and possibility to ask questions; (*2*) proposing shareholder resolutions; (*3*) exercising voting and cash-flow rights; (*4*) receiving information about company matters; (*5*) preventing non-pro-rata distributions; and (*6*) different classes of shares.

Company law also contains instruments that ensure that non-controlling shareholders share in the profit in proportion to their stake in the company and prevent the controlling shareholder from extracting profits. In this respect, discussants indicated the role that the duty of loyalty and care provisions play in curtailing the siphoning off of profits and other company assets. In addition, it was noted by several participants that the accessibility and legal sophistication of the judiciary and court system are essential to exercising shareholder rights. They pointed to the shortcomings of derivative shareholder actions to provide investors with the possibility of clawing back their investments appropriated by managers and controlling shareholders. On this issue, there are significant variations across jurisdictions.

In order for company law and enforcement to work effectively, participants emphasised the importance of proper disclosure practices by boards. The primary source of information for investors is the periodic publication of the company's annual accounts and reports, which is common in many jurisdictions, though different from requirements for listed companies. It was nevertheless noted that individual information rights, such as the right of inspection of the company ledger, books and other records, should protect shareholders in cases where public information is inadequate and market controls and trust are weak.

Participants noted that within the boundaries of company law, business participants should have the discretion to voluntarily – through contracts – adopt their own governance structure and shape other internal mechanisms that reflect how they want to organise their business relationship. The degree of flexibility varies across countries and legal business forms. For instance, private companies and limited liability companies tend to give more leeway to contract around company law provisions than, for instance, joint stock companies, which are predominant among publicly held firms.

In order to influence contractual flexibility, policy makers have drafted corporate governance codes that offer usually non-binding standards that reflect best practices and ensure good governance. As these codes are often based on the OECD Principles of Corporate Governance, they address the following topics: *1)* the rights of shareholders and key ownership functions; *2)* the equitable treatment of shareholders; *3)* the role of stakeholders; *4)* disclosure and transparency; and *5)* the responsibilities of the board. In general, these corporate governance codes focus on listed companies. Participants argued that these codes could also provide a useful framework for improving corporate governance in non-listed companies. The broad adoption of these norms and standards will increase trust and investment opportunities across a range of non-listed companies. There was general agreement, however, that corporate governance codes should set out the best practice principles without obliging firms to comply or explain any non-compliance. Such a formality would only increase costs and decreases the coveted flexibility in structuring the organisation of non-listed, private companies.

Participants resisted the idea of having separate corporate governance codes for non-listed companies. The diversity of non-listed business firms could be a problem in designing separate sets of corporate governance standards. In particular, participants from emerging and transition economies noted the possible counterproductive effect that a separate set of principles could have on the development of a good corporate governance system. Creating additional corporate governance codes for non-listed companies would lead to inconvenience and confusion. It would not only overshoot the target of promoting good governance, but would also hamper the creation of a corporate governance culture through raising awareness and training.

III. Next steps

The International Experts Meeting also discussed potential follow-up actions.

This kick-off meeting contributed greatly to a better understanding of corporate governance problems and possible solutions for non-listed companies. However, many corporate governance issues concerning non-listed companies remain unresolved and further in-depth discussion and research are necessary in order to assess the conclusions and remarks made at the meeting. In this regard, it is important to focus on specific issues, and take into account the diversity in geographic circumstances. The remarks and conclusions from this Experts Meeting should therefore be discussed in the OECD's ongoing corporate governance policy dialogue programmes with non-members.

First, in terms of an external framework to support corporate governance, it was agreed that non-listed companies do not need a separate set of corporate governance principles or guidelines. A code in addition to the existing local and OECD Principles could easily overstretch regulators. The question arises: What is the role of the existing OECD Principles of Corporate Governance within the regulatory framework of non-listed companies across OECD and non-OECD countries? Future issues for discussion include the legal environment, dispute resolution mechanisms, and exit procedures.

Second, internal mechanisms for improving corporate governance in non-listed companies should address improving transparency of decision-making processes as well as on training and education for

managers and shareholders. It was suggested that the OECD could play a useful role in creating awareness about corporate governance in non-listed companies.

Third, it is necessary to get a better grasp of the specific governance problems and the impact of corporate governance solutions on the performance of non-listed companies. Most research has focused on listed companies. More research is needed also about the circumstances in which legal and regulatory mechanisms provide a more efficient alternative to the generally preferred contractual arrangements.

Fourth, the International Finance Corporation's corporate governance methodology for family-owned or founder-owned unlisted companies provides a useful tool that should be further discussed. Feedback from participants was solicited and should be the subject of future discussions.

Participants had little doubt that corporate governance of non-listed companies will receive more attention in the future. The concrete experiences with different corporate governance approaches that the participants exchanged at the meeting provide an important starting point for further discussions about what policy makers can do to facilitate the development of a good corporate governance regime for non-listed companies in both OECD and non-OECD countries.

Documentation from this International Experts Meeting, including the agenda, presentations and background papers, can be found on the OECD Corporate Affairs website at www.oecd.org/daf/corporate-affairs.

