



Corporate Governance of Non-Listed Companies in Emerging Markets

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FOREWORD

While the corporate governance debate has mostly focused on listed companies in countries with developed capital markets and companies with dispersed shareholdings, the challenges of corporate governance in non-listed companies deserve special attention, especially in countries where equity markets are less developed. Relatively little attention and research has been devoted to this subject, but recent experience in implementing the *OECD Principles of Corporate Governance* contains important lessons for improving the business environment for non-listed companies.

What are the corporate governance characteristics of non-listed companies? What are the driving forces for improving corporate governance practices in non-listed companies? What is the role of a public policy framework in supporting good corporate governance of non-listed companies? These are some of the questions addressed in this publication which provides policy-makers, board members, managers, equity providers, creditors and other stakeholders with an overview of the policy issues that arise in the debate on corporate governance of non-listed companies. It will be of particular value to participants in the Regional Corporate Governance Roundtables.¹

Part I of the publication features comparative papers on the legal framework, disclosure requirements and financing of non-listed companies. Part II contains papers describing the corporate governance framework and the practices of non-listed companies in selected non-OECD countries. Taken together, the papers provide a panorama of the different ownership structures, legal traditions, cultural contexts, corporate governance challenges and possible incentives for better corporate governance of non-listed companies around the world.

The papers presented in this publication were prepared, in the context of the OECD's new work on corporate governance of non-listed companies, for the first international experts meeting held in Istanbul, Turkey on 19-20 April 2005. The presence of participants from 36 countries attests to the strong interest in this subject.

Special thanks go to the participants in the Istanbul meeting who contributed their experience and provided through their papers as well as the discussion an important basis for developing a better understanding of corporate governance practices in non-listed companies. The OECD is grateful to the Japanese government for supporting this work. The publication was prepared by Fianna Jesover from the OECD Corporate Affairs Division, edited by Beatrix Dekoster with technical support from Alexandra Geroyannis, Ijeoma Inyama and Edward Smiley.

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.

TABLE OF CONTENTS

Introduction	7
---------------------------	---

Part I

COMPARATIVE PAPERS

<i>Chapter 1</i>	Financial Disclosure - An Economic Analysis by Philip Barry	19
<i>Chapter 2</i>	Ownership and Financing Structures by Stijn Claessens and Konstantinos Tzioumis	39
<i>Chapter 3</i>	National Variation in Financing Patterns by Thomas W. Hall	65
<i>Chapter 4</i>	The Role of the Law in Developing Efficient Corporate Governance Frameworks by Erik P.M. Vermeulen	91

Part 2

COUNTRY PAPERS

<i>Chapter 5</i>	Brazil: Corporate Governance - Challenges and Opportunities by Leonardo Viegas	133
<i>Chapter 6</i>	Bulgaria: Corporate Governance of Large Non-Listed Companies by Stefan Petranov	139
<i>Chapter 7</i>	China: Policy Implications by Zhengjun Zhang	145
<i>Chapter 8</i>	Colombia Corporate Governance as an Instrument of Competitiveness by Andrés Bernal	159
<i>Chapter 9</i>	Eurasia: Corporate Governance Challenges of Non-Listed Companies by Alum Bati	163
<i>Chapter 10</i>	India: An Overview of Corporate Governance of Non-Listed Companies by Sumant Batra	167
<i>Chapter 11</i>	Kyrgyz Republic: Corporate Regulations by Nazul Abdrahmanova	187
<i>Chapter 12</i>	Lebanon: How is Professional Management Monitored? by Dr. Fouad Zmokhol	193
<i>Chapter 13</i>	Macedonia: Recent Developments by Samir Latif and Dr. Gregory F. Maassen	197

<i>Chapter 14</i>	Mexico: Corporate Governance Practices <i>by Sam Podolsky</i>	223
<i>Chapter 15</i>	Morocco: Public Policy Framework <i>by Amina Benjelloun</i>	227
<i>Chapter 16</i>	Venezuela: Promoting a National Agenda Based on Ethics, Transparency and Accountability <i>by Sonia de Paola de Gathmann</i>	231
<i>Annex 1</i>	IFC Methodology.....	243
<i>Annex 2</i>	Agenda for the International Experts Meeting on Corporate Governance of Non-Listed Companies.....	250
<i>Annex 3</i>	List of Participants.....	254

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 Roundtables¹ 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.

1. 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 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 corporate governance debate

The debate on corporate governance² 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 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 offer or 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 accord³, 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-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 alternative 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 decrease 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.

2. 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.

NOTES

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

PART I

COMPARATIVE PAPERS

Chapter 1

FINANCIAL DISCLOSURE - AN ECONOMIC ANALYSIS*

by
Philip Barry**

This paper considers, from a first principles perspective, whether large private corporations should be required by the government to disclose publicly their financial accounts.¹ In undertaking this assessment we adopt a conventional national economic welfare perspective. In particular, we assess whether the benefits to the economy as a whole of proposals for mandatory financial disclosure by large private corporations are likely to exceed the economic costs.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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Introduction

Reporting requirements for large private companies vary widely across the major industrial economies. The two largest industrialised economies, USA and Japan, do not require large private companies to disclose publicly their financial accounts. On the other hand, the three other members of the G5, Germany, France and the UK, do require large private companies to disclose publicly their accounts. In those countries that require disclosure by private companies, alternative legal structures are often available that permit enterprises or their owners to avoid public financial disclosure, albeit at a cost in terms of the compliance or restructuring costs incurred.

The Table 1.1 below summarises our overall assessment of the costs and benefits of requiring large private corporations to disclose publicly their financial accounts.

Table 1.1 **Overall assessment of the costs and benefits of mandatory financial disclosure by large private corporations**

Benefits	Costs
Reduces costs of credit	Loss of personal privacy
Information for other stakeholders	Loss of competitive position
Information for resreachers	Undermining of private property rights
	Direct compliance costs
	Administrative costs

The primary benefit of mandatory disclosure is that certain creditors may have better access to information on the financial performance and position of the company. That benefit is likely to accrue largely, if not fully, to the disclosing company through, for example, lower interest rates on its loans. One would normally expect that such a benefit would be taken into account by the company when it considers whether to disclose voluntarily or not.

There may also be some benefits to other stakeholders (*e.g.* employees) or other interested parties (*e.g.* academic researchers) who may not otherwise have access to such information.

The costs of compulsory disclosure are likely to include:

- a loss of privacy, as information of a personal nature on the financial position and performance of closely held firms is made public;
- a loss of competitive position for companies that combine through a co-operative or franchise structure relative to business enterprises that are part of a single company. The individual member companies in the co-operative or franchise would be required to disclose publicly their accounts while their competitors that are part of a single consolidated company will only be required to report publicly at the consolidated level;

- undermining of private property rights. We take as a starting point that the financial information of private corporations is a private good, not a public one;
- increased direct compliance costs, including the additional costs companies incur of having to produce, have audited and file the necessary financial statements;
- the costs the government incurs in having to administer the scheme, including in recording the accounts, making them available for viewing by the public and enforcing the rules; and
- the restructuring costs that companies may incur as they seek to get around the mandatory disclosure requirements.

The restructuring costs are costs companies will incur as they seek to avoid having to incur the other costs noted above. Therefore, the restructuring costs should not be regarded as additional to the other costs noted above.

Because they are costs a company would be prepared to incur to avoid even greater costs, the restructuring costs can give a useful indication of the minimum level of overall costs that a closely-held company and its shareholders expect to incur as a result of the policy. Some large private companies have stated they will take “whatever steps are necessary” to avoid any proposed regulatory changes that would make public financial reporting compulsory in New Zealand. One such company, Foodstuffs NZ Ltd, estimates the direct costs of restructuring that the group would incur to be around USD 15 million to USD 30 million (excluding any allowance for tax imputation credits that might be lost).² It is very difficult to see that the benefits to legitimate users of the accounts (*i.e.* users other than competitors) would exceed this amount. Indeed, figures from Australia indicate that the publicly stored accounts of large private corporations are only accessed around three to four times per year on average.³

Overall, in our assessment, the benefits of introducing a regime of mandatory financial reporting for private companies are unlikely to outweigh the costs. The costs of the proposal for mandatory public reporting for large private companies appear to be relatively large and definitive. The benefits, on the other hand, are either likely to be contracted for voluntarily or are likely to be minor. Indeed, given the absence of significant externalities, if the benefits of disclosure did outweigh the costs, it is likely that companies would disclose voluntarily their accounts (as companies often do for substantial creditors).

In conclusion, in our view countries should be cautious about changing their regulatory regimes to mandate financial disclosure by private companies. Some countries, principally the European members of the OECD, have a tradition of requiring such disclosure. However, in those countries alternative institutional or business forms are likely to have evolved that permit private enterprises and/or their owners to avoid public financial disclosure where they value such privacy highly enough. Where a country does not have a history of requiring public disclosure by large private corporations, the analysis in this paper suggests that such countries should treat with caution any proposals to change their regimes and compel private companies to file their financial statements publicly.

If change in the regulatory regime is required, one option is that disclosure be mandated but with shareholders of private corporations having the ability to vote for the company opting out of having to disclose publicly its accounts. This “opting-out” proposal would permit companies to avoid having to incur the costs of mandatory disclosure noted above, and leaves it in the shareholders’ hands to decide ultimately whether their companies’ accounts are in the public domain.

This paper provides, from a first principles perspective, an analysis of whether large private companies should be required to disclose publicly their financial accounts.⁴

In this assessment we take a national interest perspective, applying the tools of conventional welfare economics to assess whether it is likely to be in the national economic interest to mandate financial disclosure by private companies. Our analysis draws in particular on the insights from institutional economics, transactions costs economics, public economics, public choice theory and the relevant empirical literature.

This paper begins by presenting a conventional framework for analysing public policy. The next section applies this framework to the issue of whether governments should require private companies to file publicly their financial reports. In particular, we focus on the nature of the problem that proposals to make filing by private companies mandatory seek to address, the costs and benefits of the proposed policy and whether the costs of the proposal are likely to outweigh the benefits. The final section of the paper provides our overall conclusions. Annex 1 to the paper summarises the reporting requirements for large private corporations in the G5 countries. Annex 2 describes the current requirements for reporting in New Zealand and the changes to that reporting regime proposed in a recent New Zealand government discussion document. The third Annex provides an examination of the case for harmonising New Zealand's reporting regime for private companies with that of Australia.

An Assessment of the Case for Mandatory Disclosure

1. The framework

This paper considers whether large private corporations should be required by government regulation to disclose publicly their financial accounts. In undertaking this assessment we adopt a conventional national economic welfare perspective. In particular, we assess, from a first principles perspective, whether the benefits to the economy as a whole of proposals for mandatory financial disclosure by large private corporations are likely to exceed the economic costs.

A good summary of the key steps in the analysis and design of public policy is provided in the public policy guidelines issued by the New Zealand Ministry of Economic Development.⁵ These guidelines state that “best practice” design public policy should be based on:

1. identifying clearly the nature and magnitude of the problem and the need for government action;
2. identifying the public policy objective(s);
3. identifying the feasible options (regulatory and/or non regulatory) that may constitute viable means for achieving the desired objectives(s);
4. assessing the net benefit of the proposal, including the total regulatory costs (administrative, compliance, and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options; and
5. undertaking appropriate consultation on the proposal.

We apply this framework for public policy analysis in our assessment of proposals to make reporting by large private corporations mandatory.

2. What is the problem?

As noted above, the first step in public policy analysis is identifying clearly the problem that needs to be addressed. Without this first critical step being undertaken carefully and rigorously, the subsequent

policy analysis can go off the rails: one can be left, at the end of the process, with “a solution in search of a problem.”

In the case of a proposal for mandatory disclosure by private companies, it is not clear what problem such a proposal is seeking to address. The case provided for mandatory filing rests typically on the assessed interests of other stakeholders who are seen to face an “asymmetry of information” without mandatory disclosure.⁶ It might be suggested that such asymmetry of information reflects a “market failure” that justifies government intervention. However:

- information on the financial affairs of a closely-held company is a private, not a public, good;
- just because there may be others who could benefit from access to a private good does not mean the government should dictate that these others should have access to it at no charge. Many people have holiday homes around the country that are little utilised and which, no doubt, others could benefit from if they could access them. However, the government doesn’t attempt to weigh up the costs and benefits to the different potential users of their having access to these homes. Nor does the government mandate public access to these assets;
- there are private solutions to information asymmetry. The costs of not disclosing financial information for a company are likely to be largely, if not fully, borne by the company itself. For example, Myers and Majluf (1984) show that when insiders know more about a firm’s prospects than outside investors, securities can be “lemons” so that firms can only issue new securities by offering them at a discount. If a closely controlled company does not supply the information that creditors want, the company either will not get the credit or will have to pay a higher price for it. Indeed, banks will often require from borrowers much more detailed and timely information (*e.g.* monthly financial reports on specified financial ratios) than is required by statute. If a company refused to supply such information to the lender, it would have to finance its investment opportunities in other ways.

Even if there is some remaining “market failure” (or “incomplete contracting”), this does not automatically justify government intervention.⁷ The costs of government intervention need to be assessed against the cost of not intervening. Such an assessment involves a comparison of the costs of contracting via the market with the costs of collective action via the government. That is, it involves assessing whether the costs of voluntary contracting to address the perceived “information asymmetries” are greater or less than the costs of coercive “contracting” (*i.e.* government intervention). As is discussed below, in the case of disclosure of financial information by closely held corporations, it seems unlikely that the costs of voluntary contracting would typically be large. The main beneficiaries of mandatory financial disclosure by large private firms are likely to be relatively few in number, being certain creditors and competitors.^{8,9} Further, as is discussed below, the benefits of mandatory disclosure for creditors are unlikely to be large, as creditors always have the option of not lending if the company will not voluntarily disclose the required information. However, the costs of the proposed government intervention may be large (as is discussed below).

3. *Other suggested benefits of mandatory financial disclosure*

Several other arguments are sometimes put forward for justifying mandatory public filing by large private corporations. These arguments are addressed below.

1. **Entity neutrality:** it is sometimes claimed that because publicly listed companies must disclose their financial statements, then large private corporations should have to do so also. This is seen by some as promoting a “level playing field” between different organisational types (or what is claimed by some as promoting “entity” or “competitive” neutrality).

There is a very good case for government policy – through its taxation, regulation or other policies – not to distort a business’s choice of organisational form (and other business decisions). However, it is a misunderstanding of the concept of competitive neutrality to argue that because one enterprise chooses to operate under one set of rules or in one particular organisational form, all other enterprises should have to do so also. When a company voluntarily chooses to list on the stock exchange, it inevitably accepts certain costs, one of which is the requirement to publish its financial statements. It does not follow that other enterprises, which do not choose to operate as publicly listed companies, should therefore be required to incur the full costs of listing also. That would be akin to saying that because one football team chooses to go on the field with an extra striker, and one less defender, the other team should be required to have one less defender also.

Paradoxically, a quest for “entity neutrality” between public and private companies, in terms of financial reporting, would in fact generate a new “non-neutrality” between different forms of enterprises. As is discussed below, the owners of co-operative enterprises and franchises will be put at a serious competitive disadvantage relative to their “single-company” competitors.

2. ***Economic significance***: it is sometimes suggested that the “economic size or economic footprint” of an enterprise should determine whether an enterprise should have to report publicly. The argument is that because a large enterprise affects many people, the people it affects have a right to access the financial information of the enterprise.

Size is one consideration in determining the case for mandatory public disclosure, but it is not clear if this is a sufficient or even a key consideration in determining the appropriate degree of public financial disclosure by an entity. Size is relevant to the extent that it influences the relative costs of compiling reports to the required standards. But it is an enterprise’s choice of corporate form, and in particular the nature and dispersion of the shareholding, not the size of the enterprise *per se*, that is the principal determinant of whether financial reports should have to be public or not. If the overall regulatory framework is right – and in particular if the government has confidence in its overall competition policy – then there is no obvious reason to be concerned with the size of an enterprise. Just because one or many outsiders have an interest in the financial position of the company does not give those outsiders an automatic right of access to the financial records of the enterprise.

3. ***Limited liability as a privilege***: it is argued by some that “limited liability” is a privilege and one of the costs of that privilege should be disclosing the information necessary to make objective assessments about the company, particularly financial reports”.¹⁰

This argument is flawed. As the New Zealand Business Roundtable has noted, “...limited liability is not a privilege. It is simply an implicit contractual arrangement and existed under common law before company statutes were created.”¹¹ Anyone trading with XYZ Limited knows that those who put money into it do not have a general legal liability beyond the funds invested. That is what “limited” means. The limited liability regime has proved to be a hugely successful institution that is of great benefit to all participants in the economy and to the nation as a whole.¹²

Overall, as Benston points out when assessing the claimed benefits of mandatory financial reporting, there is usually no attempt to examine rigorously what the real benefits are and to put a value on them.¹³ General purpose financial reports typically are unlikely to provide sufficiently useful and timely information to external stakeholders to warrant mandatory filing. Further, mandatory disclosure

can actually lead to the disclosure of financial information that can be misleading or can suppress information that may otherwise have been provided voluntarily. An example of the former can be companies reporting asset values at “fair value”, when “fair values” must be derived from estimates rather than actual market values. An example of the latter is that the SEC previously prohibited the inclusion of forecast financial information in prospectuses.

4. *Have all the costs been taken into account?*

Discussions of the costs of mandatory financial disclosure tend to focus on the direct compliance costs (*i.e.* the costs of producing, auditing and filing financial reports). While important, these direct compliance costs are likely to be dwarfed by the broader economic costs of mandatory disclosure.

These economic costs include potential competitiveness costs; the broader costs to the economy associated with a taking of private property rights; and the cost arising from the loss of personal privacy. These costs are likely to be reflected in the restructuring costs private companies are prepared to incur to avoid having to disclose their financial accounts.¹⁴

A. *The competitiveness implications for certain business structures*

Requiring private companies to disclose publicly their financial statements could result in a loss of competitive position for companies that combine through a co-operative or franchise structure relative to business enterprises that are part of a single company. This is because the individual member companies in the co-operative or franchise would be required to disclose publicly their accounts while their competitors that are part of a single consolidated company are required only to report publicly at the consolidated level.

A good example of these competitive consequences is provided by the retail food sector in New Zealand. Currently the retail food sector in New Zealand is dominated by two groups, the Foodstuffs group (a co-operative) and Progressive Enterprise Ltd (an Australian-owned company). Together these two groups account for almost 100% of supermarket sales. Currently Progressive (as an overseas-owned company) is required to file publicly its accounts at the consolidated level, while the Foodstuffs co-operative group publicly issues reports at a broadly similar aggregate level.¹⁵ Neither Progressive nor Foodstuffs is currently required to disclose the financial performance of their individual supermarkets.

If private companies were required to disclose their accounts, the individual supermarkets in the Foodstuffs co-operative group would be required to release publicly their financial statements. This is because, within the co-operative, the individual supermarkets are separate companies, each of which owns shares in the co-operative group.¹⁶ However, Foodstuff’s sole major competitor, Progressive, would still be required only to disclose its accounts at the group (consolidated) level. As a result, Progressive would have access to information on the financial performance and position of individual supermarkets in the Foodstuffs group. This could permit Progressive, if it chose, to single out those Foodstuff supermarkets most vulnerable to attack. Foodstuffs, however, would not have access to the accounts of the individual supermarket business units of its competitor.

Similar, seemingly perverse competitive effects could arise with franchise arrangements. In the fast-food market in New Zealand, for example, a number of companies that report at the group level compete with franchisees. For example, the publicly listed Restaurant Brands NZ Ltd that operates the Kentucky Fried, Pizza Hut and Starbucks Coffee outlets competes with the individual, independently owned franchisees in the McDonald’s chain. These individual McDonald franchisees could have to report publicly their financial position, while their local competitors that are part of the Restaurant Brands Company would not.¹⁷ Similarly, in the retail “do-it-yourself” (DIY) market in New Zealand, the individual, independently

owned and operated Mitre ten stores may have to file their accounts while the stores owned by their “single-company” competitor, Bunnings, would not have to (except at the national level).

As can be seen from the above examples, requiring large private companies to disclose their financial statements would disadvantage the combining of individual enterprises through a co-operative or franchise structure and advantage the alternative of a number of enterprises being wholly owned, since the latter business structure is not required to release financial information except at the consolidated level. As a result, an attempt to achieve “entity neutrality” between public and private companies will end up undermining neutrality between separately owned and wholly owned business structures. It is not clear what policy reason there would be for favouring the former form of “neutrality” over the latter. Our conclusion is that the concept of entity neutrality as applied in this context is fundamentally flawed.

B. The lack of regard for private property rights

The importance of secure private rights for economic prosperity is emphasised by such institutions as the World Bank and the International Monetary Fund, and in contemporary economic literature.¹⁸ Indeed, arguably the most important protection afforded to the individual by the law is the protection of his or her property (broadly defined).

The financial accounts of closely held companies are private property. Proposals to require large private corporations to disclose their accounts seem to pay little or no attention to this consideration. Instead, it is proposed that regulations be passed to remove the private property rights in the “national interest”, with no suggestion of compensation and quite insufficient analysis of whether the so-called benefits outweigh the costs.

C. Privacy costs

If their companies have to make their financial accounts public, the loss of personal privacy is typically a major issue for owners of closely held corporations. Often private companies are family-owned and may be a single husband and wife team. Further, such family-owned businesses can be located in smaller cities and towns where they may be the largest business in the city/town. In such smaller communities, the consequence of a loss of personal privacy can be especially large.

D. Incentives to restructure

Where a regulation imposes costs on a company, the business will naturally have an incentive to take steps to minimise or avoid the effects of the regulations. In the case of mandatory financial reporting for large private corporations, the costs noted above are likely to be large, especially for some companies, and these companies will face strong incentives to restructure their operations in a way to try and avoid the effects of the regulations.

One large privately owned company, Foodstuffs NZ Ltd., has estimated that it will cost them between around USD 15 million and USD 30 million to restructure their organisation to avoid the consequences of government proposals to make financial disclosure mandatory. This estimate does not include an allowance for taxation consequences (imputation credits that may be lost by the individual companies). Nor does the estimate include an allowance for the losses in business efficiency that may result from the changes to Foodstuffs’ business model that are required to avoid the proposed legislation.

The restructuring costs are a deadweight loss to the economy. They reflect an expenditure of resources that is incurred simply as a result of the regulations. It should be noted, however, that the costs that are incurred to avoid the consequences of regulations are not additional to the other costs of the

regulations noted elsewhere in this paper. The restructuring costs are incurred to avoid companies facing these other costs (like a loss of privacy) and therefore to the extent the company is successful in achieving its aim, the other costs will not be incurred.

Because restructuring costs are costs that a company is prepared to incur to avoid even greater costs, restructuring costs can give a useful indication of the minimum level of costs that a company expects to incur as a result of the policy. Foodstuffs have advised us that they will take “whatever steps are necessary” to avoid the proposed financial reporting regime (largely to avoid the loss of competitive position and to avoid the loss of privacy for the owners of the individual supermarkets). The USD 15 million to USD 30 million restructuring costs Foodstuffs is prepared to incur, therefore, gives an indication of the possible magnitude of the costs the proposed policy change would impose on one large private New Zealand company.

5. *Do the overall benefits outweigh the costs?*

The Table 1.2. below provides our assessment of the overall likely costs and benefits of the proposal to require large private companies to disclose their financial statements.

Table 1.2 Overall benefits and costs of mandatory financial disclosure by large private corporations

Benefits	Costs
Reduces costs of credit	Loss of personal privacy
Information for other stakeholders	Loss of competitive position
Information for researchers	Undermining of private property rights
	Direct compliance costs
	Administrative costs
	Restructuring costs

The principal benefit of mandatory financial disclosure is that other stakeholders or interested parties will have access to the information. Considering each of the principal parties in turn:

- in the case of creditors, economic theory indicates (as noted above) that the benefits, if any, are likely to be largely, if not fully, captured by the disclosing company. Further, creditors may well require more timely and detailed information than is available from annual financial reports;
- in the case of competitors, providing them access to otherwise commercially confidential information is likely to be detrimental rather than beneficial to the economy as a whole;
- in the case of employees of the large private company or other groups who are not able to contract for the information, the benefits are likely to be small, if any. Indeed, employees of the company may be worse off if public disclosure of the accounts undermines the competitive position of their employer; and
- there are likely to be benefits, albeit relatively minor, to some researchers (*e.g.* academics) and the users of their research.

The other claimed benefits from mandating disclosure for private companies have been considered above and are not found to provide a compelling case for mandatory disclosure.

Overall, on the basis of our analysis, it seems difficult to conclude in this case that the benefits of intervention outweigh the costs. The costs of the proposal for mandatory public reporting for large private companies are substantial and definitive. The costs include the loss of personal privacy, the loss of competitive position, the undermining of private property rights, and the increased compliance costs the companies are likely to incur. The benefits on the other hand are either likely to be contracted for voluntarily or are likely to be minor. Indeed, given the absence of significant externalities,¹⁹ if the benefits of disclosure did outweigh the costs, it is likely that companies would already disclose their accounts (as companies often do for substantial creditors). The fact that companies do not choose to disclose publicly their accounts suggests that the costs to the companies of disclosing publicly their accounts exceed the likely benefits.

Conclusions

The analysis provided in this report indicates that introducing a requirement that large private corporations must disclose publicly their financial statements is unlikely to achieve an appropriate balance between the costs and benefits. Requiring large private corporations to disclose publicly their accounts is likely to impose definitive and significant costs, while the benefits of the proposal are unclear.

The costs arise from the adverse consequences for personal privacy, the lack of commercial confidentiality, the loss of personal property rights and the increased direct costs companies will incur from having to comply (and/or the costs they will incur seeking to avoid the regulations). The benefits, on the other hand, of disclosing more information are likely to accrue largely, if not almost completely, to the disclosing company. Those benefits would be expected to be taken into account by the company in its own consideration of what information it chooses voluntarily to disclose and to whom.

The regulatory requirements for financial reporting by large private companies vary widely amongst OECD countries. In countries that have a tradition of requiring disclosure, alternative institutional or business forms are likely to have evolved that permit private enterprises and/or their owners to avoid public financial disclosure where they value such privacy highly enough. However, in countries that do not have a history of requiring public disclosure by large private corporations, the analysis in this paper suggests that such countries should treat with caution any proposals to change their regimes and compel private companies to file their financial statements publicly.

NOTES

1. In New Zealand, private corporations are not required to disclose publicly their financial accounts at present. However, the New Zealand Ministry of Economic Development (MED) has proposed in a recent discussion document, "Review of the Financial Reporting Act 1993, Part II", that large private corporations should have to disclose publicly their financial accounts.
2. The combined turnovers of the member companies of the Foodstuffs Group make them the 2nd largest trading group in New Zealand.
3. MED (2004), p. 56. Australian legislation (the Corporations Act 2001) requires that large proprietary companies file audited financial statements with the Australian Securities and Investments Commission.
4. The definitions used for "large" for private corporations differ across countries. For G5 countries that apply a simple definition for financial disclosure purposes, a company is defined as "large" if its sales are greater than around USD 10 million, assets are greater than around USD 5 million and it has more than 50 employees (with a two out of three test applied). Refer to Annexes 1 and 2 for more details on definitions used by individual countries.
5. Refer MED (1999).
6. MED (2004) p. 34.
7. For a good discussion of the fallacies of applying a simple market failure analysis in the case of financial reporting, refer to Leftwich (1980).
8. Our assertion that the users of the accounts of large private corporations are likely to be relatively few is supported by evidence from Australia. In Australia, where large private corporations must disclose their accounts, the information is typically accessed only three or four times per year on average (MED, 2004, p. 56).
9. If there are only few users of the accounts of large private corporations, the obvious question is why could those users either jointly or separately not contract with the company to provide the desired information? As is noted above, creditors do in fact often contract for disclosure of financial information. In the case of competitors, the reason such contracting does not generally occur is most likely because the costs to the disclosing firm of providing the information are large.
10. MED (2004), p. 54.
11. Day, B. (2002).
12. Epstein (1995).
13. Refer Benston (1977) and (2003).
14. In the US, following the passage of the Sarbanes-Oxley Act of 2002, with its increased disclosure and related internal-control requirements, the number of companies that have decided to "go dark" (*i.e.* cease

filing their accounts with the SEC by deregistering their securities) has increased significantly. Refer to Leuz, Triantis and Wang (2005).

15. The Foodstuffs group is comprised of three member companies – Foodstuffs (Auckland) Ltd, Foodstuffs (Wellington) Co-operative Society Ltd. and Foodstuffs (South Island) Ltd. – and the umbrella national organisation, Foodstuffs (N.Z.) Ltd. Currently the three regional Foodstuff co-operatives publicly file their accounts.
16. The individual Foodstuffs supermarkets are almost without exception family companies comprising only one or two shareholders, and are therefore not required to disclose publicly their financial accounts at present. Under s3(2) of New Zealand’s Securities Act, an offer of securities made to relatives or close business associates of the issuer does not constitute an offer of securities to the public. Further, under s6 of the Financial Reporting Act, companies with less than 25 shareholders are not deemed to be “issuers” of equity securities.
17. Whether the individual McDonald franchisees would have to disclose would depend on their size: under the proposed reporting thresholds, only the largest franchisees would be likely to have to file their accounts.
18. See, for example, Landes, D. (1998), North, D. (1990) and Olsen (2000).
19. As is noted above, economic theory indicates that the costs of not disclosing are likely to be borne primarily by the company itself. Or to put it another way, the costs of voluntary contracting to get around the perceived “externalities” do not appear to be great.

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ANNEX 1

REPORTING REQUIREMENTS FOR PRIVATE COMPANIES IN THE G5

This Annex summarises the financial reporting requirements for non-listed companies in the G5 countries (USA, Japan, Germany, France and UK). While best endeavours have been made to ensure the accuracy of the summary material provided in this paper, the reporting requirements in individual countries are multifaceted and can be complex. Further, within federal countries, the reporting requirements can vary from state to state.

United States of America

In the USA there is no federal statutory requirement for private corporations to have their accounts audited or to make their accounts public.

Issuing companies (*i.e.* companies that issue securities to the public and are registered under the Securities Exchange Act, 1934) are required to file publicly their audited accounts with the Securities and Exchange Commission (SEC). Further, all companies with more than 500 equity security holders of record and more than USD 10 million in assets, regardless of whether they have ever “gone public” (*i.e.* had their securities registered under the Securities Exchange Act), have to file their accounts with the SEC. In addition, companies which de-register but still have 300 security holders of record or more must continue to file with the SEC.¹

Every state also has its own securities laws – commonly known as “Blue Sky Laws”. These regulations are extensive and require registration of securities offerings, and registration of brokers and brokerage firms. The exact laws vary from state to state, with each state having its own regulatory agency, typically known as the state Securities Commissioner, which administers the law.² As best we have been able to ascertain, there is no requirement at the state level for audit or disclosure of financial statements for private companies. Individual states would be unlikely to require disclosure as it would not be difficult for companies to migrate their place of incorporation to states that have a favourable regulatory environment.

In addition to the federal and state legislative requirements, where a company’s securities are listed on an exchange or market, that exchange or market can impose its own listing requirements. Thus, for example, both the NYSE and NASDAQ require securities listed on their respective exchanges to be registered under the Securities Act (and therefore for the company to file its accounts publicly). Companies whose securities trade on the “Over the Counter Bulletin Board” (OTCBB) are also required to file their accounts with the SEC. However, companies whose securities trade through other systems, such as the “Pink Sheets” (a daily publication compiled by the National Quotation Bureau containing price quotations for over-the-counter stocks) are typically not required to be subject to SEC reporting requirements and do not have to file publicly their financial statements.

Japan

In Japan, public disclosure of financial statements is not required for private companies.

Large private companies are required by the Japanese commercial code (law) to have their accounts audited by an independent auditor. A company is defined as large if it has stock capital over 500 million yen or total liabilities exceeding 20 billion yen. Audited reports must be included in the agenda for the ordinary meeting of shareholders. The ordinary meeting should be held within three months of the company’s balance sheet date.

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1. For further information on the SEC requirements, refer to <http://www.sec.gov/about.shtml> and http://www.sia.com/capitol_hill/html/securities_act_of_1933.html.
 2. For more information, refer to www.seclaw.com/bluesky.htm.

Germany

In Germany, large private corporations are required by law to file their financial statements with the commercial register where the company is incorporated. The financial statements are then publicly available.

Audit requirements depend on the size of the company. A company's financial statements have to be audited if two or more of the following three criteria apply.

The company has:

- sales exceeding around 8 million euros;
- total assets exceeding around 4 million euros;
- more than 50 employees.

The company has to prepare consolidated financial statements if its consolidated sales exceed around 38 million euros, its consolidated total assets exceed around 19 million euros and the consolidated companies have more than 250 employees. If two of the three before mentioned criteria are met, the consolidated financial statements have to be audited.

France

In France, all companies have to publish their statutory financial statements, their consolidated financial statements and their management report. The statements have to be publicly available after each annual general shareholders' meeting. The accounts have to be available to anybody who requires them and who asks for them at a specific "desk" of the commercial court.

Whether a company has to have an external audit depends on the legal form of the enterprise and its size:

- enterprises with the legal form SA (*Société Anonyme*), SCA (*Société en Commandite par Actions*) and SAS (*Société par Actions Simplifiée*) must have a statutory auditor, regardless of their size;
- enterprises with the legal form SARL (*Société à Responsabilité Limitée*) only need a statutory audit if their numbers (during the two preceding years) are higher than a total balance sheet of 1.55 million euros, a turnover of 3.1 million euros, and 50 people.

All these enterprise forms can be private or public companies.

United Kingdom

All limited liability companies in the UK are required to disclose publicly at least some financial statements. The accounts have to be filed with the Registrar of Companies.³

Large private British companies are required to disclose publicly their financial accounts. Generally these accounts must include:

- a profit and loss account;
- a balance sheet signed by a director;
- an auditors' report signed by the auditor;
- a directors' report signed by a director or the secretary of the company;
- notes to the accounts; and
- group accounts (if appropriate).

3. For detailed information on UK filing and auditing requirements, refer to <http://www.companieshouse.gov.uk>

For smaller companies, these accounts may be in abbreviated form (basically just a balance sheet) and the accounts need not be audited. However, they are still on public record. To benefit from a “small” company exemption, as set out in the Companies Act, two of the following three criteria must be met:

- turnover less than 5.6 million pounds; and
- net assets less than 2.8 million pounds;

No more than 50 employees

Companies that are public companies, carrying on regulated activities under the Financial Services and Markets Act 2000, trade unions or a parent or subsidiary (unless part of an eligible group) must have their accounts audited.

The most common large organisations that do not have to publish financial information are partnerships, such as accountants and lawyers. However, other legal forms are available that may permit people to avoid having to disclose their private finances. These legal forms include family or trading trusts and privately held groups with offshore intermediate holding companies.

ANNEX 2

PROPOSED CHANGES IN NEW ZEALAND

This Annex summarises the current financial reporting requirements for companies in New Zealand and outlines proposals in a recent discussion document issued by the New Zealand Ministry of Economic Development that “large” private companies be required by the government to file publicly audited financial accounts.¹

Current reporting requirements in New Zealand

Currently, under New Zealand’s Financial Reporting Act 1993 (“FRA”), only “issuers”, “overseas-owned companies” and public sector companies are required to file publicly their financial reports.²

In regard to closely held corporations (that are neither “issuers” nor “overseas owned”), the current New Zealand legislative requirements are that they must:

- prepare financial statements that comply with Generally Accepted Accounting Practices (“GAAP”);³ and
- have audits performed, unless a unanimous shareholders’ resolution is passed (annually) that no audit is required – refer to the Companies Act s196(2).

There is, therefore, no requirement for the great majority of closely held companies to file financial statements – as noted above, the FRA limits this requirement to “issuers” and “overseas companies”.

The discussion document’s proposals

The New Zealand Ministry of Economic Development (“MED”) is currently reviewing the FRA. As part of its review, the MED has issued a discussion document in which it is proposed that “large” private companies be required by the government to publicly file audited financial accounts.

A private company is defined as “large” if it passes a “two out of three” test. Specifically, a company is defined as large if it satisfies two of the following three criteria.

The company has:

- consolidated assets of USD 10 million (or more);
- consolidated operating revenue of USD 20 million (or more);
- 50 full time equivalent employees (or more).

Under the discussion document’s proposals, private companies that are not “large” (as per the above test) would be able to opt out of the requirement to disclose publicly their accounts or have them audited if 100% of shareholders agree. However, if one or more shareholders object to the proposal to opt out, the (“not large”) private company would have to disclose its reports publicly and/or have them audited.

1. MED (2004).

2. “Issuers” are defined in the FRA as including listed companies and any other company that has issued securities for which an investment statement or a registered prospectus is required under the Securities Act 1978. “Overseas-owned companies” are defined as companies where 25% or more of the voting rights are held by a non-resident or by a company or subsidiary of a company incorporated outside New Zealand.

3. Unless the company is very small (with assets less than USD 450 000 and revenue less than USD 1 000 000), in which case it need only produce very basic financial reports that are not filed and, if all shareholders agree, do not have to be audited (refer to FRA s2 for a complete definition of “exempt” companies).

Companies would be able to apply for exemption from the above requirements to a reconstituted Accounting Standards Review Board (ASRB). No guidance on the criteria the reconstituted ASRB would use for providing such exemptions is provided in the discussion document.

The above proposals are stated as the MED's "preferred approach" in relation to private companies. The discussion document also includes an alternative proposal that would permit large private companies to opt out of the mandatory provision if 100% of shareholders agree (the MED's "alternative approach"). Under this alternative proposal, a large private company – just like a small one – would have to disclose its reports publicly and/or have them audited if one or more shareholders object to the proposal to opt out.

ANNEX 3

THE CASE FOR EFFECTIVE HARMONISATION WITH AUSTRALIA

Australia currently requires large private companies to file publicly their financial accounts. An argument sometimes put forward for making public reporting for large private companies mandatory in New Zealand is that New Zealand should harmonise its regime with Australia's.

The first question to consider is whether alignment between New Zealand's and Australia's reporting regimes is being sought because Australia's regime is regarded as "international best practice" or because harmonisation with Australia's regime is being sought as a goal in itself.

If Australia's reporting regime is assessed to be international best practice, then alignment with Australia may be appropriate. However, there is little evidence that the Australian regime is considered best practice. Indeed, the Australian regime was reviewed by the Australian Parliamentary Joint Statutory Committee, with the majority of the Committee recommending changing the reporting requirements so that "large" private companies did not have to disclose publicly their accounts.¹

Even if Australia's current regime were considered international best practice, it would be appropriate to also take into account New Zealand's particular institutional features. Two particular features that may be of importance here are that:

- New Zealand's domestic markets are relatively concentrated compared to those in other countries;² and
- New Zealand has a number of large enterprises that have adopted a co-operative form and a large number of assets that are held in various types of trust. For example, the agricultural industry is dominated by co-operatives and New Zealand's largest grocery retailer, Foodstuffs, is a co-operative.

With relatively few companies in many domestic markets, the effects of a regulation requiring one company to disclose its accounts at a detailed (regional level) will have a greater effect on competition than if there were more players. Likewise, a regulation that impacts particularly on co-operatives will have a significant effect in some New Zealand markets.

If, however, the objective in aligning with Australia is harmonisation, it is worthwhile reflecting on what New Zealand is seeking to achieve through harmonisation. The primary objective of harmonisation of New Zealand's business regime is generally taken to be to reduce "unjustified impediments to conducting business on a trans-Tasman basis".³ The relevance of such an objective to private companies is not clear. The great majority of large New Zealand private companies are unlikely to operate in Australia. Further, by definition such large private (non-issuer) companies can only have limited shareholdings by Australians or other non-residents.⁴ Therefore, it is difficult to see that substantial advantages could be gained from harmonisation with Australia in the case of large private corporations.

The dangers to New Zealand of "harmonisation for harmonisation's sake" have been pointed out by Neil Quigley, Professor of Economics at Victoria University. As Quigley notes, "The harmonisation of laws may provide benefits to those firms who operate in more than one jurisdiction. But it may impose higher transaction and compliance costs on the vast majority of firms who operate only in the domestic market."⁵

Further, Quigley notes that there can be substantial benefits to New Zealand maintaining independence in its regulatory regime. Maintaining independent regulations permits New Zealand to achieve a competitive advantage by putting in place regulations that have lower compliance and transaction costs than those in other countries.

1. Parliamentary Joint Statutory Committee on Corporations and Securities Report on Aspects of the Regulation of Proprietary Companies (2001) http://www.aph.gov.au/Senate/committee/corporations_ctte/propcom/report/report.pdf

2. Arnold T., Boles de Boer, D. and Evans L. (2003).

3. MED (2004), p. 52.

4. As is noted in footnote 23 above, if a company has more than 25% of its voting rights held by Australians or other non-residents, it must already disclose its financial accounts.

5. Quigley, N. (2003).

Chapter 2

OWNERSHIP AND FINANCING STRUCTURES *

by

Stijn Claessens *and* Konstantinos Tzioumis

In this chapter, we use a large firm-level dataset covering 19 European countries in order to compare the ownership and financing structures, and performance of listed (LCs) and large non-listed companies (NLCs). For the overall sample, we find that the vast majority of NLCs have either a large or medium blockholder. This contrasts the ownership structure of LCs, which usually have no blockholder with an over 50% stake. Moreover, we present information on typology of ultimate blockholders, as well as financial ratios in LCs and NLCs. The results from matched-pairs analysis, employed in order to directly compare the two categories, suggest that NLCs' financing structures are more geared towards debt financing and the shorter term. Although NLCs use relatively less fixed assets, they appear more capital intensive than LCs. In terms of performance, NLCs have higher returns on assets and equity than LCs do, but lower margins, with these differences remaining when conducting multivariate regressions. Overall, the results suggest that, while ownership structures and corporate governance mechanisms differ between NLCs and LCs, these differences do not affect their performance materially.

* The views in this paper are those of the authors and do not reflect the views of the OECD or its Member countries.

Introduction

There has been much emphasis given in the last few years by policy makers and the academic community to the corporate governance issues of large, listed corporations (LCs). In many countries though, the bulk of economic activity is carried out by non-listed firms (NLCs). Many of these NLCs are small and, in developing countries especially, SMEs account for the largest share of employment and economic activity. But in many countries there is a sizable share of economic activity conducted by large non-listed companies (NLCs). While comparable data are missing, these can vary from the *Mittelstand* in Germany to the large suppliers of Japanese multinationals or the *chaebols* in Korea.

The question arises whether these NLCs face different corporate governance issues than the LCs do. Clearly, to the extent that their ownership structures are very different, we would expect to find some differences in terms of corporate governance mechanisms used. Often it will be the case that management and ownership are closely linked for NLCs, as in family controlled firms, in which case the nature of the principal agent problems will be different from those of large LCs with diffuse ownership structures and professional management. In part related to differences in ownership structures, there are likely to be variations as well in the external financing structures of NLCs and LCs. Being non-listed and possibly less open in terms of financial information may mean that NLCs rely more than LCs on bank financing. Also, in that they operate different type of businesses or are of different sizes, we could expect differences also in corporate governance.

Whether all of these differences actually exist and whether they are reflected in the performance of firms are open questions, particularly since the corporate governance literature to date has given little attention to the issues of NLCs relative to those of LCs. In this paper, we use a large firm-level dataset covering 19 European countries to study actual differences in ownership and financing structures, and performance of LCs and (large) NLCs. We find that the ownership structures of NLCs are dominated by industrial groups, often since they are subsidiaries of other firms or members of corporate groups. For the non-subsidiaries and not group-affiliated NLCs, the ownership structures are predominantly family, but this does not differ much from the ownership structures of LCs once one controls for the presence of large industrial owners. Matching NLCs and LCs by size and type, we find that the financing structures of NLCs are more geared towards debt financing and the shorter term. Although NLCs have relatively less fixed assets on their balance sheet, they appear more capital intensive than LCs. In terms of performance, NLCs have higher returns on assets and equity than LCs do, with these differences remaining when conducting multivariate regressions controlling for firms' characteristics. We do not find that ownership structures for NLCs are associated with specific differences in performance: in other words, while corporate governance mechanisms may differ, we do not see this reflected in performance differences. Overall, the results suggest that, while ownership structures and corporate governance mechanisms differ between NLCs and LCs, these differences do not affect their performance materially.

The rest of the paper is organised as follows. Section 1 describes data sources and definitions. Section 2 provides some simple comparisons between NLCs and LCs in terms of ownership structures, external financing and investment patterns and performance. Section 3 does careful matching of firms based on several criteria, repeats the comparisons and also performs some simple regressions. Section 4 concludes.

1. Data description

For the purposes of this study, we utilise the Bureau van Dijk's Amadeus database which contains almost 7.5 million firm-year observations for LCs and NLCs across European countries (including Eastern Europe). The Amadeus database is created by collecting standardised data received from 50 vendors across Europe. The coverage varies by country, but since its launch in 1994 the coverage has constantly increased.

The Amadeus database includes firm-level information for 22 balance sheet items, 22 income statement items and 21 financial ratios, as well as employment, date of incorporation, industry classification (4-digit NACE), degree of consolidation of accounting reporting, ownership structure, legal form, listing status, and headquarters address. All level variables are presented in current U.S. dollars by conversion at end-of-year or average exchange rates.

We start with the Amadeus January 2005 version and select all firms with operating revenues over USD 50 million that contain information on important variables, namely operating revenues, number of employees, total assets, fixed assets, intangible assets, return-on-assets, return-on-equity, EBIT margin and date of incorporation.” We further focus on firms that appear in Amadeus in both 2002 and 2003, thus constructing a balanced panel. We drop observations from countries with less than 20 observations (*i.e.* Liechtenstein, Serbia and Montenegro, Luxembourg, Monaco, Cyprus, Latvia, Hungary, Estonia, Bulgaria, Lithuania, and Austria). Finally, we drop all observations from Ireland due to numerical inaccuracies (*i.e.* repeated values in several variables).

We next identify firms’ non-listed or listed status, from the Amadeus variable “Publicly-quoted”, which takes the values ‘Yes’ or ‘No’. Then, we identify firms’ ownership structures and classify firms based on the presence of blockholders using the ‘Independence Indicator’ variable (hereafter, Ind_Ind) from Amadeus. Hence we can construct variables indicating the presence and the size of the blockholder, defined by Amadeus as any owner with direct or total ownership representing more than a 25% stake in a firm.

Concerning the presence of blockholdings, we create dummy variables for three wide categories: (i) the firm has a shareholder with total or direct ownership of over 50% (Ind_Ind is C); (ii) the firm has at least one shareholder with total or direct ownership of over 25%, but less than 50% (Ind_Ind is either B+, B or B-); and (iii) the firm has no shareholder with total or direct ownership of over 25% (Ind_Ind is either A+, A or A-).¹ The – proportionally few – firms for which Amadeus has no particular ownership information (*i.e.* Ind_Ind is either unknown or missing) are dropped from the sample.

In order to examine in detail the ownership structure of European firms, we focus on the ultimate owner, defined by Amadeus as the largest owner in a firm with total or direct ownership of over 25% (*e.g.* an ultimate owner could have two blockholdings in a firm, one direct and one indirect). In particular, we make a distinction among the types of ultimate owners. We aggregate the information available in Amadeus’ variable ‘ultimate-owner-type’ into five different types of ultimate owners: (i) *state*, when the ultimate owner is the state or a public authority; (ii) *family*, when the ultimate owner is either a family or an individual; (iii) *industrial* company; (iv) *financial* company, when the ultimate owner is either a financial company, an insurance company, or a bank; and (v) *other*, when the ultimate owner is one of the following: employees/managers, foundation, or mutual a pension fund/trust.

As indicators of firm performance, we employ the return-on-assets (ROA), return-on-shareholders equity (ROS) and earnings-before-interest-and-taxes (EBIT) margins. ROA reflects management efficiency in using the available assets to generate profit. ROS measures the rates of return on shareholder’s investment. The EBIT margin measures profit as a percentage of operating revenues and identifies the firm’s efficiency in cost control and pricing strategies, as well as the market structures in which the firm operates. Concerning investment, financing, and performance behaviour, we construct three variables, namely fixed assets as a percentage of total assets, the ratio of sales to fixed assets, and non-current debt as a percentage of total debt. The exact formulae for each of these variables can be found in the Appendix.

This paper takes into consideration, to some extent, differences in accounting standards and market structures across Europe, by presenting aggregate descriptive statistics by region. In particular, we create

dummy variables for Western Europe (*i.e.* Belgium, France, Germany, the Netherlands, and the United Kingdom), Southern Europe (*i.e.* Greece, Italy, Portugal, and Spain), Northern Europe (*i.e.* Denmark, Norway, and Sweden), and Eastern Europe (*i.e.* Croatia, Czech Republic, Poland, Romania, Russian Federation, and Ukraine). Another dummy variable indicates ‘High-Income’ countries, namely all those in Western, Southern and Northern Europe, as well as Switzerland. Finally, firm-level data are aggregated based on whether firms belong to the manufacturing sector (NACE 15-37), and on whether firms file consolidated or unconsolidated financial statements.

2. Simple data comparisons

We start with the results for the total sample, or for 27 144 observations, of which 23 558 are NLCs and 3 586 LCs.² We first provide descriptive information on the firms’ ownership structure. Due to the cross-sectional nature of the ownership information in Amadeus, which presents only the latest ownership structure for each firm, a firm can be classified as having either a large blockholder (over 50% stake), or a medium blockholder (stake between 25% and 50%), or even no blockholder (no one owns a stake over 25% in the firm).

We start with constructing percentages depicting the portion of firms that fall in each of the three categories. The results for each country are presented separately for non-listed (Table 2.1) and listed (Table 2.2) firms.³ The most important finding is that only 11% of NLCs have no substantial blockholder, compared to 45% of LCs. In a similar fashion, 84% of NLCs have a large blockholder, compared to only 29% of LCs. However, these numbers vary significantly across countries. About 82% of LCs in the United Kingdom have no blockholder, whereas we observe no such LCs in the Czech Republic and Romania.

In order to better illustrate the results for each country, we graphically contrast the percentage of firms with a large blockholder (*i.e.* over 50%) in non-listed and listed firms (Figure 1). The same process is repeated for the percentage of non-listed and listed firms with no shareholder having a stake of over 25% (Figure 2). The countries in both Figures are sorted using the differences in the same ownership variable between non-listed and listed firms. The United Kingdom and the Netherlands consistently appear to have the largest difference in ownership structures of LCs and NLCs. On the other extreme, there is little difference in the ownership structures of LCs and NLCs in Russia. Interestingly, in terms of blockholder presence in LCs and NLCs, there is little divergence between some EU countries (*e.g.* Belgium, Greece, Italy) and Eastern European countries.

In an effort to further analyse the ownership structure, Tables 2.3a-2.4b present detailed information on the type of blockholders. In particular, Tables 2.3a and 2.4a illustrate the presence of specific types of ultimate ownership as a portion of the total sample of firms, whereas Tables 2.3b and 2.4b estimate the incidence for each type of ultimate owner only for firms with a large blockholder.⁴ The tables provide information for each country and geographic region, as well as for consolidated and unconsolidated firms.

Table 3a illustrates the importance of industrial firms as ultimate owners in NLCs: almost half of the firms have an industrial firm as an ultimate blockholder with a stake of more than 25%. The highest percentage is 58% for the UK, and the lowest is 3% for Croatia. On average 7% of firms have the state as a significant blockholder, with the highest percentage (63%) for the Ukraine and the lowest (1%) for Spain and the UK. Family-owned firms are important as 17% of NLCs have family blockholders with an ownership stake of more than 25%. The country with the highest share of firms with a 25% or more stake belonging to family blockholders is 50% for Greece and the lowest is 4% for the Ukraine. The ownership stakes of financial firms are generally small, with only 5% of the firms on average having a financial

blockholder with a stake of more than 25%. The largest differences among regions are between Eastern Europe and the other regions, since in Eastern Europe the state is much more important as an owner. High-income countries have the most firms owned by industrial firms. Firms with consolidated financial statements are more likely not controlled by a blockholder, possibly as these are more likely to be free-standing corporations and not part of industrial groups.

Table 2.4a illustrates that for LCs the picture is quite different, mainly as there are much fewer firms with a large blockholder, as already highlighted in Table 2.2. For LCs with a large blockholder, the family is the most important blockholder followed by industrial firms. The state and financial firms are the least important blockholders, although for some countries the state is a very important blockholder even in LCs, like in Russia, where 60% of the LCs have the state as the largest blockholder. Similarly, in Poland, the state is still an important blockholder. Again, LCs in Central and Eastern European countries have ownership structures that are very different from those in any other group of countries.

Tables 2.3b and 2.4b illustrate the ownership structures for firms where there is a large ultimate blockholder (*i.e.* with more than a 50% stake). Here, for NLCs, industrial firms are the most important (some 62%) ultimate blockholders, whereas for LCs family-owned firms constitute the largest (some 48%) group of firms that have a blockholder with a stake of more than 50%. Differences among countries are also large here, although this is less the case for NLCs.

Again, we provide a graphical illustration of the ownership concentration. In Figure 3 we graphically contrast the type of ultimate large blockholders (*i.e.* with stakes of over 50%) in non-listed and listed firms, by region. In particular, we employ stacked columns, thus comparing the percentage that each type of owner contributes to the ownership landscape across regions. Eastern European firms are outliers in terms of the state being the ultimate owner in both LCs and NLCs. By contrast, in Western Europe, the state has little presence as a large blockholder in firms. Moreover, with the exception of Eastern Europe, the type of ultimate owners is similar across country-groupings. In particular, family as an ultimate owner is more prominent in LCs than in NLCs, while industrial firms are more common as ultimate owners in NLCs than in LCs.

Next, in Tables 2.5 and 2.6 (for non-listed and listed firms, respectively), we provide some descriptive information on activities and financial performance, in the form of ratios. These (financial) ratios relate to profitability, efficiency, liquidity, solvency, investment behaviour, debt structure, and capital intensity. Again, the information on financial ratios, as well as ownership structure, is aggregated by geographic regions and accounting consolidation. We further distinguish between manufacturing and non-manufacturing firms.

Comparing Tables 2.5 and 2.6 shows that NLCs have higher ROA and ROS than LCs do. In terms of financial structure, NLCs tend to be more leveraged than LCs, with the debt-to-equity ratio being 2.4 for NLCs compared to 1.45 for LCs. In terms of investment, NLCs seem to invest less in both fixed assets and intangible assets. NLCs also rely much more on short-term debt as their share of non-current debt is only 13% compared to 34% for LCs. In terms of capital intensity, NLCs have a higher turnover than LCs, as their ratio of sales to fixed assets is almost 6 compared to 2.35 for LCs. However, the EBIT margin is lower for NLCs, 3 percentage points lower than the 5 percentage points for LCs. This suggests that NLCs are more engaged in trading activities, with lower fixed asset needs, and lower margins. These comparisons nevertheless have to be treated carefully, as the samples cover very different types of firms, most notably in terms of size, but also in terms of industry, country, and age.

3. Matching firms and regression results

As noted, the simple comparison of ownership structures, investment, financing and performance of independent samples of non-listed and listed firms can be problematic. Although such comparison is useful for the presentation of descriptive statistics for non-listed and listed firms, it is not suitable for directly comparing these types of firms. The reason is that the (independent) samples of non-listed and listed firms are substantially different. Table 2.7a demonstrates this considerable disparity in terms of firm size, as proxied by both operating revenues and employment. In particular, it is shown that LCs are much larger than NLCs, with the largest differences occurring in Western Europe and with firms in high-income countries. Only for the unconsolidated sample of firms are the differences statistically insignificant, as these are similarly sized firms in terms of operating revenues, but not in terms of employment.

Table 2.7b demonstrates the differences between LCs and NLCs by providing data on the industry composition of the respective samples for LCs and NLCs. More specifically, compared to the sample of LCs, the sample of NLCs contains more firms from the construction, manufacturing, trade and transportation industries (NACE sectors d, f, g, i), but fewer from industries related to utilities, financial and business services (NACE sectors e, j, k). Similar differences exist between LCs and NLCs for firm age (not reported).

Given these substantial differences in terms of various firm characteristics (*e.g.* size, industry classification, age) between the samples of LCs and NLCs, an alternative empirical design is needed in order to address sample differences. In particular, we construct matching pairs of LCs and NLCs, which allows for direct comparison of firm variables between these two types of firms. The two groups of LCs and NLCs are paired using seven criteria: country, year, industry, level of consolidation in financial statements, operating revenues, employment and date of incorporation. Country, year and industry are matched in order to establish similar institutional and regulatory contexts, as well as comparable competitive environments. Accounting information in consolidated statements is fundamentally different from that in unconsolidated statements due to regulatory requirements and aggregation of diverse accounting practices of the subsidiaries. Matching by operating revenues and employment is done to control for differences in firm size. Firm age is also a matching factor since firms adjust their financing decisions depending on their stage of development. In this sense, matching-pairs analysis provides a solution for concerns about comparability.

From a statistical viewpoint, the main advantage of matched-pairs analysis (also known as analysis of dependent samples) is that the standard deviation of the test statistic is usually smaller, thus making it more likely to detect a false null hypothesis. Moreover, identified sources of potential bias (the matching criteria) are controlled. Overall, these advantages increase the power of the tests from matched-pairs, and allow us to understand whether non-listed status of a firm affects various corporate governance and financial indicators.

We construct the matched pairs by employing the matching algorithm from Abadie *et al.* (2004).⁵ Using the aforementioned seven criteria, we manage to create 1 328 matched-pairs of LCs and NLCs. After sorting the universe of matched pairs by matching accuracy, we select the upper 50% (*i.e.* 664 pairs), which includes the pairs that are very closely matched. Then, using the matched pairs, we perform parametric and non-parametric tests in order to examine whether various variables (on ownership structure and financial ratios) are significantly different between LCs and NLCs. The results from the mean and median comparisons are presented in Tables 2.8a and 2.8b for ownership, in Table 2.9 for performance and efficiency, and in Table 2.10 for asset and debt structure.

In terms of ownership structures, we find that the results for the unmatched samples remain. NLCs consistently have higher incidence of large blockholdings (over 50% stake) compared to LCs. On the contrary, LCs have higher incidence of medium blockholdings (between 25% and 50% stake) or lack of blockholding (*i.e.* no blockholding over 25%). The only country group for which consistently there is little difference between LCs and NLCs is Eastern Europe. Also for the Southern European and unconsolidated firms, differences are not substantially different for the presence of medium blockholders (25%- 50% stake). It should be noted though that some of these subgroups of firms have relatively few observations.

Table 2.8b presents the findings for ultimate ownership. In particular, it is shown that the incidence of the State as a medium or large blockholder is higher in NLCs. As a mirror image, the incidence of Family as a medium or large blockholder is higher in LCs. Only when one considers large ultimate blockholdings in manufacturing firms, does the difference becomes considerably smaller for both the State and Family. Regarding Industrial firms as ultimate owners, there seems to be no substantial difference between LCs and NLCs.

For performance and efficiency comparisons, Table 2.9 indicates the following differences: NLCs have higher ROA and ROS, but lower EBIT margins than LCs do. These differences are generally statistically significant for all the country/firm groupings, except for Eastern European and unconsolidated firms. The results support that NLCs perform better than LCs, but may be operating in businesses with lower profit margins.

In terms of capital intensity, investment behaviour and debt structure, differences are maintained for the two groups when using the matched samples: NLCs have relatively fewer fixed assets on their balance sheets, have higher sales turnover and a lower share of long-term debt, with all differences statistically significant. There is less of a pattern though for the Northern and Southern European countries and to some extent for the unconsolidated firms. It nevertheless confirms the overall picture that NLCs tend to operate businesses that are less capital intensive, have a high turnover, and have more difficulty accessing long-term credit markets.

We next employ regression analysis to investigate the determinants of accounting performance, in terms of return-on-assets (ROA) and return-on-shareholders (ROS). Examining the effect of non-listed status and ownership structure on firm performance is an important component of this study. If, after all, there is little difference between NLCs and LCs in terms of performance, then the differences in ownership structure may not be as material.

For the purposes of our regression analyses, we construct a cross-sectional sample of 12 791 firms for the year 2003. After controlling for firm size, firm age, asset structure, consolidated accounting, country effects and industry effects, we investigate if non-listed status and ownership structure should have a significant influence on firm performance (averaged over three fiscal years, 2001-2003). Table 2.11 illustrates Pearson and Spearman correlations of the independent variables used in the estimations. The correlations are low or moderate suggesting the absence of multicollinearity. Tables 2.12 and 2.13 present the regression results for ROA and ROS, respectively.⁶ We find that the control variables have the following sign: firm size, as proxied by firm operating revenues or employment, is positively related to ROA/ROS; consolidated accounting is associated with lower ROA/ROS; a higher share of fixed assets is associated with lower ROA/ROS; and firm age counts positively only towards ROA. The signs of these coefficients are not always intuitive; the point of using them nonetheless is that these variables control in the widest way for firm characteristics. When doing so, we still find that NLCs have higher ROA (some 0.5 percentage points) and higher ROS (some 4 percentage points) – which are the magnitudes for the NLC dummies – than LCs do.

We also investigate the effects of ownership structures on the performance of firms. We find that firms with a large blockholder have higher ROA/ROS (specification III, in Tables 2.12 and 2.13). Splitting further the firms that have large blockholders, we find that when the blockholder is a family, firms have higher ROA/ROS (specification IV in Tables 2.12 and 2.13). We also find that particularly firms with an industrial firm as large blockholder have higher ROA/ROS. In general, medium blockholders do seem to be associated with lower ROA/ROS. When we interact the presence of a large blockholder (with a stake of more than 50%) with a dummy for NLCs, we find that there is no separate strong, statistically significant relationship with ROS/ROA. This suggests that the presence of large blockholders does not affect the performance of NLCs differently than the performance of LCs.

Conclusions

This paper compares LCs and NLCs in Europe, in terms of ownership structure and financial ratios. In particular, it provides descriptive statistics in terms of presence and type of blockholder, as well as financial information on performance, efficiency, liquidity, debt structure and capital intensity. Moreover, in order to address the problem of heterogeneity when comparing independent samples of LCs and NLCs, this paper directly contrasts LCs and NLCs by using matched-pairs analysis. Furthermore, multivariate regressions examine the effect of ownership structure on firm performance.

The analysis finds that the typical NLC has a large blockholder, which is usually a family, an industrial firm, or even the state. On the other hand, the typical LC has no large blockholder, or, in some cases, only a medium blockholder (mostly a family or an industrial firm). Although ownership structures vary greatly by country, the variations within the country are much smaller between NLCs and LCs. In addition, when considering firms that have blockholders, the ownership structures of NLCs and LCs differ perhaps less than expected. With the exception of Eastern European firms, both LCs and NLCs have mostly either families or industrial firms as blockholders.

From a performance viewpoint, while NLCs may face different corporate governance problems than LCs, they seem able to resolve these equally well since performance differences are small between matched firms. If anything, these differences show that NLCs perform better than LCs do, at least for this sample period. This finding of superior performance for NLCs persists in both matched-pairs analysis and multivariate regression. Thus, one conclusion could be that the presence of blockholders in NLCs offers advantages in monitoring and control, and generates organisational benefits in terms of decision speed and unity of command. Moreover, NLCs may benefit from avoiding the cost of complying with reporting and other requirements that are imposed on listed firms, thus saving them resources, and potentially allowing them to focus on longer-term investment strategies.

As this research aims to compare NLCs with – generally larger – LCs, it considers only large firms (*i.e.* with over USD 50 million in operating revenues). However, for future research on the topic, it would be interesting to focus on smaller firms that attract less monitoring by institutional investors and the media, thus allowing for greater blockholder discretion. Future research could also investigate the role of country differences in explaining the (lack of) effects.

Table 2.1 Descriptive statistics for ownership in non-listed European firms, by country^a

Countries	Percentage of non-listed firms with:			# obs.	Median oper. rev. \$m
	A shareholder with over 50% stake	At least one shareholder holding a stake between 25% and 50%	No shareholder over 25% stake		
Belgium	85.12	5.51	9.37	1 452	144
Croatia	90.00	5.00	5.00	80	132
Czech Rep.	90.63	0.00	9.38	64	155
Denmark	80.19	4.81	15.00	1 040	141
France	94.97	2.72	2.31	4 772	139
Germany	84.27	10.48	5.24	496	246
Greece	77.07	20.38	2.55	314	134
Italy	81.04	9.83	9.13	1 424	137
Netherlands	89.92	5.12	4.96	1 250	178
Norway	79.46	11.62	8.92	740	134
Poland	93.59	2.56	3.85	156	107
Portugal	89.09	3.64	7.27	110	148
Romania	84.85	9.09	6.06	66	144
Russian Fed.	63.64	23.23	13.13	198	150
Spain	85.03	8.43	6.54	1 804	142
Sweden	79.91	1.58	18.51	1 772	146
Switzerland	62.71	8.47	28.81	118	203
Ukraine	66.90	19.01	14.08	284	144
UK	80.83	0.35	18.82	7 418	155
All countries	84.45	4.24	11.31	23 558	148

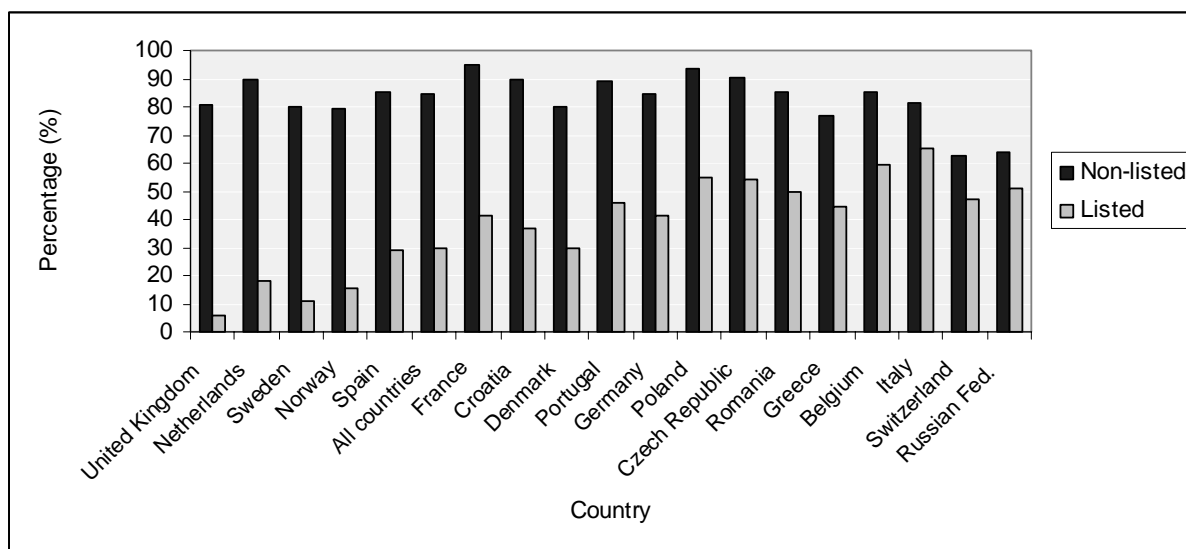
a) The table contains descriptive ownership statistics for a balanced panel of 23 558 non-listed European firms in 2002 and 2003, with annual operating revenues of over USD 50 million. The *mean* value is reported for the three ownership dummy variables.

Table 2.2 Descriptive statistics for ownership in listed European firms, by country^a

Countries	Percentage of non-listed firms with:			# obs.	Median oper. rev. \$m
	A shareholder with over 50% stake	At least one shareholder holding a stake between 25% and 50%	No shareholder over 25% stake		
Belgium	59.46	21.62	18.92	74	321
Croatia	36.84	15.79	47.37	38	113
Czech Rep.	54.17	45.83	0.00	48	270
Denmark	29.69	34.38	35.94	128	397
France	41.10	32.19	26.71	584	402
Germany	41.11	27.78	31.11	360	535
Greece	44.59	35.14	20.27	148	161
Italy	65.17	14.61	20.22	178	367
Netherlands	17.86	20.24	61.90	168	795
Norway	15.79	47.37	36.84	76	258
Poland	54.55	36.36	9.09	22	79
Portugal	45.71	20.00	34.29	70	546
Romania	50.00	50.00	0.00	8	113
Russian Fed.	50.98	41.18	7.84	102	300
Spain	28.75	32.50	38.75	160	523
Sweden	11.11	37.78	51.11	270	293
Switzerland	47.37	17.54	35.09	228	461
UK	5.84	12.34	81.82	924	343
All countries	29.89	25.10	45.01	3 586	356

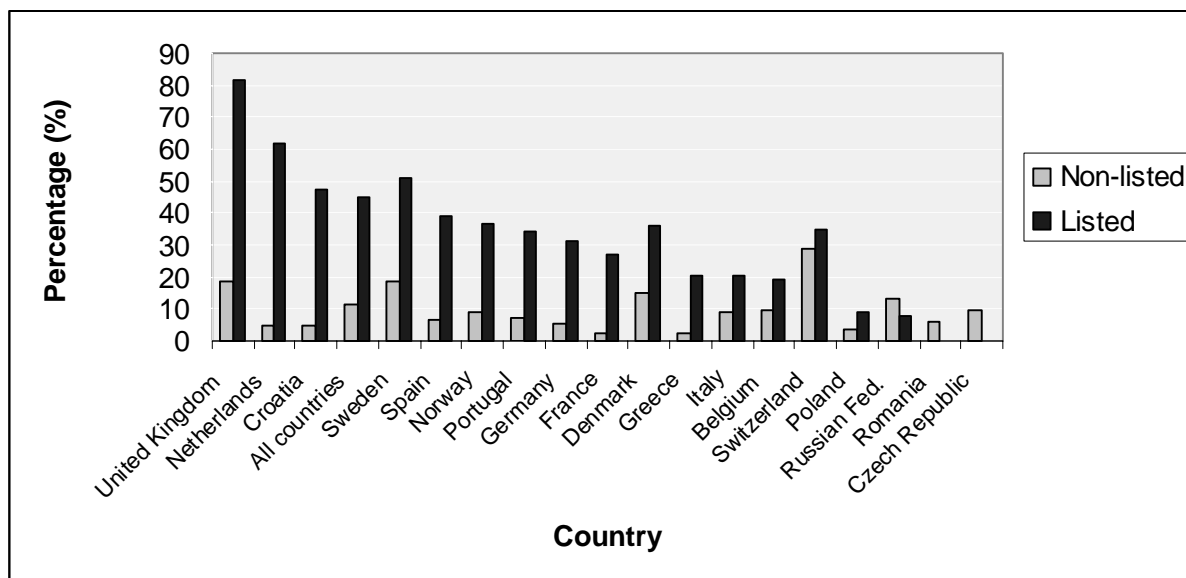
a) The table contains descriptive ownership statistics for a balanced panel of 3 586 listed European firms in 2002 and 2003, with annual operating revenues of over USD 50 million. The mean value is reported for the three ownership dummy variables.

Figure 2.1 Percentage of firms with a blockholder owning more than a 50% stake^a



a) The figure graphically contrasts the percentage of firms with a large blockholder (*i.e.* over 50% stake) in non-listed and listed firms. The countries are sorted according to the difference observed in the respective percentages of non-listed and listed firms.

Figure 2.2 Percentage of firms with no blockholder owning more than a 25% stake^a



a) The figure graphically contrasts the percentage of firms with no blockholder owning more than a 25% stake in non-listed and listed firms. The countries are sorted according to the difference observed in the respective percentages of non-listed and listed firms.

Table 2.3.a Type of ultimate owner in blockholders with a stake of over 25% in non-listed European firms, as a percentage of all available firms^a

Countries	Type of ultimate owner in firms with medium or large blockholder					% of firms with no blockholder	# obs.	Median oper. rev. \$m
	State	Family	Industrial firm	Financial firm	Other			
Belgium	4.65	9.31	55.27	8.69	0.93	21.12	644	161
Croatia	41.37	44.82	3.44	0.00	3.44	6.90	58	123
Czech Rep.	11.11	27.77	44.44	0.00	0.00	16.67	36	121
Denmark	3.01	15.51	39.22	6.89	1.72	33.62	464	143
France	5.76	31.05	52.52	4.68	2.01	3.96	2 776	138
Germany	33.10	18.91	33.78	5.40	0.00	8.78	296	266
Greece	10.41	50.00	32.29	3.12	0.00	4.17	192	123
Italy	5.66	34.56	33.71	6.79	0.84	18.41	706	145
Netherlands	13.91	10.30	51.54	6.70	1.54	15.98	388	194
Norway	16.41	30.84	33.33	2.48	0.49	16.42	402	126
Poland	50.94	18.86	22.64	1.88	0.00	5.66	106	116
Portugal	20.00	26.66	36.66	0.00	3.33	13.33	60	150
Romania	12.50	25.00	50.00	0.00	0.00	12.50	32	116
Russian Fed.	43.18	11.36	13.63	2.27	0.00	29.55	88	140
Spain	1.34	32.43	48.76	3.57	0.67	13.20	894	145
Sweden	12.09	5.58	38.83	4.18	1.16	38.14	860	155
Switzerland	34.69	10.20	14.28	4.08	2.04	34.69	98	187
Ukraine	63.44	4.30	9.67	0.00	1.07	21.51	186	155
UK	1.32	5.72	58.09	5.06	2.60	27.18	5 136	149
All countries	7.10	17.09	49.23	4.91	1.80	19.85	13 422	148
Western Europe	4.43	14.19	55.17	5.28	2.18	18.72	9 240	150
Southern Europe	4.53	34.88	40.92	4.64	0.75	14.25	1 852	142
Northern Europe	10.66	14.13	37.65	4.51	1.15	31.87	1 726	144
Eastern Europe	47.82	16.20	17.39	0.79	0.79	17.00	506	131
High-income	5.51	17.12	50.48	5.07	1.84	19.96	12 916	148
Consolidated firms	3.92	9.71	32.56	4.38	1.89	47.52	4 428	161
Unconsolidated firms	8.67	20.72	57.43	5.18	1.75	6.23	8 894	142

a) The table contains descriptive statistics for the type of ultimate owner in 13 422 observations of non-listed European firms in 2002 and 2003 with a medium or large blockholder (*i.e.* between 25-50% or >50% stake in the firm). The mean value is reported for the dummy variable of each of the five types of ultimate ownership, as well as the dummy for independence (*i.e.* no blockholder with direct or total ownership of over 25%). All subsidiaries of industrial firms (as indicated by 100% direct or total ownership) are excluded from the sample, in order not to overestimate the percentage of industrial firms as ultimate owners. Similarly, all firms with medium or large blockholders, but with missing information for the type of blockholder, are excluded from the sample.

Table 2.3b Type of ultimate owner in blockholders with over 50% stake in non-listed European firms, by country and region^a

Countries	Type of ultimate owner					# obs.	Median oper. rev. \$m
	State	Family	Industrial firm	Financial firm	Other		
Belgium	5.66	11.74	70.00	11.33	1.21	494	166
Croatia	44.44	48.14	3.70	0.00	3.70	54	122
Czech Rep.	13.33	33.33	53.33	0.00	0.00	30	133
Denmark	4.76	24.48	57.14	10.88	2.72	294	141
France	5.84	32.59	54.65	4.76	2.15	2 602	138
Germany	37.19	19.00	37.19	6.61	0.00	242	275
Greece	11.11	50.00	37.50	1.38	0.00	144	134
Italy	6.32	41.89	43.47	7.11	1.18	506	149
Netherlands	17.56	12.83	60.13	7.43	2.02	296	194
Norway	18.36	36.05	42.17	2.72	0.68	294	123
Poland	56.25	18.75	22.91	2.08	0.00	96	119
Portugal	23.07	30.76	42.30	0.00	3.84	52	148
Romania	16.66	16.66	66.66	0.00	0.00	24	116
Russian Fed.	62.50	20.83	12.50	4.16	0.00	48	159
Spain	1.67	35.65	57.93	4.17	0.55	718	151
Sweden	19.92	8.98	62.50	6.64	1.95	512	176
Switzerland	55.17	17.24	24.13	0.00	3.44	58	190
Ukraine	83.87	4.83	11.29	0.00	0.00	124	147
UK	1.77	7.75	80.08	6.88	3.49	3 716	170
All countries	8.55	20.78	62.36	6.01	2.27	10 304	156
Western Europe	5.27	17.38	68.19	6.44	2.69	7 350	160
Southern Europe	5.07	39.15	50.14	4.78	0.84	1 420	147
Northern Europe	15.45	20.36	55.63	6.72	1.81	1 100	149
Eastern Europe	58.51	19.68	20.21	1.06	0.53	376	130
High-income	6.66	20.82	63.96	6.20	2.33	9 928	157
Consolidated firms	7.31	17.05	63.82	8.15	3.65	2 134	228
Unconsolidated firms	8.88	21.76	61.98	5.45	1.90	8 170	144

a) The table contains descriptive statistics for the type of ultimate owner in 10 304 observations of non-listed European firms in 2002 and 2003 with a large blockholder (*i.e.* >50% stake in the firm). The *mean* value is reported for the dummy variable of each of the five types of ultimate ownership. All subsidiaries of industrial firms (as indicated by 100% direct or total ownership) are excluded from the sample, in order not to overestimate the percentage of industrial firms as ultimate owners. Finally, all firms with missing information for the type of large blockholder are excluded from the sample.

Table 2.4a **Type of ultimate owner in blockholders with over 25% stake in listed European firms, as a percentage of all available firms^a**

Countries	Type of ultimate owner in firms with medium or large blockholder					% of firms with no blockholder	# of obs.	Median oper. rev. \$m
	State	Family	Industrial firm	Financial firm	Other			
Belgium	5.00	10.00	30.00	5.00	15.00	35.00	40	469
Croatia	7.14	21.42	7.14	0.00	0.00	64.29	28	134
Czech Rep.	11.11	0.00	88.88	0.00	0.00	0.00	18	228
Denmark	5.26	13.15	18.42	0.00	2.63	60.53	76	308
France	2.13	47.43	11.96	4.27	0.85	33.33	468	500
Germany	3.57	36.42	16.42	2.85	0.71	40.00	280	433
Greece	6.45	51.61	16.12	1.61	0.00	24.19	124	161
Italy	15.38	44.61	9.23	3.07	0.00	27.69	130	403
Netherlands	1.51	6.06	9.09	1.51	3.03	78.79	132	877
Norway	3.84	19.23	19.23	3.84	0.00	53.85	52	310
Poland	37.50	25.00	25.00	0.00	0.00	12.50	16	74
Portugal	0.00	22.22	33.33	0.00	0.00	44.44	54	627
Romania	-	-	-	-	-	-	-	-
Russian Fed.	60.00	0.00	16.66	6.66	3.33	13.33	60	289
Spain	1.58	12.69	31.74	3.17	1.58	49.21	126	529
Sweden	1.62	14.63	23.57	3.25	0.81	56.10	246	293
Switzerland	7.14	22.44	21.42	4.08	4.08	40.82	196	470
Ukraine	-	-	-	-	-	-	-	-
UK	0.23	5.33	3.71	0.92	2.08	87.70	862	361
All countries	4.32	22.13	13.88	2.47	1.71	55.50	2 908	383
Western Europe	1.45	21.43	8.86	2.24	1.90	64.09	1 782	450
Southern Europe	6.91	34.56	20.73	2.30	0.46	35.02	434	343
Northern Europe	2.67	14.97	21.92	2.67	1.06	56.68	374	301
Eastern Europe	37.70	8.19	26.22	3.27	1.63	22.95	122	207
High-income	2.87	22.68	13.35	2.44	1.72	56.93	2 786	404
Consolidated firms	2.74	21.47	12.56	2.43	1.82	58.95	2 626	433
Unconsolidated firms	19.14	27.65	26.24	2.83	0.70	23.40	282	173

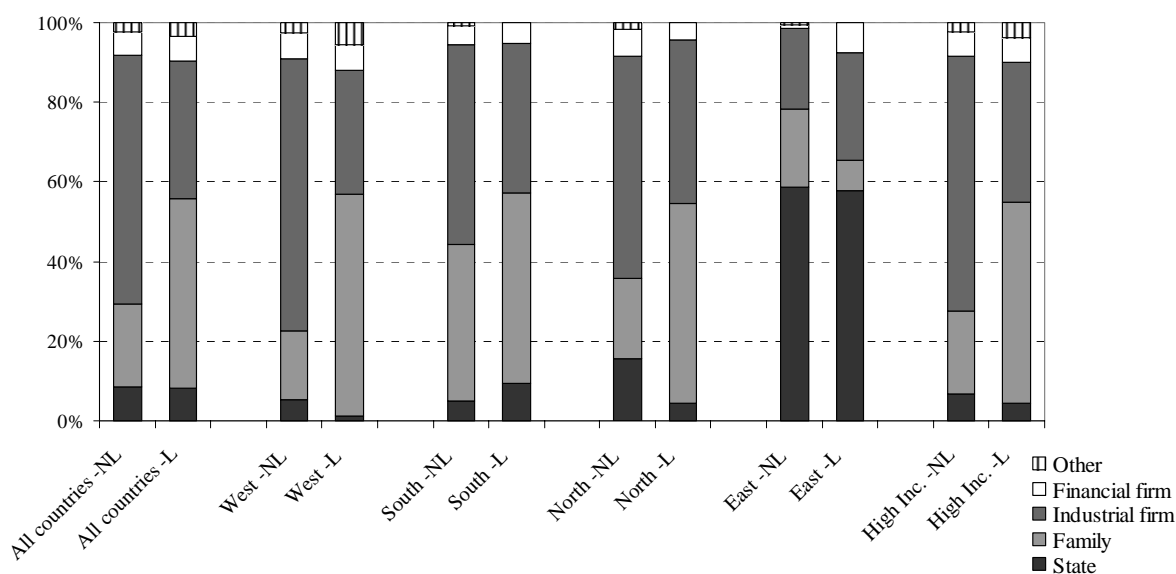
a) The table contains descriptive statistics for the type of ultimate owner in 2 908 observations of listed European firms in 2002 and 2003 with a medium or large blockholder (*i.e.* between 25-50% or >50% stake in the firm). The *mean* value is reported for the dummy variable of each of the five types of ultimate ownership, as well as the dummy for independence (*i.e.* no blockholder with direct or total ownership of over 25%). All firms with medium or large blockholders, but with missing information for the type of blockholder, are excluded from the sample.

Table 2.4b **Type of ultimate owner in blockholders with over 50% stake in listed European firms, by country and region^a**

Countries	Type of ultimate owner					# of obs.	Median oper. rev. \$m
	State	Family	Industrial firm	Financial firm	Other		
Belgium	0.00	25.00	37.50	12.50	25.00	16	246
Croatia	33.33	33.33	33.33	0.00	0.00	6	201
Czech Rep.	33.33	0.00	66.66	0.00	0.00	6	230
Denmark	14.28	42.85	42.85	0.00	0.00	14	243
France	0.00	70.45	19.31	9.09	1.13	176	358
Germany	3.70	55.55	38.88	1.85	0.00	108	334
Greece	7.40	55.55	33.33	3.70	0.00	54	199
Italy	18.42	60.52	15.78	5.26	0.00	76	487
Netherlands	0.00	25.00	50.00	0.00	25.00	16	1 083
Norway	0.00	66.66	33.33	0.00	0.00	6	321
Poland	40.00	20.00	40.00	0.00	0.00	10	164
Portugal	0.00	38.46	61.53	0.00	0.00	26	906
Romania	-	-	-	-	-	-	-
Russian Fed.	73.33	0.00	13.33	13.33	0.00	30	456
Spain	0.00	16.66	72.22	11.11	0.00	36	688
Sweden	0.00	50.00	41.66	8.33	0.00	24	221
Switzerland	6.66	35.55	44.44	6.66	6.66	90	490
Ukraine	-	-	-	-	-	-	-
UK	0.00	21.73	47.82	8.69	21.73	46	222
All countries	8.10	47.56	34.59	6.21	3.51	740	368
Western Europe	1.10	55.80	30.93	6.62	5.52	362	341
Southern Europe	9.37	47.91	37.50	5.20	0.00	192	463
Northern Europe	4.54	50.00	40.90	4.54	0.00	44	244
Eastern Europe	57.69	7.69	26.92	7.69	0.00	52	245
High-income	4.36	50.58	35.17	6.10	3.77	688	385
Consolidated firms	4.56	51.79	33.22	6.18	4.23	614	410
Unconsolidated firms	25.39	26.98	41.26	6.34	0.00	126	222

- a) The table contains descriptive statistics for the type of ultimate owner in 740 observations of listed European firms in 2002 and 2003 with a large blockholder (*i.e.* >50% stake in the firm). The *mean* value is reported for the dummy variable of each of the five types of ultimate ownership. All firms with missing information for the type of large blockholder are excluded from the sample.

Figure 2.3 Type of ultimate ownership in non-listed and listed firms with a blockholder having a stake of over 50%



- a) The figure shows the type of ultimate owner of firms with blockholders having a stake of over 50% in the firm. The data are presented in Tables 3b and 4b, and are drawn from 10 304 non-listed and 740 listed European firms in 2002 and 2003. Finally, country-information is aggregated in terms of regions, as well as income level.

Table 2.5 Descriptive statistics for ownership and financial ratios in large non-listed European firms^a

	Ownership			Profitability		Liquidity & Solvency			Investment Behaviour & Debt Structure			Capital Intensity & Efficiency		Sample Size
	Percentage with blockholder over 50%	Percentage with a blockholder between 25% and 50%	Percentage with no blockholder over 25%	Return-on-assets	Return-on-shareholders	Current ratio	Liquidity ratio	Debt-to-equity ratio	Fixed assets as a % of total assets	Intangible assets as a % of total assets	Non-current debt as a % of total	Sales/fixed assets ratio	EBIT margin	
All countries	84.46	4.24	11.31	4.72	16.80	1.22	0.96	2.40	30.96	0.26	13.30	5.90	3.16	23 558
Western Europe	86.47	2.29	11.24	5.02	18.10	1.22	0.98	2.40	28.48	0.15	11.57	6.74	3.05	15 388
Southern Europe	82.91	9.86	7.23	3.78	15.89	1.16	0.91	2.87	29.35	1.04	12.23	5.09	3.42	3 652
Northern Europe	79.96	4.62	15.48	4.70	14.55	1.33	0.99	2.35	37.57	0.67	27.23	5.12	3.15	3 552
Eastern Europe	76.42	13.44	10.14	4.76	10.85	1.18	0.84	0.90	56.03	0.08	8.55	2.21	4.11	848
High-income countries	84.75	3.90	11.35	4.72	16.97	1.22	0.97	2.45	30.10	0.32	13.44	6.11	3.14	22 710
Consolidated firms	62.30	5.92	31.78	4.31	13.60	1.27	0.95	2.13	38.66	1.09	23.54	4.45	3.23	6 620
Unconsolidated firms	93.10	3.59	3.31	4.96	18.65	1.21	0.97	2.51	27.85	0.16	10.51	6.65	3.14	16 938
Manufacturing firms	88.84	3.57	7.59	4.88	14.08	1.31	0.95	1.84	36.60	0.32	16.41	4.13	3.96	8 510
Non-manufacturing firms	81.96	4.63	13.41	4.66	18.59	1.19	0.97	2.81	26.54	0.26	11.17	8.35	2.81	15 048

- a) The table contains descriptive statistics for the balanced panel of 23,558 observations of non-listed firms in 2002 and 2003, with annual operating revenues over USD 50 million. The *mean* value is reported for the dummy variables in the 'Ownership' categories, whereas for financial ratios the *median* value is reported. Country information for non-listed firms is aggregated based on geographic, income and industry criteria. In particular, the total sample is divided into Western Europe (*i.e.* Belgium, France, Germany, the Netherlands, and the United Kingdom), Southern Europe (*i.e.* Greece, Italy, Portugal, and Spain), Northern Europe (*i.e.* Denmark, Norway, and Sweden), and Eastern Europe (*i.e.* Croatia, Czech Republic, Hungary, Poland, Romania, Russian Federation, and Ukraine). In a related fashion, high-income countries are all those in Western, Northern and Southern Europe, including Switzerland. Finally, descriptive statistics are presented based on (i) whether firms belong to the manufacturing sector (NACE 15-37) and (ii) whether firms file consolidated or unconsolidated financial statements.

Table 2.6 Descriptive statistics for ownership and financial ratios in large listed European firms

	Ownership			Profitability		Liquidity & Solvency			Investment Behaviour & Debt Structure			Capital Intensity & Efficiency		Sample Size
	Percentage with a blockholder over 50%	Percentage with a blockholder between 25% and 50%	Percentage with no blockholder over 25%	Return-on-assets	Return-on-shareholders	Current ratio	Liquidity ratio	Debt-to-equity ratio	Fixed assets as a % of total assets	Intangible assets as a % of total assets	Non-current debt as a % of total debt	Sales/fixed assets ratio	EBIT margin	
All countries	29.89	25.10	45.01	4.42	11.86	1.35	1.00	1.45	47.86	5.84	34.00	2.35	5.16	3 586
Western Europe	24.45	21.42	54.12	4.64	13.24	1.31	0.96	1.54	46.05	9.07	32.09	2.75	4.99	2 110
Southern Europe	46.76	25.90	27.34	4.09	10.65	1.23	0.89	1.53	50.62	3.40	30.41	1.65	6.95	556
Northern Europe	16.88	38.40	44.73	3.85	10.84	1.52	1.10	1.51	49.95	6.88	44.75	2.46	4.27	474
Eastern Europe	49.54	37.61	12.84	4.50	8.47	1.27	0.99	0.72	62.32	0.06	22.20	1.54	6.75	218
High-income countries	28.62	24.29	47.09	4.42	12.08	1.35	1.00	1.51	46.94	6.85	34.86	2.42	5.09	3 368
Consolidated firms	27.35	23.75	48.89	4.40	12.14	1.36	1.00	1.53	46.81	7.65	35.56	2.49	5.00	3 166
Unconsolidated firms	49.05	35.24	15.71	4.63	9.40	1.28	0.98	0.89	57.26	0.37	22.57	1.52	7.38	420
Manufacturing firms	27.33	23.76	48.91	4.43	10.88	1.53	1.02	1.25	45.69	4.92	35.27	2.54	5.15	1 149
Non-manufacturing firms	31.10	25.73	43.17	4.42	12.34	1.26	0.98	1.58	49.64	6.56	33.26	2.25	5.17	2 437

- a) The table contains descriptive statistics for the balanced panel of 3 586 observations of listed firms in 2002 and 2003, with annual operating revenues over USD 50 million. The *mean* value is reported for the dummy variables in the 'Ownership' categories, whereas for financial ratios the *median* value is reported. Country information for publicly listed firms is aggregated based on geographic, income and industry criteria. In particular, the total sample is divided to Western Europe (*i.e.* Belgium, France, Germany, the Netherlands, and the United Kingdom), Southern Europe (*i.e.* Greece, Italy, Portugal, and Spain), Northern Europe (*i.e.* Denmark, Norway, and Sweden), and Eastern Europe (*i.e.* Croatia, Czech Republic, Hungary, Poland, Romania, Russian Federation, and Ukraine). In a related fashion, High-Income countries are all those in the Western, Northern and Southern Europe, as well as Switzerland. Finally, descriptive statistics are presented based on (i) whether firms belong to the manufacturing sector (NACE 15-37) and (ii) whether firms file consolidated or unconsolidated financial statements.

Table 2.7.a The case for matching-pair analysis: Size of listed vs. non-listed firms^a

	Operating Revenues [in \$m]			Employment			Sample size
	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	
All countries	2 861 (356)	450 (148)	***	11 673 (1 768)	1 580 (448)	***	27 144
Western Europe	3 716 (417)	502 (152)	***	15 273 (2 124)	1 584 (462)	***	17 498
Southern Europe	2 068 (319)	370 (140)	***	5 624 (1 239)	1 012 (378)	***	4 208
Northern Europe	1 478 (305)	334 (142)	***	6 551 (1 052)	1 021 (377)	***	4 026
Eastern Europe	493 (215)	271 (135)	***	7 657 (3 171)	6 016 (2 500)	*	1 066
High-income	3 014 (375)	457 (148)	***	11 933 (1 720)	1 415 (432)	***	26 078
Consolidated firms	3 185 (410)	685 (169)	***	12 636 (1 937)	2 524 (592)	***	9 786
Unconsolidated firms	416 (181)	358 (140)		4 411 (1 145)	1 211 (404)	**	17 358
Manufacturing firms	2 736 (288)	399 (142)	***	10 038 (1 604)	1 320 (522)	***	9 659
Non-manufactur. firms	2 920 (399)	479 (150)	***	12 444 (1 902)	1 727 (379)	***	17 485

- a) This table presents tests for equality of firm size between listed and non-listed firms. In particular, non-listed and listed firms are compared in terms of mean/median firm size and age using parametric tests (*t*-tests). Operating revenues and employment are used as proxies for firm size. For each variable under comparison there are three columns; two columns for the means for non-listed and listed firms, respectively, and one column for the significance of the difference. Medians are placed in parentheses. Asterisks are used to demonstrate a significant difference at 1 (***) , 5 (**) and 10 (*) percent level, respectively. Similarly, lack of asterisks suggests that there is no significant difference between listed and non-listed firms. The total sample is divided into Western Europe (*i.e.* Belgium, France, Germany, the Netherlands, and the United Kingdom), Southern Europe (*i.e.* Greece, Italy, Portugal, and Spain), Northern Europe (*i.e.* Denmark, Norway, and Sweden), and Eastern Europe (*i.e.* Croatia, Czech Republic, Poland, Romania, Russian Federation, and Ukraine). High-income countries are all those in Western, Southern and Northern Europe, including Switzerland. Finally, data are aggregated based on (i) whether firms belong to the manufacturing sector (NACE 15-37), and (ii) whether firms file consolidated or unconsolidated financial statements.

Table 2.7.b The case for matching-pair analysis: Industry composition of listed vs. non-listed firms^a

	Listed	Non-listed
Section A: <i>Agriculture, hunting and forestry</i>	0.28	0.55
Section B: <i>Fishing</i>	0.06	0.05
Section C: <i>Mining and quarrying</i>	1.95	1.36
Section D: <i>Manufacturing</i>	32.04	36.12
Section E: <i>Electricity, gas and water supply</i>	4.52	2.87
Section F: <i>Construction</i>	4.21	5.41
Section G: <i>Wholesale and retail trade</i>	9.48	27.40
Section H: <i>Hotels and restaurants</i>	1.23	1.07
Section I: <i>Transport, storage and communication</i>	5.02	6.61
Section J: <i>Financial intermediation</i>	2.96	1.92
Section K: <i>Real estate, renting and business activities</i>	35.81	14.33
Section L: <i>Public administration and defense</i>	0.00	0.07
Section M: <i>Education</i>	0.11	0.04
Section N: <i>Health and social work</i>	0.39	0.37
Section O: <i>Other community, social and personal service activities</i>	1.95	1.82
Other (<i>i.e. Sections P and Q</i>)	0.00	0.02
	Sample size	
	3 586	23 558

- a) This table presents descriptive statistics for the industry composition of the samples of listed and non-listed firms, based on the NACE classification system. Numbers in the 'listed' and 'non-listed' columns represent the percentage of firms from the respective industry in each sample.

Table 2.8.a Matched-pairs analysis for ownership structure: Presence of blockholders in listed vs. non-listed firms

	Block>50%			25%<Block<50%			No Block>25%			Sample size
	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	Listed	listed	Diff.	
All countries	22.28	64.75	***	23.64	8.13	***	54.06	27.1	***	1328
Western Europe	17.3	65.64	***	16.53	2.03	***	66.15	32.31	***	786
Southern Europe	50.66	70.66	**	17.33	26.66		32	2.66	***	150
Northern Europe	14.37	61.43	***	39.21	9.8	***	46.4	28.75	***	306
Eastern Europe	48.38	64.51		45.16	29.03		6.45	6.45		62
High-income countries	21.01	64.77	***	22.59	7.1	***	56.39	28.12	***	1266
Consolidated firms	17.6	63.2	***	22.88	5.63	***	59.5	31.16	***	1136
Unconsolidated firms	50	73.95	***	28.12	22.91		21.87	3.12	***	192
Manufacturing firms	23.58	66.66	***	24.61	10.76	***	51.79	22.56	***	390
Non-manufactur. firms	21.74	63.96	***	23.24	7.03	***	55.01	28.99	***	938

a) This table illustrates the percentage of firms with blockholders using matched pairs of listed and non-listed firms. For each ownership dummy variable under comparison there are two columns for the means for non-listed and listed firms, respectively. The total sample is divided to Western Europe (*i.e.* Belgium, France, Germany, the Netherlands, and the United Kingdom), Southern Europe (*i.e.* Greece, Italy, Portugal, and Spain), Northern Europe (*i.e.* Denmark, Norway, and Sweden), and Eastern Europe (*i.e.* Croatia, Czech Republic, Poland, Romania, Russian Federation, and Ukraine). High-income countries are all those in the Western, Southern and Northern Europe, as well as Switzerland. Finally, data are aggregated based on (a) whether firms belong to the manufacturing sector (NACE 15-37) and (b) whether firms file consolidated or unconsolidated financial statements.

Table 2.8.b Matched-pairs analysis for ownership structure: Type of ultimate owner in listed vs. non-listed firms^a

	Panel A Type of ultimate owner if blockholding is larger than 25%									Sample size
	State			Family			Industrial			
	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	
All countries	7.20	16.52	***	46.61	33.89	***	37.71	35.59		472.00
High-income countries	3.18	10.90	***	49.09	35.90	***	38.63	38.18		440.00
Manufact. firms	0.00	5.40	**	55.40	39.18	**	40.54	47.29		148.00
Non-manufactur. firms	10.49	21.60	***	42.59	31.48	**	36.41	30.24		324.00

	Panel B Type of ultimate owner if blockholding is larger than 50%									Sample size
	State			Family			Industrial			
	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	
All countries	6.91	17.55	***	44.68	32.97	**	42.02	38.29		376.00
High-income countries	2.87	11.49	***	47.12	35.05	**	43.10	41.37		348.00
Manufact. firms	0.00	3.70		50.00	38.88		48.14	57.40		108.00
Non-manufactur. firms	9.70	23.13	***	42.53	30.59	**	39.55	30.59		268.00

a) This table presents differences in ultimate ownership type between listed and non-listed firms. The focus is on the three main types of ultimate owners; *i.e.* State, family and industrial company. For each ownership dummy variable under comparison there are two columns for the means for non-listed and listed firms, respectively, thus illustrating the percentage of firms with each type of ultimate owner. Notably, the matched-pairs are fewer than the ones in Table 8a because in the case of ultimate owner typology it is needed to drop from the initial sample all observations for independent firms, observations with missing information for the type of ultimate owner, and observations from subsidiaries (*i.e.* non-listed firms that are wholly owned by industrial companies). Finally, besides the six criteria (year of operation, 2-digit NACE industry, level of consolidation, operating revenues, number of employees, and date of incorporation), an additional criterion during the matching process for the results in this table is the requirement for matched firms to have the same kind of blockholding; *i.e.* either medium or large blockholding.

Table 2.9. **Matched-pairs analysis: Performance and efficiency in listed vs. non-listed firms^a**

	Return-on-Assets			Return-on-Shareholders			EBIT margin			Sample size
	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	
All countries	2.67 (3.95)	4.83 (4.13)	***	4.54 (9.98)	12.61 (13.55)	** (***)	7.01 (4.71)	5.61 (3.69)	**	1 328
Western Europe	2.92 (4.17)	4.42 (4.00)	*	5.76 (10.78)	11.20 (13.64)		7.12 (4.48)	5.36 (3.18)	** (***)	786
Southern Europe	6.41 (4.02)	5.79 (4.14)		11.92 (9.07)	28.37 (17.09)	** (**)	10.13 (6.38)	6.86 (5.86)	*	150
Northern Europe	-0.52 (2.89)	5.03 (4.12)	***	-3.28 (7.72)	7.81 (12.02)	* (**)	4.43 (2.79)	5.03 (2.81)		306
Eastern Europe	4.77 (3.97)	7.96 (5.82)		6.12 (7.91)	23.28 (9.74)		6.27 (5.00)	9.28 (4.91)		62
High-income countries	2.57 (3.95)	4.68 (3.96)	***	4.46 (10.03)	12.09 (13.69)	** (**)	7.04 (4.71)	5.43 (3.45)	** (*)	1 266
Consolidated firms	2.10 (3.90)	4.48 (3.93)	***	3.44 (10.30)	9.30 (12.82)		6.45 (4.47)	5.28 (3.25)	*	1 136
Unconsolidated firms	6.09 (4.08)	6.94 (5.38)		11.03 (8.32)	32.23 (16.66)	*** (**)	10.28 (5.97)	7.59 (5.13)		192
Manufacturing firms	1.97 (4.15)	4.70 (4.43)	**	-1.70 (8.32)	11.48 (10.83)	* (*)	4.58 (5.10)	4.50 (3.73)		390
Non-manufact. firms	2.97 (3.89)	4.89 (4.12)	**	7.13 (10.77)	13.09 (14.56)		8.02 (4.45)	6.08 (3.64)	**	938

a) This table presents tests for equality of firm characteristics between listed and non-listed firms. In particular, non-listed and listed firms are compared in terms of mean/median firm performance and efficiency using parametric (*t-test*) and non-parametric (*Sign*) tests. Return-on-Assets and Return-on-Shareholders are employed as proxies for firm performance. EBIT margin is used as a proxy for firm efficiency. For each variable under comparison there are three columns; two columns for the means for non-listed and listed firms, respectively, and one column for the significance of the difference. Medians and the results from the Sign- tests are placed in parentheses. Asterisks are used to demonstrate a significant difference at 1 (***) , 5 (**) and 10 (*) percent level, respectively.

Table 2.10 Matched-pairs analysis: Capital intensity, investment behaviour and debt structure in listed vs. non-listed firms^a

	Fixed assets as a percentage of total assets			Sales/(fixed assets) ratio			Non-current debt as a percentage of total debt			Sample size
	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	Listed	Non-listed	Diff.	
All countries	46.69 (44.80)	39.56 (37.00)	*** (***)	7.31 (2.82)	13.77 (4.01)	*** (***)	31.69 (27.68)	28.76 (21.50)	**	1 328
Western Europe	45.68 (42.90)	37.02 (33.24)	*** (***)	8.14 (3.24)	14.71 (4.81)	*** (***)	30.19 (23.37)	25.16 (15.82)	*** (*)	786
Southern Europe	44.81 (43.64)	32.60 (34.15)	*** (**)	5.25 (1.65)	12.92 (3.82)	** (**)	24.04 (23.04)	24.44 (15.05)		150
Northern Europe	47.87 (47.29)	45.84 (41.39)		6.96 (2.87)	14.31 (3.73)		40.34 (37.87)	40.23 (39.18)		306
Eastern Europe	51.02 (51.46)	49.45 (58.97)		5.71 (1.75)	5.94 (2.06)		18.87 (19.26)	17.59 (5.94)	(*)	62
High-income countries	46.47 (44.50)	39.07 (36.08)	*** (***)	7.38 (2.88)	14.15 (4.08)	*** (***)	32.31 (28.35)	29.31 (22.08)	**	1 266
Consolidated firms	46.21 (44.55)	39.90 (37.12)	*** (***)	7.58 (2.97)	14.09 (4.05)	*** (***)	33.18 (29.16)	30.40 (24.02)	**	1 136
Unconsolidated firms	49.53 (49.12)	37.54 (35.22)	*** (***)	5.71 (1.82)	11.88 (3.50)	** (**)	22.84 (20.96)	19.04 (6.08)	(**)	192
Manufacturing firms	46.59 (44.34)	38.01 (37.00)	*** (***)	3.43 (2.64)	7.99 (3.53)	*** (***)	26.79 (25.01)	24.12 (17.92)	(**)	390
Non-manufact. firms	46.73 (45.52)	40.20 (36.99)	*** (***)	8.92 (2.96)	16.17 (4.35)	*** (***)	33.72 (28.92)	30.69 (23.70)	**	938

- a) This table presents tests for equality of firm characteristics between listed and non-listed firms. In particular, non-listed and listed firms are compared in terms of mean/median capital intensity, investment behaviour and debt structure using parametric (*t-test*) and non-parametric (*Sign*) tests. Proxies for these three aspects are the ratio of fixed assets to total assets, the ratio of sales to fixed assets, and the ratio of non-current debt to total debt, respectively. For each variable under comparison there are three columns; two columns for the means for non-listed and listed firms, respectively, and one column for the significance of the difference. Medians and the results from the *Sign*-tests are placed in parentheses. Asterisks are used to demonstrate a significant difference at 1 (***) , 5 (**) and 10 (*) percent level, respectively.

Table 2.11 Means, standard deviations and correlations of variables for analysis^a

Variable	Mean	S.D.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(1) Operating revenues (ln)	19.38	1.14		0.56*	0.19*	0.14*	0.06*	-0.23*	0.04*	-0.05
(2) Employment (ln)	6.31	1.62	0.61*		0.25*	0.35*	0.11*	-0.31*	0.06*	-0.13*
(3) Consolidated (dummy)	0.36	0.48	0.23*	0.25*		0.20*	-0.01	-0.42*	0.13*	-0.47*
(4) Fixed. assets/total assets ratio	0.36	0.25	0.16*	0.31*	0.18*		0.03*	-0.21*	0.08*	-0.15*
(5) Firm age (in years)	32.12	28.72	0.13*	0.18*	0.04*	0.07*		-0.10*	0	0
(6) Non-listed (NL)	0.86	0.343	-0.29*	-0.33*	-0.42*	-0.20*	-0.15*		-0.28*	0.44*
(7) Medium blockholder (25-50%)	0.07	0.25	0.04*	0.06*	0.13*	0.07*	0.02*	-0.28*		-0.50*
(8) Large blockholder (>50%)	0.76	0.42	-0.09*	-0.14*	-0.47*	-0.14*	-0.03*	0.44*	-0.50*	

- a) Descriptive statistics for independent variables used in OLS regression for determinants of accounting performance are given below. Pearson and Spearman correlation coefficients are reported below and above the diagonal, respectively. The asterisk (*) denotes two-tailed significance levels equal or less than 0.05 ($\alpha \leq 0.05$). The pooled sample, obtained from *BvD Amadeus*, contains 12 791 firms for fiscal year 2003 with operating revenues over USD 50 million.

Table 2.12 Regression analysis on determinants of accounting performance: ROA^a

Independent Variables	Dependent Variable			
	ROA _(3 years)	ROA _(3 years)	ROA _(3 years)	ROA _(3 years)
	I	II	III	IV
Intercept	0.044 (0.03)	0.126 (0.10)	0.101 (0.08)	0.565 (0.39)
Operating revenues (<i>ln</i>)	0.386*** (4.02)	0.376*** (3.91)	0.371*** (3.87)	0.306*** (2.91)
Employment (<i>ln</i>)	-0.091 (-1.12)	-0.093 (-1.15)	-0.097 (-1.20)	-0.064 (-0.71)
Consolidated (<i>dummy</i>)	-1.846*** (-9.37)	-1.725*** (-7.98)	-1.627*** (-7.67)	-1.553*** (-6.57)
Fixed assets/total assets ratio	-4.543*** (-11.77)	-4.523*** (-11.67)	-4.497*** (-11.60)	-4.310*** (-10.33)
Firm age (<i>in years</i>)	0.009*** (3.22)	0.009*** (3.23)	0.009*** (3.22)	0.009*** (3.07)
Non-listed (NL)	0.829*** (3.10)	0.594** (1.99)	0.532* (1.94)	0.564* (1.90)
NL × large blockholder (>50%)	—	0.353 (1.63)	—	—
Medium blockholder (25-50%)	—	—	-0.428 (-1.32)	-0.551* (-1.67)
Large blockholder (>50%)	—	—	0.579*** (2.69)	—
Large blockholder is state	—	—	—	-0.368 (-0.71)
Large blockholder is family	—	—	—	0.572* (1.69)
Large blockholder is industrial company	—	—	—	0.824*** (3.41)
Large blockholder is financial company	—	—	—	0.453 (0.80)
Large blockholder is other type of company	—	—	—	1.420* (1.76)
Country effects	Yes	Yes	Yes	Yes
Industry effects (2-digit NACE)	Yes	Yes	Yes	Yes
Observations	12 791	12 791	12 791	10 290
R ²	0.073	0.073	0.074	0.077

Significant at 1% (***), 5% (**), and 10% (*) level.

- a) The sample consists of 12 791 observations for fiscal year 2003. The dependent variable is the three-year return-on-assets (ROA), which is the average of annual ROA over three consecutive fiscal years. The coefficient for each variable is presented with the corresponding t-statistic in brackets. The values of t-statistics (based on the Huber/White robust estimator of variance) appear in parentheses below each coefficient estimate for OLS estimation.

Table 2.13 Regression analysis on determinants of accounting performance: ROS^a

Independent Variables	Dependent Variable			
	ROS _(3 years)	ROS _(3 years)	ROS _(3 years)	ROS _(3 years)
	I	II	III	IV
Intercept	-16.003** (-2.21)	-15.728** (-2.17)	-16.343** (-2.23)	-12.231 (1.48)
Operating revenues (<i>ln</i>)	4.218*** (6.72)	4.186*** (6.64)	4.170*** (6.63)	3.668*** (5.16)
Employment (<i>ln</i>)	-1.362** (-2.49)	-1.370** (-2.51)	-1.377** (-2.52)	-1.109* (-1.75)
Consolidated (<i>dummy</i>)	-11.565*** (-9.22)	-11.161*** (-8.45)	-10.803*** (-8.34)	-11.081*** (-7.62)
Fixed assets/total assets ratio	-29.955*** (-10.76)	-29.889*** (-10.73)	-29.788*** (-10.67)	-29.704*** (-9.59)
Firm age (<i>in years</i>)	-0.009 (-0.62)	-0.009 (-0.62)	-0.009 (-0.64)	-0.008 (-0.50)
Non-listed (NL)	4.820*** (3.94)	4.040*** (2.60)	3.972*** (3.03)	3.902*** (2.68)
NL × large blockholder (>50%)	—	1.174 (0.84)	—	—
Medium blockholder (25-50%)	—	—	0.012 (0.01)	-0.327 (-0.17)
Large blockholder (>50%)	—	—	2.230* (1.80)	—
Large blockholder is state	—	—	—	-4.468 (-1.60)
Large blockholder is family	—	—	—	3.256 (1.57)
Large blockholder is industrial company	—	—	—	3.409** (2.36)
Large blockholder is financial company	—	—	—	-3.708 (-1.09)
Large blockholder is other type of company	—	—	—	-0.381 (-0.04)
Country effects	Yes	Yes	Yes	Yes
Industry effects (2-digit NACE)	Yes	Yes	Yes	Yes
Observations	12 791	12 791	12 791	10 290
R ²	0.060	0.060	0.060	0.060

Significant at 1% (***), 5% (**), and 10% (*) level.

- a) The sample consists of 12 791 observations for fiscal year 2003. The dependent variable is the three-year return-on-shareholders (ROS), which is the average of annual ROS over three consecutive fiscal years. The coefficient for each variable is presented with the corresponding t-statistic in brackets. The values of t-statistics (based on the Huber/White robust estimator of variance) appear in parentheses below each coefficient estimate for OLS estimation.

NOTES

1. Note that the signs next to the letters A and B indicate the degree of certainty – with regard to accuracy - that Amadeus gives to the classification, based on the number of identified shareholders (the sign ‘+’ depicts very high certainty, whereas the sign ‘—’ indicates low certainty). Since the vast majority of ownership information on blockholdings is either of high or medium certainty, we aggregate based on the letter and we do not further differentiate based on the sign.
2. Since the sample is a balanced panel for 2002 and 2003, the number of observations is twice the number of firms.
3. On a less important note, Tables 1 and 2 also illustrate the size differences: the average operating revenues of NLCs is USD 148 million, whereas it is USD 356 million for the LCs. In terms of size, differences among countries with regard to median operating revenues are smaller for NLCs, with a maximum of USD 246 million for Germany and a minimum of USD 107 million for Poland. Among LCs, differences are greater among countries, with a maximum median operating revenue of USD 795 for the Netherlands and a minimum of USD 79 million for Poland. Although there are differences between the sizes of NLCs and LCs, we do not differentiate these statistics by size of firms. For this sample, ownership structures do not appear to vary substantially with firm size, probably because we already focus on large firms (i.e. those with over USD 50 million in operating revenues). Only when we compare groups of non-listed firms of very different size, for instance firms with less than USD 100 million operating revenues versus firms with more than USD 300 million operating revenues, do we observe considerable differences in ownership structure (not reported)..
4. Note that in Tables 3a and 4a we dropped firms that are explicitly classified by Amadeus as being subsidiaries or 100% owned by an industrial firm, as well as firms for which this type of blockholder data is missing.
5. Abadie, A., D. Drukker, J. Leber-Herr, and G.W. Imbens (2004), Implementing matching estimators for average treatment effects in Stata. *Stata Journal*, 4(3), pp. 290-311.
6. Notably, both the significance and magnitude of the OLS estimates for non-listed firms and blockholders (i.e. specification IV in Tables 12 and 13) hold, even if we employ a two-stage estimation in order to account for possible sample selection bias due to missing observations regarding the type of blockholder.

APPENDIX

1. Variables definition

A. Profitability

$$\text{Return}_{on_Assets} = \frac{\text{Profit(Loss) before Taxation}}{\text{Total Assets}}$$

$$\text{Return}_{on_Shareholders} = \frac{\text{Profit(Loss) before Taxation}}{\text{Shareholders Funds}}$$

B. Liquidity & solvency

$$\text{Current}_{ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Liquidity}_{ratio} = \frac{\text{Current Assets (Stocks)}}{\text{Current Liabilities}}$$

$$\text{Debt}_{to_equity}_{ratio} = \frac{\text{Total Debt}}{\text{Shareholders Equity}}$$

C. Investment behaviour & debt structure

$$\text{Asset}_{structure}_1 = \frac{\text{Fixed Assets}}{\text{Total Assets}}$$

$$\text{Asset}_{structure}_2 = \frac{\text{Intangible Assets}}{\text{Total Assets}}$$

$$\text{Debt}_{structure} = \frac{\text{Noncurrent Debt}}{\text{Total Debt}}$$

D. Capital intensity & efficiency

$$\text{Capital}_{Intensity} = \frac{\text{Sales}}{\text{Fixed Assets}}$$

$$\text{EBIT}_{margin} = \frac{\text{Operating Profit(Loss)}}{\text{Operating Revenues}}$$

2. Matching criteria

Each non-listed firm is matched with a listed firm along exact or approximate criteria.

These seven criteria are as follows:

- **Exact Criteria:** Country, Year, two-digit NACE industry, Consolidated Accounting
- **Approximate Criteria:** Operating revenues, Employment, Date of Incorporation

Also in Table 2.8b, besides these seven criteria, an additional (exact) criterion employed is the requirement for matched firms to have the same kind of blockholding; *i.e.* either medium or large blockholding.

Chapter 3

NATIONAL VARIATION IN FINANCING PATTERNS*

by
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Throughout this chapter, we focus on firms that are not listed on stock exchanges; our special emphasis is on large firms that may exhibit information asymmetries and agency costs because such companies are most likely to experience corporate governance problems (*i.e.* expropriation of value at the expense of minority shareholders). More specifically, by “large firms” we mean those that are relatively similar in size to listed firms in the same country. Thus, we focus on widely held, non-listed companies that may be of interest to policy-makers and regulators.

The first major finding of our research is that very little is known about NLC financing within OECD countries, and even less is known about them in the non-OECD context. Despite the relative paucity of studies on non-OECD NLCs, we arrive at some general findings about patterns, use of finance, and implications for corporate governance and policy. A novel finding we develop in this paper using a unique database is that, relative to listed firms in the same industry with analogous size (measured by total assets), NLCs are more likely to have greater leverage (measured either as long-term debt as a portion of assets or as a portion of total debt), at least for a selection of both OECD and non-OECD countries in Central and Eastern Europe. This research has some important policy implications. In terms of NLC corporate governance, two goals confront policy-makers: (*i*) to ensure that assets are allocated to their most efficient use, and (*ii*) to allow the greatest number of investors to participate equitably in capital markets. A major goal of future research should be to document disclosure requirements, listing requirements, and legal remedies in various settings around the world, for both listed companies and NLCs.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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Introduction

This paper addresses three themes: (i) What are the key sources and patterns of financing for large, non-listed companies (NLCs) for OECD and non-OECD countries? (ii) How are investment and lending decisions made in the context of privately held companies? (iii) What requirements exist to accommodate various types of outside capital, and how can policy decisions assist firms in obtaining external finance?

Throughout this paper, we focus on firms that are not listed on stock exchanges; our special emphasis is on large firms that may exhibit information asymmetries and agency costs because such companies are most likely to experience corporate governance problems (*i.e.* expropriation of value at the expense of minority shareholders). More specifically, by “large firms” we mean those that are relatively similar in size to listed firms in the same country. Thus, we focus on widely held, non-listed companies that may be of interest to policy-makers and regulators.

Thus, what can be ascertained about their sources of finance, financing patterns, decisions, corporate governance problems and appropriate policies to deal with them is tentative at this point. The typical non-OECD environment is characterised by relatively weak investor protection, which is also true for a number of OECD countries. A by-product of this research is that sharp distinctions—such as those between listed and unlisted, OECD and non-OECD—are to some extent over-simplifications. In terms of capital market characteristics, some OECD members may have more in common with nearby non-OECD members than, for example, with the United States; some listed firms with very infrequent trading may be more similar to NLCs than to listed companies in deep and liquid capital markets. For example, small investors in a Romanian NLC may face problems that are more similar to those of minority shareholders of an illiquid but listed firm in the Czech Republic (an OECD member) than those of an NLC in the United States. Indeed, in the U.S., minimal disclosure requirements are based on the number of shareholders, and not on whether a firm decides to list on a public exchange (although most widely held firms are in fact listed).

For example, we find that dispersed shareholders of NLCs are perhaps in *more* danger of facing expropriation (“private benefits of control” extracted by block-holders at the expense of minority shareholders) relative to dispersed shareholders of listed firms—especially because NLC shareholders are likely to face a less liquid market for their ownership stake. So-called private benefits are difficult to observe, but include transfer pricing, asset stripping, and use of the firm’s assets as collateral for loans taken out by controlling shareholders.¹ These problems are more likely to take place when the control rights deviate from the cash-flow rights afforded by share ownership. Often, pyramidal ownership structures present a method for families or other groups to extract such benefits at the expense of minority shareholders. For NLCs that do not disclose information to all shareholders, such practices are inherently easier to conceal. We present some evidence from previous studies of listed firms to provide proxies for how private benefits of control vary in different countries.

This may indicate that NLCs face fewer agency problems between large shareholders and managers, especially if debt serves as a disciplining device used by controlling shareholders. In other settings, greater leverage imposed by active owners forces managers to achieve regular earnings necessary for interest payments (in contrast, failure to pay dividends is not a liability on the firm); also, if the firm fails, managers lose control to creditors. It remains to be seen if these aspects of debt hold in the non-OECD cases, where legal rules relating to creditors may not be effectively enforced. Nevertheless, we find that, even controlling for a number of factors that are associated with leverage in other studies, NLCs tend to have more debt than their listed counterparts, in both OECD and non-OECD cases.

The first goal means that policy-makers should allow shareholders (often, holders of controlling blocks) to control managers in order to prevent the latter from acting contrary to the interests of owners. The second goal means that NLC minority shareholders need protection from controlling shareholders, who will be tempted to extract private benefits of control. Devices for protecting minority shareholders include a well-functioning legal system to allow redress in the event of malfeasance, strong and independent boards of directors, and transparency of ownership and rights (control and cash flow) associated with equity shares. Further discussion about the existing OECD Principles of Corporate Governance and their application to NLCs in non-OECD settings is certainly warranted.

1. Demand and Supply for External Finance

The patterns of actual financing—quantities of debt and equity issued—reflect the demand and supply for external funding, both of which can be affected by government policies and the institutional environment. In terms of *demand*, privately held firms face an inherently higher cost of capital compared to public firms that list shares in liquid equity markets (the extent of this premium is measured using the concept of “marketability discount”), which affects the quantity of external finance demanded.² The reason stock markets exist, then, is to increase the liquidity of a firm’s ownership: more liquid assets are worth more. Thus, assets of a liquid (listed) firm that are otherwise identical to assets of an unlisted firm will be worth more.

Of course, there may be advantages to remaining closely held: maintaining control, secrecy, avoiding disclosure costs, etc. The benefits—and costs—of “going public” and obtaining a large number of (potential) owners vary according to a number of factors, and at the very least relate to the liquidity of the bourse and often required extensive disclosure. Another factor that affects the demand for capital for both listed and unlisted firms concerns the effectiveness of *corporate governance*: if manager interests are not aligned with those of shareholders, firms may borrow too much or too little, and otherwise act at odds with the goal of maximising the value of equity. This is the classic corporate governance situation (diverse shareholders attempting to prevent controlling managers from diverting resources to their own benefit). In the case of NLCs, however, strong controlling shareholders generally are able to impose their preferences upon management. In the case of the NLCs, small shareholders are the potential victims of block owners—their ownership of a non-marketable, minority interest in a firm can be impacted substantially, even in institutional environments that are set up to assist small shareholders.

How big does a firm become before it lists on an exchange in the U.S.? There are several large U.S. corporations that could easily pass the listing requirements of major stock exchanges, but choose not to, and remain closely held. Note that the SEC requires firms with a large enough base of owners³ to disclose, whether they are listed or not (Leunz, *et al*, 2005). The policy issue of protection of small shareholders revolves not so much around whether a firm is listed, but more around whether firms are widely held. Depending on the legal setting, a NLC that is widely held may not be required to disclose, and this is a major policy implication of corporate governance for NLCs.

Even though many large firms that are widely held are forced to disclose, there are some firms that have recently chosen to go private, especially in light of the changes in disclosure following the implementation of Sarbanes-Oxley legislation. According to one estimate (Block, 2004), the cost of disclosure increased from less than USD 1 million to almost USD 2 million per year. In the time period from January, 2001 to July, 2003, 236 firms decided to voluntarily delist (an exercise that generally costs less than USD 100 000). The managers and current owners of these firms decided that the benefits of being publicly listed (potentially increased liquidity) were not worth the costs (greater disclosure). Especially for firms that are not experiencing the liquidity benefits that can accrue to public listing, going private may actually increase owner welfare if the costs of disclosure outweigh the liquidity benefits of being widely held.

The national environment also affects the aggregate *supply* of external finance. For example, financial repression (holding interest rates below their equilibrium level to create a surplus of capital that can be allocated to government-favoured firms, industries, or programmes) at the macroeconomic level can lead to a capital crunch for companies, be they held privately or publicly. At the same time, rules and regulations that tax investment (either explicitly or through hidden taxes, such as corruption and opacity—see Wei and Hall, 2001) will tend to limit the supply of external finance, all else being equal.

2. NLC Financing Patterns and Composition: Previous Studies

We now turn to some important conceptual issues relating to NLC finance, and consider empirical studies relating to actual patterns of financing. Financing constraints have been studied in other contexts, and it has been shown that access to highly liquid public equity markets is the exception rather than the rule for the vast majority of firms in most countries (Beck, et al., 2002, 2004, 2005); these studies do not, however, focus on the case of large, unlisted firms, which are the subject of this paper. Indeed, from the perspective of the majority of individual firms around the world, finance in the form of liquid publicly traded shares is the exception rather than the rule. Firms must accumulate assets at a pace no greater than their ability to retain earnings if they cannot obtain external equity or debt, and this is the case for many companies around the world.

Indeed, debt is one of the most important types of external finance, and includes loans from financial institutions such as banks, or, more rarely, corporate bond markets. Note that short-term debt is often provided by suppliers and other businesses (*e.g.* trade credit), but is generally not considered part of a firm's capital structure because it can be relatively easily adjusted by managers, who can, for example, increase or decrease accounts payable over the current period without too much difficulty. Another form of external finance, private equity investment, comes from a small group of relatively wealthy investors, or their agents; in rare cases this includes funds from venture capitalists or later-stage buyout firms. A potentially important third category relates to cross-holdings of equity from other firms. The latter kind of financing is technically “external” to the firm, but may in fact be related to pyramidal ownership (see Claessens, *et al.*, 2000), such that controlling shareholders use overlapping equity ownership among firms to extract private benefits of control by driving a wedge between the cash flow rights and control rights of various classes of ownership shares.

One relatively well-studied pattern of financing relates to capital structure: that is, the relative portions of equity and long-term debt firms use to back their assets. Since managers are often the immediate decision-makers in terms of borrowing, the decision inherently relates to corporate governance. Debt may serve to discipline the conduct of managers, preventing them from increasing the amount of assets above the optimal level as seen from the point of view of owners. By definition, for a firm that is well-managed from the perspective of owners, the level of debt should maximise the value of ownership. In the case of closely held NLCs, large block owners generally have effective control of managers, and this will mean that such firms could have more debt than firms where management is over-investing (we test and confirm this hypothesis later on in the context of large NLCs in Central and Eastern Europe). Such firms may also be more likely to exhibit private benefits of control, where managers acting in the interests of controlling shareholders act in ways that reduce the value of minority equity stakes; for example in Bulgaria, the controlling premium has been estimated to be 80% (see Atanasov, 2005).

Unfortunately, the research relating to actual patterns of financing tends to focus on publicly-listed firms as opposed to NLCs; many studies cover U.S. firms, fewer are about the non-U.S. OECD (especially Europe and Japan) setting, and very few address the non-OECD setting. This means that the amount of research on publicly listed, U.S. firms is vast, whereas academic studies on NLCs in non-OECD countries is extremely sparse. Nevertheless, we will examine briefly each of these cases in turn, focusing on the non-listed company case, and contrasting it when possible to the case of listed firms.

A. *Financing patterns in OECD countries*

Given the importance of bank-based finance in many OECD countries that do not follow the Anglo-Saxon model, the difference between publicly-listed firms and privately held ones may be less important for determining financial structure and other investment decisions than may be the case in the U.S.

According to data from Spain—which, although an OECD member, can also be characterised by relatively weak legal protection of small shareholders—“minority expropriation is a much more important and widespread problem in closely held firms than in listed firms” (Gutierrez and Tribo, 2004, p. 4). Another study using data on Spanish listed firms finds that the debt increments promoted by outside owners are larger when managers are entrenched, and that debt is an effective mechanism for preventing over-investment (Pindado and de la Torre, 2005).

If the financial behaviour of NLCs depends on the legal environment (which has been shown for listed companies—see La Porta *et al.*, 1997 and 1998), then studies of legal system variation could be applied to the NLC sector, although little such work has been done. An interesting study of finance-related changes in laws on the books (Hyytinen, Kuosa, and Takalo, 2003) specifically examines Finland, so is not comparative in nature. Another study on Finnish firms (Maury and Pajuste, 2004) examines the effects of multiple large shareholders on valuation. A more equal distribution of votes among large blocks has a positive effect on the value of the firm. Rajan and Zingales (2003) examine long-term changes in financial development in a few OECD countries over a long period of time, but do not examine firm-level capital structure variation. They find that the size of the financial sector fluctuates over time, so that “Anglo-Saxon” countries with common law legal traditions do not inherently have greater financial depth universally.

B. *Financing patterns in non-OECD countries*

We are aware of only a few studies that concern NLCs in non-OECD settings. Given the illiquidity of stock markets in most such countries, however, the difference between listed and non-listed firms may not be extreme. Indeed, in some countries, listing requirements are very minimal. The advantages of public listing relate to liquidity, so an illiquid listed firm may be very similar to an NLC in any event. Compared to minority shareholders of listed firms, minority shareholders of NLCs may be subject to similar or perhaps greater extraction of private benefits of control, but if disclosure is weak in both cases, the difference may not be too great. In fact, it is in some cases illegal for ownership shares of some NLCs to be sold to non-owners without the express permission of current owners. Minority shareholders of such companies might be very prone to expropriation. One reason why the number of studies devoted to non-OECD settings is relatively low compared with studies of the U.S. and European OECD countries has to do with lack of national statistical data and quality of accounting information in these settings. In fact, in many countries in Europe, disclosure rules exist even for firms that are very closely held. The actual amount of disclosure required by regulators seems to vary significantly among countries, and a major goal of future research should be to document listing requirements, disclosure requirements, and thresholds related to the number of owners in different countries around the world.

Globe-spanning studies

The market for external finance has been studied in papers that include large numbers of countries. Even among listed companies, however, size matters—larger firms tend to have easier access to credit and more leverage. And, as stated above, debt is related to corporate governance because it may have a disciplining effect on management.

How is leverage in turn affected by government policy? A very early study of debt among large, publicly traded firms in developing countries (Glen and Pinto, 1994) notes the importance of liberalisation and the removal of government rules on firm-level finance. A more recent study by Fan, *et al* (2003) considers leverage and financial ratios for a large number of firms in 39 countries. As usual, they only consider listed firms, but the results may be instructive for NLCs. They find that legal and tax systems are associated with leverage and debt maturity, and that the institutional environment (measured using the Corruption Perception Index published by Transparency International) matters as well. Pinkowitz, *et al* (2003) find that, controlling for per capita output, firms in countries with more extensive investor protection hold less cash. Another study examines judicial efficiency, finding that firms in countries with more efficient judiciaries face lower spreads between deposit and lending rates (Laeven and Majnoni, 2004).

Even if the legal environment does not encourage transparency, firms may voluntarily reveal additional information. Using firm-level measures of disclosure, Durnev and Kim (2003) find that variation in disclosure increases as the legal environment gets less-friendly to investors. Firms with greater growth opportunities, greater needs for external finance, and more concentrated cash-flow rights practice more disclosure and better governance. Firms with more disclosure and better governance are also valued higher on the stock market.⁴

Table 3.1 **Block premia for OECD and non-OECD countries**

	Mean Controlling vs. Non-Controlling Premium (percentage of equity)		Mean Controlling vs. Non-Controlling Premium (percentage of equity)
OECD		Non-OECD	
Australia	0.02	Argentina	0.27
Canada	0.01	Brazil	0.65
Czech Republic	0.58	Chile	0.15
Denmark	0.08	Colombia	0.27
Finland	0.02	Egypt	0.04
France	0.02	Hong Kong	0.01
Germany	0.1	Indonesia	0.07
Italy	0.37	Israel	0.27
Japan	-0.04	Malaysia	0.07
Korea, South	0.16	Peru	0.14
Mexico	0.34	Philippines	0.13
Netherlands	0.02	Singapore	0.03
New Zealand	0.03	South Africa	0.02
Norway	0.01	Taiwan	0
Poland	0.11	Venezuela	0.27
Portugal	0.2	Non-OECD Mean	0.159
Spain	0.04		
Sweden	0.06		
Switzerland	0.06		
UK	0.02		
US	0.02		
OECD Mean	0.106		

Source: Dyck and Zingales, 2004; higher numbers indicate market expectations of more expropriation of minority shareholders.

Measuring the private benefits of control has until now been possible only using listed firms. One technique is to compute the difference between the value of controlling and non-controlling equity shares in the same company. A study by Dyck and Zingales (2004) does just that, and Table 3.1 presents the results, broken down for OECD and non-OECD countries. The average (mean) premium for shares priced as a controlling block and expressed as a percentage of the firm's equity is somewhat higher in non-OECD countries, but the difference is not statistically significant (p-value of 0.33). Although this study used listed firms, the block *premia* may be analogous to the case for NLCs. *Nenova* (2000) also provides an early measure of the private benefits of control.

Regional studies

A number of studies examine credit in non-OECD countries in two major regions: Central and Eastern Europe and East Asia. The number of papers is related to events that have generated much attention: the transition from communism in Central and Eastern Europe and the Asian currency crisis.

Central and Eastern Europe (CEE)

Given the events of the past twenty years, many studies of CEE countries relate to the banking sector and the impact of ownership and firm status (foreign, state-owned, privatised, *de novo*) on performance. Previous studies that specifically focus on external finance and legal development in Central and Eastern Europe (Slavova, 1999; Köke and Schröder, 2003; Pistor, Raiser, and Gelfer, 2000; Krkoska, 2001; Berglöf and Bolton, 2002) tend to do so at the aggregate level, examining stock market development or banking assets as a portion of GDP, but eschewing examination of individual firms. The factors associated with capital structure of individual firms are therefore difficult to determine in such research.⁵

One study that specifically addresses firm-level investment (Johnson, McMillan, and Woodruff, 2002) focuses on manufacturing companies based on a 1997 survey, but does not examine the effect of changes in *de jure* regulations over time, and only includes five countries (Poland, Romania, Slovakia, Ukraine, and Russia). Day and Taylor (2004) analyse the implications of debt on corporate governance in Central and Eastern Europe, but find that institutional features hinder its effectiveness. These include the structure and performance of the banking system, effectiveness of systems for accounting and audit, existence of a framework for creating and enforcing contracts, procedures for taking and enforcing collateral provisions, and regulations regarding exit (bankruptcy, insolvency, and efficient management during periods of financial distress). For publicly listed companies in Poland, private benefits of control associated with block ownership exist, but are lower than for the advanced industrialised setting (Trojanowski, 2002).

We know of one study that specifically examines the effects of changes in creditor rights (Hall and Jørgensen, 2005) on firm-level leverage. Using tens of thousands of firm-year observations in various nations at differing levels of economic development and financial market sophistication, that paper investigates the effects of within-country changes in creditor protection on firm-level leverage and debt maturity. Even in the face of firm and macroeconomic controls, laws regarding tradability of land and secured transactions are related to the relationship between asset tangibility and leverage and debt maturity. The *de facto* institutional environment (rule of law), and *de jure* rules of creditor protection are positively and significantly associated with both the amount of debt and its maturity. Institutions and *de jure* law seem to be substitutes in their effects on firm behaviour.

East and South Asia

One of the best studies of financing patterns in non-OECD countries is that by Claessens *et al* (2000), who examine almost 3 000 companies in nine East Asian countries. They find that the “typical”

corporate governance problem of dispersed owners trying to control managers does not apply very well in the region.⁶ Cross-holdings, family holdings, and pyramid structures mean that voting rights can exceed formal cash-flow rights for large owners. The concentration of control generally diminishes with per capita output, perhaps indicating that wealthier countries provide better protection for minority shareholders (or, that countries with better protection become wealthier).

A further investigation of publicly-traded firms in East Asia may also have implications for NLCs. Claessens, *et al* (2002) examine the effect on valuation of ownership concentration in 1 301 such firms in eight countries. They find that value increases with the cash-flow ownership of the largest shareholder, consistent with the argument that block ownership is associated with fewer “typical” corporate governance problems of incentive misalignment between controlling managers and dispersed investors. On the other hand, they find that firm value falls when the control rights of the largest shareholder exceed its cash-flow ownership, which is consistent with the view that entrenched managers block take-over attempts, limiting the value of the firm when they hold too much equity relative to non-managers.

Bunkanwanica, Gupta, and Rokhim (2003) examine entrenched managers of listed firms in Thailand and Indonesia. They find that debt structure is linked to corporate governance, such that firms with more entrenchment tend to have higher levels of debt. Yeh and Woitdke (2005) also examine entrenchment in East Asia, but focus on the composition of the board of directors for Taiwanese publicly traded firms. They find that corporate governance is “worse” when the board is dominated by members who are affiliated with the controlling family, but “better” when the board is dominated by members who are not so affiliated. Relative firm value is negatively related to board affiliation in family-controlled firms. Although these findings are based on publicly traded firms, they may have implications for NLCs, especially in environments with low disclosure and weak investor protection (as is typically the case in the non-OECD context).

In India, business group affiliation is associated with the structure of transactions costs and agency conflicts that firms face (Manos, 2002). Examining listed firms, Kumar (2005) finds that companies with weaker corporate governance mechanisms, dispersed shareholders, and group affiliates tend to have higher levels of debt, whereas firms with institutional or foreign owners tend to have lower levels of debt. These relationships, as has been found in other studies, are non-linear in nature.

One way to examine agency theories relates to dividend payout policies. The optimal level of payments to shareholders (dividends) minimises transactions costs associated with setting the payout ratio either too high or too low (Easterbrook, 1984; Rozeff, 1982). High growth rates and high volatility of growth imply greater dependency on external finance, encouraging firms to increase the level of dividends so as to ensure their ability to issue additional equity in the future. The portion of the firm owned by insiders, however, should be negatively associated with the payout ratio because corporate governance problems are minimised in such cases (this is the NLC situation). Although most of the empirical work has been done using publicly listed firms, private firms also pay dividends. Rao and White (1994) show that dividend policies of 66 NLCs do in fact reflect the same findings. Perhaps by paying dividends, private firms can induce monitoring by bankers, accountants, and tax authorities.

Manos (2002) finds that group affiliation tends to enhance the sensitivity of the dividend decision to the transaction cost structure faced by the firm; that is, the negative correlation between dividend payouts and growth opportunities, returns volatility, and liquidity is not as strong for firms with such affiliations. A greater portion of ownership by foreign institutions leads to greater dividend payouts, although again this effect is mitigated by the presence of group affiliation. On the other hand, such affiliation increases the positive relationship between the presence of institutional investors and the target payout ratio. Most relevant for the current paper, Manos (2002) finds that firms with more dispersed ownership have higher

target dividend payout ratios, which he interprets to mean that such firms have greater collective action problems of monitoring. Surprisingly, the portion of insider ownership is also found to have a positive relationship with the target dividend payout ratio.

3. New Findings on NLC Financing Patterns and Corporate Governance

Table 3.2 displays data on the leverage of a large number of small and large unlisted firms in many countries in Central and Eastern Europe.⁷ The level of long-term debt certainly varies across countries, whether measured as a portion of total assets or as a portion of total debt. Note that it is relatively easy for firms to obtain a reasonable amount of short-term debt in the form of trade financing, accounts payable, and bank loans, but that long-term debt is important for firms if they wish to lock-in low rates when monetary policy is easy, or if they wish to match the duration of their long-term assets using similarly long-term liabilities.

The specific focus of this paper, however, is not on the large number of small and medium-sized enterprises, but on the larger NLCs that are of analogous size to listed companies. Such firms are more likely than very small companies to exhibit issues and concerns for policy-makers regarding corporate governance because they are more likely to have dispersed (minority or non-controlling) shareholders. For this reason, we embarked on a matching procedure such that for every firm-year observation for a listed company, we found a firm-year observation for an unlisted company with the same three-digit SIC code (*i.e.* a firm in the same industry as the listed firm) in the same country and year. Thus, if we had data on a Bulgarian listed firm with a SIC code of 301 in 2001, we found a matching unlisted firm with identical SIC code for which we had data in 2001. We chose the unlisted firm with the closest level (either smaller or larger) of total assets to the listed firm. Since an NLC may have either more or fewer total assets than a listed firm, it was possible for each listed firm-year observation to be matched with up to two NLC comparisons, one larger and one smaller. As in Table 3.2, we omitted firms with total debt larger than total assets, to avoid any clearly spurious observations.

Table 3.2 Assets and leverage of all unlisted firms in Central and Eastern Europe

Country	Log of Total Assets	Long-term Debt to Total Assets	Long-term Debt to Total Debt
Bosnia and Herzegovina	7.849544	3.92%	10.11%
Bulgaria	6.758736	3.15%	5.81%
Croatia	8.058126	0.00%	0.00%
Czech Republic (OECD)	8.060947	10.18%	16.57%
Estonia	7.771031	9.45%	14.93%
Hungary (OECD)	8.234254	0.83%	1.36%
Latvia	7.571722	12.59%	19.81%
Lithuania	8.541999	12.04%	22.83%
Macedonia	8.163802	4.15%	9.05%
Poland (OECD)	8.418666	8.86%	13.73%
Romania	7.04159	3.04%	5.07%
Russian Federation	7.728751	2.03%	3.74%
Slovak Republic (OECD)	8.128053	9.16%	16.36%
Slovenia	8.557916	0.00%	0.00%
Ukraine	7.494293	3.23%	7.17%
Yugoslavia	8.184058	5.08%	12.04%
OECD average	8.21048	7.26%	12.00%
Non-OECD average	7.8101307	4.89%	9.21%

The data set resulting from this matching procedure is described in Table 3.3. Panel A of that table breaks down by OECD affiliation and country the number of listed company firm-years, the number of NLC matches, and the average of log total assets for the two groups. The final column indicates whether the size difference of listed firms and matched NLCs is statistically significant. For no OECD countries, nor for the OECD firms taken as a whole, were the differences meaningful. For Bulgaria, Estonia, Latvia, and Slovenia, the NLCs were significantly smaller than the listed companies they were matched with, but this was not the case for the other non-OECD countries.

Panel B of Table 3.3 indicates some interesting results that may reveal patterns of financing that relate to corporate governance. The bottom of the table compares listed and NLC firms based on leverage and debt maturity (for leverage, LTD/TD measures long-term debt divided by total debt, and TD/TA measures total debt divided by total assets; debt maturity is measured by LTD/TD, which is long-term debt divided by total debt). In the OECD countries in our sample (the Czech Republic, Hungary, and Poland—there were not enough observations from the Slovak Republic), we found that both measures of leverage were significantly higher in NLCs compared to listed companies. This is an interesting finding, and holds true for non-OECD countries as well.

Corporate governance may be related to leverage in three important ways. Higher leverage is a potential signal of a strong, controlling shareholder, if (i) a block-holder wished to maintain control by not diluting existing equity with more equity (the “non-dilution entrenchment effect”), or if (ii) the controlling block-holder wanted to signal to the outside capital market that corporate governance is sound and that the value of minority shares will not be extracted. Conversely, a high level of debt will restrict the power of a controlling shareholder to extract private benefits of control, since some portion of revenues will be diverted to interest payments as opposed to transfer pricing, asset stripping, etc. In East Asia, the dominant effect seems to be the non-dilution entrenchment effect (Du and Dai, 2005), which is consistent with the studies we presented above. If this is the case in Central and Eastern Europe, our findings are consistent with an interpretation that NLCs are in fact subject to stronger control by a dominant shareholder or group of shareholders, which indicates high levels of potential expropriation of minority owners.⁸

To gain an understanding of the relationship between leverage and a number of other factors for both listed companies and NLCs, we consider some basic multivariate regression analysis, the results of which are presented in Table 3.4. In Panel A we consider the OECD and non-OECD case, and examine two measures of leverage (LTD/TD and TD/TA), as well as a measure of debt maturity (LTD/TD). The control variables are asset tangibility (fixed assets/total assets), ROA (return on assets), effective tax rate (taxes divided by EBIT—earnings before interest and taxes), and size (natural log of total assets). Curiously, we find that for firms in the OECD countries, asset tangibility is positively related to the first measure of leverage, but negatively related to the second. ROA matters most in non-OECD countries, where it is negatively related to leverage and debt maturity. In line with previous studies, size matters in that the coefficient for log of total assets is positive, and is significant in the case of leverage (meaning, larger firms have more debt).

Panel B of Table 3.4 indicates differences between listed companies and NLCs. We re-estimate the regressions of Panel A, but include a dummy variable that takes the value of “1” for firm-year observations from unlisted companies. Consistent with Panel B of Table 3.3, NLCs have more debt in both OECD and non-OECD settings. As noted above, this may indicate the presence of one or more strong controlling shareholders who are able to hold managers in check by using the disciplining device of debt. The coefficients for the NLC dummy are higher in the OECD setting, perhaps indicating that the difference between NLCs and listed companies is not as great in the non-OECD setting.

Table 3.3 **Listed firms vs. similar NLCs in Central and Eastern Europe**
after truncation and removal of firms with no ROA

Panel A

Country	# of Firm-Year Observations		Mean Log of Total Assets—Unlisted Firm-Years		T-Test p-value for difference in means
	Listed Companies	Comparison NLCs	Listed Companies	Comparison NLCs	
OECD:					
Czech Republic	21	28	9.685	9.567	0.178
Hungary	9	13	9.12	9.214	0.783
Poland	58	98	9.183	9.044	0.178
Mean of OECD firm-years	88	139	9.296	9.165	0.121
Non-OECD:					
Bulgaria	503	563	8.396	7.89	0.000***
Croatia	4	3	8.871	8.934	0.89
Estonia	26	13	9.3	8.885	0.051*
Latvia	16	16	9.524	8.506	0.000***
Lithuania	27	24	9.2	8.932	0.379
Macedonia (FYR)	2	3	9.215	9.392	0.576
Romania	132	202	8.98	8.888	0.188
Slovenia	22	13	9.522	9.015	0.000***
Mean of Non-OECD firm-years:	732	837	8.627	8.214	0.000***

Panel B

Variable	OECD			Non-OECD		
	Mean of Firm-Year Obs.	Mean of Firm-Year Obs. (Unlisted)	P-value of T-test	Mean of Firm-Year Obs. (Listed)	Mean of Firm-Year Obs. (Unlisted)	P-value of T-test
Tangibility	0.496	0.467	0.365	0.555	0.554	0.908
ROA	-0.008	-0.027	0.535	0.005	-0.011	0.027**
Effective Tax Rate	0.427	0.266	0.42	0.371	0.578	0.203
Log of Total Assets	9.296	9.165	0.121	8.627	8.214	0.000***
LTD/TA	0.047	0.101	0.003***	0.03	0.047	0.001***
LTD/TD	0.134	0.164	0.313	0.064	0.081	0.043**
TD/TA	0.399	0.56	0.000***	0.34	0.419	0.000***

Interestingly, we also find that NLC firms in non-OECD countries have significantly longer-term debt compared to their listed counterparts. The corporate governance implications of this finding are unclear, and need further research. It may be that strong, controlling shareholders in NLCs force managers to take on more long-term debt contracts relative to listed firms, whereas this is not the case in the OECD countries of Central and Eastern Europe that we include in the analysis.

Table 3.4 **Regression results**
GLS random effects; p-values in parentheses

Panel A

Dependent Variable:	LTD/TA		LTD/TD		TD/TA	
	Yes	No	Yes	Yes	No	No
OECD?						
Constant	-0.183 (0.357)	-0.079* (0.075)	-0.35 (0.232)	0.261 (0.404)	0.680*** (0.000)	-0.134* (0.069)
Asset Tangibility	0.145*** (0.005)	-0.217 (0.261)	0.516*** (0.000)	-0.242*** (0.002)	-0.521*** (0.000)	0.038 (0.256)
ROA	-0.008 (0.882)	-0.069*** (0.001)	0.096 (0.252)	-0.322*** (0.000)	-0.339 (0.000)	-0.097** (0.013)
Effective Tax Rate	-0.003 (0.688)	-0.001 (0.506)	-0.011 (0.443)	-0.003 (0.612)	-0.002 (0.298)	-0.002 (0.339)
Log of Tot. Assets	0.021 (0.330)	0.016*** (0.001)	0.027 (0.380)	0.04 (0.235)	0.003 (0.746)	0.023*** (0.005)
# Firms	101	413	101	101	413	413
# Obs	145	953	145	145	953	953
R ² (overall)	0.103	0.027	0.267	0.132	0.242	0.019
Wald Chi ²	10.15** (0.038)	23.38*** (0.000)	50.86*** (0.000)	24.31*** (0.000)	308.66*** (0.000)	16.24*** (0.003)

Panel B

Regressions with NLC dummy variable

Dependent Variable:	LTD/TA		LTD/TD		TD/TA	
	Yes	No	Yes	No	Yes	No
OECD?						
Constant	-0.307 (0.129)	-0.119*** (0.010)	-0.449 (0.141)	-0.189** (0.014)	-0.011 (0.973)	0.550*** (0.000)
Asset Tangibility	0.156*** (0.002)	-0.02 (0.309)	0.528*** (0.000)	0.042 (0.218)	-0.236*** (0.002)	-0.516*** (0.000)
ROA	0.002 (0.971)	-0.068*** (0.001)	0.105 (0.212)	-0.094** (0.016)	-0.299*** (0.000)	-0.337*** (0.000)
Effective Tax Rate	-0.002 (0.750)	-0.001 (0.447)	-0.009 (0.513)	-0.002 (0.297)	-0.003 (0.643)	-0.002 (0.232)
Log of Total Assets	0.03 (0.164)	0.018*** (0.000)	0.035 (0.273)	0.027*** (0.001)	0.057* (0.084)	0.011 (0.233)
NLC (1=NLC)	0.055** (0.025)	0.030*** (0.006)	0.041 (0.242)	0.039** (0.020)	0.154*** (0.001)	0.096*** (0.000)
# Firms	101	413	101	413	101	413
# Obs.	145	953	145	953	145	953
R ² (overall)	0.146	0.046	0.274	0.032	0.267	0.286
Wald Chi ²	15.60*** (0.008)	31.06*** (0.000)	52.37*** (0.000)	21.75*** (0.001)	35.78*** (0.000)	338.77*** (0.000)

4. Making Investment and Lending Decisions: Policy Implications

The next step in our analysis is to examine factors that affect decisions revolving around external finance for NLCs. Just like listed firms, NLCs participate in a market for external finance, where supply and demand of credit and equity investment determine the lending rate and equity cost of capital. Figure 1 indicates some advantages and disadvantages of various types of financing; the relative attractiveness of one or another type of financing can affect the firm's decision to invest. For example, there are benefits of long-term debt relative to short-term debt, but disadvantages as well. Given these influences on the demand for finance, it is also true that policies designed to increase the quantity of external finance are related to policies that lower its cost. Policies in turn affect the relative attractiveness of one or the other type of financing; lowering the corporate tax rate tends to favour equity as opposed to debt (the tax shield benefit of leverage will decline), all else being equal.⁹ After discussing the decision to borrow, we review the likely effect of these policies on the price and supply of external finance.

A. *The investment and lending decision: what matters*

As mentioned, the “typical” corporate governance issues in the finance literature generally relate to the incentives of controlling managers *vis-à-vis* dispersed owners. Given that for NLCs, ownership tends to be concentrated, these classic corporate governance problems are less salient. Nevertheless, a number of misaligned incentives and agency conflicts can occur, which for a variety of reasons may affect the firm's investment decision, even if the firm does not face a capital crunch.

How do these corporate governance dynamics affect lending and investment decisions? As mentioned above, large block shareholders may take advantage of minority shareholders through the exercise of control benefits. In advanced capitalist economies, shareholders of common stock have a number of mechanisms to ensure their rights are protected—including legal recourse—which at the very least include a sell-off of the firm's equity and resulting lower share price. One mechanism for block-holders to extract value is to perform a reverse stock split, so that 100 shares are converted to one share. Thus, any shareholders with fewer than 100 shares do not have the minimum one share needed to vote in electing the board of directors. So, rules against reverse stock splits (or those requiring a majority of shareholders to approve them) and rules that require any tender offers to allow for minority shareholders the option to sell shares back to the company, can serve to protect small shareholders. And, for the NLC case, if there is no liquid market for shares of equity, minority shareholders are even more likely to be disenfranchised.

Especially in countries with poorly functioning stock markets, creditors may play a significant role in corporate governance. The ability of creditors (mainly, banks) to function in this capacity is controversial, and extensive discussion of this possibility surrounded the emergence of transition economies. For example, the Polish minister of finance Piotr Sota (1995) argued that banks “are excellent restructuring agents”; Hungarian official Szekely (1995) concurred, noting that the Polish policy of bank-led restructuring and corporate governance worked because of the existence of a stability fund. Others are less sanguine about the substitutability of creditors for shareholders in terms of their role in corporate governance (Grosfeld, 1997; Demirguc-Kunt and Maksimovic, 1995). Dittus and Prowse (1995) and Long and Rutkowska (1995) argued that bank ownership of shares—as opposed to providers of debt financing—could lead to a mitigation of the differences between creditor interests and shareholder interests. Whether bank-led corporate governance is ideal in Central and Eastern Europe or even in other settings is still an open question. In many non-OECD countries especially, the beneficial corporate governance role potentially played by rating agencies is also less likely to occur, mostly because corporate bond markets are nascent and illiquid.

B. Requirements for external financing: policy implications

External finance is not a necessary condition for secular economic development—the presumed ultimate goal of policymakers—but it can provide an important stimulus to innovation and economic growth. It is of course possible for a successful company to organically grow from accumulated retained earnings, and short-term external finance is generally available in the form of trade credits, accounts payable, and bank loans and lines of credit. But, to tap into “true” external finance (meaning equity and long-term debt), the most successful and fastest growing firms may need creditors and external equity investment, whether they are listed or not. This means the legal environment matters for NLC credit and equity markets.

So, then, why do different countries have different degrees of disclosure and investor protection? Testing a theoretical model using OECD country data, Pagano and Volpin (2000) find that in some countries low protection for investors may result from a political agreement between entrepreneurs and workers. Low protection for minority shareholders actually increases the private benefits of control for entrepreneurs. In other countries, high protection for employees (*i.e.* rules and institutions that make it difficult for managers to fire or sack workers) shelters low-productivity workers from competition with high-productivity workers. They find that, among OECD countries, employment and shareholder protection are negatively correlated. The policy implications of this are clear, but not uncontroversial.¹⁰

In any event, to exceed the maximum possible organic growth rate, firms will need access to external finance, and there are several sources of it. For policy to be effective, well-governed private firms should be allowed to choose among the various sources of long-term external finance, free of distortions introduced by subsidies or excessive taxation, although the extent of subsidies and taxes will be determined primarily according to political processes, and will vary in different political jurisdictions.

Policies to promote debt finance

The empirical findings on debt finance focus on the bargaining between debtors and creditors. In countries with ineffective collateral registries, creditors may demand higher risk premia on lending, leading to lower quantities of external debt finance. This seems to be especially true for long-term debt finance, which may be preferable for firms because it allows them to lock in rates during periods of easy monetary policy, and allows them to match long-term assets with long-term liabilities. Rules relating to information (*e.g.* credit bureaus that have information on the reliability of NLC borrowers) may also reduce risks faced by creditors. Secured transactions laws and legislation for the tradability of land seem to be important steps for countries that wish to increase the level of external debt finance for their NLCs.

Related to collateral registries and information provision, the procedures involved in bankruptcy seem to matter as well. A classic theory of leverage (the trade-off theory) argues firms will borrow based on balancing the benefits (interest payments are generally tax-deductible, so the rate of corporate income taxation *vis-à-vis* other tax rates matters) against the costs (the losses incurred from bankruptcy, including risks of perfecting claims to collateral, and legal expenses, judiciary delays, etc.). Therefore, countries that wish to encourage more long-term debt financing should ensure that their courts and legal systems provide low-risk remedy for creditors, who will not otherwise risk investing in such environments or who will charge much higher rates of interest on lending, generally leading in turn to lower quantities of borrowing. Failing this, government regulation and supervision of NLC credit may be a substitute for commercial law that fails to protect the interests of investors.

Policies to promote external private equity finance (domestic and international)

External equity investment from domestic sources is sometimes a possibility for firms. However, such investment comes at the cost of existing owners yielding portions of ownership, and potentially

control. Even among OECD countries, significant variation exists in the market for external equity finance of NLCs.¹¹ For the vast majority of NLCs that are not in the high-technology area, the specific investment form known as “venture capital” is generally unavailable, and such external equity investment is less common. Finance for such firms, however, still follows the rules of supply and demand; if external equity investors do not feel protected, they will charge a higher required return, or will refuse to invest. Outside the OECD context (Lerner and Schoar, 2004), firms in countries with common law legal settings—and with greater protection for minority shareholders—tend to face a lower cost of capital (higher valuation).

International equity investment is potentially available for listed firms in the form of “portfolio investment.” Nevertheless, foreign direct investment—that is, purchasing a controlling interest of equity in a foreign company—is a well-known alternative, and has been extensively studied. As is true of most other kinds of external finance, enforcement of laws and rules that facilitate investor protection would seem to promote increased quantities of FDI. For example, rules that prevent foreign firms from obtaining controlling interests, especially in settings where minority shareholders are not protected, seem to be clear disincentives for FDI. In addition, rules against profit repatriation probably may reduce the quantity of FDI as well, or increase its price (meaning, a higher cost of capital required from the recipient firm).¹²

Figure 3.1. Simple typology of costs and benefits to the firm from financing types

Type of Financing	Costs/Disadvantages	Benefits/Advantages
Internal (retained earnings)	Reliance on internal funds may constrain growth of the firm’s assets and sales.	Low transaction costs (no issuing fees); low information asymmetry.
Short-term debt (trade financing and accounts payable)	Interest rate volatility may create business risk for firms that rely on short-term debt; suppliers may increase rates for late payers.	Low transaction costs, easily available credit.
Long-term debt	Generally more expensive than short-term debt due to generally upward sloping yield curve, corresponding to greater default risk for longer-term contracts. Problematic if capital markets function better/worse than government allocation of credit.	Firms can lock-in long-term rates, bank debt has lower information asymmetry <i>vis-à-vis</i> publicly traded equity.
Raising additional equity (private)	Existing ownership is diluted; private equity firms are often sophisticated counter-parties, generally interested only in short-term investment.	Venture capitalists may be very good at helping the firm increase sales, replace underperforming managers, find complementary technologies, etc.
Raising additional equity (IPO)	Changes nature of firm (many new owners); disclosure requirements may be very costly (Sarbanes-Oxley).	For firms with high market/book ratios, equity may be preferable to debt (Microsoft; Intel).

Conclusion and agenda for future research

We now conclude our brief survey of NLC financing trends and corporate governance issues with a summary, a series of policy issues, and an outline of a broad research agenda concerning unresolved issues. An overall finding of our research is that sharp distinctions, such as those between listed and unlisted firms, OECD and non-OECD settings, etc., are not absolute in terms of their implications for financing patterns. For example, the number of owners is probably more important than listing status for determining what firms should be required to disclose information. Widely held firms should disclose, but the definition of what constitutes a widely held vs. a closely held firm varies in different countries, and is in the end a political consideration. Similarly, the exact degree of protection for minority shareholders is also a political decision—countries that provide little such protection, however, provide little incentive for consumers and small investors to diversify their portfolios of assets by purchasing shares of listed firms. Another example concerns capital market characteristics: some OECD countries may be more similar to nearby non-OECD countries than, for example, to the United States; and some listed firms with very infrequent trading may be more similar to NLCs than to listed companies in deep and liquid capital markets. This magnifies the importance of studying NLCs in non-OECD settings, both for the sake of the firms and, more generally, for discovering how similar or different these NLCs may be with regard to listed companies in their own country and to firms in OECD countries.

The major policy areas that are important for considering NLC corporate governance and access to external finance may in fact not be very different from those that affect listed firms—the key issue is the number of owners and the concomitant disclosure requirements. Thus, many of the existing OECD Principles of Corporate Governance primarily meant for listed firms might be usefully applied to the non-OECD, NLC context. A major exception to this concerns issues related to the “typical” corporate governance problem: the ability of dispersed, minority shareholders to control management. Given the fact that listed and NLC firms in the non-OECD context tend to have very high ownership concentration, differences between them relating to corporate governance may not be extensive, especially in countries with illiquid, opaque, or poorly functioning equity markets (*i.e.* many of them).

The ability of firms to voluntarily disclose information, of course, means that laws relating to judicial proceedings and recourse may be as, or potentially more, important than laws that mandate disclosure.¹³ Thus, from the sparse, existing studies that have relevance for NLC corporate governance in the non-OECD setting, we can tentatively conclude that the best way to ensure effective access to external finance (and low costs of capital), and effective corporate governance, is to decrease the risks posed to creditors and providers of external equity by enacting investor protection laws and enforcing them. Specifically, sponsoring or subsidising effective and enforced collateral registries, collection and appropriate dissemination of information on previous borrower actions, reasonable levels of disclosure based on the number of the firm’s owners, providing effective remedy for foreign sources of capital, and setting proper levels of various income tax rates (both corporate and individual) should all help NLCs obtain external funds for growth.

Policymakers are faced with achieving essentially two goals. On the one hand, assets in society should be employed as efficiently as possible—this means tight control of owners over managers which, in many legal settings, comes through controlling shareholders. On the other hand, potential investors (consumers) should benefit from the opportunity to diversify their assets by spreading them among many different firms and allowing proxies, such as institutional investors and boards of directors, to prevent managers from diverting value at the expense of owners. In some countries, share ownership through mutual funds (unit trusts) leads to diversified portfolios for consumers, and lower costs of capital for firms; this is a model that might be replicated elsewhere. If ownership can be concentrated in such shareholders, activist ownership provides a check against abuse by either management or block-holders.

Recent spectacular corporate governance failures in a number of countries—and high estimated control premia in many other countries—have highlighted situations where corporate governance might fail in its task to facilitate the achievement of both these fundamental goals (Buchanan and Yang, 2005). The OECD Principles of Corporate Governance provide an important context for policymakers, and their application to NLCs with dispersed shareholders may be in the interests of society at large. Transparency and accountability are keystones to achieving both of these goals.

Despite these broad conclusions, it is clear that significant gaps exist in our knowledge of NLC financing in both OECD and non-OECD settings. Does the non-marketable nature of minority positions in NLCs in fact mean that such shareholders are inherently disadvantaged, relative to minority shareholders of listed firms? Are controlling interests more valuable in closely held firms? Future research could also usefully address questions concerning, for example, the ability of firms to decide voluntarily to disclose information to investors and the impact this will have, and address the question of which laws serve as substitutes or complements in their effect on access to external finance for firms that voluntarily disclose.

In addition, many of the topics that have been extensively studied for publicly traded firms should be addressed for NLCs. It is likely that legal factors (investor protection, bankruptcy procedures, collateral rules, information on borrower history) may have similar effects on listed and non-listed company access to finance, whereas issues related to information asymmetry between suppliers and demanders of external finance may be better policed through privately reached decisions on the proper level of disclosure, again based on the number and type of owners rather than on the firm's decision to list or not. In terms of understanding the corporate governance of NLCs and their access to external finance, we are in early days.

NOTES

1. Asset stripping is where the controlling shareholders instruct management to sell the firm's assets to another company that is, for example, 100% controlled by the large blockholder at below-market rates. The small shareholders now hold a small portion of a worthless firm, and the controlling shareholder now has 100% of the assets of the new firm—this exercise robs the small shareholders of the old firm to the benefit of the controlling shareholder. Less extreme examples might relate to transfer pricing, where managers under the control of dominant shareholders sell or purchase goods and services at above or below market prices in order to divert revenues from the firm's small shareholders. Dividend payment differences between controlling (preferred stock) and non-controlling shareholders (common stock) may also occur.
2. To see this, consider the ability of an owner-manager of a restaurant to sell it. Just as in the case of selling the family residence, the manager may have to wait a long time to find a willing buyer. To sell the business quickly, the manager may have to accept a steep price reduction—the liquidity discount. A commercial real estate agent will likely charge a large fee for helping the manager sell the business, as well. Contrast this to selling an ownership stake of a large company listed on a liquid stock exchange. Not only can shareholders quickly liquidate their holdings, the price reduction will generally be very small (there is, however, often a small difference between the bid and offer prices, but the transaction costs will be very low, especially if the sale is conducted online).
3. Generally, 300, or for very small firms, 500 “shareholders of record;” the number of actual owners could be larger if they are grouped together “in street name”.
4. The implications of this for NLCs are interesting. In general, NLCs correspond more closely to listed firms in countries with few disclosure requirements (they are both opaque relative to firms that list in environments of high disclosure). An interesting research question would be to consider the degree of disclosure (to whom?) by NLCs in both opaque and transparent legal environments. How do disclosure requirements affect small shareholders, for either listed or NLCs?
5. The globe-spanning literature on market-based vs. bank-based financial system structure and firm-level access to external finance is generally cross-sectional in nature, and often omits countries from Central and Eastern Europe. This is somewhat ironic given that the seminal research on bank- vs. market-led development contrasted the role of external finance in Russia, Germany, and the United Kingdom (Gershenkron, 1962).
6. This confirms findings for large corporations in wealthy countries (La Porta, *et al*, 1999).
7. This information comes from the Amadeus data base, but has been “cleaned” such that firm-year observations with more debt than assets have been deleted (it is possible to have negative book equity, but it is also likely that such observations were mis-reporting either debt or assets or both). Note that according to the data, firms in Croatia and Slovenia possessed no long-term debt. Omitting those countries, we performed t-tests but found no significant difference between leverage for firms in the four OECD countries compared to others in the broad sample of all unlisted firms, which includes relatively small companies. In further tests (reported in Tables 3 and 4), we only consider large unlisted firms, NLCs that we differentiate using a matching procedure described in the text.

8. It is of course difficult to measure the extent of private benefits of control for NLCs. One could take the approach of Gutierrez and Tribo (2004), and compare differences from median ROA of listed vs. NLC firms in the same industry—a lower ROA may indicate managers are transfer pricing or otherwise diverting assets away from minority shareholders. Unfortunately with this approach, the very illiquidity of NLC shares means that such firms face a higher cost of capital *vis-à-vis* listed firms, so a finding of lower ROA for NLCs may simply indicate differences in the cost of doing business, as opposed to revealing any private benefits of control.
9. The relationship between preference for type of external finance, on the one hand, and firm characteristics, on the other, need not be monotonic. For example, Isachenkova and Mickiewicz (2004) find that firms with a dominant owner holding between 25%-49% of shares are most likely to choose equity finance. Close links with a lending bank seem to facilitate access to non-banking sources of funds, such as those supplied by industrial partners.
10. “legal rules can evolve only by exchanging higher investor protection for lower employment protection, or vice versa. For countries in Continental Europe, that are characterised by low investor protection and high employment protection, increasing the degree of investor protection may be impossible to implement without a contemporaneous reduction of the degree of job security.” (p. 26).
11. The United States has some of the most sophisticated markets which, during the early stage of a company’s development, can be termed “venture capital”, and for the expansion and buy-out stage of investment, is often simply termed “private equity”. The United Kingdom, Israel, and Scandinavian countries also have thriving markets. Yet, according to the European Venture Capital Association (2001) and recent research (Hall, 2005), the cost of capital facing private-equity financed firms is related to the institutional setting, with more forgiving settings spelling a lower cost of capital for venture-capital backed firms.
12. FDI and domestic credit appear to be substitutes (Krkoska, 2001), but are complementary with foreign credit and privatisation revenues.
13. Meaning, if firms want a lower cost of capital that comes with disclosure, they can freely choose to do so, as some have. The same thing applies for firms in emerging market settings that have put independent, outside representatives on the board of directors—mandatory rules may be unnecessary if investors are well-informed and able to look out for their own interests.

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Chapter 4

**THE ROLE OF THE LAW IN DEVELOPING
EFFICIENT CORPORATE GOVERNANCE FRAMEWORKS***

by

Erik P.M. Vermeulen **

The purpose of this chapter is to address the main corporate governance issues for non-listed companies. It will analyse the economic and legal problems of these companies, and examine the diverse theoretical arguments for and against the importance of a corporate governance framework for non-listed companies, thereby placing corporate governance analysis on a new footing. The paper will review current corporate governance discussions and reforms in emerging and transition markets. In these markets, the corporate governance discussion took off in the wake of the financial crises in Asia, Russia and Brazil in the mid-1990s. It will show that the recent reform approach has been dominated by governance concerns that derive from agency problems in publicly held firms and the respective weaknesses in legal regulation (Guriev, *et al* 2003). Special attention will be given to issues involving, from a range of diverse standpoints, the different ownership and control structures of non-listed companies, the role of legal and contractual mechanisms in the emergence of good corporate governance practices, and the task of policymakers to help non-listed companies improve their corporate governance and business performance.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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Introduction

The contemporary corporate governance debate is concerned primarily with the design of a legal, institutional and regulatory framework that helps protect weak and widely dispersed shareholders against self-interested managers. Since the relationship between managers and shareholders is characterised as a “principal-agent” relationship (Berglöf 1997), solving this managerial-shareholder agency problem appears to be corporate governance policymakers’ long-standing dilemma for publicly listed companies. It is recognised that the equity investors in publicly held companies may encounter many complex and costly problems of shirking and opportunism on the part of directors and management. Information and collective action problems prevent close monitoring of management performance and enable directors and managers to develop a variety of techniques to tunnel assets and extract profits and private benefits from the company for their own interests.

Corporate governance reforms are high on policy agendas. Proposals have arisen to alter, among other things, the role of non-executive directors, executive pay, disclosure, the internal and external audit process, and sanctions on managers’ misconduct. Suggestions have been advanced to create new standards of integrity for auditors, analysts and rating agencies. Policymakers and lawmakers are prompted to design measures to protect a company’s shareholders from fraud, poor board performance and auditor failure. These most notably include the certification of accounts by Chief Executive Officers and Chief Financial Officers, the imposition of internal controls, prohibition of company loans to managers, and the requiring of firms to establish an independent audit committee. The objective of these corporate governance measures is to create value to the primary stakeholders of the publicly held company, i.e., the shareholders.¹

That is not to say that other stakeholders are neglected. No company ever survived that ignored the interests of employees, customers and suppliers (Yener 2002). The public debate, however, focuses generally on the internal elements of the corporate governance framework that mediate in the relationship between self-interested management and weak, dispersed shareholders. This is hardly surprising since provocative comparative studies argue that the greater effectiveness of the legal rules covering protection of company shareholders in common law countries, compared to the rules originating in their civil law counterparts, explains the out-performance of the financial systems and equity markets in Anglo-American countries (La Porta, *et al* 1997, 1998, 2000).²

The “best practice” rules and principles that arise from the burgeoning corporate governance literature and reforms specifically cover the protection of shareholders in listed companies. Although the corporate governance principles specifically cover publicly held firms, it might be argued that they indirectly affect non-listed companies. To be sure, given the limited market for and the restricted transferability of interests in non-listed companies, business participants should ideally be engaged in bargaining for contractual provisions that deal with the protection of a company’s stakeholders. However, these contractual mechanisms are often very costly solutions due to technological limitations, private information and strategic behaviour. That is not to say that economic actors do not use contractual mechanisms to deal with the possibility of opportunistic behaviour; but it does mean that, with an incomplete contracts paradigm, business participants may not be able to contract their way into governance structures that deal with every contingency *ex ante*. Moreover, the costs of designing a contractual corporate governance structure that minimises the expected risks of opportunism and can be enforced by judicial process is prohibitively high.

Policymakers, therefore, typically recommend the application of the corporate governance rules and principles tailored to the needs of publicly held companies. In fact, many of the “best practice” rules and principles are imposed on non-listed companies by government, investors, insurance companies, lenders

and others. They tend to leave the special needs of closely held, non-listed companies as more of a backwater. It is certainly reasonable to infer that rules and principles that ensure (i) the basis for an effective corporate governance framework; (ii) define the rights of shareholders and the responsibilities of management; and (iii) set out norms for enhanced disclosure and transparency, could also improve the governance of closely held companies. This leads, however, to the question of whether such a “one-size-fits-all” approach to corporate governance regulation is justified in economic and social terms.

Indeed, non-listed companies do not always seem to benefit from the spillover effect. For instance, the compliance costs could be exorbitantly high. This is especially true of corporate governance provisions that are still being dodged by publicly held companies due to their cumbersome and time-consuming nature. Moreover, the increased information costs and uncertainty about the application of the terms by courts may have a detrimental effect on the performance of closely held companies. It is therefore suggested that the typical organisational structure of these companies demands an approach different from publicly held firms. This is implicitly acknowledged with the financial reporting requirements for non-listed firms. An alternative approach implies varying levels of control and commitment and help firms to tailor the organisation of the firm to their particular needs. A distinct corporate governance framework not only helps to define the internal and external stakeholders’ expectations *ex ante*, but also, and more importantly, assists judiciaries and arbitrators in solving problems *ex post*.

Naturally questions arise concerning the applicability of the publicly held corporate governance framework to non-listed companies. In the contemporary debate on corporate governance, the importance of non-listed companies is largely ignored. Until recently, few academics or policymakers even acknowledged the importance of creating effective measures for closely held companies, let alone the need for improved institutions to stimulate social welfare and economic growth. The problems of publicly held firms are not fully present in closely held companies. The “closely held *versus* public” dichotomy is a useful classification system to explain the different kinds of incentive and governance structures in play and, more importantly, it helps policymakers to rethink corporate governance mechanisms and reforms. It is not surprising therefore that the dichotomy is reflected in the legal systems of most jurisdictions around the world (Lutter 1990).³

There are two extreme types of closely held firms. On the one side, there are so-called “open”, non-listed firms, such as companies with the potential to go public in the short term and unlisted mass-privatised companies with a relatively high number of shareholders.⁴ On the other side of the continuum of closely held firms, there are the contractual arrangements in which the firm-owners retain substantial autonomy and the small partnerships in which the owners are active managers themselves. In between there are larger companies that have neither listed shares nor the intention to go public in the short term. This paper focuses on this middle group of companies, where we find family-owned companies, group-owned companies, private investor-owned companies and joint ventures. This type of companies is often characterised by the three-way conflict between majority shareholders, managers and minority shareholders (Berglöf and Claessens 2004).

Since these larger non-listed companies are regarded as the backbone of a robust economy, policymakers have become more and more aware that neglecting the governance needs of these firms will stunt productivity growth and job creation. The rapid pace of technological change and the decreasing international barriers to trade over the past decade have not only created new strategic and organisational opportunities for firms, but have also made them more vulnerable to risks (Sakai 2002). Hence, it is submitted that in order to help these companies fully exploit the new opportunities and adjust more easily to immediate uncertainty, policymakers at both national and international level should endeavour to devise the most efficient corporate governance framework as part of their long-term

strategy to foster investment, innovation and entrepreneurship. Although corporate governance reforms around the world are generally inappropriate for closely held companies, a shift in focus from publicly held companies to closely held companies is arguably important in emerging and transition countries, where most of the firms are not listed and ownership and control are typically not completely severed.

As these companies continue to rely on bank and family financing, and private equity sources for expansion and growth, it is necessary to learn more about the specific corporate governance challenges and opportunities that surround these firms. Of course, the corporate governance framework is only one of the many determinants of investment and expansion decisions. There is little doubt that the main considerations affecting these decisions are operational and macro-economic. Nevertheless, in the age of globalisation, companies are likely to be increasingly sensitive to corporate governance issues. The fact that international companies, attracted by the promise of fast-growing emerging and transition markets, are increasingly pursuing growth in these markets, makes improved corporate governance of non-listed companies a priority. A corporate governance framework must allow companies to ideally match their legal status with their organisational needs, giving them the opportunity to grow and develop in the context of a highly competitive business environment.

The paper is divided into four parts. The first part analyses the significance of the diverse patterns of ownership and control in non-listed firms. The economic theories of the firm are taken as a starting point for identifying the set of problems that internal business participants – controlling shareholders, minority shareholders and managers – need to solve when structuring their company. It is submitted that an economic analysis sheds light on the role that a legal corporate governance framework plays in facilitating or in interfering with the internal relationship between the participants. Part 2 continues to explore the arguments for and against the importance of a legal framework for non-listed companies. Although the general view is that corporate governance is of utmost importance, it is still not clear which legal mechanisms promote economic and social welfare and boost economic growth. This part identifies legal mechanisms that could be employed by policymakers, lawmakers, the judiciary and other economic actors in solving corporate governance problems. Part 3 discusses the corporate governance framework in emerging and transition markets. It is limited to regions and jurisdictions where corporate governance issues have recently attracted the attention of policymakers in Corporate Governance Roundtables that took place in Asia, Latin America, Russia, Eurasia⁵ and the Middle East and North Africa (MENA) region. Part 4 concludes by offering an assessment of the techniques used by regulators in this sector.

1. The Theory of the – Closely Held, Non-listed – Firm⁶

A. *Why should one care about the theory of the firm?*

This part of the paper introduces economic concepts fundamental to the analysis of corporate governance structures that are best suited to meet the needs of closely held companies. Understanding these concepts will enable policymakers to identify the potential tensions between the participants in these companies and assist in their resolution. In pursuing this objective, this part builds on the best available theories from law and economics. For instance, theories of the firm, which dominate the thinking of economically oriented policymakers, focus on the question of why business people either place a transaction in the market or locate it inside a firm, and what are the boundaries of the firm. More importantly, they help policymakers understand the key problems that business participants encounter and indicate what the core features of a corporate governance framework ought to be if economic and social welfare is to be promoted. Indeed, an economic analysis of closely held firms reveals the role the law must play in facilitating solutions for corporate governance problems.

As mentioned in the introduction, this paper focuses on the middle group of closely held companies, such as family-owned companies, group-owned companies, private investor-owned companies and joint ventures. These firms tend to be typified by: (i) a smaller number of shareholders; (ii) no ready market for the corporate stock; and (iii) substantial (majority) shareholder participation in the management, direction and operation of the company.

B. Contractual theory of the firm

Companies are generally viewed as a nexus-of-contracts. The nexus-of-contracts theory treats firms as entities that serve as a nexus for a set of relational contracts among its participants (Jensen and Meckling 1976). In this respect, a corporate governance framework should be viewed merely as a “standard form contract” that represents the different points on the continuum of types of firms. This theory is arguably an appropriate and socially desirable concept, since it draws attention to the variety of needs (*i.e.* rights and duties) of participants involved in different companies (Hart 1989). Nonetheless, the nexus-of-contracts theory of the firm does not explain why firms require a particular type of corporate governance structure. Moreover, the theory’s narrowly conceptualised assumptions – *i.e.*, that (i) the firm is best viewed as a set of incentive contracts; (ii) the function of the legal system is to supply rules and standards that are *ex ante* efficient; (iii) rationally informed firm participants will bargain themselves into efficient governance structures; and (iv) the firm’s contracts are self-enforcing and do not require judicial enforcement – are successfully challenged (Bratton, *et al* 1996). In general, the complaint against the nexus-of-contracts theory is not that relational contracts are irrelevant to understanding the internal organisation of the firm, but that it is difficult and costly for firm participants to write *ex ante* complete contracts inside the firm. For one thing, people intend to act rationally, but they are simply not able to foresee and describe all future contingencies in a contract. Economists claim that people are “boundedly rational” (Williamson 1985). More importantly, even if contingencies can be dealt with contractually, information asymmetries and strategic bargaining often prevent efficient and complete contracts from emerging (Milgrom and Roberts 1988). In short, relational contracts are often incomplete due to the difficulties for the participants to (i) foresee some contingencies at the outset of the relationship; (ii) specify all contingencies in the contract; (iii) monitor the performance of the other participants; and (iv) enforce the relational contracts (Hart 1995: 23; Klein, *et al* 1978: 303).⁷

C. Incomplete contracts theory of the firm

Viewing the firm as an incomplete contract provides a broader understanding of the legal and non-legal mechanisms required for the optimal design of corporate governance frameworks, and, more significantly, of the importance of having corporate governance frameworks in general. Incomplete contract theories, which in many ways build on and formalise the concepts and ideas of transaction cost economics, attempt to explain how structuring as a particular type of firm deals with opportunistic behaviour.⁸ Indeed, when parties can simply write a complete contract, they specify in full detail what each party must do in each state of the world and how the surplus should be shared. In practice, bounded rationality and private information inevitably entail contractual incompleteness. Consequently, firm participants may have to renegotiate the contract to react to unforeseen contingencies, which may lead to an opportunistic attempt by one of them to obtain more of the *ex post* return on investment.

The transaction cost theory of the firm essentially assumes that firm participants have less scope to act opportunistically if the transaction takes place within a firm rather than in the market.⁹ However, it does not explicitly describe the mechanisms through which organising as a firm could lead to more efficient investments. The incomplete contracts theory of the firm, on the other hand, explains in more detail which mechanisms inside the firm mitigate moral hazard and hold-up problems. The most influential theory is the Grossman-Hart-Moore framework of property rights (Grossman and Hart 1986;

Hart and Moore 1990; and Hart 1995). This theory emphasises the importance of economic ownership of physical or non-human assets in a firm. Carrying out transactions in firms solves moral hazard and hold-up problems, because the owner of the firm enjoys the “residual right of control” over the firm’s physical assets. This means that the owner has “the right to decide all usages of the assets in any way not inconsistent with a prior contract, custom, or law” (Hart 1995: 30).¹⁰ In this view, ownership is a source of power *ex post*, which fosters and protects investments and so prevents a non-owner from appropriating rents and business opportunities. Unified control over the physical assets of the firm automatically leads to control over human assets, since employees, including management teams, can be denied continuous access to the assets in which they have made human capital investments.

A basic understanding of the property rights theory makes it relatively easy to explain what the function of corporate governance is in the context of publicly held companies. A corporate governance framework determines, among other things, how control over the firm’s resources is allocated, and how hierarchy is created within the firm. It acts as a facilitator, enabling managers and the widely dispersed shareholders to move towards the optimal governance equilibrium within a firm. To see this, let us consider some of the key features of company law, which is the main source of legal corporate governance mechanisms: (i) a company is a legal entity that holds the firm’s assets; (ii) the limited liability feature allows shareholders, many of whom are wealth constrained and risk-averse, to diversify their risks; and (iii) company law creates centralised management, to which the shareholders delegate important control rights. These principles facilitate the separation of residual control from residual risk-bearing – usually referred to as the separation of ownership and control (Jensen and Meckling 1976). In a publicly held company the shareholders are simply too small and numerous to exercise the residual rights of control (Hart 1995; Hansmann 1996). It would be too costly if all of them were involved in decision management. Moreover, the shareholders, who are only interested in the company’s share price, lack the expertise and competency to take part in the decision-making process. As a consequence, the property rights theory of the firm recognises that delegating residual control rights is necessary to facilitate management’s participation in the firm and to give management sufficient incentives to undertake relationship-specific investments (Aghion and Tirole 1997).

The relationship between the widely dispersed shareholders and the managers is characterised as an “agency relationship” in which the managers are the agents and the shareholders are the principals (Berglöf 1997). From this perspective, the shareholders may encounter many complex and costly problems that need to be addressed by legal mechanisms. The delegation of control leads to substantial monitoring costs, as opportunistic managers often exploit the collective action problem barrier to effective monitoring by dispersed shareholders.¹¹ It is recognised that this principal-agent problem is due to managers having superior information on investment policies and the firm’s prospects. Managers tend to be better informed, which allows them to pursue their own goals without risk. Consequently, shareholders find it difficult, due to their own limitations and priorities, to prompt managers to pursue the objectives of the owners. Dispersed shareholders who are unable to solve their collective action problem assist opportunistic managers to extract private benefits of control through self-dealing. Herein lies the most important role of developing an effective corporate governance framework that provides proper incentives for the board and management to act in the interest of the company and its shareholders, and furnishes these shareholders with sufficient monitoring information (OECD 2004).¹²

D. Multi-owners in closely held companies

Whilst the incomplete contracts theory of the firm provides a powerful insight into how publicly held companies are organised and what the main focus of the corporate governance debate should be, it does not, correspondingly, offer a clear explanation of the problem of multi-owner closely held companies in which the identity of the shareholder is the most important characteristic. The preceding

discussion suggests that multi-owner closely held companies are sub-optimal due to the sharing of residual control rights. Information asymmetries induce controlling shareholders to divert corporate opportunities for their own interests. Box 4.1 describes a number of mechanisms that allow controlling shareholders to be able to obtain greater premium for their shares. Upon first inspection, sharing ownership rights is consequently inefficient in that the anticipation of opportunistic behaviour severely inhibits shareholders' investments. Indeed, from an incomplete contracting perspective, ownership by more than one party is only reasonable under very restrictive conditions. For instance, a multi-owner structure may be optimal if parties merely invest physical capital (rather than human capital).

Box 4.1. Controlling shareholders and private benefits of control

The most widely used mechanism to accumulate control power with a limited investment are ownership pyramids or cascades, which can enable shareholders to maintain control throughout multiple layers of ownership while at the same time sharing the investment with other (minority) shareholders at each intermediate ownership tier. A pyramidal structure of share holdings is one of the most popular mechanisms that reduce the liquidity constraints of large shareholders while it allows those shareholders to retain substantial voting power. Whereas pyramids of share stakes require smaller investment of capital (smaller cash flow rights), the large shareholder can still control his target company. For instance, if shareholder X owns 51% of the voting equity of firm Y, which in turn owns 51% of the voting equity of firm Z, there is an uninterrupted control chain that gives shareholder X absolute majority control. Still, the cash flow rights of shareholder X are merely 26%.

In a similar vein, the issuance of dual class voting shares to separate ownership and control allows a large shareholder to transfer resources from the company. The private benefits of control are non-transferable benefits beyond the financial return on investment. For example, if a car producer attracts a subcontractor to supply him with car seats, a large share holding in the subcontracting company can yield an important (strategic) advantage. The large shareholder is usually allowed a seat on the board of directors and will thus receive non-public information on the firm's cost structure or on supply contracts of the competitors. The large shareholder could, for example, after obtaining such strategic information, renew negotiations about the subcontractor's price. Consequently, such transactions can lead to the creation of another kind of agency conflict, namely the oppression of minority shareholder rights. Another example illustrates the danger of expropriation of minority shareholders: suppose that a shareholder owns 51% of the voting shares in firm A and that this shareholder also owns 100% of the equity of firm B. If firm A is a supplier of firm B, the controlling shareholder may be tempted to reduce the transfer price of goods sold to firm B. This way profits are maximised in firm B of which the shareholder has full control and owns all the cash flow rights, whereas profits are minimised in firm B at the expense of the minority shareholders.

The fact that, in the real world, firms are usually structured as closely held companies casts doubt on the robustness of the Grossman-Hart-Moore conception of the firm. Indeed, parties often choose joint ownership structures deliberately to reduce hold-up and moral hazard problems (Klein, *et al* 1978). The question, then, is why do business participants prefer joint ownership of the firm and its assets. First, complete integration of ownership and control may be too costly and difficult. For instance, firms that are largely dependent on intellectual research and human capital and own few (if any) specific physical assets, such as professional firms and software houses, arguably do not thrive well on vertical integration. In addition, given the uncertain output and high monitoring costs within these firms, self-monitoring by team members will be a better remedy for preventing moral hazard problems (Alchian and Demsetz 1972: 790; Hansmann 1996: 70-71). Box 4.2 gives another example of a closely held firm in which the owners are actively involved in the venture.¹³ Second, rather than protection against opportunism, firm participants may choose a governance structure that offers more individual adaptability – that is, a structure that gives parties the ability to adapt to changed circumstances in a more self-interested manner. Third, national laws may require that at least one of the two or more shareholders in closely held companies is a local resident. This could obviously hamper a foreign owner's preference for the integration of ownership. Fourth, minority shareholders may remain in closely held companies after delisting (see Box 4.3). Fifth, family companies, whose initial integrated ownership and control have dissipated, with members of the second and third generations of the founding family receiving

ownership interests but not participating actively in management, leaving the operations of the company to another controlling shareholder. Sixth, and perhaps most importantly, other mechanisms than integrated ownership of physical assets may protect business parties against opportunistic behaviour.

Box 4.2. Private equity-owned companies

Private equity firms tend to monitor their investments through active participation, namely by due diligence, establishing a relationship with the companies' managers and by sitting on their board of directors. Whilst involvement in key corporate functions tends to limit moral hazard problems, information asymmetries are likely to persist and can potentially create significant value dilution for investors. Information asymmetries are likely to arise from two principal sources: (i) the entrepreneur has information unavailable to the private equity firm, and (ii) the entrepreneur's information is often distorted by overestimating his chances. The first kind of information concerns the actual product, technology and market, as well as the quality, ethics and fortitude of the entrepreneurial team, whereas the second kind of information could diverge dramatically from reality, due to the entrepreneur's personal attachment to the venture and the feeling that his bright idea will definitely yield the expected wealth. Nevertheless, to a certain extent, private equity firms must contemplate the conflicting interests of the business's founder in order not to destroy the incentive for the latter to go to any lengths to make the venture a success.

Conflicting interests concern in particular the control of the business and issues involving the private equity firm's means of exit. Private equity firms typically choose to exit the venture either through a public offering, transferring their shares piecemeal, or by trade sale. In the final stage, the private equity firms reap the fruits of their investment, while the entrepreneur hopes to recoup control over "his" firm. It comes as no surprise that the nature and costs of exit are also shaped by the venture's internal governance structures and *ex ante* contracts.

Whilst the literature on private equity and venture capital emphasises the one-sided moral hazard issues that characterise the relationship between private equity firms and private equity-backed firms, this relationship cannot be explained exclusively in such terms. It is now recognised that to a certain extent the relationship resembles a "double-sided moral hazard problem", with each party contributing resources so as to maximise their joint wealth. In order for the venture to succeed, the (leading) private equity firm must be willing to provide the entrepreneur with "value-added" services, if the venture has the chance to raise its performance. The importance of these services has recently been demonstrated by the setback of the "new economy", which showed that the provision of capital alone is usually not enough to fertilise promising ventures. Value-added services involve identifying and evaluating business opportunities, including management, entry or growth strategies; negotiating further investments; tracking the firm's portfolio and coaching the firm's participants; providing technical and management assistance; and attracting additional capital, directors, management, suppliers and other key stakeholders and resources. Since these non-financial contributions are a substantial element of the private equity relationship, it might be argued that the entrepreneur, in obtaining these services from the private equity firm, is also subject to shirking and opportunism. Entrepreneurs often believe that private equity firms either fail to meet their obligation to provide value-added services, or try to renegotiate the contract, including their promise to add services, as soon as they obtain more leverage.

When the residual rights of control are not allocated to one owner – or, as in publicly held companies, to a homogenous and monolithic group – parties tend to rely more on implicit contracts and non-legally enforceable norms (Baker, *et al* 1997; Rock and Wachter 2000). Reputation concerns and fear of retaliation and of the breakdown of the business relationship induce parties to adhere to these implicit contracts and norms (Cooter and Eisenberg 2001). Parties are sometimes inclined to abide by certain norms that encourage co-operation, because their relationship is built on trust or because acting unselfishly is embedded in the relationship. In family business, for instance, firm participants have often internalised strict norms of family loyalty, which may result in the parties reflexively making relationship-specific investments and performing satisfactorily, thereby maximising the owners' welfare and profit.¹⁴ In this view, the more expensive legal, monitoring and ownership mechanisms are of secondary importance in family firms (Posner 1996). They may even have a counterproductive effect. Although trustworthy business parties may have natural preferences to act honestly, incentive mechanisms could crowd out these preferences, replacing trust in the relationship with trust in the particular legal mechanisms. They may invite initially trustworthy parties to change their attitude towards each other.

Box 4.3 Delisting of shares in India

In the early years of the 21st century, there was a growing trend of delisting shares from the Indian stock exchanges. In particular, multinational companies (MNCs) have been pursuing delisting activities for several reasons. First, depressed market conditions present an opportune moment for acquisition of the remaining securities from the shareholders. Second, the liberalised FDI norms and removal of sectoral caps now allow foreign companies to hold 100% equity in many key sectors and provide an opportunity to control entire holdings, so as to give complete flexibility in operational decisions. Third, the wish to retain listing only in one place, preferably in the home country.

It has been argued that the current criticism of the growing trend of delisting shares does not appear to be against delisting *per se*, but stems from the present perception of shareholders that the exit mechanism and the exit price being offered to minority shareholders inadequately compensates them for the total loss of investment opportunity. Investor interest would therefore be better served if the available safeguards in the case of delisting were further strengthened and the exit pricing were fair, transparent and not detrimental to the investors' interest.

Source: Securities and Exchange Board of India (SEBI), Report of the Committee on Delisting of Shares (13 August 2002).

Also, in joint ventures, reputation concerns play a pivotal role and may prevent deviation from implicit contracts and norms (Ott 2003).¹⁵ The rules of the joint venture game rely on self-enforcing norms and implicit contracts because repeated interactions make it possible to exploit reputation concerns in order to punish or reward behaviour. This is especially true of joint ventures between domestic and foreign parties. Because these international joint ventures are often set up to combine the technological knowledge of the foreign partner with the local knowledge of the domestic partner, it is obvious that their investments are complementary, generating the surplus together. Furthermore, in the real world, business partners often refrain from opportunistic behaviour and engage in practices that build trust in that they become reciprocal actors (Fehr and Gächter 2000).¹⁶ They are willing to co-operate because they expect the other partner to co-operate as well, and not because they expect to generate more surplus from repeated interactions. Under these circumstances, the presence of partners who show a willingness to punish other partners at their own expense helps to enforce implicit contracts and norms, thereby reducing moral hazard and hold-up problems. The prevalence of unsuccessful international joint ventures in China exemplifies the importance of trust in joint ventures (see Box 4.4).

Box 4.4. International joint ventures in China

After China opened its doors to the world economy in the late 1970s, most multinationals thinking about setting up in China used the joint venture. China even insisted on this structure when permitting foreign investments. The knowledge of a local partner proved to be invaluable for steering a path through China's bureaucracy and giving instant access to the local workforce and management. However, international joint ventures in China are seldom successful. One of the exceptions is French Alcatel's joint venture in Shanghai. Currently, Alcatel Shanghai Bell is a foreign invested company limited by shares, with Alcatel holding 50% + 1 shares and the Chinese shareholders holding the remainder. It is the leading telecommunications infrastructure and solutions provider in China.

Over the last decades, most international joint ventures in China went sour because, among other things, the joint venture partners disagreed on how to expand the business, disputes arose over management style and roles, and the foreign joint venture partners had difficulties to protect their intellectual property.

The poor communication, misunderstandings and disputes were due to several reasons: (i) failure to appreciate the differences in the Chinese market; (ii) failure to appreciate the ferocity of domestic competition; and (iii) failure to appreciate and understand cultural differences. It goes without saying that these failures have a detrimental effect on the building of trust and the enforcement of other non-legal mechanisms. For instance, it appears that a misunderstanding of the Chinese concept of "Guanxi" – the network of relationships among various parties that co-operate together and support one another – is a serious impediment to a successful joint venture. Not legal mechanisms, but the personal relationships based on honesty and trustworthiness are paramount for doing business in China.

Source: KPMG, Consumer markets in China – the real deal? June 2004.

Conclusion

Even if most people are self-interested human beings who face strong incentives to act opportunistically, multi-ownership structures may be efficient in an incomplete contracting setting. In many circumstances, extra-legal mechanisms play a crucial role in preventing opportunism. For instance, it is submitted that reciprocity is a significant reason why relational contracts are left incomplete and abound in vague terms (Lewis 1999: 263-264). At the same time, the game theory models suggest that if economic actors cannot organise their relationship contractually, simply because they are unable to bargain their way into a governance structure by using actual and exhaustive contracts, their business relationship can thrive on non-legally enforceable mechanisms (Bratton 1995). Legal rules and standards could even hamper the functioning of norms and implicit contracts. As noted in the preceding section, trustworthiness is not necessarily imposed through a legally enforceable rule or standard, such as a fiduciary duty. While some argue that such a legal trust norm could have some role in norm creation, which helps to prevent the greater threat of opportunistic behaviour in multi-ownership structures, others point to the fact that, for example, fiduciary duties may be counterproductive under certain circumstances. Not only could the opportunistic use of these duties involve costly intra-relationship disputes and litigation, but it could also increase the transaction costs of contracting around these legal norms.¹⁷ The same seems to apply to reciprocity. Empirical research suggests that the explicit threat of invoking fiduciary duties could destroy the “good will” of fair and honest parties in such a way that they are no longer willing to co-operate voluntarily. Commentators note that explicit legal remedies could crowd out the positive reciprocity effect. When parties have the explicit opportunity of bringing a remedial action against the opportunistic party, they seem to rely more on the “stick” and less on the “carrot”.

Yet the economic models do not describe a framework that completely dispels or neglects the role of the law. Rather than emphasising that a firm can emerge spontaneously without a legal governance structure, they point to the role of the law in supporting corporate governance arrangements that preserve the extra-legal mechanisms, which help to lessen the costs of the bargain constraints. In this context, the incomplete contracts concept of the firm holds out several important lessons for the discussion on corporate governance of non-listed companies. In general, the influence of this concept on the discussion is twofold. First, it helps us to understand the function of corporate governance in non-listed companies. Second, and more significantly in the context of this paper, it advocates what the corporate governance mechanisms must be in order to reduce transaction costs and solve post-contractual opportunism, such as moral hazard and hold-up problems. The next part of this paper will view the corporate governance framework of closely held companies as an incentive system, and discuss specific issues regarding the role and design of its legal rules and institutions.

2. Legal framework of corporate governance of non-listed companies

Introduction

Recognition of the conflicts between controlling and minority shareholders draws attention to the need for a variety of institutions and rules for dealing with these issues. The previous part of the paper 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 are contractual in nature and include ownership structure, the board of directors, managerial compensation, financial transparency, and adequate information disclosure. External mechanisms, on the other hand, are market-based techniques designed to reinforce the internal governance structure of the firm. For instance, the possibility of shareholder exit by tender to a hostile offer or is viewed as the most efficient external device for restraining managers from managerial self-dealing. However, while the so-called “market –for –corporate control” certainly aligns to some extent the interests of managers and shareholders, the

absence of a market for shares of non-listed companies would require more complex mechanisms to control abusive and under-performing managers and shareholders. As discussed, trust and reputation concerns could play an important role to optimise incentives and constrain opportunism.

Non-legal internal and external mechanisms offer a partial solution to the corporate governance problems. To be sure, in circumstances where legal regulation would otherwise be justified, non-legal mechanisms can be of considerable practical significance in imposing costs on opportunistic behaviour. This is not to say, however, that these mechanisms are the most important factor in curtailing conflicts of interest between the controlling and minority shareholders. This part of the paper describes a legal framework that helps to define and determine the internal and external mechanisms of corporate governance. Business statutes and corporate governance best practices not only provide a sound legal framework that protects stakeholders' participation and information rights, but also furnishes business participants with "off-the-rack" arrangements upon which they can fall back when establishing the distribution and allocation of powers and responsibilities within the company.

Company law, for instance, serves to facilitate the separation of ownership and control. It gives the general meeting of shareholders an *ex ante* incentive to make investments of financial capital,¹⁸ and delegates the residual control rights to management. In a publicly held company the shareholders are, as discussed earlier, usually too small and numerous to exercise the residual rights of control. It would be too costly if all of them were involved in decision management. Moreover, the shareholders, who are only interested in the share price, lack the expertise and competency to take part in the decision-making process. Although company law typically limits the shareholders' ability to intervene in management's decision-making power, it would be erroneous to conclude that shareholders are deprived of every control right within the firm. In order to mitigate shareholder hold-up by management, shareholders are given, among other things, the right to elect and remove managers and the right to information and dividend. In addition, shareholders have the legal power to veto substantial asset purchases or sales initiated by the managers, such as mergers and acquisitions. Finally, company law and the extended corporate governance regulations set the internal rules for each of the participating groups within the company. How do they work? How can decisions be made? How are they represented? How can they react to unforeseen problems that are looming over the company due to bounded rationality and asymmetric information?¹⁹ Any set of policy recommendations should take account of the role the company plays in dealing with governance needs and anticipating future conflicts within the company.

A. The legal source of corporate governance of non-listed companies

Part 1 of the paper showed that, since future contingencies are uncertain and the parties' activities are practically impossible to specify or observe, these relational contracts are inherently incomplete. In order to solve the problems associated with contractual incompleteness, the firm participants can choose among different governance structures that rely more or less on "softer" mechanisms. Obviously, integrating the ownership of the crucial assets can protect investments from post-contractual opportunism. In this case, ownership and power are allocated to the party that has the largest firm-specific investment and is most crucial to the generation of surplus. The owner then has control and primary monitoring authority. Norms and implicit contracts help to ensure that both the owner of the firm and other participants inside the firm act diligently and honestly.

Multi-ownership structures prove to be very robust when relationship-specific investments are sufficiently complementary (Hauswald and Hege 2002), the parties are indispensable to each other, they both depend on unique resources (Klein *et al* 1978), and sharing ownership rights is necessary due to time and wealth constraints, and regulations. For instance, joint ventures often result in a synergy that can be very productive, especially when financially constrained parties seek to share risks (Johnson and Houston 2000).

Multi-ownership structures are typically organised in an egalitarian rather than a hierarchical fashion. Each party usually has equal control rights over the physical assets, and share equally in profits and losses (Fama and Jensen 1983). Ostensibly, multi-ownership structures work best when they involve participants of similar talents and propensities and who make similar investments (Bleeke and Ernst 1995). However, as we have seen in Part 1 of this paper, parties of different productivity and capital levels use this very popular structure. The asymmetry between the owners of the company gives participants an incentive to engage in opportunistic behaviour.²⁰ To be sure, the participants and their legal advisors could attempt to deal with the high potential of opportunism contractually, but again these contractual mechanisms are often very costly solutions due to technological limitations, private information and strategic behaviour. That is not to say that contractual mechanisms are not used to deal with the possibility of opportunism and self-dealing transactions. However, the incomplete contracts paradigm asserts that the participants may not be able to contract their way into governance structures that deal with every contingency *ex ante*.

Accordingly, the business participants usually prefer to use a legal organisational form that defines and sets forth the ownership structure, provides important contractual provisions in advance, supports the enforcement of implicit contracts and internalised norms, and gives the business relationship legal entity status. This makes the law governing the organisational form the key for the corporate governance framework for non-listed firms.²¹ The question then is choosing the most appropriate legal organisational form when analysing the persistent legal features that serve to protect participants from the misconduct by fellow participants. Publicly held firms are predominantly organised as joint stock companies or corporations. The limited liability company is, however, the prevalent business form around the world.²² This type of company accounts for more than 55% of registered businesses and 90% of output in OECD countries. The limited liability company is also the preferred vehicle for non-listed firms in emerging and transition markets. Table 4.1 shows an example of the predominant use of the limited liability company as legal organisational form in Slovenia.

Although its development has been quite different depending on the legal system, the private company or limited liability company has been adopted in almost all countries of the world. In the United Kingdom, the private company has a single legislative base. It was initially developed in practice and later recognised by the legislature, which furnished it with certain distinct features (Lutter 1998). Most countries that once belonged to the British Empire have included the private company into their own company laws, as they were already familiar with the basic legal principles of the donor jurisdiction. The second strand of development is the enactment of a separate statute for the limited liability company. Germany is renowned for its limited liability company (*Gesellschaft mit Beschränkter Haftung*), which was the precursor of separate limited liability company legislations throughout the European continent, Latin American jurisdictions, Asia, and former Socialist countries (Lutter 1998). The United States offers only a single corporate form that can be contractually tailored to the needs and wishes of closely held firms.²³

Regardless of whether they are governed by a separate statute (the “free-standing approach”) or viewed as factual variations on, or sub-type of, the general corporation (the “integrated approach”), the private company and limited liability company have developed in the image of the joint stock company with its capital-oriented structure. Since the joint stock company is designed to attract substantial amounts of capital into the firm from passive investors and, consequently, to regulate the rich and intricate principal-agency problem, this structure is poorly tailored to fit the governance needs of non-listed firms, in which ownership and control are typically not completely severed. Despite the sometimes inappropriate structure, the private company and limited liability company have nevertheless become the preferred vehicle for closely held firms.

Table 4.1 Distribution of legal entities by legal organisational form and by entity

Slovenia 31.12.1998

Organisational form	Agriculture, hunting, forestry	Fishing	Manufacturing	Electricity, gas, water supply	Construction	Wholesale, retail, certain repairs
<i>General partnership</i>	41	2	407	1	376	1 346
<i>Limited partnership</i>	5	-	93	-	95	294
<i>Limited liability company (private company)</i>	493	26	7 523	82	2 712	20 821
<i>Joint-stock company</i>	37	-	479	14	96	257

Organisational form	Mining, quarrying	Hotels, restaurants	Transport, storage, communication	Financial intermediation	Real estate, renting, business activities	Public admin., defence
<i>General partnership</i>	1	192	171	13	665	-
<i>Limited partnership</i>	-	50	39	6	170	-
<i>Limited liability company (private company)</i>	39	1 598	2 510	350	9 646	5
<i>Joint-stock company</i>	6	58	73	40	243	2

Organisational form	Education	Health, social work	Other social and personal services	Extra-territorial organisation	TOTAL
<i>General partnership</i>	65	29	110		3 419
<i>Limited partnership</i>	15	9	30		806
<i>Limited liability company (private company)</i>	531	319	960		47 615
<i>Joint-stock company</i>	2	7	25		1 339

Source: *Statistični letopis Republike Slovenije* (Statistical Yearbook of the Republic of Slovenia), 1999.

In order to meet the needs of the specialised and idiosyncratic relationships in non-listed firms, legislative and judicial adjustments have been made in a piecemeal fashion across jurisdictions through the years. Two sets of problems have arisen repeatedly due to the publicly held character of limited liability company forms. The first revolves around the enforceability of contractual attempts by participants to modify and sidestep rigid rules tailored to the needs of publicly held companies. Today, most jurisdictions either provide more flexible company laws or allow non-listed firms to contract around the rules provided by the company law statute (Lutter 1998).²⁴ The second set of problems falls under the heading of “protection of minority shareholders”. Case law sometimes assumes that limited liability companies and partnerships are functionally equivalent business forms, with the same organisational needs. This approach is based on the assumption that business participants choose the limited liability company form over the partnership form only to take advantage of limited liability and tax benefits. Advocates often propose modifications of the exit rules of non-listed companies so that business participants can enjoy the same exit options as partners in a partnership. Moreover, they argue that shareholders in a closely held firm setting may owe each other a strict fiduciary duty of good faith and loyalty.²⁵

Because it is not clear when and to what extent the partnership principles should be applied to limited liability companies, the “partnership law” analogy may be inappropriate in this context. For instance, the judicial discretion to meddle in the internal affairs of limited liability companies might entail deficiencies and inconsistencies, in that it could limit the law’s certainty and its value for larger non-listed firms. Moreover, it appears that once partnership-type doctrines are accepted in the limited liability company law, these doctrines are difficult to opt out of. Especially, inexperienced judges tend to rely on established precedents. Finally, because these doctrines are vague and open-ended, they may create confusion, thereby preventing participation of international investors.

The next section makes a fundamental break with the traditional legal treatment of the problem of “minority oppression” in limited liability companies by rejecting the partnership analogy, and discusses in more detail which organisational and legal structures are favourable for the development of non-listed companies in general. It is suggested that a legal framework, in which contractual, legal and non-legal mechanisms interrelate, is crucial to further stimulate the development of a good corporate governance framework for non-listed companies.

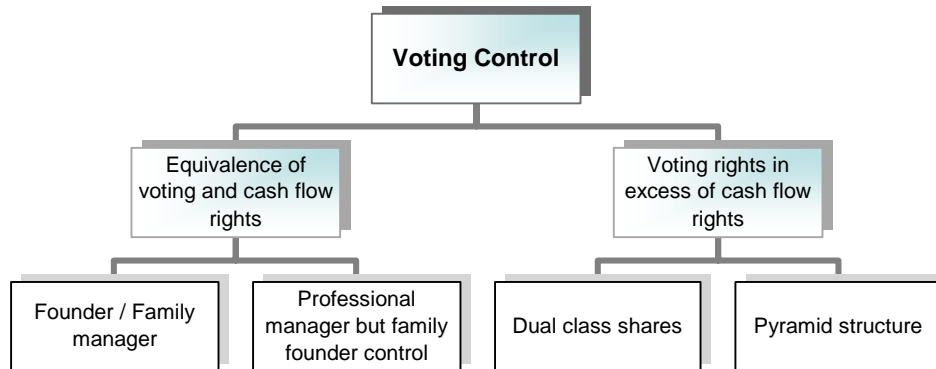
B. The role of company law in establishing a corporate governance framework for non-listed firms

Internal governance structure: board and management

Although the controlling shareholders in non-listed companies are often closely involved in management, a company law rule that provides for decentralised management directly by the controlling and minority shareholders may not be optimal for some larger non-listed firms. This is especially true for those that wish to attract external capital and attempt to limit their exposure to risk and opportunism through a combination of contractual measures and the active monitoring of management. The principal-agent literature shows that the failure to legally separate ownership from control will limit the benefits of specialisation in the firm’s decision-making. For example, if minority shareholders are prepared to take the financial risk for the firm’s ventures, it does not necessarily follow that these members will be equally suited and talented to make appropriate management decisions about the allocation of firm resources. Second, the full integration of ownership and control means undifferentiated management decision-making, which entails a more cumbersome, costly, and restricted process. Finally, a complete shareholder dominated firm will suffer higher costs due to the absence of monitoring and intervention devices to intervene on behalf of investors. The transfer of effective control to a management team, which may be directly or indirectly related to the controlling shareholder, avoids the bureaucratic costs of collective decision-making.

The limited liability company can thus be considered as a legal organisational form providing a differentiated management and control structure in which shareholders elect directors and participate in certain fundamental decisions, and directors establish policy, select managers, perform monitoring functions, and act as the firm’s agents. Because the controlling, majority shareholder elects the directors and, hence, is able to control the management of the corporation, minority shareholders are particularly vulnerable to opportunistic acts by the controlling shareholders. There are numerous strategies at the disposal of controlling shareholders to extract resources from firms they control. These include: (i) distributions of cash and property to confer benefits on shareholders; (ii) dilutive share issues; (iii) interested transactions; (iv) allocation of corporate opportunities; (v) allocation of business activities; (vi) selective disclosure of non-public information (e.g. Johnson *et al* 2000; Choi and Talley 2001). Figure 1 depicts two instances in which the majority shareholder has voting control.

Figure 4.1. Voting control within the firm



Source: Paul Halpern, Systematic Perspectives on Corporate Governance Systems, working paper, University of Toronto, 1999.

Indeed, there are reasons to believe that managers, who are directly or indirectly controlled by the controlling shareholder, will not always take the minority shareholders' best interests into account. Company law can help to discourage divergence from the minority shareholders' interests by providing rules that limit the managers' power to act solely on the directions and instructions of the controlling shareholder.²⁶ For instance, a legal rule could instruct director-managers to take into account the interest of minority shareholders and other stakeholders in exercising their powers. Moreover, shareholder approval may be required when weak management intends to enter into substantial property dealings on behalf of the company.

The safest way to ensure that the interests of minority shareholders are represented on the board of directors is the use of different classes of shares, with shareholders who have identical financial rights but are entitled to vote separately as classes for the election of specified numbers of board members. Another option is cumulative voting: a voting system that gives minority shareholders more power, by allowing them to cast all of their board of director votes for a single candidate. Cumulative voting, however, may easily be eliminated or minimised by the controlling shareholder. For instance, he or she may alter the articles of association or remove the minority shareholders' director without cause and replace him or her with a more congenial person. However, the fact is that controlling shareholders are reluctant to adopt cumulative voting.²⁷ Exit rules and fiduciary duties toward the different shareholder groups appear to be better mechanisms to diminish opportunistic behaviour.

Exit rules

Company law default rules traditionally "lock in" the participants by giving them only a very limited right to dissociate. This is not surprising in view of the fact that corporate laws were originally designed to reflect the needs of publicly held corporations where the public market for shares provides shareholders with an optimal escape route. The lack of a liquid market for limited liability company shares deprives the participants in such a company of an effective exit mechanism. This lock-in effect may help to prevent an abusive use of a buyout right, thereby increasing (at least to some extent) the stability of the firm. Yet, both legislators and judges have recognised that intimate and idiosyncratic relationships, which are also often organised as limited liability companies to take advantage of limited liability and tax benefits, may require an investment to be less permanent. Nevertheless, this argument ignores the fact that limited liability companies are often formed by business participants who have no familial relationship (Blair and Stout 2001). Box 4.5 shows legal strategies, developed in different jurisdictions, to solve disturbances among members of limited liability companies: dissolution,

withdrawal and expulsion. For instance, corporate legislation responded by supplying a narrow dissolution and/or buyout right in the event of shareholder deadlock or illegal or oppressive conduct. Case law has gone even further by sometimes deploying a version of the partnership analogy. In this view, the corporate norms of centralised management and the principle of majority rule are conducive to minority oppression, in which case the minority may face an indefinite future. Thus, in order to protect the minority against the so-called “squeeze-outs”, judicial efforts have moved the exit rules of limited liability companies more in the direction of traditional partnership law.²⁸

Box 4.5. Dissociation mechanisms across jurisdiction

Statutory bases for withdrawal – Italian law, as well as Portuguese and Brazilian law, gives a shareholder who has voted against an amendment to the company’s articles the right to withdraw from the company (*diritto di recesso*). The departed member has a claim to that part of the company’s assets (as reflected in its most recent financial statement) that corresponds to his share.

German law provides a statutory right of withdrawal in a completely different situation. Where members of a GmbH have an unlimited and continuing obligation to make contributions to the capital of the company, a member who has paid in full his contribution to the company’s original share capital may free himself from the obligation to make supplemental contributions if, within a month of a demand for additional payment, he places his share at the disposal of the company (so-called abandonment). In this situation, membership is not immediately terminated. However, the company has the power to sell the share of the affected member and to use the proceeds to satisfy its demand for supplemental contributions. Any proceeds in excess of this amount belong to the shareholder who has withdrawn.

General rules concerning a shareholder’s right of withdrawal are far more important than the above-described rules, which apply in special situations only. Statutory regulations of this kind can be found in Switzerland and Greece. They have also evolved *praeter legem* in German law. The common denominator in all of these legal systems is that withdrawal is predicated on good cause. Similar to the *diritto di recesso*, one of the most important justifications for withdrawal is a basic restructuring of the company by the majority. Another important reason is a long-standing absence of dividends, particularly if caused by a continuing process of expansion pursued by the majority. This type of withdrawal right may be regarded as a method of protecting the minority. For this reason, the right to withdraw does not arise from a simple refusal by the majority to consent to a transfer; however, it does arise if consent to a desired transfer is repeatedly refused over a substantial period of time.

Exclusion – The need to exclude members who do not perform their promised contributions naturally exists only in those legal systems which do not require complete payment for all shares at the time the company is founded.

Source: Lutter 1998

These highly discretionary remedies present tremendous potential for judges to err in construing the scope of exit rules (Miller 1997). Judges and arbitrators should act with care when conferring a partnership-type right to withdraw capital from the firm to minority shareholders who bring a cause of action for oppression. Because the dissatisfied minority shareholder has an incentive to obscure the nature of the business arrangement, it is often difficult to determine the exact underlying bargaining arrangement. As judges often lack business expertise, they rely often on notions of fairness that protect the minority interests. That is not to argue that minority shareholders can be certain that their interests will always prevail, even if the majority ignore the minority’s concerns. Litigation is often too costly and time-consuming.

The Company Law Review Steering Group in the United Kingdom anticipates that judicial gap filling can create a potential judicial wild card that creates costly uncertainty. It is, therefore, suggested that the “unfair prejudice claim” under Section 459 of the Companies Act 1985 should be limited in scope, so that the basis for the claim against self-dealing transactions by the controlling shareholder would be a departure from an agreement among the shareholders. The Steering Group follows the House of Lords in *O’Neill v. Philips*²⁹ in limiting “unfairly prejudicial conduct” to cases where the majority is acting contrary to some agreement or understanding with the minority. The Steering Group’s view on Section 459 limits the right of minority shareholders to exit the company at a fair price when a controlling shareholder has acted opportunistically.

The absence of statutory guidance, which could be adopted *ex ante*, may have a detrimental effect on both the firm and its participants. When end-period terms are prohibitively costly to arrange *ex ante* by the participants themselves and are not easily verifiable by courts and arbitrators *ex post*, legislators appear better suited to supplying the default rules for endgame settings. As such, the logic of providing these rules is to lower costs for the parties and to create a degree of predictability that could operate as a sanction against opportunism. Because exit mechanisms provide safety nets to ensure the parties' control rights and authority over the firm's assets, the question of which "default exit rule" is socially efficient is crucial. The default rule must act both as an incentive instrument and as a tool to discipline possible opportunistic abuse. These rules must be designed to contribute to the optimal governance equilibrium in the firm.

What should the statutory standard form provide? Upon first inspection, two categories of default exit rule could be contemplated. First, shareholders may have the right to compel the dissolution of the firm and liquidation of its assets. Second, shareholders may withdraw and/or be expelled from the firm and receive the "fair" value of their ownership interests. To be sure, both the dissolution and dissociation concepts may be subject to several conditions, which severely limit the voluntary and involuntary exit of participants. However, commentators have argued that in limited liability companies, both the majority and minority shareholder should be locked into the business and judicial intervention should be limited (Rock and Wachter 1999). The minority shareholders could use easy exit rules opportunistically. When the limited liability company lacks the liquidity to pay the leaving party the buyout price or holds specific assets that cannot easily be unbundled without significant loss of value, the minority shareholders could threaten to use the exit rules and, by doing so, force the majority shareholder to satisfy their demands. It is therefore argued that exit rights must be curbed in limited liability companies.

That is not to say that, given the limited market for, and often restricted transferability of, interests in limited liability companies,³⁰ business participants must always be locked into a very unpleasant investment in which hold-up problems abound. Obviously, the problem that arises in endgame settings can have a particularly heavy impact on both the firm and its participants. For instance, internal strife often encourages opportunistic behaviour not only by the controlling shareholder, but also by the minority shareholders. Although limited liability companies are characterised by the majority rule and statutory norms of centralised management, dissatisfied minority shareholders could attempt to obstruct a successful operation of the firm by playing havoc with decision-making processes. In order to help parties solve dissension and deadlocks, legislators could define specific rules that comprise the different involuntary and voluntary exit provisions. By providing clear rules, litigation costs could be reduced, since disputes could be solved more easily at a preliminary stage before trial. For instance, the law could provide that a majority shareholder, holding more than 90% of the company's shares, has the right to expel the remaining shareholders by the payment of a reasonable price. However, these dissociation provisions are not entirely without difficulties. Thorny calculation issues, particularly concerning the valuation of interest and whether payment should be deferred, abound in these endgame settings, since it is also difficult for courts and arbitrators to verify the "fair value" of interests. Consequently, it is submitted that statutory *ex ante* rules are also best equipped to provide guidance in relation to valuation issues. For instance, the rule could provide that dissociating shareholders receive the same amount in a buyout as they would receive if the company were dissolved. Goodwill will be taken into account when the buyout price is equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern.³¹

In light of the foregoing discussion, the limited liability company is best served by rules that lock-in the majority and minority participants by giving them a limited right to dissociate. This view relies on contractual arrangements by the participants themselves and on extra-legal mechanisms, such as self-enforcing norms of trust and loss of reputation, to constrain opportunistic behaviour. However, these extra-legal mechanisms can lessen, but not eliminate the inefficient subtraction of private benefits from

the firm. It is submitted that when gains of opportunism can be very large, legal rules are needed to prevent firm participants from engaging in opportunistic behaviour (Rock and Wachter 2001). As prerequisites for these legal norms of performance, minority and majority opportunism must be discouraged, and the self-enforcing character of the relationship must be preserved. In this respect, legal scholars usually point to the function of fiduciary duties.

Fiduciary duties

Fiduciary duties have evolved differently across a range of contexts involving different types of parties and consensual relationships. For instance, traditional partnership law has developed broad and strict fiduciary duties. Partners expect honesty, fair dealing and mutuality of effort from each other. In this view, even though partnerships can be described as contractual in the broad sense that the partners have entered the relationship voluntarily, fiduciary duties are moral concepts of the highest order, and are not contractually modifiable. These duties are necessarily open-ended standards of performance that can be separated into (i) a duty of care and loyalty; (ii) a duty to disclose information; (iii) a duty to preclude from self-dealing transactions, personal use of partnership assets, usurpation of partnership opportunities, and competition with the partnership; and (iv) a duty of good faith and fair dealing.

Because fiduciary duties are open-ended and vague, it might be argued that a breach of fiduciary duty is often hard for an outside party, such as a court, to verify, and consequently will only assist in preventing opportunism to a limited extent (Easterbrook and Fischel 1986). For instance, fiduciary duties are only brought into play when the trust-based relationship breaks down and *ex post* renegotiation is cumbersome. Yet, proponents of strict and broad fiduciary duties suggest that these high standards of performance have a distinct function that supplements the remedial actions provided by statute. Fiduciary duties help to foster the development and internalisation of trust and norms in a particular business relationship. In this respect, fiduciary duties have a prophylactic function.

Traditionally, the broad scope of fiduciary duties distinguishes partnerships from limited liability companies. While managers stand in a fiduciary relationship to the company and its shareholders, managers of companies appear to have a more relaxed set of fiduciary duties. In limited liability companies, the legal concept of fiduciary duty has two quite different functions. First, managers are generally expected to perform their duties with the care of a prudent person who manages his own affairs of equal gravity. Second, the managers owe the company a duty of loyalty that limits the possibility of self-dealing transactions, prohibits managers from usurping corporate opportunities and forbids unfair competition with the company. In short, fiduciary duties offer protection against the managers' pursuit of personal interest and excessively negligent behaviour. They cannot be used to discipline directors in the performance of their official duties, thereby second-guessing managers' business judgements.

In terms of the fiduciary duties law concerning transactions with a dominant shareholder, managers are generally exposed to few risks. For instance, in the United States, courts have typically been reluctant to allow interested transactions with shareholders holding 50% or more ownership stake or exercising explicit control over the company.³² Nevertheless, business transactions with a controlling shareholder can be justified. Arguably, clever directors and officers, given weak fiduciary duties, will initiate many of their business transactions with favoured shareholders.

It is not quite clear whether shareholders in limited liability companies owe each other a fiduciary duty. As noted earlier, in some jurisdictions courts increasingly extend the application of strict partnership-type fiduciary duties to shareholders of these companies. Because there are no capital market forces that help to constrain opportunistic behaviour, there really is something to the partnership metaphor. It might be argued that in limited liability companies, where management functions are (at

least to some extent) transferred from directors to shareholders, strict fiduciary duties are justified to prevent the greater threat of opportunistic behaviour.³³ However, the convergence of fiduciary duties in partnerships and limited liability companies also seems to have its limitations. Some law and economics scholars argue that strict and broad fiduciary duties at all levels of closely held firms could be counterproductive. In this view, broad fiduciary duties could encourage parties to engage in over-monitoring at the expense of productivity (Talley 1999).³⁴

For instance, joint venture partners rely more on renegotiation and reputational incentives than vague and open-ended fiduciary duties to overcome the consequences of incomplete contracts. Moreover, they often prefer to specify their rights and duties in an agreement (Hölmstrom 1999). For instance, they usually draft explicit buyout options in the joint venture contract (see Box 4.6).³⁵ Vague fiduciary duty concepts may increase the transaction costs of negotiating the terms of the agreement and even foreclose potentially productive ventures. This is especially true of joint ventures between rival enterprises that want to deal at arm's length outside the scope of the jointly held firm. These venturers normally do not want to be hampered by broad legal concepts of trust while renegotiating their deals.

In light of this discussion, many legal scholars believe that fiduciary duties should vary across the type of business form. They question whether broad fiduciary duties are optimal under different circumstances and recognise that opportunism in closely held relationships is not always best addressed by imposing broad and vague fiduciary duties. They conjecture that if fiduciary duties are varied to suit various relationships, the parties' *ex ante* adoption of a particular business form sends a signal about their organisational preferences. When limited liability companies are best served by rules that lock-in majority and minority shareholders, the question arises: where does this leave the judicial role on minority protection?

Duty of loyalty

The advantages of being locked-in do not, of course, apply across the board. For instance, judicial intervention is justified to prevent so-called non *pro rata* distributions that are not based on any agreement among the business participants. In so far as this principle is crucial to the strategy of allowing controlling shareholders to manage the company in the general shareholder interest, it is necessary to strictly enforce this principle. Indeed, the "non *pro rata* distribution" principle corresponds with important features of limited liability company law that help to prevent the opportunistic transfer of wealth from the minority shareholders to the controlling shareholder.

Company law can play an interesting role in solving problems involving non *pro rata* distributions. First, it can provide the participants with a rule stating that all shareholders share in the company's profit in proportion to their stake in the company, unless otherwise agreed upon. In the event of dissolution, the law can provide that the residual assets of the firm – anything left after creditors are paid and other obligations fulfilled – will be divided *pro rata* among the shareholders. Moreover, shareholders in limited liability companies can be bestowed with a legal mechanism that gives them a statutory pre-emptive right to subscribe for newly issued shares proportional to their existing shares in the capital of the company.³⁶ Thus seen, company law rules help to align the interests of the controlling and minority shareholders. Indeed, when non *pro rata* distributions are prevented, the controlling shareholder, in maximising the value of his stake, likewise maximises the value of the minority shares.

Box 4.6. Contractual “divorce” measures in joint ventures

Voluntary winding-up – A deadlock may trigger a defined period (say 90 days) for final negotiation between the parties. If no resolution is reached, this mechanism would then entitle either party to require the joint venture company (JVC) to be wound up. The value of the JVC on a break-up basis is likely to be less than as a going concern, which should act as a restraint against a party initiating the process lightly. Liquidation would involve a sale of all the JVC's assets, the proceeds of which would then be distributed to the shareholders according to their respective equity interests.

Buy-out of a minority – Provision may be agreed that, where the deadlock has arisen through persistent use by a party of its veto rights (usually, but not necessarily, a minority veto), the other party may have a call option—and, possibly in some cases, the other party a put option. The buy-out right might be triggered, say, where the minority party (or its nominated director) has exercised a veto on resolutions on certain fundamental or “reserved” matters on more than a specified number of occasions, or boycotted meetings at which such resolutions were to be considered.

Put/call options – Sometimes the mechanism of a put (or call) option exercisable by either party may be used—although such a structure can be very arbitrary, depending on which party first delivers the notice exercising the option.

Russian roulette/shoot out – The most dramatic solution (supported by some, but criticised by many as too arbitrary) is a termination “shoot-out” procedure whereby, after the occurrence of a defined deadlock event and usually after a warning notice period: 1) party A has the contractual right to notify party B that it wishes to sell its shares in the JVC to party B (or to buy party B's shares) at the price per share stated by party A in its notice; 2) within a stated period, party B must then elect either to sell its own shares to A, or to buy A's shares – in either case, at the price per share stated in A's notice; and 3) after the initial notice, there is therefore a compulsory sale and purchase between the parties as a result of which, in a two-party venture, the JVC will end up in the sole ownership of one party.

Texas shoot-out/highest sealed bid – In this variant, party A serves a notice on party B stating that it is willing to purchase B's shares in the JVC at a stated price. Party B has a period in which to elect either (i) to sell at that price or (ii) to indicate that it wishes to purchase A's interest at a higher price. If option (ii) is chosen, then: 1) each party submits under a sealed bid (to a designated third party) a price per share which it would be prepared to pay the other party for the latter's shares in the JVC; and 2) the lower bidder is obliged to sell his shares to the higher bidder at the higher bidder's price.

Like the “Russian roulette” procedure, this mechanism tends to favour the party having greater financial strength.

Fairest sealed bid – This is a more refined version of the “shoot-out”. Each party submits to an independent third party a sealed bid per share at which it is prepared to purchase the other party's shares in the joint venture. The independent third party then decides which of the bids represents the “fairest price” (i.e. the price closest to the price determined by such a third party as the fair value or as the price based on the valuation method provided for in the joint venture agreement). The party losing the bid would then be required to sell its shares in the JVC at this price or, alternatively, to agree to the other party's wishes in respect of the deadlock. Obviously, this method also involves a large element of risk or luck, given the serious consequences of getting the bid price wrong.

Sale shoot-out – Another variant, serving also as an exit route, is for the “shoot-out” to operate on the basis of the price at which each party is willing to sell its interest in the JVC. For example: 1) party A serves a notice on party B stating that it is willing to sell its shares in the JVC at a stated price; 2) party B has a period in which to elect either (i) to buy at that price, or (ii) to indicate that it wishes to sell its interest in the JVC to A at a stated price, which must be lower than the price in A's notice; and 3) on receipt of party B's notice, if B has offered to sell its shares, A has a period in which to elect either (i) to buy at the price stated in B's notice, or (ii) to indicate that it wishes to sell its interest in the JVC to B at a stated price, which must be lower than that in B's notice.

The process goes on until one of the parties is a willing buyer (which will happen at some stage because the sale price is reduced each time). The procedure normally provides that the sale price has to be reduced by a specified percentage each time a notice is given in the process.

Source: Hewitt 2001

Table 4.2 IAS 24 (after the December 2003 revision)

Objective: ensuring that a firm discloses the existence of related parties and related party transactions, which may affect its financial position.	
Related Parties	
IAS 24.9	<p>A party is related to an entity if:</p> <ul style="list-style-type: none"> • (a) directly, or indirectly through one or more intermediaries, the party: • (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries); • (ii) has an interest in the entity that gives it significant influence over the entity; or • (iii) has joint control over the entity; • (b) the party is an associate (as defined in IAS 28 Investments in Associates) of the entity; • (c) the party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures); • (d) the party is a member of the key management personnel of the entity or its parent; • (e) the party is a close member of the family of any individual referred to in (a) or (d); • (f) the party is an entity that is controlled, jointly controlled or significantly influenced by or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or • (g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.
IAS 24.11	<p>Not related are:</p> <ul style="list-style-type: none"> • two enterprises simply because they have a director or key manager in common; • two venturers who share joint control over a joint venture; • providers of finance, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an enterprise; • a single customer, supplier, franchiser, distributor, or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.
Related Party Transaction	
IAS 24.9	A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.
Disclosure	
IAS 24.12	Relationships between parents and subsidiaries (irrespective of transactions)
IAS 24.16	Key management compensation
IAS 24.17-18	<p>Related party transactions:</p> <ul style="list-style-type: none"> • the amount of the transactions; • the amount of outstanding balances, including terms and conditions and guarantees; • provisions for doubtful debts related to the amount of outstanding balances; • expense recognised during the period in respect of bad and doubtful debts due from related parties
IAS 24.21	The firm must provide proof if it states that related party transactions were made on terms that are common in arm's length transactions.

Source: Deloitte. IASPLUS (<http://www.iasplus.com>)

The duty of loyalty provides a safety valve against harmful evasion of the rules of “non pro rata” distributions. The duty of loyalty establishes that a controlling shareholder may not profit from his position at the expense of the welfare of the minority shareholders. The duty of loyalty can operate in tandem with non-legal mechanisms, such as self-enforcing norms of trust and reputation, to curb shareholder opportunism. Apart from unusual situations, the duty of loyalty could function well to protect investors against one-time acts of substantial self-dealing. To be sure, it has been argued that judicial gap filling is prone to error. However, it is submitted that courts can more easily determine whether financial distributions are made correctly than decide in cases involving the protection of minority shareholders’ employment and decision-making rights in the firm. Practice learns that judicial intervention in the latter conflicts is far too complex due to unverifiable factors and could undermine the self-regulatory mechanisms required for stable, co-operative business relationships (Rock and Wachter 1999).

Information rights

In order for the duty of loyalty to operate effectively, minority shareholders must have means to detect opportunistic behaviour by the controlling shareholder. Herein lies a second reason for intervention by the judiciary. Like the enforcement of the non *pro rata* distribution principle, the protection of the information rights of minority shareholders must be another important feature of limited liability company law.

Minority shareholders may gather public information and limited liability information. The main source of public information is the periodical publication of the company’s annual reports. In Europe, larger limited liability companies are obliged to publish audited annual reports under law (Lutter 1998).³⁷ For instance, the Fourth European Companies Directive extended disclosure requirements in general to all limited liability companies.³⁸ The Fourth Directive contains detailed requirements for the preparation of balance sheets, profit and loss statements, and annual reports. Although the Directive demands that the accounts give a true and fair view of the assets, liabilities, financial position and results of the company, the information is not always accurate. For instance, in the Netherlands, the annual accounts must be adopted by the shareholders within five months following the end of the financial year. But companies may extend this period to 13 months, which, obviously, will severely diminish the reliability of the disclosed information. Moreover, annual reports do not fully disclose information about the possible expropriation of the company’s benefits. Direct and indirect transactions between the company and the controlling shareholder can affect the accuracy of the financial reports. There is satisfactory transparency regarding such transactions for all listed companies within the European Union under IAS 24.³⁹ Publicly held companies will be required to prepare, for each financial year starting on or after 1 January 2005, consolidated accounts in conformity with the IAS. With respect to related party transactions, this change implies that publicly held companies be mandated to disclose the nature of the relationship, the types of transactions and the details of the transactions necessary for an understanding of the financial statements.⁴⁰ In related party relationships where control exists, disclosure of the relationship is required even if there have been no transactions (see Table 4.2).⁴¹

At present, the Accounting Directives require only that non-listed companies disclose information about transactions with affiliated businesses, which are only one type of related party. However, the European Commission has recently launched an Action Plan on further Modernizing Company Law and Enhancing Corporate Governance in the European Union in response to the High Level Group of Company Law Experts report.⁴² This Action Plan seeks to address the remaining gaps in the harmonisation process and strengthen the Commission’s role as a driving force in company law reform in the European Union. The Action Plan aims to strengthen shareholders’ rights and protection for employees, creditors and the other interested parties, and to foster the efficiency and competitiveness of European firms. The Action Plan also proposes that greater transparency should be required from

unlisted companies. Disclosure should be limited to what is material, in other words to those elements which are significant for an assessment of the financial statements. The recent proposal to amend the Fourth and Seventh Directives in relation to related parties proposes an extension of IAS-24 to smaller non-listed companies. EC regulators defend the requirement on the grounds that: *i*) related party transactions are very often material for non-listed companies; and *ii*) disclosure would not be too cumbersome, as these firms usually do not have complicated off-balance sheet arrangements.⁴³

Nevertheless, there is a multitude of ways to evade the IAS-24 rule. As we have seen in Box 1, the controlling shareholder is able to obtain non-public information and use it for personal financial benefit or tip other family members – who might then make an investment decision on the basis of this information. The inaccuracy of public information is less pressing if a minority shareholder is also a director in a company. In that case, he will be able to influence and monitor the management decisions directly.⁴⁴ Legally required shareholder approval may have the same effect. However, if minority shareholders are not in a managerial capacity or involved in the decision-making process, they are unlikely to gather the information without relying on a legal mandate. In the US, an individual shareholder is entitled to substantial information. For example, Delaware company law provides:⁴⁵

Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts there from. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder.

Engaging in information gathering about opportunistic transactions influenced by the controlling shareholder are obviously “proper purposes” under Delaware law.

Derivative actions

The enforcement of minority shareholder informational rights and the norm against non pro rata distributions are clearly important in the context of non-listed companies. Unlike their publicly held counterparts, there is generally no extensive gatekeeper system available that reduces the information asymmetry between the shareholders. Indeed, in publicly held companies, so-called reputational agents – such as investment bankers, financial media, investment advisors, corporate governance analysts – improve the monitoring and the detection of opportunistic behaviour within firms. Shareholders in non-listed companies must rely more on judicial gap-filling to ensure that their rights are protected. In order to bring an action for the controlling shareholder's breach of fiduciary duty, some jurisdictions provide for what are known as derivative suits. From the standpoint of the defendant, the incentives to bring these actions depend on the nature and character of the litigation and the size of the award. These derivative suits are brought by one or more shareholders in the name of the company and for the benefit of the company as a whole, and are an exception to the usual rule that a company's board of directors manages the company affairs. A non pro rata distribution claim falls within the realm of derivative actions. Since company managers are often largely controlled by majority shareholders, it goes without saying that these actions are often necessary to block the attempts of controlling shareholders to profit from self-dealing transactions with the company (see Figure 1).

As derivative suits cause high litigation costs and great uncertainty, restrictions to prevent a dissatisfied minority shareholder from obstructing the successful operation of a company by acting in his own personal interest are in place in many jurisdictions. For instance, the minority shareholder is required to own stock at the time of the challenged action and throughout the suit. Moreover, although derivative suits create incentives for companies to settle the matter, settlements are often subject to

judicial review. Finally, recoveries go to the company and will not benefit shareholders directly. In response, plaintiffs have sought to institute direct actions. However, since the guiding principle in limited liability companies is preserving the beneficial lock-in effect, then it is correct to require a derivative suit in lieu of a direct suit by the minority shareholder. Under this principle, any recovery must be paid into the company's treasury and remain there until some sort of pro rata distribution is made. Courts must of course permit shareholders to bring a direct individual action to enforce shareholders' rights to inspect corporate books, pre-emptive rights, and to compel dividends. In this respect, the combination of direct individual actions and derivative suits could enhance the protection of minority shareholder rights.

Conclusion

This part of the paper discussed legal mechanisms to address the problem of misconduct by controlling shareholders in non-listed companies. It is argued that when the gains of opportunism are very large, legal rules and norms are needed to prevent parties from engaging in opportunistic behaviour. As prerequisites for these standards of performance, majority opportunism must be discouraged, and the self-enforcing character of the relationship must be preserved. In this regard, we examined the function of fiduciary duties, particularly the duty of loyalty. The duty of loyalty helps to foster the development of trust and norms in a particular business relationship. It is argued that statutory rules and case law must prevent non pro rata distributions and facilitate information gathering by minority shareholders. In this respect, it is important to note that the effectiveness of courts in providing an efficient deterrent depends both on the ability of parties to bring actions and the quality of courts to resolve matters. Presumably many of the protections available to shareholders are, in practice, outside the reach of business participants due to the lack of courts' residual lawmaking powers and the substantial procedural barriers that discourage litigation. The next section assesses the important insights from this section and discusses the various reforms that policymakers in transition and emerging markets may wish to consider when devising a corporate governance framework for non-listed companies.

3. A corporate governance framework for transition and emerging markets

A. The importance of a separate corporate governance framework for non-listed companies

This part of the paper grows out of the ongoing debate among policymakers in transition and emerging markets on the need to improve corporate governance to increase investment, capital market efficiency, company performance and social welfare. Advocates of such reforms claim that the financial crises in transition and emerging markets in the period of 1997-1998 were due to a weak institutional framework for corporate governance. Commentators who favour reform argue that they have defined a link between investor protection and the development of a robust economy (Globerman *et al* 2004). They suggest that policymakers address governance problems by devising a legal framework that facilitates an effective ownership and control structure and enhances efficient outcomes, both in terms of private and social welfare.

Traditionally, the corporate governance discussions and reforms have been structured around the needs of publicly held firms. Indeed, to the extent that policymakers in transition and emerging economies have few revenue-based incentives for researching and designing optimal rules for non-listed firms, they propose – for the most part – the application of the corporate governance framework designed for publicly held companies to closely held firms. However, non-listed companies may be burdened by a number of regulatory requirements that cause firms to incur substantial costs in carrying out their normal business activities (Saidi 2005). Moreover, the imposition of the corporate governance instruments on non-listed firms could be viewed as disproportionate and over-regulatory, which might impede the development of an efficient supply of legal rules for a range of firms.

The linking of corporate governance reforms to publicly held and closely held companies involves significant costs (*e.g.* increased information costs and uncertainty, distortions in the signalling function of the corporate governance framework, decreased coherence of terms, erroneous gap-filling by courts and negative spill-over effects) that outweigh possible linking benefits. It is therefore suggested that a separate reform project for closely held companies would be more efficient in providing firms at different levels with different sets of rules and norms (Saidi 2005). In this respect, alternative corporate governance frameworks help firms to tailor the organisation of their business to their particular needs. A distinct set is better positioned to define the firm participants' expectations. Another advantage is that it is easier for policymakers to create coherent and clear benefits for "delinked" corporate governance frameworks, which are consequently better able to attract firms to their network. Indeed, as more firms adopt the corporate governance mechanisms for non-listed companies, networks of legal actors specialising in this legal framework (*e.g.* legal advisors and researchers) will develop, thereby offering legal services of higher quality and lower cost (Kahan and Klausner 1997). Furthermore, firms may choose to adopt the framework to attract and accommodate (foreign) investors who expect firms to use it.⁴⁶ Finally, and most importantly, transition and emerging markets depend to a large extent on the development of non-listed companies that continue to rely on self-financing, private equity and the banking system for expansion and growth. In this respect, a corporate governance framework that is considerably out of step with the social and economic needs of most companies in emerging and transition markets arguably leads to inefficiency. The fact that non-listed companies rely more on home country legal protections of minority shareholders than firms that access global capital markets elicits the importance of their own corporate governance requirements (Doidge *et al* 2004). That is, of course, not to say that policymakers should completely change course and redirect their focus only to corporate governance issues of non-listed companies. Corporate governance reforms for publicly held firms tend to have some positive spill-over effects on non-listed firms: *i*) these reforms improve the investment climate in regions; and *ii*) they help to facilitate the conversion from non-listed to listed companies. It is therefore suggested that, in order to maintain the momentum of corporate governance reforms, a framework for listed companies and one for non-listed companies should be developed separately, but simultaneously (see Table 4.3).

Table 4.3 Corporate governance projects in emerging and transition companies

<i>Type of firm</i>	<i>Corporate governance problem</i>	<i>Importance of research</i>
Non-listed companies	Three-way conflict between majority shareholders, managers and minority shareholders.	The majority of firms are non-listed family owned enterprises (FOEs); the corporate governance framework must be in line with social and economic needs.
Listed companies	Separation of ownership and control: agency problem. Controlling shareholders' opportunism,	Encouraging the separation of ownership and control. Improving capital markets. Creating incentives for public listing.

B. Company law reform or corporate governance codes?

Given their special needs, it is sometimes argued that non-listed firms require a separate set of corporate governance principles (Saidi 2005). This section considers the role of corporate governance codes in promoting the adoption of good governance within transition and emerging markets. It appears that many jurisdictions attempt to encourage good governance not only via changes in their company and securities laws, but also through the promulgation of more enabling corporate governance codes. Nevertheless, the enabling legal mechanisms that could discipline opportunistic behaviour and provide minority shareholders with greater protection are unlikely to be considered sufficient. To be sure, it is submitted that these codes could create awareness around corporate governance issues. However, since application of corporate governance codes in practice rather than in books is important, it is argued here that a set of principles will not always produce the coveted effect for non-listed companies.

The function of corporate governance codes is to offer firms and other stakeholders a set of flexible principles that represent the “best practice” and, hence, help to mitigate opportunism and enhance business performance. These codes have a number of benefits. Bar associations and other private interest groups can draw on their own resources when participating in the drafting process. Even though there are high costs associated with participation in a corporate governance reform project, people tend to place high value on being part of reform committees, partly because of the reputational benefits associated with the creation of such a code. Moreover, compared to statutory law, corporate governance codes result in a different type of legal product. First, these codes are for the most part drafted by disinterested lawmakers and experts, whose main concerns are reputational benefits and updating their legal expertise. Second, the code drafting process, which relies on technical input from experts rather than from interest groups, is more likely to produce a coherent set of rules that may reduce in the long run opportunistic behaviour. In contrast, statutory lawmaking, which relies more on politically oriented decision-makers to reach substantive compromises, more closely tracks a political model of lawmaking. As a consequence, the legal rules produced will tend to reflect the interest group compromises overall. Third, since drafters of corporate governance codes are often motivated by considerations of reputation, they will be less inclined to create value-decreasing statutes. Fourth, corporate governance codes facilitate the optimal production of “best practice” principles that meet the needs of distinct firms on the one hand, while introducing norms that reflect the ever-changing dynamics of the business environment in which firms operate on the other. In general, codes serve to limit the effects of lock-in obsolescence when the corporate governance groups and committees are engaged in the continuous revision of the codes against the background of changing market conditions.

However, since the success of the corporate governance codes depends on their adoption by firms without amendment, reform committees have little incentive to instigate radical changes that firms are unlikely to adopt. In other words, it is a better strategy for committee members to distil the common denominator of the various business practices and to leave aside controversial subjects. In fact, as corporate governance committees put pressure on firms to adopt the principles, it is obvious that interest groups have high-powered incentives to lobby the reform committees. Otherwise, interest groups run the risk of being stuck with a corporate governance code that may prove disadvantageous to them. So, the “stickiness” of promulgated corporate governance principles reinforces their lobby incentives. Thus, if interest groups are successful at lobbying the corporate governance committee, their efforts may have a widespread effect.

This is especially true of corporate governance codes, updates and upgrades that offer a high level of flexibility by following the “comply or explain” rule. It is submitted that firms tend to adopt and comply with the boilerplate and standardised provisions of the codes rather than explain – even though more optimal – non-compliance (Kahan and Klausner 1997). In fact, it might be argued that the “comply

or explain” approach contributes significantly to the “lock-in” effect in the context of rules and norms of corporate governance. This inflexibility often leads to inefficiency, as the codes’ provisions and mechanisms fail to respond to changes in underlying social and economic conditions. In this view, the attempts to determine detailed “best practice” codes could entail a costly and “sticky” mechanism, which turn the corporate governance codes into nothing more than blue-prints for box-tickers.

There is another problem related to the use of corporate governance codes for non-listed companies. It is widely acknowledged that a combination of economic incentives and private enforcement mechanisms drive firms to adopt corporate governance principles. Indeed, reputation building and the value-enhancing effect of adopting corporate governance principles are the main reasons for the success of a corporate governance code, when public enforcement tools are still in a developing stage. As we have seen in the previous part of the paper, so-called reputational agents play a pivotal role in the acceptance and implementation of the corporate governance codes. These agents are of paramount importance to the development of the capital market. In the publicly held firm context, they perform particular types of services for firms, which put them in a good position to determine whether the firms are committed to “best practices”. Reputational agents include the auditors who sign off on companies’ financial data; the lawyers who advise companies on disclosure standards and other securities law requirements; the research analysts who warn investors away from unsound companies; and, last but not least, the stock exchange commissions and watchdogs. It is obvious that in the context of non-listed firms, there is hardly a role for these agents. As a consequence, the necessity and effectiveness of a separate corporate governance code for non-listed companies is questioned here. To be sure, the banking systems in transition and emerging markets could help to implement corporate governance codes for non-listed companies by demanding that these firms comply with the respective code as part of the process of credit rating and risk assessment. Obviously, the prerequisite for this implementation strategy is an effective corporate governance framework in the banking sector (Berglöf and Claessens 2004; Saidi 2005). However, this may not be sufficient. Corporate governance reform in the banking sector is already sufficiently complex, and the creation of additional external demands could easily overstretch regulators. Moreover, even if a corporate code is introduced, there remain questions about the suitability of these measures for regulating non-listed companies.

It might be argued that foreign investors could put pressure on domestic companies to abide by certain corporate governance norms. However, these foreign investors often require the domestic firm to emulate foreign corporate governance mechanisms. This process could gain momentum, as more and more investors penetrate into transition and emerging markets. Foreign firms seeking to invest in these markets arguably put considerable pressure on the local corporate governance reforms, as they – including their lawyers and financial advisors – convey their corporate governance standards to the transition and emerging markets. Policymakers should therefore not jump on the corporate governance reform bandwagon and promulgate a set of “best practice” principles for non-listed companies. In this context, policymakers should direct their focus on flexible company law legislation that enhances private ordering and makes it possible to emulate the most efficient contractual corporate governance mechanisms.

C. Company law features

Statutory requirements and private ordering

From the perspective of law and economics, statutory and judicial organisational law offers standard form contracts that help to economise on transaction costs such as drafting, information and enforcement costs, and to limit opportunism and fill gaps in the relational contract. From this perspective, company law offers models that cover the relationships between the participants inside the firm and the representation of the firm in their dealings with outside participants, such as creditors. The business

statutes act as a set of “off-the-rack” terms upon which business participants can fall back when establishing the distribution and allocation of powers and responsibilities for varying levels of control and commitment (Easterbrook and Fischel 1991). That is not to say that company law provides economic actors with a set of all-encompassing standard form agreements. The theoretical and empirical contributions to the literature on incomplete contracts have shown that providing a set of default terms that deal with every possible contingency is a complex and uncertain process. Theories of the firm therefore suggest that, besides the statutory and judicial default rules, the ownership structure of the legal business forms and the interaction between explicit and implicit contracts help the parties and institutions involved in dispute resolution to fill the inherent gaps in the business relationship.

The upshot is that governmental lawmakers, *i.e.* legislatures and judges, should implement, administer and enforce business form legislation. As discussed in the previous part, pro rata distribution rights, pre-emptive rights and information rights must protect minority shareholders. A more efficient regulatory response involves determining the appropriate level of regulation. In pursuing this goal, lawmakers should focus on designing legislation that contains clear and simple fall-back provisions tailored to the requirements of most non-listed firms. In other words, a company law statute should supply a comprehensive set of default terms that the majority of parties would have bargained for in a costless world (Masten 1988; Ayres and Gertner 1989). By doing so, company law not only helps to minimise transaction costs, but also creates the necessary flexibility to amend the corporate contract when social and economic change so demands.

There are several advantages in putting the responsibility of company law design in governmental hands. In addition to economies of scale, the publicity of the legislative process reduces the information costs for potential users of the company law statute. Moreover, networks are more likely to arise around legislative products. Most importantly, the implementation and enforcement of company law rules and entity status will be accomplished more easily.

Enforcement

Duty of loyalty

In the previous part of this paper, we have seen that company law with explicit rules against non pro rata distributions alone is not sufficient to protect minority shareholders. The duty of loyalty appears to offer an *ex post* mechanism to fill the gaps in the corporate contract. The duty of loyalty is a backstop, open-ended standard that makes contractual obligations contingent on circumstances that are verifiable by courts *ex post*, but prohibitively costly to identify *ex ante* (Ayres 1992). Given the importance of an independent and high quality judicial system, it is argued that importing fiduciary duties, such as the duty of loyalty, without, the less easily replicated, judicial expertise and other enduring advantages, such as a well-developed case law, will not produce the coveted effect (Pistor and Xu 2002). Thus seen, incorporating an open-ended duty of loyalty in the company law statute, along with the possibility of derivative suits, may not function well in emerging and transition countries that lack the required judicial system. Indeed, it appears from roundtable discussions that measures to improve the efficiency of the judiciary process are of utmost importance in emerging and transition markets. Insufficient experience, lack of precedents, shortage of human and financial resources, and limited training opportunities are common problems in these markets. From this perspective, judicial discretion to intervene in the business relationship *ex post* will do more harm than good.

It follows that it would be desirable to draft specific and narrow formal legal rules instead of vague standards (Kaplow 1992). The law must define the scope of the duty of loyalty. A definition of this duty in more exclusive terms could make clear what is expected of the business participants in the short and

long term, thereby increasing the effectiveness of corporate governance mechanisms. Since directors are often somehow related to the controlling shareholder, the company law statute could state that directors must not authorise, procure or permit the company to enter into a transaction, or enter into a transaction with the company, if they have an interest in the transaction which they are required to disclose to any persons and have not disclosed to the extent so required. Furthermore, it could define the duty that directors (or those “connected with” them) may not appropriate or exploit a corporate opportunity. It might be argued that clear rules provide a legal incentive for directors and the controlling shareholder to forego opportunistic behaviour and encourage them to abnegate self-interested behaviour.

Although the costs of promulgating rules exceed those of drafting and promulgating standards, rules may internalise much of the transition costs. In this respect, the benefits of bright-line legal rules are threefold. First, firms may spend less in learning the content of the law. Second, firms may become better informed about rules than standards and thus better conform their behaviour to the law. Third, simple, bright-line rules that participants will often comply with voluntarily – and a strong sanction for violating the rules – help the judiciary to solve a conflict in the most efficient way. A strict interpretation of the rule, however, raises the vexed question of the possibility of opting out of the defined duty of loyalty. In order to answer this question, one should distinguish between the fiduciarian and the contractarian views. While the former defends restrictions on fiduciary waivers, the latter considers fiduciary duties as default rules that the parties should be permitted to opt out of upon mutual agreement. Since foreign investors are likely to be important sources of equity capital in emerging and transition economies, where economic circumstances change rapidly, it is argued that the contractarian approach is the preferred option in emerging and transition markets. To be sure, a mandatory approach arguably provides better protection for minority shareholders. However, business participants may be in the best position to reflect their relational wishes in a contract. In this view, the duty of loyalty rules are penalty default rules from which parties cannot opt out without signalling their intention.⁴⁷

Self-enforcing model of company law

Professors Black and Kraakman (1996) have developed a “self-enforcing” approach to drafting company law. They propose a rule requiring shareholder approval for self-interested transactions. Although their model aims at publicly held companies, a similar approach could be proposed for limited liability companies. By offering clear and bright-line rules for an internal approval procedure, company law would *i*) increase the available information for shareholders, and *ii*) prevent the need for judicial interpretation, which is often unavailable and unreliable in transition and emerging markets. In order to be effective and efficient in the long run, the company law statute should not only describe and classify precisely the transactions that need approval, but also the formal legal procedure that has to be followed. In this way, company law would be brought into step with prevailing corporate governance values. Such a proposal tends to be efficient because it offers business participants a set of default terms that limit the drafting and information cost burdens while providing flexibility to react to social and economic changes. To the extent that company law offers firms and legal decision-makers, such as courts, a set of simple and coherent terms, the legislation will provide an acceptable low-cost corporate governance framework for business planning and operation, and the resolution of conflicts. The supply of clear and simple rules will arguable be regarded as value-enhancing (Easterbrook and Fischel 1991).

Public versus private information

Transparency and disclosure play a key role in the larger system of corporate governance. As noted earlier, adequate disclosure is widely recognised as a crucial mechanism to mitigate the adverse effects of controlling shareholder opportunism and to ensure the accurate protection of minority shareholders. Information about the company’s financial situation and material transactions is crucial for regulating the

conflicts between controlling and minority shareholders. Mandatory disclosure rules of balance sheets, income and cash flow statements and external auditor reports are generally implemented in emerging and transition economies. However, the most important question, in practice, is whether the information provided to minority shareholders is reliable and adequate to monitor effectively the actions of directors and, more importantly, controlling shareholders.

The roundtable discussions involving emerging and transition countries identify potential difficulties of relying solely on public information. First, the accounting standards adopted across emerging and transition countries are different and often outdated. Since unification of accounting standards is crucial for better disclosure and transparency, most countries are in the process of adopting – or have already adopted – IAS. But most companies in the emerging and transition countries lack the sufficient expertise to prepare IAS financial statements and, therefore, rely heavily on auditors. The complications with the mandatory disclosure system arise, however, not only from the complexity of many of the accounting rules and standards, but also involve auditors' problems of detecting material misstatements in financial reports. There is a lack of certified auditors. As a result, there is a need for more training in most countries where local auditors are practically unfamiliar with the new accounting standards. It is obvious that in such an environment, particular attention needs to be paid on safeguarding independence.

As long as there is no accurate system of disclosure and transparency in place, individual rights to inspect the books of the companies enhance information flow and ensure that at least some controlling shareholders abstain from opportunistic behaviour. The law could provide for access rights to be subject to a pledge of confidentiality by the individual shareholder. This decision on the regulation of information rights can be explained in terms of a trade-off between the need for minority shareholder protection and the reluctance of companies to disclose sensitive information. It goes too far, however, to deny the right to information when the periodical information that the company provides to shareholders is inadequate to protect minority shareholders and market controls are weak.

Conclusion

Undeniably, the promulgation of clear and bright-line rules is costly, and legislative updates cannot avoid that parties immediately adopt opportunistic strategies that subvert the rule. This seems especially true of business laws in the dynamic economic and social environment characteristic of transition and emerging markets. Nevertheless, it might be argued that, in order to operate effectively, company law must provide clear rules to support the efficient working of the corporate governance framework.

However, parties should be allowed to change the rules of the game. To illustrate the importance of this, let us assume that in the context of closely held business firms, the legislators have promulgated clear rules for efficiency reasons. The judiciary in emerging and transition countries is, for several reasons, unable to adjust the statutory rules if economic and social change renders them obsolete. Because the judiciary is not able to keep pace with economic and social evolution due to time constraints and the lack of precedents, the legislators must occasionally provide an update in order to satisfy demand-side pressures from firms. But the legislators must anticipate being overruled by the business participants, and so their laws tend to be consistent with the dictates of efficiency. The judiciary who analyse conflicts within the firm can impress on legislators the importance of legal reform, when most parties have contracted around a particular company law rule. By doing so, they provide yet another safeguard. The end result is that the cost of outdated law is minimised, and the supply of legal rules matches demand.

4. Conclusions

In recent years corporate governance has become an important topic for both research and business practice in emerging and transition markets. But the discussion has focused on the governance problems of large publicly held firms. Given that non-listed companies are the rule rather than the exception worldwide, and that non-listed companies will continue to play a significant role in a wide variety of economies, more systematic corporate governance research is needed in this area. Moreover, it is well appreciated that the corporate governance of closely held firms differs substantially from that of publicly held firms. If academic research is to inform and improve corporate governance in emerging and transition economies, it is therefore of paramount importance to analyse corporate governance issues in closely held firms. This paper endeavoured to contribute to filling this gap by focussing on corporate governance reforms in markets in which a) closely held firms are particularly common, and b) a significant share of the foreign investment resources are directed towards non-listed companies. This research highlights company law rules that could improve the performance of closely held firms and create mechanisms (incentive and information systems) that impede opportunistic behaviour in these companies.

In this paper, it is argued that an effective company law framework for non-listed companies in transition and emerging economies is required. The most important issue concerns understanding what the most efficient mechanisms are and what the role corporate governance plays in non-listed companies. There seems to be a consensus that the most pressing matter involves the abuse of minority interests by controlling shareholders. Quite apart from private benefits and financial tunnelling, the abuses also involve opportunistic restructuring, asset sales, related party transactions, transfer pricing, and squeeze outs. Listed companies frequently have controlling shareholders who are regulated by a combination of legal and market techniques to limit the cost of such abuses. Non-listed and listed closely held firms share many similar strategies to prevent opportunism. For instance, the non-legal mechanisms of trust and reputation are important for securing co-operation for both types of companies. However, multi-ownership in publicly held companies is considered more advantageous for constraining large shareholders due to the important role that reputational agents play in both reducing information asymmetries and detecting fraud. Corporate governance codes can supply principles for standard setting and enhancing enforcement by markets. In practice, these codes are soft law that can easily translate into hard law constraints. Nevertheless, non-listed companies arguably demand stringent regulation to curb appropriations and settle expectations.

Company law is the most important source of corporate governance techniques in the context of non-listed companies. Minority shareholders' interests can be protected by rules that restrict managers' power to act in response to directions given by controlling shareholders. More effective lock-in rules and squeeze out regulation, for instance, are highly important for promoting share transfers and investment in these companies. To ensure, moreover, both continued investment and minority protection, it is desirable that the lawmakers devise clear and precise valuation methods and procedures that are not cumbersome. At the same time, fiduciary duties can play a role in preventing non pro rata distributions. But, open-ended fiduciary duties in markets with less experienced courts and legal systems may prove less effective. The duty of loyalty nonetheless provides an important safety mechanism to protect investors against the abusive tactics of controlling shareholders. From the perspective of emerging and transition markets, however, these duties are not easily enforceable unless they are clearly enunciated as formal legal rules.

Disclosure and transparency are important elements in any corporate governance system. If these regimes are still in an early phase of development, it is vital to re-direct attention to individual shareholder rights and information rights. A very important way to ensure the ability of shareholders to employ legal techniques is to secure accurate and timely information on the financial affairs and performance of the company involved. To be sure, the strength of the shareholders' rights depends

largely on the regular disclosure to authorities. However, the drawback of public disclosure is that it may not be able to inform investors of potential conflicts or company performance due to a variety of bottlenecks in its transmission. It is therefore necessary to enhance individual information rights, through a direct action, by ensuring the right of inspection of company ledger, books and other records.

Enforcement is another approach to protect investors in non-listed companies. Investors are likely to resort to this mechanism if other gatekeepers, like the reputational agents mentioned above, are insufficient. Given the limitation of direct actions by individual shareholders, it is important to enforce the principle of non pro rata distribution on behalf of the company. Derivative suits provide minority investors with the possibility of clawing back their investment appropriated by managers or controlling shareholders. The success of these actions depends on investors' access to information, the incentives provided to lawyers and the sophistication of the court system. While these factors may vary across countries, the promulgation of clear rules is, as we have seen, essential to the adequate protection of the minority's interests in non-listed companies.

Although this paper emphasised the importance of clear and simple company law rules, it is argued that one legal framework suitable for non-listed companies across the board would be difficult to achieve. It is therefore suggested that company rules need to be as flexible as possible to enable these companies to contract into the desired organisational structure. In order to help participants to organise and manage their business in the most effective manner, optional guidelines could be implemented to supplement the existing legal frameworks. Such guidelines do not enshrine principles and norms that are a "must" for adoption by all firms. These guidelines should be in the form of advice.⁴⁸ In that respect, they serve three purposes: *(i)* they provide the business participants with recommended solutions to complement the contractual flexibility of the company law rules; *(ii)* they provide focal point solutions to corporate governance problems among business participants; and *(iii)* they can assist business participants in the interpretation and implementation of good governance practices. These guidelines preferably contain recommendations on the different ownership and control structures of non-listed companies, the composition of the board of management, transparency requirements, accessing outside capital, and strategies for succession planning and conflict resolution. Optional guidelines could not only play a pivotal role in furthering education and awareness with regard to the importance of good corporate governance practices, but also contain provisions about the benefits of educating and training board members and shareholders to become competent and reliable business participants in non-listed companies.

NOTES

1. It is widely understood that there are significant differences in the two main systems of corporate governance. See, *e.g.* Berglöf (1997: 97-99): The market-oriented corporate model and the relationship-based (or network-oriented) corporate system. It is argued that relationship-based systems recognize the claims of non-shareholders (stakeholders) in the process of corporate governance and consequently provide a comparatively weak governance structure for monitoring and enforcement of minority shareholder rights. In contrast, the Anglo-American governance system (market-oriented model) is more attuned to the norms of shareholder wealth maximization, stringent financial disclosure and investor protection.
2. In their study of 49 countries, La Porta, *et al* compared the quality of shareholder protection and law enforcement by taking 8 corporate governance indicators that protect minority shareholders into account: 1) one share – one vote; 2) proxy voting by mail; 3) is the deposition and subsequent blocking of shares required for taking part in the general meeting of shareholders; 4) cumulative voting/proportional representation; 5) minority protection mechanisms; 6) minimum percentage of share capital needed for calling an extraordinary general meeting; 7) pre-emptive rights; and 8) mandatory dividend.
3. In the real world, the line between publicly held companies and closely held companies is not always clear. For instance, in relationship-based corporate systems, large publicly traded companies are often characterized by a concentrated ownership system in which a so-called ‘block-holder’ actually controls the firm and its assets. Because they are owned by insider coalitions or wealthy families, these ‘publicly held companies’ could arguably be perceived as closely held firms.
4. For an explanation of the origin and development of mass-privatized companies, see OECD (2004).
5. Eurasian countries participating in the Roundtables include Armenia, Azerbaijan, Georgia, Moldova, Mongolia, Kazakhstan, Kyrgyzstan, Ukraine, and Uzbekistan.
6. In this paper, the terms ‘closely held company’ and ‘non-listed company’ are used interchangeably. In this respect, a closely held company is a company whose shares are not generally traded in the securities market.
7. Because opportunistic behaviour is often observable to the parties involved, but not verifiable by courts, relational contracts are inherently incomplete.
8. Two forms of opportunistic behaviour should be distinguished: moral hazard and hold-up problems.
9. Williamson (1985) argues that the combination of asset specificity, environmental and behavioural uncertainties, and transaction frequency explains the existence and boundaries of the firm. If transactions are repeated more frequently, levels of uncertainties are high and the relationship-specific investments are made, parties are better off organizing as a firm, which in Williamson’s view solves the hold-up problem by mitigating opportunistic behaviour and improving investment incentives.
10. The residual claimant receives the net income that the firm produces, *i.e.* whatever remains after all revenues have been collected and all debts, expenses and other contractual obligations have been paid (Milgrom and Roberts 1992: 291; Fama and Jensen 1983: 302-303).

11. Rational shareholders have incentives to free-ride on the costly monitoring efforts of other shareholders. Attempts to engage in collective monitoring will therefore fail if a few shareholders bear the entire cost, but receive only a portion of the benefits.
12. Clearly, good corporate governance does more than regulate the ownership and control arrangements inside the firm. A corporate governance framework would not be credible if it did not affect outsiders. Not only does corporate governance provide rules and institutions that enforce the internal ownership and control arrangements of the firm, but it also contains rules that protect other stakeholders, like employees and creditors, against externalities that may arise from the opportunistic behaviour of insiders. Again, it must be noted that this paper focuses on the internal elements of corporate governance.
13. The setback of the 'new-economy' has shown that the contribution of the passive investors, who merely provide capital, is often not sufficient to fertilize a promising and innovative idea. Consequently, venture capitalists closely monitor their investments, actively participate in the venture's strategic decisions and furnish the venture with value-added services. These services (*e.g.* identifying business opportunities and management assistance) are often more important than their financial resources. In this respect, start-up firms are typical closely held companies. However, these firms also resemble publicly held companies. For instance, in order to help make the venture a success and to professionalize its internal organization, outside directors are brought into the firm, thereby separating effective control and management from risk-bearing (Hellman and Puri 2000).
14. Internalized norms become part of the firm participants' character. Violating such a norm may provoke self-criticism and guilt, thereby acting as a self-enforcing mechanism (Cooter and Eisenberg 2001).
15. Economists have used game theory to analyze how reputation effects work as a self-enforcing mechanism in relationships. It appears that if a game is repeated, a built-in provision for punishing deviations arises (Halonen 2001).
16. If one assumes that a fraction of the people are concerned about 'reciprocity', in that they respond to friendly or hostile actions even when these responses prove very costly, implicit contracts and norms can be sustained even in a so-called one-shot game.
17. See Ribstein (2000), noting that 'opportunistic use of legal remedies does not carry the same connotation as fraud and therefore tempts even relatively honest actors'.
18. See Hansmann (1996: 62) (arguing that publicly held companies have the important advantage that their owners generally share a single well-defined objective: to maximize the net present value of the firm's earnings).
19. La Porta *et al* (1997, 1998, 2000) claim that the rights of the individual shareholder within the 'general meeting of shareholders' are better protected in common law systems, leading to more efficient financial systems.
20. For instance, in many economic situations, business participants of different productivity and capital levels use a multi-owner structure (Sherstyuk 1998). If one of the participants is more productive or makes larger investments than the other(s), the less productive participants have an incentive to shirk, free-ride or engage in other opportunistic behaviour.
21. Since the shares of non-listed companies are not generally traded in the securities market, and share transfer deals take place outside the official exchanges, securities regulations have a minor or no role to play in providing the corporate governance framework for these firms.

22. See *Doing Business in 2004, Understanding Regulation*, a copublication of the World Bank, the International Finance Corporation and Oxford University Press.
23. The shortcomings of this method have been solved recently by the promulgation of highly flexible legal organizational forms, such as the Limited Liability Company and the Limited Liability Partnership.
24. Since the European Court of Justice's judgments recently encouraged the introduction of competitive lawmaking within the European Union, European member states increasingly allow contractual deviations from the company law statutes.
25. For instance, in the United States and Germany, the judiciary has viewed the private company as a 'quasi-partnership'. See *Donahue v Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975) and, to a lesser extent, *Wilkes v Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976). In Germany, the German Supreme Court imposed a broad fiduciary duty on controlling shareholders of the German close corporation – *Gesellschaft mit beschränkter Haftung (GmbH)* – in the ITT case (BGH 5 June 1975, BGHZ 65, 15 (ITT)).
26. It is argued that broad actual agency authority creates additional risk of opportunism, in that it fails to fully appreciate the benefits of specialising decision management and decision control. The decision process could be divided into four steps: (1) initiation, (2) ratification, (3) implementation, and (4) monitoring. Steps (1) and (3) are typically allocated to the same actors and, therefore, conveniently called decision management. Steps (2) and (4) are called decision control. See Fama and Jensen (1983: 303-304).
27. See, for instance, Sang-Woo Nam and Il Chong Nam (2004) (noting that in Thailand, Indonesia and the Republic of Korea, only a few firms adopted this mechanism after it had been introduced). Cumulative voting allows shareholders to multiply the number of shares owned by the number of board of director positions to be voted on, and then to cast that number for one or more directors.
28. A squeeze-out can be defined as an action of the majority to cut the minority off from any say in management and any significant distribution of the business earnings. See Gevurtz (1995: 498) (comparing squeeze-out with the freeze-out situation in which the majority uses legal compulsion to force an unwilling minority to sell out its interest).
29. [1999] 1 W.L.R. 1092.
30. In closely held firms, one often finds restrictions on interest transferability. Three basic types of restrictions are commonly employed: first refusals, first options and consent restraints. See Cary and Eisenberg (1988: 421-422).
31. This example is derived from the Revised Uniform Partnership Act in the United States (§701).
32. *Kahn v. Lynch Communication Systems*, 638 A2d 1110 (Del 1994).
33. This threat is perfectly described by Easterbrook and Fischel (1991: 238) ('[d]rafters of the organizing documents of a closely held corporation cannot avoid a trade-off. On the one hand, they must provide some protection to minority investors to ensure that they receive an adequate return on the minority shareholder's investment if the venture succeeds. On the other hand, they cannot give the minority too many rights, for the minority might exercise their rights in an opportunistic fashion to divert returns.').
34. Talley argues that broad fiduciary duties might be inefficient as they create incentives for the business participants to spend resources on monitoring each other rather than on productive activities.

35. See Holmström (1999: 81) (mentioning the variations on ‘shootout’ clauses, in which one party proposes a price that can be accepted as either the selling or buying price of the joint venture). See also Chemla *et al* (2002).
36. Dominant shareholders may use the issuance of new shares to expropriate private benefits from the minority shareholders. See Sang-Woo Nam and Il Chong Nam (2004), stating that the pre-emptive rights were not well protected in the East Asian countries until very recently.
37. In contrast, a US non-listed company which has total assets exceeding USD 10.000.000 and more than five hundred shareholders must publish its accounts (Securities Exchange Act of 1934 §12(g)).
38. Some smaller enterprises are exempted from the publication of certain information.
39. International Accounting Standards (IASs) are developed by the International Accounting Standards Committee (IASC), whose purpose is to develop a single set of global accounting standards. Further to the restructuring of the IASC, on 1 April 2001 the new Board (as one of its first decisions), renamed the IASC as the International Accounting Standards Board (IASB) and, as far as future international accounting standards are concerned, renamed IAS as International Financial Reporting Standards (IFRS). These standards should, wherever possible and provided that they ensure a high degree of transparency and comparability for financial reporting in the European Community, be made obligatory for use by all publicly traded Community companies.
40. IAS 24.22.
41. IAS 24.20. In December 2003, the IASB issued a revised version of IAS 24, which expands and clarifies the disclosure of related party transactions.
42. Communication from the Commission, Modernizing Company Law and Enhancing Corporate Governance in the European Union—A Plan to Move Forward (available at europa.eu.int).
43. European Commission, Proposal to Amend the Fourth and Seventh Company Law Directives.
44. It goes without saying that all members of a company’s board of directors (including minority directors elected through cumulative voting) should have the right to inspect the company’s accounts and books.
45. Del. Code. Ann. tit. 8, §220(b) (1998).
46. See Klausner (1995: 785-786) (arguing that where information asymmetries exist and signalling is costly, marketing network externalities may exist).
47. Because of asymmetry of information and the consequential incompleteness of the relational contract, it has been argued that majoritarian default rules may not always be desirable. Backstop rules that parties would not have contracted for could be more efficient at times. For instance, if it is costly for the courts to come up with a tailored rule that the parties would have wanted, it may appear more efficient to design a default rule that forces parties to contract explicitly. These ‘penalty default rules’ are also appropriate to situations in which parties can act opportunistically because they withhold private information. By devising penalty default rules, lawmakers can induce parties to contract around the default, simultaneously revealing information to less informed parties.
48. See McCahery and Vermeulen (2005, forthcoming) for a further analysis of the role of optional guidelines in enhancing corporate governance standards.

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PART 2

COUNTRY PAPERS

- Chapter 5* **Brazil: Corporate Governance - Challenges and Opportunities**
by Leonardo Viegas
- Chapter 6* **Bulgaria: Corporate Governance of Large Non-Listed Companies**
by Stefan Petranov
- Chapter 7* **China: Policy Implications**
by Zhengjun Zhang
- Chapter 8* **Colombia Corporate Governance as an Instrument of Competitiveness**
by Andrés Bernal
- Chapter 9* **Eurasia: Corporate Governance Challenges of Non-Listed Companies**
by Alum Bati
- Chapter 10* **India: An Overview of Corporate Governance of Non-Listed Companies**
by Sumant Batra
- Chapter 11* **Kyrgyz Republic: Corporate Regulations**
by Nazul Abdrahmanova
- Chapter 12* **Lebanon: How Is Professional Management Monitored?**
by Dr. Fouad Zmokhol
- Chapter 13* **Macedonia: Recent Developments**
by Samir Latif and Dr. Gregory F. Maassen
- Chapter 14* **Mexico: Corporate Governance Practices**
by Sam Podolsky
- Chapter 15* **Morocco: Public Policy Framework**
by Amina Benjelloun
- Chapter 16* **Venezuela: Promoting a National Agenda Based on Ethics, Transparency and Accountability**
by Sonia de Paola de Gathmann

Chapter 5

BRAZIL: CORPORATE GOVERNANCE - CHALLENGES AND OPPORTUNITIES*

by
Leonardo Viegas**

This chapter describes the characteristics of Brazilian non-listed companies and the efforts of the Brazilian Institute of Corporate Governance (IBGC) to build awareness and stimulate the use of good corporate governance practices through effective use of research, communications and training activities designed especially for NLCs.

1. Non-listed companies in Brazil

According to the market research firm IDC, there are about 6 000 companies in Brazil with over 250 employees. Only 120 of those companies are listed *and* regularly traded on the São Paulo Stock Exchange (Bovespa). Even some of the listed companies, however, could be considered non-listed companies (NLCs) under the broad definition of NLCs provided in the “Note on scope” of the draft agenda of the OECD meeting.

The suggested definition for NLCs as “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” would encompass companies formally considered as listed. This is the case of some large government-controlled companies in the energy and financial industries, large family-controlled groups and privatised companies under foreign control because of the small amount of shares that are freely traded. From a corporate governance point of view, these companies “look and feel” like NLCs because boards of directors are appointed essentially by controlling shareholders.

Brazilian NLCs can be roughly divided into the following categories:

- Companies partially or completely under founder/family control;
- State-owned and government-controlled companies; and
- Wholly-owned subsidiaries of international corporations.

This paper will focus on family-controlled NLCs with short references to the other categories.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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2. Family-controlled NLCs

The overwhelming majority of NLCs in Brazil are family-controlled. A significant number of large companies were founded in the 1950s, a period when entrepreneurship flourished in Brazil. These companies are now owned and sometimes run by members of the second or third generation of the founding family. Many of these companies are experiencing succession problems in management and ownership. Some large companies are by choice unlisted, but have financial stakeholders (equity and/or creditors) besides their controllers. Professional managers run the more experienced and mature family-controlled NLCs, although the founder family may continue to play an important governance/shareholder role. In the last ten years, many companies tapped private capital markets (including private equity) and developed an understanding of what the corporate governance requirements are. Some may soon follow the example of the eight companies that made highly successful IPOs in the last 12 months. These IPOs were made in the elite segment of the São Paulo Stock Exchange known as Novo Mercado (New Market), a separate listing that requires good corporate governance practices of its listed members. There is a growing understanding among members of these family groups that good corporate governance creates value for the company, reduces disputes between heirs and successors, and contributes to the company's sustainability in the long run.

State-owned and government-controlled companies

During the 1990s, some of the largest government-owned companies in the transportation, chemical, steel, telecommunication and financial industries were privatised and are now under private domestic or foreign control. A significant number of companies are still wholly owned by, or are under the control of, federal and regional governments. Many of these companies are seriously seeking better governance standards in order to improve performance and facilitate access to capital.

Wholly owned subsidiaries of international corporations

International corporations generate a significant part of the Brazilian gross domestic product (GDP). Many of these companies are wholly owned subsidiaries of public corporations in their home countries. This is the case of the automobile companies and some utilities. These subsidiaries are known for their poor corporate governance practices, such as lack of transparency, non-disclosure of relevant financial information and pro-forma boards of directors.

3. NLCs and the IBGC code of best corporate governance practices

The Brazilian Institute of Corporate Governance (IBGC) is a non-profit organisation that was founded in 1995 by a group of business people who believed in the power of good corporate governance to create value for corporations and for society as a whole. At that time, corporate governance was a concept vaguely associated with the protection of minority shareholders and good corporate behaviour – and its Portuguese translation sounded like yet another phrase of imported consultant jargon with little meaning for the business community.

In the steps taken by the IBGC to promote the ideas of corporate governance in Brazil, a very important development was the publication in 1999 of the first version of a “Brazilian Code of Best Practices”. Using the codes that had already been published around the world as a basic guideline, the Institute's board of directors drew up a comprehensive code adapted to the Brazilian legal framework and business environment.

One big difference compared with published international codes is that the IBGC code, to broaden its scope, takes into account not just listed companies, but also NLCs and even partnerships. Another

difference is that US- and UK-inspired codes of best practices focus mainly on the board of directors as the weak link between shareholders and management, whereas the IBGC code focuses on practices and relationships between owners, the board of directors, the management, the independent auditors and the fiscal council (the fiscal council is a Brazilian specific legal provision to support the rights of minority shareholders). The choice to take into consideration the whole system of governance in the code is due to the prevalence of controlling owner(s) in most Brazilian companies. The IBGC code includes a short, practical definition of corporate governance, which demanded extensive discussions of the board. The code was launched with high visibility at the São Paulo Stock Exchange and with the support of the hosts and of the Brazilian securities and exchange commission (CVM). The code has produced an important effect, doing much to consolidate and communicate the concept of corporate governance, and has become the basis for education programmes of the Institute.

Preaching the gospel of good corporate governance

Since the very beginning, the Institute realised that it should create events to spark the interest of the Brazilian business world in corporate governance. Monthly meetings for IBGC members provide an opportunity to discuss corporate governance issues with invited guests: directors, CEOs, investors, lawyers, auditors, consultants and regulators. Sir Adrian Cadbury, guru of the corporate governance world, addressed the Institute's members in one of the early events. Another outstanding event brought Ira Millstein to speak at the São Paulo Stock Exchange. Guest speakers and the attendance of these meetings include representatives of both NLCs and listed companies, and the discussions include issues such as succession in property and management of family-controlled companies.

Since the year 2000, the IBGC holds 1-day annual congresses. Panel discussions often include NLC issues, especially those concerning family-controlled companies. The founder and president of the Family Business Network, Alden Lank, spoke at the gala dinner before the first congress. The 2004 congress had 380 registered participants. Of the 43 companies represented (not counting service providers such as law, accounting, and consulting firms), 23 were NLCs. Under the broad definition of NLCs provided in the agenda of the OECD meeting, about 80% of the companies might be considered to be NLCs.

Training as a means to promote good corporate governance practices

An early IBGC education project consisted of organising two week-long seminars, the first in Boston/New York in 1998, and the second in London/Paris in 1999. A group of 20 business people participated in a series of lectures by Harvard professors, executives and directors of pension funds, stock exchanges and associations.

In 1999 the Institute organised the first training course for corporate directors. Lecturers were recruited among IBGC members; and students came from the members' network of companies. It soon became apparent that the majority of participants belonged to family-controlled NLCs with little knowledge of capital markets and the challenges of a global economy. Training programmes usually have a high content of "how to do" disciplines, but the needs of IBGC course participants tend to be more of a conceptual nature with a high content of "what and why" issues. For example, case studies that exemplify successes and failures can help to generate empathy and motivation.

Since 1999, about 1 500 students have participated in the IBGC open enrolment and in-house courses. In 2004 alone there were 578 participants. The student profile of IBGC open enrolment courses is extremely varied and makes the IBGC courses unique. In any class we may find a 20-year-old heir concerned with his first job in the family business, sitting next to the founder of another company concerned with disputes among his grandchildren (the eldest IBGC student was over 80). Some students

are seasoned CEOs of international corporations who are close to retirement and are thinking of becoming professional directors. There may be a widow who owns a controlling stake in a large company sitting next to an investment analyst of a pension fund. Some students may be lawyers, auditors and consultants. Others work for NGOs concerned with social and environmental issues. All they have in common is their involvement with governance in their organisations.

In-house courses have a far more homogeneous attendance. The demand here consists of tailor-made courses for different constituencies. Courses for listed companies are the exception. Most in-house demand comes from NLCs: family groups and government-owned companies. In 2004, for example, there was a strong demand for training government officials who were directors or auditors of companies in which the state has a stake.

As the attendance figures grew, the course offerings were adapted to satisfy the needs of different segments. Present programmes consist of the following courses:

- *The Director Training Course* is the oldest offering and is presently in its 16th version. It consists of 64 classroom hours and covers concepts, legislation, business and financial strategy, financial statements and ethics.
- *The Best Practices Course* is a short, 16-hour course that essentially covers the IBGC Code of Best Corporate Governance Practices.
- *Corporate Governance for Family-controlled Companies* is a 40-hour programme similar to the director training programme, with emphasis on family issues such as family constitution, succession, marriage settlements, testament rules, exit rules, career systems, family councils, conflict resolution, etc.
- *The Board Case* is a role-play course based on a case study, where participants take turns in playing the roles of a board member, an audit committee member and a compensation committee member. This course is a joint venture between the IBGC, Deloitte and Spencer Stuart.

The following new courses are under development:

- *Risk Management and Control* is a two-day course specially designed for members of audit committees, fiscal councils, and internal and independent auditors. It explores risk management techniques and the relationships between the board of directors, internal auditors, independent auditors, fiscal council members and management.
- *Family Office in Family-controlled Companies* is a compact three-day workshop designed to explore the separation of family affairs from those of the company. It will describe the functions of a family office as a concierge or investment manager, and address issues dealing with taxation, accounting and estate planning, asset allocation, etc.
- *Advanced Issues of Corporate Governance* will be half-day seminars about special situations faced by corporate directors, such as “critical problems in the disclosure of financial statements”, “conflict risks”, “executive compensation”, “evaluation of merger/acquisition proposals” and “evaluation of financial transactions”. These courses could function as continued education for students who have participated in the basic programmes.

Challenges and opportunities for better corporate governance in NLCs

Like in many countries, there is a limited supply of information about NLCs in Brazil, maybe because family-controlled companies are deeply involved with the family itself. Reliable information sources, such as the Internal Revenue Service and credit information, are of course not available. Macroeconomic trends – tight fiscal policies and high interest rates – are presently inauspicious. Company informality is growing along with ever-rising taxation and antiquated labour regulations. Yet there are signs of strength in those family-owned NLCs that seem to realise that they have to rely on themselves for performance and growth. Positive signs are also noticeable in the very different environment of government-controlled NLCs, many of which are engaged in programmes for improving governance standards so that they can access capital markets.

Additional opportunities for the further development of NLCs include:

- The São Paulo Stock Exchange will soon launch an “Access Market” with the co-operation of the IBGC. This programme will help family-controlled NLCs to raise governance standards and eventually tap capital markets.
- IBGC will launch a research project to assess the corporate governance practices of family-controlled companies. This project will be sponsored by the CIPE (Center for International Private Enterprise). Research conclusions will be published and used to create guidelines for the training of shareholders and directors of participating companies. They will also form the basis for a focused training course on family-controlled NLCs.
- The IBGC has been holding talks with the IoD – the Institute of Directors of the UK – in order to improve education efforts for directors. In the future, this initiative may lead to a joint certification of directors.

IBGC Mission

The IBGC aims “to be the most important national corporate governance reference, by developing and promoting the best concepts and practices in Brazil and contributing to improve corporate performance leading to a more equitable, responsible and transparent society”

.www.ibgc.org.br

Chapter 6

BULGARIA: CORPORATE GOVERNANCE OF LARGE NON-LISTED COMPANIES*

by
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Introduction

Large non-listed companies in Bulgaria differ substantially in their corporate governance systems. This heterogeneity is a natural result of the origin and evolution of Bulgarian firms as market agents. Under normal market circumstances companies begin their lives as private companies and become publicly traded when they need additional capital or when they want to create a liquid market for trading in their ownership rights. The impetus for becoming a publicly traded company comes from the company itself and there are different costs to that.

Normal development of firms in a market environment usually starts as personal or family businesses financed by founders' savings. When successful businesses start to grow they meet corporate governance issues related to access to capital, monitoring of professional management, transparency and accountability to stakeholders.

The origin of large non-listed companies in Bulgaria follows quite a different pattern – the privatisation of state-owned enterprises. Due to the various privatisation techniques employed, different results of the privatisation process and the early stage of their market development, Bulgarian enterprises are quite heterogeneous in terms of corporate governance practices. At this stage, three large groups of non-listed companies¹ can be outlined. Their characteristics are analysed in this paper.

1. Common characteristics of large non-listed companies

In 2003 the Company Law, which regulates non-listed companies, was amended extensively and included some “corporate governance” provisions. These provisions are directed at improving corporate governance by setting higher standards.² Although they lay a good foundation, for the time being their efficiency in practice is not high. The reason is that with a high level of ownership concentration, which is usually the case for non-listed companies, these provisions can be easily eluded and circumvented.

The general attitude with respect to corporate governance issues in non-listed companies can be observed in a recent report:³

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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- Corporate governance provisions are “adequate for publicly traded companies but inadequate for those not publicly traded”;
- The business community has a “poor understanding” of corporate governance;
- These problems must be addressed to improve shareholder rights and the “ability of companies to obtain commercial financing by establishing themselves as creditworthy, based on the appropriate application of corporate governance principles”; and
- Lack of experience in commercial law matters hinders judges.

One common characteristic is that almost all non-listed companies have a very low level of transparency. Although required to disclose some information, large non-listed companies do not comply fully, and both the volume and quality of the information they disclose do not impress. Disclosure requirements are standard and equal for all non-listed companies, regardless of their size and form of incorporation. Firms are required to file the following documents in the court of registration:

- by-law (with relevant amendments, if any);
- annual financial reports (non-listed companies can choose between national and international accounting standards); and
- auditor’s report.

In most cases, the documents above cover all the information provided by non-listed companies. The culture of full and transparent disclosure is almost non-existent. Specialised departments and/or employees for investors and media relations are also usually missing.

The protection of investors is stipulated by the Commercial Law with respect to related parties transactions and transactions involving a large part of the assets. Such transactions should be approved by the general assembly of the company or unanimously by the board of directors. Shareholders with more than 5% of the stock have the right to amend the general assembly agenda.

Another common characteristic is that managerial practice is still lacking the institution of independent directors. Boards are usually small and represent the majority shareholder. There is no practice to make use of different committees, such as an audit committee, corporate governance committee, senior management training committee, and carrier and remuneration committee.

2. Differentiating characteristics

Besides their common characteristics, large non-listed companies also have differences, which provide a basis for classifying them into three groups. The first group includes enterprises privatised by insiders through special preferential schemes. Ownership in those companies formally belongs to managers and employees, who control the majority stake or have full ownership *via* a company registered for that purpose only. In most cases, there are also outside shareholders with minority stakes – the state, former employees and managers, former owners.⁴ Most often, control of the majority stake is only formally exercised by all managers and employees. In fact, it usually belongs to a tiny group of former or current managers.

Such an ownership structure forms a control pyramid, with a close circle of people at the top. In these companies management and ownership are not separated, which minimises the agency problem. The close ties within the controlling circle make sure that political connections and business secrets, so crucial in the initial phases of business, are kept confidential. At the same time, people from that circle

are not bound by family ties, and thus are probably missing the possible advantages of family control, like long-term planning and family values.

The most important problems for companies of this group, at this stage, are lack of transparency of operations and difficulties in access to capital. Another set of problems for those firms is related to the qualifications of board members, which clearly have a direct impact on the companies' success. A good board should be comprised of members who are able and willing to contribute specialised knowledge and experience in the relevant business areas. Yet, strong political ties, lobbying and personalisation have created most boards in this group.

The second group of companies consists of companies privatised as public ones through the mass-privatisation programme. Later, after a process of ownership concentration, they were de-listed from the stock exchange. This process has left a large number of private companies with thousands of minority shareholders.⁵

Such a corporate strategy is not surprising if viewed as a sensible adaptation to dysfunctional markets and institutions. Given the level of corruption and the lack of well developed shareholder rights during the transition period, dispersed ownership is not viable. This results in a natural tendency to highly concentrated ownership.

In this group of companies, ownership structure is comprised of one majority shareholder (the privatising company) and a lot of minority shareholders, who collectively own only a small stake in the company. Most often the majority shareholder is a holding company, successor of a privatisation fund from the mass privatisation programme, while minority shareholders are usually former and current employees, juridical entities, and the state.

In this case, many of the common corporate governance problems can be observed. In comparison to the former category of large non-listed companies, key problems here are related to transparency and managerial control. The issue of access to capital is less painful compared to the first group of companies. Within the holding structure it is usually possible to re-distribute financial resources, as well as provide more and better collateral for bank loans or for issuing bonds.

Many of the large enterprises in Bulgaria were privatised by foreign investors. They comprise the third group of companies. These are currently daughter companies of foreign companies and are part of control pyramids, which differ in their number of levels and size. The pyramids might have several intermediary levels, including offshore companies, which could complicate the picture further. Two different cases can be distinguished here. The first sub-group represents companies that belong to a pyramid on top of which is a mother company listed in its home country. The second sub-group consists of companies whose mother company is a non-listed company in its home country. The most significant cases belong to the first sub-group, although there are many examples of the second sub-category as well.

In both sub-groups several corporate governance problems could be identified. On one hand, these concern relations between the majority shareholder and minority shareholders. Minority shareholders, although with a small stake, could be large in number, especially in large companies. It is important also, from the point of view of economic policy, to note the following fact. Even when the majority shareholder comes from a country of high corporate governance standards, and even if the majority shareholder is a listed company in that country, it is not automatically guaranteed that it will comply with those high standards with respect to the local daughter company. At least in Bulgaria, there are cases of opportunistic corporate governance behaviour on the part of foreign investors, who are usually known to comply with higher standards in their home country.

In this group one can find many of the corporate governance problems related to transparency, and to monitoring and control of management. There is a broad range of very different corporate governance practices here. This is natural, given the fact that mother companies come from different countries with a specific corporate governance culture and follow different corporate strategies. Investors vary from listed to private, closely held companies, and range from Anglo-Saxon and European to Russian and Korean ones. As a result of this, quite different corporate governance practices are observed, imported from the mother companies, both in terms of the composition of boards and management and control systems.

The issue of access to capital is usually not a problem for companies belonging to this group, or at least much less of one, compared to other groups of companies. Financial resources are usually provided by or through the mother companies. They, as a rule, have good access to international capital markets, have higher credit ratings compared to daughter companies and can mobilise cheaper financial resources for investment projects, when necessary.

Large state-owned enterprises can be categorised as a specific separate group. These are non-listed companies, controlled by a single owner – the state – while some of them have already tested, or plan to use, capital markets for financing large projects.

In state-owned enterprises, the respective government ministries appoint managers. As is well documented in economic literature, state-owned enterprises are not managed effectively and the following difficulties can be expected:

- low level of transparency;
- using these enterprises for political purposes;
- lack of proper motivation for employees and management; and
- problems of competence and corruption.

Bulgaria is by no means an exception, and such phenomena are constantly observed. They exist even in public companies where the state owns the majority stake and where requirements for corporate governance are higher in principle.

As can be seen from the classification above, the picture is so heterogeneous that it is doubtful that a universal policy could be applied for stimulating effective corporate governance in all cases of large non-listed companies in Bulgaria. The typical pattern of a very successful independent entrepreneur or family business is practically non-existent at this stage of development of the Bulgarian economy. Most probably this will evolve over time, and gradually enough cases in number and significance will emerge. Yet, the picture of large non-listed companies in Bulgaria is different from the typical case, and this implies specific economic analyses and specific economic policies targeted at the creation of a favourable legal and regulatory environment that will motivate and support effective corporate governance in large non-listed companies.

NOTES

1. For the purposes of this paper, the following dual classification is used. *(i)* “non-listed” or “private” companies, for which corporate governance is legislated only by the Company Law; and *(ii)* “public” companies, which are governed by both the Company Law and the Law on Public Offering of Securities. This classification is based on Bulgarian legislation. Corporate governance issues matter mostly for joint stock companies from both categories.
2. In the course of public discussions, there was resistance by a number of businesses to some of the proposals as being too far-reaching, expensive and complicated.
3. See the assessment of the Commercial Law 2002 (USAID, consultants Booz, Allen, Hamilton, 2002).
4. In the process of transition to a market economy, and under the privatisation programme, ownership rights were given back to former owners (before 1944) of land and industrial property.
5. The legislation permits standards accommodating concentrated ownership for the “going private” process.

Chapter 7

CHINA: POLICY IMPLICATIONS *

by
Zhengjun Zhang **

1. Background

Depending on type of ownership, non-listed companies in China can be classified into four forms: state-owned and state holding enterprises, collective enterprises, privately run enterprises and stock enterprises. This classification is due to the ongoing reform process in China, which has gone from a planned economy to a market economy, and from the total domination of state-owned enterprises (formerly named state-run enterprises), to the inception, formation and development of a non-state-run economy (collective enterprises and privately run enterprises), and then to an even match between state-owned and non-state-owned enterprises. The ups and downs of these two kinds of enterprises have led to big differences in the nature of corporate governance in China.

A. *Before 2000: a brief review*

Before 1978: collectivism under a planned economy, single type of ownership, with no separation between management and ownership

Before 1978, China had a planned economy, which was essentially collective equalitarianism under “the big rice bowl” system. Basically there was no privately run economy. The SOEs (state-owned enterprises) were directly run by the government. Enterprises were just production units. As to what to produce, how much to produce and how to produce, this was all decided by orders issued by government agencies. The characteristics of enterprise governance were as follows: single type of ownership, with no separation between management and ownership; the direct involvement of several government departments, acting as owners in the operation process, such as in production decision-making; appointment, removal, employment and salary of staff; finance and funds; etc. The factory director’s control over the enterprise was limited to organising the production process under the limitation of certain kinds of resources, and enterprises lacked both flexibility in the market (weak competitiveness in the market) and self-determination (weak incentives).

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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From 1978 to 1992: loosening regulation, introducing market mechanisms, and strengthening material incentives gradually

The major course of SOE reform was loosening control and profit concession. Since 1978, increasing the self-determination of enterprises became the dominant attitude of government economic management departments. There were pilot projects, where control rights, which were held by the government in the past, were transferred to management, including some profit retention, bonus decisions, production of some unplanned products and promotion of middle-level management. Later, a contract system was introduced into SOEs in the country. This means that the owner allows the contractor to manage his property and both parties sign an agreement whereby the owner gets fixed returns and the contractor gets the extra part, or both parties allocate the returns proportionally. In 1988, the “Law of Wholly People-Owned Industrial Enterprises” stated as follows: the property of the enterprise is wholly owned by the people, while the government authorises the enterprise to manage its operation; the enterprise has the qualification of a legal person, and so has civil responsibilities by means of its property; the enterprise functions under a system where overall responsibility is borne by the factory director or manager, who is the legal representative of the enterprise. In 1992, the “Status of Management Mechanism Conversion of Wholly People-Owned Enterprises” further clarified 14 self-determination rights enjoyed by enterprises, including rights of production, pricing, purchasing, sales, import and export, investment decision-making and personnel matters, etc.

Restrictions on the development of a non-state-owned economy were gradually loosened. In 1979, “the individual economy” was opened up, allowing people to engage in the service and handicraft industry. From 1980 to 1982, the contract system was implemented in rural areas, allowing farmers to contract the land which was collectively owned by villages, and to establish their own family farms, which greatly mobilised the enthusiasm of farmers. One of the effects of the rural reform was the emergence and quick development of township enterprises, mainly in the coastal areas, like southern Jiangsu and Zhejiang Province. In 1992, the total industrial output value of the villages and township enterprises accounted for 35% of the output for the whole country.

The characteristics of SOE governance during this stage were as follows: the SOEs gradually broke away from the planned economy and got involved in market competition, while interference of the government was greatly reduced; the management and staff of the enterprises were provided with the incentive mechanism, while the fundamental framework of the enterprise (factory system) and that of the state exercising ownership of the enterprise remained unchanged; close ownership; the relation of property rights is confused, with the factory director having the actual ownership right and insider control far and wide. The institutional problems at a deeper level were gradually becoming evident.

From 1993 to 2000: equal attention is paid to corporate reform and market construction

The corporate reform of SOEs. The Third Plenary Session of the 14th Central Committee of the CPC held in 1992 set the objectives for establishing a market economic system, and clearly pointed out that in order to intensify the reform of the SOEs, we should focus on the “innovation of the enterprise system” and establish a modern enterprise system with “clear relation of property rights, definite rights and responsibilities, separation of enterprise from government, and scientific management” as its main characteristics. In 1993, a company law was passed, defining for the first time in law the corporate forms, rights and responsibilities, mergers, and bankruptcy, etc. After the 15th NPC of the CPC in 1997, it was pointed out that the state-owned economy had to make a strategic adjustment, and the Fourth Plenary Session of the 15th Central Committee of the CPC in 1999 further made clear the requirements for reforming the corporate system, establishing effective corporate governance and diversifying the stock right structure. The corporate reform of the large SOEs thus entered the stage of establishing a modern

enterprise system in accordance with international standards and systematic advancement. Driven by the local government, the reform of small and medium SOEs moved faster in practice. The main forms were as follows: transfer enterprise ownership right to staff members; whole sale; import non-state-owned investors to build corporate system; and put out the enterprise to be leased and managed by someone.

The non-state-owned enterprises quickened their development, many of them changing into corporations from “small and medium SOEs” and “village and township enterprises”. Since the reform of the SOEs was sure to lead to fairly large-scale lay-offs, the non-state-owned economy, which was regarded as the main creator of social employment opportunities, obtained a series of policy supports from governments at various levels. Many non-state-owned enterprises developed from small and medium SOEs and the “villages and township enterprises” without clear relation of property rights, which further promoted the quick development of the non-state-owned economy. In 2000, the employment population of the non-state-owned economy accounted for 65% of workers in cities and towns, and its fixed assets investment represented 50% of that of the whole society.

The characteristics of SOE governance during this stage were as follows: the framework of corporate governance has been established; the goal of establishing a modern enterprise system has been set; corporate reform has been promoted and strengthened through such means as legislation, institutional reform, breaking-away from administration departments, breaking up the administrative monopoly, restructuring and listing, etc. The main existing problems were as follows: the confusing relation of property rights has not been resolved; the function of ownership was still being exercised by many government agencies, and the problems of the overreaching interference of ownership and insider control coexisted; although the fundamental framework of corporate governance had been established in corporate enterprises, some basic responsibilities and mechanisms were still lacking; a non-transparent “multi-level legal person system” still existed, leading to chaotic capital flow, intense conflict of interest, profit gaining through private manipulation and abusing the rights of minority shareholders.

The governance problems of non-state-owned enterprises were as follows: the non-transparent “multi-level legal person system” and abusing the rights of minority shareholders; lack of a mechanism to ensure that responsibilities and obligations are assumed by board members; the excessive power of the chairman of the board of directors, combining the role of “legal representative of the enterprise” and the CEO function; confused or overlapping relationship between the board of directors and the executives, and insider control.

2. Practice in recent years

A. State-owned assets management system reform

The reform of the state-owned assets management system and the establishment of the State-owned Assets Supervisory and Administration Commission

In 1998, in correspondence with the rapid corporate reform of the large SOEs, some of the former central government industrial departments that had been in charge of large SOEs were withdrawn, and the SOEs that were directly under government control also finished their break-away from central government industrial departments. However, some large enterprises were still managed by the central government. In terms of assets, those enterprises were linked to the Ministry of Finance; in terms of personnel, parts of them were linked to the newly established central enterprise working committee of CPC, and other parts were linked to the central organisation department of CPC. Some enterprises saw supervising power transferred from the central government to local governments; some, with lesser importance, were restructured and combined with other enterprises; some administrations were turned

into shareholding companies during administrative department withdrawal, and restructured or integrated with other enterprises. Breaking-away and re-linking highlighted the reallocation of interests.

These reforms have led to new supervisory agencies, but whether these are the Ministry of Finance, the central enterprise working committee of CPC, or the central organisation department of CPC, their supervisory capability and professional level cannot be compared with those of central government industrial departments and the former State Assets Administration Authority (Zhang Wenkui, 2002). The supervision of enterprise managers suddenly changed from excessive interference in the operation of the enterprise into loose monitoring, which led to a vacuum in monitoring. To strengthen monitoring, the government has generally adopted the authorised management contract, which requires that enterprise managers maintain and increase the value of state assets. Meanwhile, the government supervises the enterprises and the enterprise managers through appointing supervisory directors and accountants. However, these measures have a low supervisory effect with high cost, and are prone to lead to chaos in corporate governance and insider control.

Academia and administrations at various levels, from the central government to local governments, have examined the system of state assets management at great length, and reached common ground in many respects. For example, they think that the government cannot directly manage too many SOEs, and this problem can be solved by a three-level model: the administration of state property rights→holding companies→common SOEs.

In terms of system reform of the enterprise, aiming to address the problems of poor asset quality, redundant employees and the heavy debt burden common in SOEs, many SOEs have separated the core capital from the former enterprise and carried out stock-jointing, IPO and listing, thus leaving behind past burdens such as non-core capital, bad debts and redundant personnel in the former enterprise (named renewal enterprise), and achieving the goals of attracting social capital investment and streamlining core professional workers. In fact, these enterprises have adopted the practices of “new enterprises with new systems and old enterprises with old systems”. This kind of reform meets with little resistance and has a more rapid effect. However, governance problems follow: it is very difficult for the listed companies to become a legal person entity with complete independence; the renewal enterprise, as a dominant shareholder, still controls the listed company, often leading to cases of trapping outside money and hollowing out listed companies.

In view of the above problems, the 16th NPC of the CPC held in November 2002 put forward the following decisions: all state-owned assets should be wholly owned by the state, the investor property rights of these assets should be separately exercised by governments at various levels; the central and local governments should set up state assets administration authorities with “integration of personnel, business and assets management”, to fulfil investor responsibilities on behalf of the state. In March 2003, the State-owned Assets Supervisory and Administration Commission (SASAC) of the State Council was established, with the main responsibilities of promoting strategic adjustments of the layout of the state-owned economy, intensifying enterprise system reforms, exercising ownership rights on behalf of the state, and improving corporate governance of state-owned and state holding enterprises.

Main measures in state assets supervision

After the establishment of the SASAC of the State Council, the top priority is to set up the fundamental framework for the new supervisory system of state assets, including regulation and institution building. In co-operation with the Legal Affairs Office of the State Council, SASAC drafted the “Provisional Regulations of the Supervision and Management of State Assets in the Enterprise”, which was promulgated for implementation on 27 May 2003. SASAC also promulgated four

corresponding regulations and regulatory documents on checking assets and ratifying capital, performance assessment, property rights transfer, and the standardisation of SOE system reform. Under the survey and guidance of SASAC of the State Council, local SASACs were established one after another within one year or so. The fundamental work in state assets supervision was strengthened, the methods of checking assets and ratifying capital were put forward, the “Registration Regulation of the Property Rights of State Assets in the Enterprise” was promulgated, and the work of checking assets and ratifying capital was planned and promoted full scale among the central enterprises; and the work of the board of supervisors in the SOEs was also strengthened and improved.

The second priority is to standardise the SOE property rights exchange, and guide and promote the reform and restructuring of SOEs. SASAC of the State Council has formulated “Suggestions on the Standardisation of the System Reform of the SOEs” and “Provisional Methods for Managing the Transfer of State Property Rights in the Enterprise”; it has strengthened the supervision of the state property rights exchange in the enterprise; standardised the exchange and transfer of property rights; accelerated a reasonable flow of state assets; pushed forward the separation of the supplementary business from the major business in SOEs and promoted the system reform of the supplementary business, while redeploying and settling redundant personnel. In the future, SASAC also intends to carry out the property rights exchange of central enterprises in three major property rights exchange agencies, respectively in Beijing, Tianjin and Shanghai. The Shanghai Joint Property Rights Exchange, Tianjin Property Rights Exchange Centre and the Beijing Property Rights Exchange are responsible for publishing the information on the transfer of the state property rights of the central enterprises and organising related property rights exchange activities through the regional property rights market.

The third priority is building corporate governance. Performance assessment methods for the management of executives of central enterprises have been published. Executives from 187 central enterprises have signed annual performance liability contracts, and pilot projects for publicly selecting and employing senior enterprise executives were established. From June to November 2004, 22 central enterprises were organised to employ 23 executives from both home and abroad. The central SOEs were asked to establish the boards of directors, under which the independent audit committees were set up. Six central enterprises were selected as pilot projects for establishing a board of directors. In the pilots, the wholly state-owned company sets up and approved the board of directors, and selects board members from supervisors; the board of directors selects and appoints senior executives; the executives exercise the personnel right according to law, where employees within the enterprise can compete for positions while people outside the enterprise can also have an opportunity for public employment.

B. The drain and loss of state assets, the environment of non-state enterprises and their corporate governance

Controversies over the drain and loss of state assets

In June 2004, Professor Lang Xianping, a Hong Kong-based economist, published a paper with case studies, charging that many non-state enterprises saw in the reform of SOEs a chance to embezzle state assets and capital; he included some of China’s star non-state enterprises, like TCL, Haier and Greencool, in this criticism. According to Lang’s remark, both Haier’s curved MBO and TCL’s ownership reform should be suspected as “embezzling state assets”. Greencool operated in a different way, using 0.9 billion RMB to take over an enterprise that owned a solid capital of 13.6 billion RMB in total. Meanwhile, Greencool should also be suspected of taking the illegal actions of “embezzling the funds of listed companies” and “unfair purchase by depressing the prices”.

Lang Xianping stated that the current method of reform to “get the SOEs to recede and let the non-state enterprises move forward” has two big problems: one is the illegal activities resulting from a lack of regulation and related laws; the other is that the customised price privately set between the buyer and seller must result in the drain and loss of state assets because of the low prices. Therefore, we must regulate the reform of the ownership of assets to call a stop to assets ownership transactions made in private, and ensure that the transactions of state assets ownership are disclosed, transparent, contestable and severely audited. MBOs should be prohibited – MBOs are in fact MBIs, since the money is loaned by state banks and prices are set by the leaders of non-state enterprises. Moreover, a professional executives system that has both the incentive mechanism and stresses trust and responsibility should be established.

Lang Xianping’s analysis and criticism raised a wide discussion on the drain and loss of state assets, reform of SOEs, sins of non-state enterprises and even issues concerning, for example, the hatred of the rich and hatred of corruption. This was reported in the media, and many scholars joined the discussion.

Oposing voices mainly expressed that the reform of SOEs should by no means be stopped, even if there are some transformation problems, and only the reform of assets ownership can mediate the unclear relationship between the government and enterprises. If we beg the question of defining the materiality of assets ownership and only have reform of management control, the “chronic illness” of the Chinese system of ownership will not be cured. SOEs receding and non-state enterprises moving forward, as well as the privatisation of SOEs, has been the path taken by economic reform over the past two decades, and is not a delicate design by anyone. The entrepreneurs of non-state enterprises are people who make a contribution to society and should be well treated, and the hatred of the rich should not be a motivating force. The hatred of the rich and corruption should be distinguished and should not be a stumbling block in the development of the non-state-owned economy.

In conclusion, all circles of society admit that there is a drain and loss of state assets in the SOE reform process. The contention actually focuses on how to treat the problem and what kind of measures should be taken. However, Lang’s criticism is significant in that it has brought government and all circles of society to reflect once again on the reform of SOEs. There is no doubt that the reform of SOEs will continue to raise questions in the future, but it will proceed under the requirements of better regulation, transparency and severe auditing.

Actions against the drain and loss of state assets

During the big discussions, SASAC sped up the review of the reform of SOEs and the transfer of assets ownership, and produced a series of documents on the review of the transfer of assets ownership, regulations on structural reform, statistical data collection on assets ownership transactions of SOEs, audits on central enterprises, internal audits, and identification of the added value and maintenance of state assets.

Accordingly, the review of assets ownership transfers of SOEs was carried out nationwide, focusing on enterprises and units that transferred state-owned assets ownership after 1 February 2004, and on related companies that had assets ownership transactions. MBOs were listed as the top priority to be reviewed.

In September 2004, SASAC for the first time officially remarked on the reform of the assets ownership of SOEs. It stated that to improve the reform of big SOEs, we must adhere to the principle that ownership and management control should be separated, and that major enterprises should be controlled by state capital. Big state-owned and state holding enterprises should not be MBOs or even controlled by management, for this method of combing ownership and management control will hinder the development of effective corporate governance. As for small and medium sized SOEs, the reform should be fair and carried out publicly, with the premise of protecting the legal rights and interests of shareholders and other stakeholders.

The discussions mentioned above on the drain and loss of state assets not only reflect the problems of the reform process of SOEs, but also give us a picture of the environment in which non-state enterprises operate. Under the feudal system of Old China, the power of resource allocation was concentrated mainly in the hands of the emperors and officials of different grades. Since the reform and opening up of China, market-based systems and administration systems exist simultaneously; the state-owned economy still dominates and administrative power still plays the major role in the allocation of resources (WU Jinglian, 2003). Through regulated co-operation and self-motivation, some non-state enterprises have been successful in attracting foreign risk capital and have developed quickly. Others, instead, have become rich through illegal means, which are chiefly three: the first is rent seeking, which results from the administration's intervention in market activities, such as limiting the field by the bottom price; the second is to make huge profits under imperfect market mechanisms, loose supervision, and by actions such as trapping outside money through listing, stock manipulation, tax evasion, etc.; and the third is to embezzle public wealth and state assets during the reform process of the economic system and structural change of assets ownership, including the reform of SOEs, through such means as depreciating the value of state assets and fabricating bad performance.

Governance issues in non-state enterprises

Box 7.1. The financial crisis of the De Long Company, and the Hua Rong Assets Management Company entrusted to manage it

In April 2004, the fact that three public companies controlled by the De Long Company collapsed in the stock market set off the discounting crisis of the financial companies (securities companies and city commercial banks) under the control of De Long. The courts froze the assets of De Long, and its subsidiaries and related companies were on the edge, unable to operate normally. Therefore, the central government entrusted the Hua Rong AMC to take over the trust management of De Long and restructure the company.

According to the president of the Hua Rong Company, the assets of De Long are mainly divided into two major parts. One is industry, with 200 enterprises, ranging from ketchup and cement to heavy trucks and ferroalloy. The other comprises financial companies. De Long holds shares in many securities companies, rental and loaning companies, trust funding companies and commercial banks. De Long is a big company that operates across geographical areas and industrial sectors. In 2002, De Long began a big action, which was to establish many "shell companies" (dozens) that superficially seemed to have no shareholding relationship with De Long, and then transferred huge assets and capital to these companies and individuals.

There are two main reasons for the financial crisis of De Long. One is that the financial institutions controlled by De Long acted illegally. The China Banking Regulation Commission's report on the termination and adjustment of the Jin Xin Trust Company, and the CSRC's reports on the trust management of the De Heng, Heng Xin and Zhong Fu securities companies, all mention actions that violate regulations and laws, and that must be terminated or entrusted to management. In addition, the industrial enterprises of De Long had the common flaws of other enterprises, such as fake registered capital, tax evasion, etc.

The second reason lies in the business strategies. Confidence swells to the point where one imagines that being big will maximise power, and believes that manipulation in the stock market is evidence of a super capital operation, a combination of industrial capital and financial capital. De Long was wrong with its operation strategies and development thinking.

Edited and adapted from *Caijing*, 23 (29 Nov. 2004).

C. Construction of the system, models and mechanisms of corporate governance

Laws, decrees and documentation on corporate governance in non-listed companies

The laws and decrees for non-listed companies in China include the following: the General Rules of the Civil Law implemented in 1987, which deal with enterprise loan guarantees and bankruptcy; the Company Law, announced in 1993 and revised in 1999, which is the specific law and regulation for limited corporations and stock companies with limited liability; the Law on Industrial Enterprises Wholly Owned by the People, announced in 1988, which regulates the governance of non-corporate SOEs; the Law on the Bankruptcy of Enterprises (in trial) announced in 1986, which is the law and regulation for the bankruptcy of wholly people-owned enterprises; the Audit Law of 1994, which concerns the state auditing agency's regulations on regular audits for SOEs; the Accounting Law announced in 1985 and revised in 1999, which regulates the basic accounting system of enterprises and units; the Law Against Unfair Competition, passed in 1993, which restrains unfair competition for the good functioning of the market; the Trust Law of 2001, which concerns trust relationship and activities; the Codes of the Supervisory Board in SOEs announced by the State Council in 2000, and the Provisional Regulations of the Supervision and Management of State Assets in the Enterprise announced by the State Council in 2003.

Government documents relevant to corporate governance include, for example: the General Rules of Enterprise Accounting, the Enterprise Accounting Principles, and the Audit Principles, published by the Ministry of Finance in 1992; the Enterprise Accounting System was published in 2000, and the Enterprise Accounting Principles were revised in 2001; the Principles of Corporate Governance of Listed Companies were jointly published by the CSRC and the State Economy and Trade Commission in 2002, which are also a key reference for the big SOEs and non-state-owned enterprises that are to be listed; the Regulations on Internal Accounting (the basics, monetary capital, etc.) published by the Ministry of Finance; the Assessment Principles on the Performance of State Assets and the Assessment Codes of the Performance of State Assets jointly published in 1999 by the Ministry of Finance and the State Economy, the Trade Commission, the Ministry of Personnel, and the State Discipline Commission; the General Rules on Loans published by the PBOC in 1996; the Announcement by the State Council on the Control of Financial Credits in the Reform Process of Small and Medium-Sized SOEs and Collective Enterprises; the Announcement on Enforcing the Management of Financial Credits and Establishing a System that Prevents and Punishes the Act of Running Away with Financial Liabilities, etc., and related regulations on protecting bank credits published by the PBOC in 1998 and 1999; the Basic Regulations on the Establishment of the Modern Corporate System in Big and Medium-Sized SOEs and Improvement of Enterprise Management; and the Announcement on the Reinforcement of the System that Calls for the Transparency of Operations in SOEs, Collective Enterprises and State Holding Enterprises, jointly published by the Central Committee of the CPC Office and State Council Office.

However, some key provisions and codes of governance are still lacking. For example, a bankruptcy law that is applicable to all enterprises is still lacking, as is a competition law prohibiting dominating status abuse or behaviour that could hinder active competition, and a takeover law or regulations are lacking as well. The available laws, such as the Company Law, do not have a number of basic provisions, which usually results in the laws not being implemented.

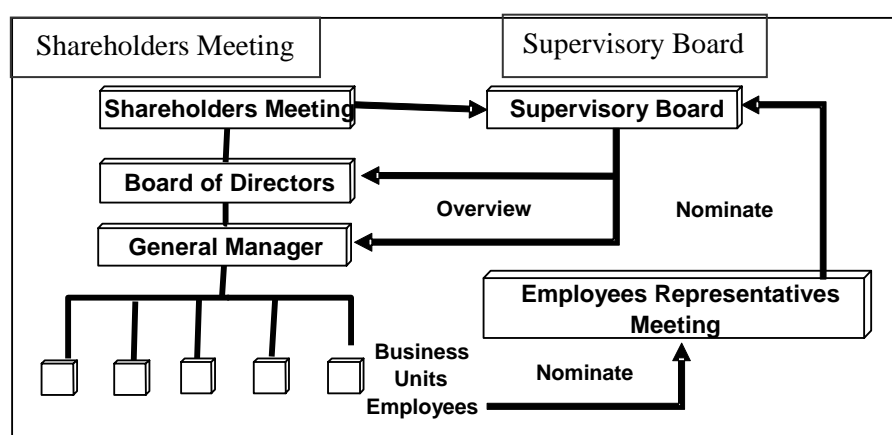
Model

The models of corporate governance for non-listed companies in China are mainly dependent on the Company Law and the Law on Industrial Enterprises Wholly Owned by the People.

For limited-liability corporations and stock companies with limited liability registered under the Company Law, the model of corporate governance is a two-tier board system, in which the responsibilities

of trust and oversight are jointly assumed by the board of directors and supervisory board; the shareholders meeting can nominate directors to organise the board, and also nominate the supervisory director as the representative of the shareholders, along with the supervisory directors nominated by the employees, to establish a supervisory board (the proportion of the two kinds of directors is not stated clearly). The board of directors is to decide the company strategies and nominate management, which is represented by the general manager. The supervisory board is to supervise the board of directors and general manager. This two-tier system is different from both the one-tier board system in the US and UK, and from the two-tier system in Germany (Li Zhaoji, 2002). The Chinese model is as follows:

Figure 7.1. **Representative of Shareholders**



There are issues concerning the two-tier board system that need to be fully reviewed and these are closely related to the Company Law.

The first issue is about concepts. The Company Law prescribes that the board chairman of the company, besides assuming the basic responsibilities of board chairman, is also the legal representative of the company. The Company Law prescribes that the wholly state-owned limited company should establish a supervisory board, but does not prescribe that the government should expedite a supervisory board. The State Council decided in 1999 to appoint special supervisory officers to big SOEs and later revised that decision and chose to appoint a supervisory board (namely, an external supervisory board). Some provinces have similar arrangements. As a result, sometimes two supervisory boards co-exist in some big SOEs in China.

The second issue is one of structure. The Company Law lacks codes on the implementation of shareholder rights (*e.g.* for shareholder lawsuits); it lacks requirements concerning the integrity, responsibilities and liabilities of the directors and executives, as well as the related oversight mechanism; it lacks basic definitions of the relationship between parent companies and their subsidiaries, and even definitions of the enterprise group and shareholders, which leads to poor corporate governance practices; it lacks codes on the responsibilities of the board and executives to provide information to shareholders or to the shareholders meeting; it lacks requirements for disclosure, such as disclosing registered corporate information and taxation information; and it lacks requirements for the oversight of financial reports. No other laws have these requirements.

The third issue is that some regulations should be more detailed but others are too detailed, which is one of the flaws and shortcomings of the Company Law. Judicial accountability in the courts should be improved, especially with regard to lawsuits concerning corporate governance and compensation; the arrangement and regulation on common business practice should be improved, such as corporate codes, decision-making rules for the board and internal management system, etc.

For the big state-owned companies directly administrated by the state and the wholly state-owned companies registered under the Law of Industrial Enterprises Wholly Owned by the-People, the corporate governance model is a general manager-in-charge system. The state directly appoints the executives of the enterprises, does not establish the shareholders meeting and board, but instead establishes an external supervisory board to oversee management. This system requires that major decisions be discussed at the office meeting of the general manager. But the office meeting is only a consultation, communication and mediation meeting for the general manager, which functions the same as the business committee or executive committee meeting headed by the CEO in multinational companies.

The advantage of this model lies in the efficiency of decision-making. The disadvantages are: the general manager is supervisor, designer (of strategies) and executive all in one, which often results in a conflict of roles and interests. Directly appointing the whole management team may increase the efficiency of the general manager, but it is hard to restrain the autocratic decisions of the general manager, and the supervisory board exercises oversight only afterwards. When the general manager makes decisions on ownership interests, contradictions that emerge are usually put to the leaders of the State Council; if not, the general manager is free to make these decisions, which often results in insider control.

3. Latest developments

Box 7.2. Ten aspects of possible Company Law revisions related to corporate governance:

1. Permitting the establishment of the one-person company, reducing registered capital, diversifying capital registration, increasing the proportion of invisible capital and overseas investment, etc. In so doing, it is easier to establish companies and make the performance of capital more efficient.
2. Introducing the definition of the corporate controller.
3. Providing a detailed definition of "related-parties relationship" and addressing the concept of "related-parties relationship", similar to the concept of "conflict of interests", in order to require that the different interest groups in the company do not use the related-parties relationship to take corporate interests.
4. Requirement that 1/3 of the supervisory board is employee representatives, and compare this with the previous requirement for employee representatives on the supervisory board.
5. Prescribing clearly the mechanism of shareholder lawsuits; that is to say, shareholders of limited companies can bring lawsuits against those whose actions harm the company, either by submitting the lawsuit in writing to the supervisory board or the board of directors, or by bringing the lawsuit directly to the courts; the qualification is to have more than 1% shareholdings in the company for 180 days.
6. Increasing the shareholder rights required by the codes and making them more flexible. For example, increasing the decision-making rights of the shareholders meeting to hire or dismiss the accounting companies and other rights required by the codes. The shareholders with 3% of the shares have the right to submit a proposal to the shareholders meeting; 1/10 shareholders or more have the right to propose the occasional shareholders meeting.
7. Improve the mechanism of disclosure to shareholders, such as the requirement for regular disclosure of the remunerations of directors, supervisors or senior executives.
8. Requirement of the integrity and responsibilities of directors, supervisors and senior executives and their compensation liabilities once they have disobeyed the rules.
9. Regulation of the termination of companies, but the liabilities should be compensated. Once the company has been terminated, if any remaining property is taken by the shareholder, then the lawsuit against the shareholder also remains valid.
10. Further detailed requirements, such as a one-share-one-vote principle in the decision-making of the board; detailed requirements for the decision-making methods and voting procedure in the shareholders meeting, board of directors and supervisory board, such as the requirement that directors, supervisors and senior executives attend the shareholders meeting to answer shareholder question; and the requirement that the shareholders meeting will further define the rights of all parties.

Currently, it is widely recognised that the reform of the incentive-driven corporate system will not adequately resolve the striking problems of the drain and loss of state assets and the high proportion of bad debts. The key now is to put forward legislation and implementation mechanisms. A law-based society is a guarantee for the effectiveness of corporate governance. Under the circumstance that administrative intervention still exists, it is more important to set up an interest-driven mechanism; once problems have emerged, the law and institutions will be motivated to resolve them.

In 2004, the State Council defined the goal of establishing a law-based government within 10 years and sped up legislation from the People's Congress, producing the Legislation Law, the Trust Law and the Small and Medium-Sized Enterprises Supporting Law, etc. In the past, established laws were slow to be revised. Not until they proved to be very stagnant would any revision be made. For example, the Company Law, which was established in 1993, was not revised until 1999, and then only two provisions were revised. Currently, the Company Law is being revised again, and the Bankruptcy Law, the Anti-Monopoly Law and the Competition Law are being drafted. The revised drafts of the Company Law and the Bankruptcy Law have already received suggestions from all sectors of society.

Conclusion

The tasks of corporate governance

Theoretically, owing to the lack of effective oversight, such as public oversight, and a mechanism for control rights contention in the stock market, corporate governance within the company and a fair and effective market mechanism seem to be essential for non-listed companies. In other words, more attention and focus should be put on balancing alternative interests within the firm, improving the oversight of interest-related individuals and groups, reinforcing the responsibilities of disclosing material information to shareholders, establishing a shareholder lawsuit mechanism, and establishing or improving basic and effective market laws, such as the Company Law, Competition Law and Bankruptcy Law.

The market-based reform of the last two decades for the establishment of a market system and the development of an incentive mechanism has become effective. The framework of the capital market, labour market and commodity market has already been established. Corporate governance of non-listed companies has to some extent improved. However, recent bottlenecks can be seen in: (i) the proportion of state-owned shares in SOEs is still big; (ii) the mechanisms of corporate governance should be improved, major concerns are the lack of essential laws and regulations, and ineffective implementation; and (iii) the lack of market mechanisms, including the lack of an effective and fair competitive environment and mechanisms for punishment of failure. If the latter two mechanisms are still lacking, the decrease and selling of state-owned shares in SOEs will increase the gap between the rich and poor, and result in corruption. In addition, efforts to reduce bad debts in state banks will accordingly be made in vain, which may influence the stability of finance and sustainable growth of the economy.

It can be seen that corporate governance of Chinese non-listed companies in the future will be confronted with two tasks: one is to seek the full support of the market system and incentive mechanism, and establish efficient market mechanisms; the other is to give content to procedural rights and establishing incentive structures and credible liabilities and penalties for laws and regulations, redefining the liabilities of entrusted organs, and establishing creditable responsibilities and punishment mechanisms. Any bias toward either task will lead to risks. Too much stress on the former may result in a slow-down of the reform; and too much stress on the latter may produce the potential for a financial crisis.

Policy implications

1. The amendment of the Company Law should be perfected as soon as possible; the publication of the fundamental laws for corporate governance, such as the Competition Law, Bankruptcy Law and Takeover Law, should be accelerated; a fair competition environment should be created for various enterprise ownerships and shareholders; a transparent and effective market, and good incentive and punishment mechanisms in the market system, should be established; the development of the market for corporate control should be promoted. Some basic clauses and principles should be paid more attention. Without them, this will lead to serious defects in corporate governance and the inability to implement laws. For example, the Company Law should include such basic clauses as the liability for information supply, the liability for corporate damage, the provision for conflict of interests, the definition for parent and subsidiary company, the call for the shareholders meeting and corporate audit.
2. An effective corporate governance system, based on the fundamental principles of liability, transparency, balance and implementation, should be established. This involves the following tasks: defining the rights and responsibilities of the concerned government departments in supervision and implementation during the development of the corporate governance system; bringing into play supplementary groups and giving rights to the key related parties; classifying in detail the rights and responsibilities of various organisations in the company, setting up a trust mechanism and a punishment mechanism for the violation of laws or breach of duty; setting up a special investigation mechanism for shareholders and a litigation mechanism; and strengthening the trustee liability of the board of directors and the disclosure system.
3. The aim is to establish a society with a legal system and an effective legal, supervisory and institutional basis; this means attaching importance to the implementation and effectiveness of laws and regulations; establishing a rolling amendment system and accelerating the publication of laws; and also setting up a balancing mechanism among various corporate governance participants, in co-operation with eliminating improper administrative interference, improving transparency and perfecting laws and regulations.
4. The governance of SOEs should focus on the following issues: the owner should be put in place; the board of directors should perform its trustee responsibility in the real sense; the problem of insider control should be overcome; the state as shareholder should become an active force in improving corporate governance; and the corporate reform in SOEs should be further accelerated.
5. The governance of non-state-owned enterprises should be promoted through the legal basis of corporate governance and the construction of a corporate governance culture. Meanwhile, we should cultivate successful enterprises to serve as role models and provide guidance.
6. The disclosure of information should be strengthened, and transparency should be made the core of Chinese corporate governance culture; different sectors of society should be encouraged to get involved in the supervision of corporate governance; and various companies, such as SOEs and even government departments performing functions of supervision, monitoring and implementation, should all have greater transparency.

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Chapter 8

COLOMBIA CORPORATE GOVERNANCE AS AN INSTRUMENT OF COMPETITIVENESS*

by
Andrés Bernal**

Corporate governance and the development of closely-held companies

The objective of this paper is to highlight some reflections and lessons learned from the work that has been done to promote corporate governance as a tool of competitiveness in an emergent economy like Colombia.¹ A practical, empirical and managerial approach was used in this eminent effort.

The challenges of corporate governance for closely held companies in emergent economies could be summarised as having two critical aspects: the need to expand and improve financing sources and the urgency to strengthen the formality of managerial processes. These two elements will increase the confidence of the investor community and they will transform the opportunities derived from globalisation into concrete benefits for the economic and social development of countries.

A full understanding of corporate governance would mean covering different economic, legal and administrative groups; the purpose of this document is to find out how corporate governance instruments can contribute to the development of closely held companies. In this respect, a wide definition of corporate governance should be used, as the problems that need to be addressed are diverse, for example: the agency problems that may arise between the company and stakeholders; the agency difficulties that could occur between the shareholder and the managers; and, finally, the problems between minority shareholders and the controllers.

The justification for this approach is that it is adequate for closely held companies, considering that they have two particular characteristics: they have a high family component, which implies that the shareholder-manager relationship is confused in a high percentage of the cases, and they do not have the incentive of the capital markets to incorporate corporate governance practices, which precisely aim to create economic incentives so that closely held companies can be governed better.

The OECD has adopted the following definition of corporate governance: “the system by which companies are directed and controlled, and whose structure specifies the distribution of rights and responsibilities between the different participants of the company, such as the board of directors,

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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1. Throughout the last three years, the Colombian Confederation of Chambers of Commerce (CONFECAMARAS), with the support of the International Center for International Private Enterprise (CIPE) implemented a programme to promote, support and create incentives for the development of corporate governance in Colombia.

shareholders and other economic agents, who maintain some interest in the company. Corporate governance also provides the structure through which the objectives of the company are established, the means to reach these objectives, as well as the way of doing a follow-up of the company's performance".

Further, with regard to corporate governance principles, the OECD states: "...a multiplicity of factors affect the governance and decision making processes of firms, and are important to their long-term success. The principles focus on governance problems that result from the separation of ownership and control. However, this is not simply an issue of the relationship between shareholders and management, although that is indeed the central element. The principles therefore have to be complementary to a broader approach to the operation of checks and balances."

So, in a sense, corporate governance principles help us to understand in economic terms the real role stakeholders play in a company. Understanding the importance of this role is essential for stakeholders of closely held companies, who generally are not very interested in getting external investors or participating in the public market.

The stakeholders of closely held companies can be classified into three categories: those who depend directly on the performance of the company; those who have an indirect relationship with the company involving its legal and contractual obligations (creditors, suppliers, regulators and insurers); and those who have an indirect interest through general benefits granted by the company (clients, community in general).

The distinction of stakeholders made in this document represents a different approach from the traditional one. It focuses not on the stakeholders themselves, but on the incentives and benefits that are generated when the company adopts corporate governance principles to improve the situation of the stakeholders. In other words, the focus is on how the situation of the company is improved when measures are taken to gain the confidence of stakeholders.

What follows are reflections on the role that every stakeholder must play in the company and on how to establish a win-win relationship between the company and the stakeholders through the implementation of best corporate governance practices.

Creditors

Corporate governance centres its attention mainly on shareholders and creditors because these are the suppliers of financial resources for the company, whether as internal shareholders or external investors (creditors). These kinds of stakeholders have a common interest in the operational and financial performance of the company. In a way, this paper is about the logical relationship that exists between investors and corporate governance, and this also applies to bank creditors, who are the principal financing sources for closely held companies. Moreover, we can say that a direct relationship exists between corporate governance and investment flows, based on the premise that corporate governance generates confidence and makes the management of resources safer. This premise also applies to the relationship between banks and companies: when good corporate governance practices are implemented reducing risk, the banks (creditors) will reduce their risk premium and provide better credit (*i.e.* at lower interest rates). This represents an economic incentive for businessmen to adopt corporate governance principles since, because of this, they can improve financing conditions for their companies and increase the competitiveness of their products and services.

Suppliers

The same logic can be used for suppliers, who usually act as an important financing source for closely held companies. The terms and conditions of financing provided by suppliers, so that goods will

be paid for and services provided, are similar to those of banks, since suppliers in this situation are acting like creditors. As companies build a better relationship with suppliers, it is possible that the latter will improve financing conditions which, for companies, would be yet another argument in favour of incorporating good corporate governance practices.

Insurance companies

Insurance companies are among the stakeholders who would benefit the most from the creation of a corporate governance culture, which would reduce the accident level of insurance carriers, in particular those with insurance policies related to the administration of companies, such as the policies of directors and officers (D&O). Despite this important aspect, insurance companies have traditionally not participated in discussions about implementing good corporate practices. These discussions generally focus on the need to formalise decision-making processes, improve internal and external controls, and strengthen the independence, objectivity and professionalism of the board of directors of companies. All this would contribute to reducing the risk of accidents, especially with regard to the policies of D&Os. That is why insurance companies are facilitating insurance conditions for companies that have strengthened their level of corporate governance, or are promising, for example, to reduce the premium when companies have implemented good corporate government practices.

All this shows that corporate governance is not an instrument of protection exclusively for minority shareholders. The concept has evolved, and is seen today as a fundamental managerial tool for improving competitiveness. This is especially important for emergent economies, which need to understand the importance of economic incentives for the business community when good corporate governance practices have been implemented.

Another important factor is the globalisation process and the need to speak a common language with stakeholders all over the world. Common corporate governance practices can serve as a universal language for developing and investing in organisations. That is why good governance measures have become a prerequisite for negotiating with big suppliers and clients, and a fundamental tool for accessing international markets.

In addition, good corporate governance can be seen as a means to set guidelines for the correct management and control of companies, to increase their competitiveness and make their administration more transparent, and so strengthen the confidence of national and foreign investors.

The initiative of the OECD, IFC and CIPE to develop a discussion of corporate governance for closely held companies is an important step forward, especially for the emergent economies, where this type of company represents the largest sector of the economy, generating the greatest number of jobs, and therefore has an enormous impact in terms of economic and social development.

For example, 124 companies are listed in Colombia's stock exchange, while 148 000 legally constituted companies are registered with the chambers of commerce. Corporate governance in emergent economies cannot be limited to big companies listed in the stock exchange but, on the contrary, must become an integral tool for improving the management and competitiveness of all kinds of organisations. One of our special concerns is to work with SMEs, with the objective of providing them with a tool for ensuring the sustainability and competitiveness of Colombian businesses in today's globalised economy. For this reason, the corporate governance programme in Colombia involves public and private institutions and focuses on corporate governance practices that can be applied to small and medium size economic structures. The documents from the programme are a guide for the independent, phased implementation of corporate governance best practices by the business sector and on an individual basis.

The basic principles of the Framework Code are transparency, accountability, the fair treatment of partners/shareholders and the responsibility of small and medium-size enterprises vis-à-vis their respective interest groups. This includes the rights and fair treatment of partners/shareholders; management; conflicts of interest; stakeholders; social responsibility; transparency and truthfulness of information and alternative dispute resolution.

In closely held companies, corporate governance plays a very important role inside the companies, becoming a mechanism for reinforcing managerial organisation, breaking up the concentration of power, introducing formal accounting systems and objective systems for contracting, and introducing formal processes for the nomination of directors.

The improvement of managerial governance in closely held companies must allow for a process of professionalisation of the board of directors, which happens when external and independent directors join the board. This should be accompanied by a formalisation of procedures, empowering the directors meetings so that they can act in a double role, adding value to the company and controlling and supervising management.

The processes of formalisation and professionalisation help to solve the problems of information asymmetries produced by managerial activity, and they will also increase the confidence, transparency and efficiency necessary for creating a better economic environment for company managers and stakeholders. Considering the particularities that developing countries have in common, it is important to elaborate a strategy for successfully introducing the concepts and measures that will ensure the protection of investors, disclosure of information, and a good relationship between companies and stakeholders, and that will empower the board of directors.

Conclusions

For closely held companies and SMEs in Colombia, corporate governance has a particular meaning. The traditional concept of agency theory “where a few people manage the money of others” does not really apply to closely held companies and even less so to SMEs. The reason is that their ownership structure has a strong family business component, in which managers and shareholders are in most cases the same people.

On a country level, the implementation of corporate governance measures allows to extend the sources of financing, and to strengthen the processes of formalisation and professionalisation, necessary elements for increasing the confidence of the investor community and translating the opportunities of globalisation into economic and social benefits.

The implementation of best corporate governance practices is not a passing trend; it is a managerial tool for speaking the international language of business. Corporate governance in closely held companies is a way to “open up” the world. Globalisation requires a new model in which the acquisition of operational alliances, and sharing knowledge and capital are combined to form the basis for growth.

Chapter 9

EURASIA: CORPORATE GOVERNANCE CHALLENGES OF NON-LISTED COMPANIES *

by
Alum Bati**

Introduction

Eurasia, a region stretching from Ukraine in the West to Mongolia in the East, whilst not a coherent region in any economic sense, is characterised by under-developed capital markets, a dominant state sector, poor legal regulation and protection for stakeholders, a handful of very large companies with monopolistic positions, situations where the national standards regulator often doubles as a service provider, adventurous investors, and rampant corruption. Both the purpose and practice of good corporate governance in this environment cannot be the same as for developed economies. This short paper looks at the real challenges that companies in Eurasia face regarding corporate governance.

Some of the spectacular recent failures in the developed world have come about not because of an absence of knowledge of good corporate governance principles or an inadequate legal system. The problems of the developed world tend to emanate from senior corporate officials abusing their position. The aim here of good corporate governance is to restrain the natural greed and arrogance of corporate executives. And whether listed or non-listed, investors have other sources of information – audited accounts and financial data, for instance, tools which do not exist widely in Eurasia.

The problems in Eurasia are different and the purpose of good corporate governance is also, in some respects, different. Even listed companies are not always free of direct government interference and influences. In such cases, good corporate governance will not be much of a shield. In the unlisted sector, governments may be less interested, though in some Eurasian countries the listed sector is so small that even the biggest of the nation's companies are unlisted.

Protecting minority shareholders is important but that is not, in my view, what should be the main driving force behind the application of good corporate governance principles in Eurasia.

In large parts of the Eurasian economy there is a trust deficiency of gargantuan proportions. Investors do not trust the corporations with which they wish to do business or in which they wish to invest. In other words, the problem is not primarily one of protecting minority shareholders – it is one of persuading investors to become shareholders, minority or otherwise. The object of good corporate governance in Eurasia must, therefore, be to give that assurance to investors. It is almost inevitable, however, that in doing so, minorities will also be better protected.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

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Issues of corporate governance in Eurasia

Eurasia, in general, is marked by strong state involvement in all sectors of the economy. Even private enterprises are often connected in some way with senior members of the various branches of government. Not only does this make business transactions opaque, but it makes enforcement of legal provisions designed to protect minority shareholders and other stakeholders difficult or impossible to enforce.

The region is also noticeably short of large private companies. Under-developed capital markets mean that the vast majority of important companies are unlisted and have a handful of dominant shareholders. Those with a large number of shareholders tend to be privatised companies with employees holding small stakes that mean little to them and are in many cases worthless in the absence of avenues of sale.

Outside of the natural resource sector, investors in the region are cautious. A number of countries in Eurasia have more or less reasonable corporate governance provisions: super-majority voting for changes to the bye-laws, etc.; requirements to audit and publish accounts; legally mandated general meetings with notice and agenda to be sent to shareholders, and so on. But, without the knowledge that courts will enforce the laws and punish defaulters, concentration on the legal niceties does not take us very far.

The remedies will take some time to bear fruit but there are steps that can be taken in the interim that are not reliant on changes in the law or in the political climate.

First, the laws already provide protections that could be better implemented. Company auditors and lenders could insist that financial disclosure is made in accordance with the law but do not always do so. International financial institutions, both as shareholders and lenders, seem less concerned with protecting minorities than perhaps they should, except to the extent that they happen to be minority shareholders themselves.

Then again, the IFIs will liberally sprinkle their shareholder and loan agreements with such restrictive covenants that these often make it difficult for other shareholders to realise their investment or for new investors to be introduced.

Trust and corporate governance

All stakeholders are in search of trust. Laws, by themselves, do not give rise to good corporate governance. In the developed economies, trust is put in auditors, lawyers, and other professionals to ensure that companies and directors comply with the law. And, as a final option, there is always the insurance market. But in Eurasia, local auditors can be suspect, and the big firms confine themselves to internationally accepted practices, which do not address all aspects of corporate governance. All that lawyers can do, at least the better ones, is to say whether a company has good or bad practices: without an effective enforcement mechanism, they cannot do much to put right any deficiencies if the principal shareholder is not inclined so to do.

Ultimately, good corporate governance is all about trust. Unfortunately, even a company that applies good corporate governance principles is not likely to be trusted by cautious foreign investors. Eurasia has many good corporate governance programmes that work hard to train managers and directors in respecting stakeholder interests. But, at best this sort of work will take time to bear fruit, and at worst will simply give an unscrupulous manager more ideas about how to help himself or his master to his/her company's assets.

The biggest difficulty that such programmes face is that the relationship between state organs or their executives (as owner – declared or undeclared, protector, subsidy provider, etc.) will only change when the political systems change. In some countries in Eurasia this is already happening and the signs are encouraging, but in others hope remains a distant fancy.

Interim solutions

In the meantime, there are other ways that corporate governance can be improved without the need to introduce changes in the laws. A largely untested area is the establishment of independent company secretaries and registrars. Such bodies can contribute considerably to good governance by ensuring that meetings are properly called, votes counted, resolutions accurately recorded, minutes honestly taken (and not capable of being tampered with), shareholders properly notified, share registers kept securely and shareholders properly recorded, access to share registers and bye-laws freely-given to all shareholders, etc.

Of course, the preservation of confidentiality will be important, but whether the independent service provider can achieve this will be for the investor to assess – assessing the qualifications of professionals will be easier than estimating the future potential of an investment.

All this will build trust and trust will ensure a growth in the number of investors. As the independent registrar/company secretary is an aspect that a potential investor can insist on, an indication of the *bona fides* of the other parties will be obtained at an early stage, before any funds have been committed and lost. An existing shareholder who wants to attract investment but who objects to an independent company secretary or registrar may have something to hide.

It is the development of mechanisms that increase investor trust in the management and directors of the companies in which they seek to make investments that will do more than anything else to hasten the flow of funds into Eurasian economies.

Chapter 10

INDIA: AN OVERVIEW OF CORPORATE GOVERNANCE OF NON-LISTED COMPANIES*

by
Sumant Batra **

Introduction

The Indian corporate sector has seen substantial and significant changes in the last ten years of liberalisation and globalisation. Global forces triggered reshaping of the Indian business sector with strong competitive pressures. The initiation of economic reforms ended decades of relative isolation, eroding both the lethargy and the traditional source of dominance of a large and powerful class of family businesses. India has grappled with the challenges posed, and capitalised on the opportunities offered by the new economic environment. The presence of foreign institutional investors has been a key driver behind the gradual improvement in disclosure standards. There are already shining examples of corporates achieving business excellence because of the excellent standards of corporate governance that were adopted. Most large companies have already adopted many desirable corporate governance practices due to sustained efforts of the government and regulators, and to self-regulating measures adopted by the industry associations. The need to access international markets for their capital requirements also motivated the companies to focus on good governance. Some Indian companies already compare most favourably with the best in the world in the field of professional management and corporate governance. One implication of all this is a huge premium on transparency.

On the other hand, the vast majority of the more than six lakh¹ incorporated companies languish with outdated practices nurtured during the years of insulated economic development that occurred in the country during the better part of its post-independence history. The issues of ownership and control, management integrity, accountability and transparency, succession and split continue to haunt these companies. Their number comprises both public and private companies (other than listed companies), including the family-founded and managed business. These issues continue to impact the growth of the economy and the vitality of the business sector.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries. They are his individual views and do not necessarily represent the views of the organisations, associations or committees with which he is affiliated, in particular the Expert Committee on Company Law set up by the Government of India.

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1. Legal, regulatory and institutional framework

In India, company legislation – *i.e.* the Companies Act 1956 (1956 Act) – provides the legal framework for companies and is the main instrument for corporate governance. This role is performed through a number of regulators functioning under the Ministry of Company Affairs (MCA) of the Government of India. The Securities and Exchange Board of India, a statutory body, further regulates the listed companies through the Stock Exchanges. The Institute of Chartered Accountants and Institute of Company Secretaries, both statutory institutions under the MCA, perform a significant role in promoting better corporate practice and governance. Though self-regulation is at a somewhat nascent stage in the area of corporate governance in the country, a number of initiatives are in place by the leading industry associations to encourage and assist the development of best practices and benchmarks in corporate governance in all companies whether large or small, private or public, listed or non-listed. It is pertinent to mention that the 1956 Act recognises broadly two types of companies – private² and public³ companies – with some special provisions for public companies with distinct features. There is, however, a discussion to recognise companies with large public interest, listed or non-listed.

Recent initiatives and developments

The issue of corporate governance has engaged the attention of the policy makers since the start of the liberalisation process. A series of measures have been adopted to meet the growing needs of the ever-evolving economic and corporate structure of the Indian market from a global perspective. The proposal of re-codification of the company law has been under consideration since 1993. Various high level and expert committees were set up to make recommendations for improving the corporate structure, including corporate governance and related best practices. Some of these committees are the Sachar Committee, Kumaramangalam Birla Committee (KBC), Narayana Murthy Committee, Naresh Chandra Committee. The Company Law Advisory Committee, set up by the Ministry of Company Affairs, constantly reviews the need of the corporate sector and its constituents for encouraging better corporate governance. A Study Group was constituted to report on improving corporate excellence through governance with the aim of enhancing the corporate image of India. The Government is currently engaged in the exciting task of enabling Indian companies to excel in a globally competitive market, create wealth for the shareholders and the nation by promoting an investor friendly environment. In terms of implementation, however, focus has so far remained on improving governance in listed companies.

Concept Paper on Company Law

In 2004, the Ministry of Commerce (MoC) issued a Concept Paper, a discussion paper to amend the 1956 Act. The objective of the Concept Paper was to engage stakeholders, experts and policy makers in a discussion on the proposed framework of new corporate law, which would serve the demands of the fast changing Indian economy and bring it up to par with international standards. The Concept Paper proposes a simplified company law in tune with international developments. It was viewed as a commendable initiative of the MoC and a superb approach to law making and the reform process by inviting a public debate and stakeholder participation before drafting the bill and taking it to Parliament. This will certainly enhance the value of the end product and its acceptability and ownership by stakeholders. The Concept Paper is timely and offers a wonderful opportunity to incorporate the features of international acceptable principles of corporate governance into the legal framework.

Dr. J. J. Irani Expert Committee on Company Law

Following the Concept Paper, the Government of India set up a High Level Expert Committee to review the existing company and insolvency laws to bring them in tune with economic developments.

Chaired by Dr. J.J. Irani, a director of Tata Sons, the leading industrial group in the country, the Expert Committee has members representing key stakeholders, experts and regulators, including the author. It concluded its work and submitted its report to the government in May 2005. The initiative is seen as a timely move to introduce good corporate governance and insolvency law reforms, as the Indian economy assumes a significant position at the world centre stage. It also offers a wonderful opportunity to bring the law up to par with international standards. This is the first time that such massive company law reforms are being undertaken since the company law came into being in 1956, and the effort is expected to change the landscape of corporate governance for all types of companies.

2. Review of the current position

This part of the paper reviews the current state of corporate governance in companies other than listed companies as legislated by existing law, mandated by regulators and recommended by industry bodies. For the ease of discussion, the review is made with a backdrop of best practices in the field of corporate governance broadly grouped under four categories: (i) those relating to *corporate boards and directors*; (ii) those concerning *operational management and control*; (iii) those dealing with *credibility and transparency of reporting*; and (iv) those bearing upon *shareholder democracy and minority protection*. Some comments are made based on the discussion that followed the Concept Paper, recommendations made by the various committees or study groups and the author's own perception of corporate governance.

A. Corporate boards and directors

Size and composition

Indian company law prescribes a minimum of two directors for a company. The number is three for public companies. Public companies with a paid-up capital of five crore⁴ rupees or more and/or one thousand or more small shareholders may have a director elected by the shareholders.⁵ Subject to this requirement, the size of the board is left to the company itself. The proviso to section 259 of the 1956 Act provides that any increase in the number of directors beyond twelve in a subsidiary of a public company requires the approval of the Central Government. The provision is viewed as being restrictive, particularly for companies that have global operations and require professionals on their board from all over the world who are experts in different fields of the business. In a world where different countries are incorporating the concept of the Supervisory Board – a board consisting of professional experts to guide, advise and supervise the decisions of the board of directors – such restrictive provisions have the impact of depriving the Indian corporate boards of the services of various professionals. This, in turn, impacts the business of the company and the Indian economy at large.

The Concept Paper proposes a minimum of seven directors in the case of certain prescribed public companies, out of which no fewer than three – or the equivalent of 50% of the members of the board, whichever is higher – shall be independent directors. The maximum number proposed is fifteen. The provision of electing a shareholder director in case of prescribed public companies has been retained.

There has been some debate on this aspect. There is a view that the minimum number could be one in case of private companies, and seven in companies with a larger public interest. Many argue against a cap on the maximum number claiming that every company should have the liberty to expand its board to serve their requirement and to avail the services of professional experts. While this view finds favour, the experts recommend that procedures are required to ensure that the authorities and the stakeholders are kept informed of the expansion of the board. This could be achieved by (i) filing of the recommended single Form 32⁶ for each director's particulars in the office of the Registrar of Company (RoC); entry in the Register

of Directors⁷, which is open to inspection by members on payment of a nominal fee; or proper disclosure in the annual report to provide the required information of every director appointed to the board.

The composition of the board of directors is critical in terms of their ability to discharge their responsibilities in the interests of all shareholders. There is a growing international trend towards independent non-executive boards. The Concept Paper proposes that the appointment of independent directors to the board be mandatory. Provision may be made for a minimum of one third of the board to be independent, excluding the nominee directors appointed on the board by the various stakeholders who are not considered independent. This would be a very significant step towards improving governance in all companies. However, some exemptions are contemplated for smaller companies with respect to the number of independent directors on the board. Independent directors are discussed in a later part of the paper.

Board chair and chief executive officer

A topic of continuing debate in the country in the area of corporate governance and practices is that of the positions of board chair and the company's chief executive officer. Given the board's perceived role of overseeing the executive, there is a general consensus that the two positions should be separated. There is recognition of the different roles of the two positions and discussion in favour of separating them as a mandatory requirement for companies with large public interest. Some argue for adoption of the Canadian guidelines on corporate governance, which, while recognising the need for independence and objectivity in the role of chair, do not accept that such a separation is the only option that would achieve the desired objective.

Board committees

There is a general recognition and trend that a major area of operational improvement in the efficient functioning of boards is the change in board processes, delegating specific responsibilities to smaller, specialised, and more manageable committees. Companies that have adopted this process have experienced better management of the full board's time, work and much more in-depth scrutiny and attention to the key elements of successful implementation of board policies. The concept of audit committees introduced for listed companies was later extended to certain prescribed public companies. It is proposed in the Concept Paper that the majority of members of this committee should be independent directors.

Many large Indian corporations constitute special committees for reviewing and reporting upon issues such as governance policies, nominations for additional or replacement appointments to the board, performance measurement of the board collectively and directors individually, and so on. Formally mandating the appointment of such committees by all the companies by law may not be rational at this stage. The matter is best left to the discretion of the companies. As a starting point, though, the concept of a governance and nominations committee (composite or separate), with three or more directors, all of them being independent, could be introduced. Such a committee could be assigned the responsibility of scanning potential candidates for board membership when the opportunity arises for additions or replacements. Being all independent, their discretion could be trusted to ensure that such additions or replacements would be in the best interests of the company and further complement the skills and expertise of the board. This committee could also be required to review and self-evaluate periodically (say once every other year) the company's performance on matters relating to governance and recommend for endorsement by the full board any changes or improvements required. In smaller size boards, perhaps the nominations and self-evaluation functions could be left to the full board itself. A stakeholders' relationship committee is also worthy of consideration.

Directors

More than ever, the role and responsibilities of company directors are under close scrutiny and surveillance by legislation, regulation, society in general and the investor population in particular. There is a growing demand for accountability and performance. A major consequence of these developments is that both the executive and non-executive directors have to assess their workload and competencies before deciding to take on additional directorship responsibilities. And on their part, companies will be obliged to compensate the directors adequately to attract and retain them.

The 1956 Act currently prescribes a ceiling of twenty companies (fifteen in the proposed amendments) of which an individual could be a director. The Concept Paper proposes to bring it down to fifteen. In practice, thanks to several permitted exclusions, this number can be exceeded significantly.

The categories of company directors (executive and non-executive) deserve separate consideration on this issue.

Executive directors include company managing directors, functional directors, and other such persons, who hold a full-time appointment in their company. Very often, they have a service contract with the company like any other employee, and not a contract for services. Even when not so documented specifically, an employer-employee relationship can easily be inferred in practice, for example through the membership of executive directors in retrieval funds meant for employee-managers of the company, or by the employee-perquisites valuation methods under tax laws being applied to their perquisites like housing or cars. Company law at present permits, under certain circumstances and with appropriate approval, an individual to be a managing director of not more than two companies, but there is no bar to such managing and other full-time directors being on other boards as non-executive directors, within the statutory ceilings on the total number of permitted directorships.

It would be legitimate and reasonable for the shareholders of a company, where large public interest is involved, to expect their full-time directors, including managing directors, to devote all or substantially all of their time, to the affairs of the company. Clearly, any extra-curricular activities, such as being on boards and committees of industry associations, academic relationships, government or regulatory committees or councils, social responsibility initiatives, etc, that are aimed at benefiting their personal and corporate image, thereby bringing value to their companies, should be welcomed and encouraged. Beyond that, whether their time should be made available to other companies and activities can be contentious. Often, it is said that being on other company boards helps in broadening the exposure of the concerned individuals and providing useful inputs that may be valuable to the company. While this argument has considerable merit, it is debatable whether such insights could not be obtained from other business, professional and social associations without full-time company directors having to undertake onerous additional responsibilities as non-executive directors on the boards of other companies. It is also worth noting that many enlightened companies specifically pre-empt their executive directors (with limited exceptions) from serving on the boards of other companies as non-executive directors. It may be desirable to highlight this healthy convention and promote its adoption by legislation, regulation, or just persuasion.

Non-executive directors include all members on company boards other than those employed full time by the companies themselves. The experience is that non-executive directors do not provide the expected time and involvement in board affairs. There is a need to provide criteria for acceptance of board memberships based on time commitments. All companies are not of the same size or complexity and, consequently, demands on their directors are different. Potential non-executive directors may have to seek from the company adequate information to help them assess the level of time-commitment that

will be expected of them before accepting such positions. Fewer directorships would naturally help companies to get adequate attention from its non-executive directors.

Non executive independent directors is a new category of directors expected to be developed for all types of companies, except for small companies, which might be exempted. The introduction of the concept of independent director is the heart and soul of corporate governance. Currently, the concept is limited to listed companies. However, it has been challenging to agree on a definition of independent director. The definition of independent director provided in the Explanation to clause 49 I (A) of the Listing Agreement has evoked many debates but is generally accepted as the most suitable definition. It reads as follows:

“Independent Director means a non-executive director of a company who apart from receiving director’s remuneration, does not have any material pecuniary relationship or transactions of such amount as may be prescribed, with the company, its promoters, managing director, full-time director, other directors, manager or its holding company and its subsidiaries, apart from possessing such attributes for being treated as independent director as may be prescribed by the Central Government from time to time.”

The Concept Paper attempts to develop a more stringent definition of independent directors. This has met considerable opposition. It is argued that logically the definition should be consistent with the one used for listed companies and that has stood the test of time. There is a concern that if a more complex qualification is provided, not many independent directors may be available for board membership. There is an agreed bottom line, however, and it is the requirement of integrity and experience.

Managerial remuneration

Remuneration, particularly of managing and full-time directors, always was an emotive issue in pre-liberalisation India, clouded as it was under the complementary imperatives of public policy, socialist goals, civil servant pay, and so on. Fortunately, these inhibitions have now largely been done away with, except for some overall company profit-dependent ceilings. Non-executive directors’ compensation packages in recent times, especially in ‘new economy industries’, have been worked out to attract good talent on to the boards. Appropriate remuneration also facilitates independence, besides formally legitimising demands for greater accountability and improved performance from such directors.

The compartmentalised ceilings that exist in company law need review. In India, the total managerial remuneration payable by a public company to its directors and its manager shall not exceed 11% of the net profits of the company for that financial year, computed as specified in sections 349 and 350⁸ of the 1956 Act. If payment of remuneration to the managing director/full-time director exceeds 5% of the net profits of the company for one such director, and 10% for all of them together, then such payment will only be with the prior approval of the Central Government.⁹ Prior Central Government approval is also required in case the payment of remuneration to any director, who is neither managing director nor a full-time director, is in excess of 1% of net profits of the company, when the company has a managing director/full-time director, or 3% of net profits in other cases.¹⁰

The current prescription is considered inadequate. All directors, executive and non-executive, expect adequate compensation for their time and effort, even in cases of absence or inadequacy of profits. Company law at present provides for minimum remuneration in such cases to managing and whole-time directors within prescribed monetary limits. There is no reason why similar considerations should not apply to non-executive directors as well, as they contribute their own time and expertise in guiding the companies forward.

Payment of remuneration to directors by any company, profit-making or loss-making, public or private, is the prerogative of the concerned management. If the details of remuneration paid to directors are appropriately captured in the books of accounts, adequate disclosures are made, the necessary filings are made with the centralised institution and there is no violation of any applicable law, then the Central Government should not be required to interfere with the internal management of a company. The Concept Paper does not deal with the compartmentalisation in a satisfactory manner. It is desirable that the cap of 11% as specified in section 198(1) should be the only cap and no other sub-limits be specified. Calculation of 11% could be on book profits after providing for depreciation and investments. Apart from making the calculations simple and comprehensible, the change would also give leverage to companies to attempt as many permutations and combinations as possible in paying their directors and manager. The removal of sub-limits for payment of managerial remuneration would give an opportunity to all companies to attract the most competent professionals and experts on their boards.

It is important to recognise that professional independence of non-executive directors and the legitimacy of demands on their accountability need to be matched by the reward systems in place in companies. It is therefore necessary that no unreasonable constraints of payment of remunerations to independent and non executive directors are imposed and that they be paid in consonance with their contribution and performance of the company.

The review of compartmentalised ceilings requires balancing measures of societal or legislative control with total managerial remuneration. The worst fears of conflicting interests between shareowners on the one hand, and controlling-dominant shareholder-executives on the other were more than confirmed in the closing decades of the last century, with outrageous pay packages for executives in several developed countries and more recently in India. Checks and balances can be provided by stipulating an upper ceiling above which shareholder approval will be required, and a further ceiling above which Central Government approval would be required.

Payment of sitting fee

In India, companies with a paid-up share capital and free reserves of ten *crore* rupees and above, or turnover of fifty crore rupees and above, can pay sitting fees not to exceed 20 000 rupees per meeting to the directors. For other companies, sitting fees cannot exceed 10 000 rupees per meeting.¹¹ It may be worthwhile to provide for two broad components of remuneration to all directors, one based on profits and the other based on their time, effort and contribution. Emerging trends indicate that such remuneration usually takes the form of a fee for attending board and committee meetings, a commission dependent upon the profits of the company, and stock options. Within the overall statutory ceilings and regulatory provisions, companies should be free to decide these components and the methods and periodicity of payments, having regard for industry practices and the need to attract the right talent to serve on their boards. Practices such as a regular monthly retainer, performance-based profit bonuses, incremental fees for board and committee chairs that involve additional time commitments, and even for membership of time-intensive committees such as audit committees, all deserve to be encouraged in the interests of developing a healthy, independent, and contributing pool of non-executive directors. The amount of sitting fees and other remunerations payable to directors could be included in the cap of 11% as discussed above.

Liabilities and disqualification

The 1956 Act provides a fairly reasonable framework for the disqualification of directors. However, they face no disqualification even if they do not attend board meetings for years and rely on leave of absence granted. This provision needs to be made more stringent, and this issue has engaged the attention

of policy makers. There is also a need to develop a framework for fixing liability of independent directors in case they contravene the law.

The serious concern, however, in spite of a suitable framework being in place, is the lack of effective implementation of the law. There is a pressing need to improve tremendously upon the implementational framework.

Offences, penalties and investigations

India needs to cover a lot of ground in this area. The existing mechanism requires the filing of a complaint by the Registrar of Company (RoC) in the court of the competent jurisdiction for the offences committed by the company or its officers. There is no in-house mechanism to deal with and dispose of complaints, even where minor offences – like not filing a document, such as an annual report (which is fined 500 rupees per day) – is committed. As a result, the RoC is left with the mammoth task of filing prosecutions in minor offences committed by companies. Courts are clogged with small and big complaints that remain pending for years as the courts are over burdened with work arising from other jurisdictions. At the end of 2003, 9 154 prosecutions were pending. Out of these, nearly 70% comprise offences where the penalty, in case of conviction, would be a fine. These cases remain pending for years. The absence of specialised courts and judges to deal with prosecutions also impairs the efficiency of disposal. This has a two-fold effect. One, it does not act as a deterrent for erring defaulters as they rely on slow, if not lack of, disposal to continue to commit offences. Second, it burdens the RoC with handling of huge number of prosecutions. At the end of the day, it impacts governance.

Other areas of concern are the insignificant amount of fines prescribed for committing various offences, which does not have a deterrent effect. Furthermore, RoC is over burdened with investigations. Given the huge number of incorporated companies in India, RoC is not able to be efficient in the investigation process. There is a need for a comprehensive review of the offences, penalties and investigation framework to make it more effective and meaningful. The Concept Paper and the following discussion suggest that there may be a paradigm shift with regard to the definition of new offences (in view of introducing new compliance and disclosure requirements), more stringent penalties and fines, quicker disposal of complaints, etc.

B. Operational management and control

Traditionally, the Indian business, particularly the family funded business, has combined the role of owner and controller, manager and governor, actor and director and, ironically, of preserver and destroyer. The subordination of boards to management, self-dealing, manipulation of accounts, related party transactions, and lack of transparency in the allocation of finance have all contributed to the endemic lack of credibility that these businesses suffer from. The liberalisation initiatives of the 1990s have exposed the inefficiencies of many of these organisations, which are trying to come to terms with the paradigm shift in doing business. Considering that in India more than 70% of business is family owned, the problem is alarming. Therefore, while India's business houses cope with the inevitable need to bring about rapid strategic, operational and financial transformation in their business, they have another additional agenda at hand: rewriting the role of the family in business in a fast changing economic scenario. Today, when the business families have taken up the exercise of rewriting the code of conduct for themselves, they realise how messy the affairs have been. The roles that members of the family play on both the family and the business front have got so intermingled that to segregate them is an uphill task.

C. Management

The most striking and commonly agreed feature of corporate governance practices in Indian private sector companies has been the widespread and widely perceived failure of boards. In a majority of the companies (other than large companies, including listed), the board simply does not exist as an institution of governance in the private sector, except in a handful of companies. Truly independent directors are rare, levels of disclosure remain poor, accounting standards weak, and transparency low. The institutional nominee system has been subjected to widespread criticism. There has also been a strong campaign to remove nominees from boards. However, undermining the institutions' right to board representation is only likely to reduce the accountability of boards even further. The solution lies in constituting a panel of professionally qualified independent directors to serve as institutional and public shareholder nominees. Accountability can scarcely work in the abstract, as every dominant shareholder knows.

A competent and independent board of directors is a prerequisite to ensure created wealth is applied for the benefit of all shareholders. The board and the executive management of the company have to address the all important task of creating and protecting such wealth and wealth-creating assets and resources. Policy-making structures and managerial and operational processes that help achieve these objectives are indeed key constituents of good corporate governance.

On a day-to-day basis, many large companies are now managed by their chief executive (whatever title may be used) and his or her team of supporting officers and other executives, and not by their board of directors. Where there is a managing director, he or she performs a dual role, one of being a director on the board and the other of being the executive operating under the supervision of the board. Full-time executives, who are also on the company's board, similarly perform two distinct roles. It is another matter that more often than not, it is extremely difficult for such full-time directors not to carry their executive hierarchical subordinate relationships with the managing director into the board room. The executive's role is to formulate strategy for consideration, comment and concurrence by the board, and thereafter to ensure its implementation within the legal and ethical framework under which the company operates. Shareholder wealth maximisation with due regard to other stakeholder interests and societal responsibilities is the primary concern of management which, for this purpose, should equip itself with the skills and competencies it needs to achieve these goals.

The thrust of corporate governance reforms in India is independence of the board of directors. While the introduction of independent directors is expected to assist largely in achieving this objective, other similar measures have been taken. The concept of chief executive officer and chief finance officer is expected to be made mandatory for companies with large public interest.

D. Control

In India, the board is responsible for controlling the company and its management by "laying down the code of conduct, overseeing the process of disclosure and communications, ensuring that appropriate systems for financial control and reporting and monitoring risk are in place, evaluating the performance of management, chief executive, executive directors, and providing checks and balances to reduce potential conflict between the specific interests of management and the wider interests of the company and shareholders including misuse of corporate assets and abuse in related party transactions."¹²

As part of its stewardship responsibilities, the board has to satisfy itself that the control mechanisms within the organisation are well in place and that they are in fact operative. The Cadbury recommendation was that the board should report to the shareholders on the effectiveness of the internal control system, with the auditors reporting thereon. On review, the Hampel Committee in 1998 decided to omit the word "effective" from this requirement in light of the difficulties in interpreting the term, and

on the ground that the directors, while reviewing internal controls, will be obliged to assess their effectiveness. Also, the committee felt that there was little to be gained by asking the auditors to publicly comment upon the directors' report on internal controls and that, instead, it would be more productive if they were to report privately to the directors. More important, the Hampel Committee extended the scope of its coverage to all aspects of control, not just financial controls. This would now include business risk assessment and response, financial management, compliance with laws and regulation, and the safeguarding of assets, including minimising the risk of fraud. The Canadian position expounded in 1994 is very similar to this, and in many respects the Canadian guidelines cover the range of requirements in greater detail. Among the examples cited is the one relating to reviewing and approving financial information where "the board will want to ensure the corporation has an audit system which can inform the board on the integrity of the data and the compliance of the financial information with appropriate accounting principles". The emphasis throughout is on board responsibility, not so much on the validation of individual transactions or instances, and, more importantly, on ensuring that appropriate systems are in place and that they are in fact being complied with and acted upon.

Internal audit and assurance

There has been a great focus on improving the important element of control by bringing reforms and transparency into the internal audit and assurance function to ensure that laid down policies are faithfully adhered to in operation and any deviant behaviour is flagged as soon as practicable, if not pre-empted through appropriate financial and control procedures. However, more initiatives are required for the audit committee and the board needs to be assured from time to time that necessary and appropriate systems are in place within the company and that they are being followed. In the case of the internal audit and assurance function, the board must ensure that the positions are staffed with competent and independent professionals, that they are of sufficient hierarchical seniority in the organisation, and that their remuneration and growth prospects are carefully planned and monitored. In particular, removal of internal audit chiefs or external firms doing the service for whatever reason must be carefully examined to ensure that an inconvenient internal auditor is not eased out of his position to the detriment of the company and its shareholders.

There is a clear distinction between the oversight role of the board and the implementation role of the executive in matters of control, as indeed in other matters as well. In the discharge of this oversight responsibility, the board will have to draw upon expert, professional, and independent support from the statutory auditors. Independence of the company's auditors thus assumes great significance. Internal auditors still need the development of a corporate governance orientation to be able to successfully perform their assigned role in corporate management and control. The Institute of Chartered Accountants of India has brought out more stringent guidelines for internal and external audit. However, there is a tendency by auditors to qualify their notes so that liability is not attached to them. There is a need to deal with this concern. Criteria for the independence of auditors have long been debated. Economic independence is almost invariably the fundamental determinant of professional and personal independence. It is in this context that measures are under way to separate the audit activity from other kinds of services, such as consulting, and the result is that several large firms internationally have moved towards such separation. Standards for fees and arm-length relationships are other areas where a number of initiatives have been taken. The Independence Standards Board, which was constituted by the Securities and Exchange Commission with equal representation from the professional audit and business segments, is in the process of bringing greater clarity to the whole issue of auditor independence. There is a case for creating a similar body – perhaps advisory in the initial stages but more regulatory later on – to be constituted by the SEBI, the Institute of Chartered Accountants of India, the Institute of Company Secretaries of India, and the Institute of Costs and Works Accountants of India. Of course, several self-regulatory provisions already exist, and company law also prescribes disqualification in audit

appointments, but in a dynamically changing situation, and with the prospect of increased globalisation of Indian business, there may be a case for a closer look at these issues.

Similar comments apply to the legal compliance framework of the corporation. The company secretary, till now charged with the responsibility of ensuring procedural formalities will, in the future, have a significantly demanding role to play in ensuring adherence to best governance practices in the board room, committee work, and in day-to-day administration on a transactional basis, so that the desired transparency and proprietary interests of the company are at all times safeguarded for the benefit of the shareholders and other stakeholders.

Corporate autonomy

Corporate governance does not imply stricter regulations and stiff penalties. The intent is to have adequate transparency, disclosures, and compliance with applicable laws and accountability. At the same time, the supremacy of the board of directors has to be recognised as being subject to shareholders' approval. Currently, Indian companies are burdened with compliance and approval requirements that not only curtail the independence of the board but also impose a complex, time consuming and costly regulatory regime on them which has a discouraging impact on corporatisation. Schedule 1 below lists the large number of compliance requirements, such as forms to be filed by the companies. Schedule 2 contains the different approvals that need to be obtained from the Central Government. In this list, a number of compliance requirements [like section 233B (2), 259, 269 of 1956 Act] are avoidable by obtaining prior approval of the shareholders at a general meeting, filing the necessary form at the recommended centralised institution, and providing adequate disclosures in the annual report. Some matters requiring regulatory approval [like sections 81(4) and 637B] can be delegated to the respective regional directors. This will improve service levels in the administrative set-up and enhance communication between the applicant and the concerned authority.

Reporting and disclosure

Company law in India requires a company's board to provide an annual report to its shareholders. The minimum contents of the report and matters requiring disclosure have been prescribed, as have been the formats in which the company's financials are to be prepared, audited and submitted to the shareholders. The auditors' report is a significantly detailed document, and must be actually read out at the annual general meetings of shareholders. Shareholders are required to decide on a number of matters, and it is important that the company provides its shareholders with adequate information to enable them to exercise their voting rights. Again, company law stipulates that explanatory statements be provided to shareholders on certain key matters that require approval by a special resolution.

The present reporting requirements for Indian corporates are archaic and out of tune with the reality of the information needs of shareholders and other stakeholders. Corrective initiatives are a priority; there is a call for much more meaningful disclosure of corporate behaviour and performance that meets specific requirements of the statutory and regulatory authorities.

Several mandatory requirements with regard to the periodical provision of financial and other information to shareholders, using electronic media wherever possible, have been introduced with respect to listed companies. Reporting measures, such as consolidation of subsidiary company accounts, segment reporting, disclosure of related party transactions and deferred taxation are in place. However, not as much attention is given to non-listed companies. The Institute of Chartered Accountants of India has issued appropriate guidelines and standards for implementing reporting measures for non-listed companies. If Indian companies are to be competitive on a global basis, it must be ensured that their reporting requirements also match global standards.

The government is undertaking a massive project to introduce the concept of electronic registries, on-line filings and on-line inspections. MCA receives enormous data from companies under the provisions of the 1956 Act, rules and regulations. A clearing house with data from confidential documents could make the information available to the public electronically since most of the information is anyway open for public inspection at the offices of RoC.

Integrity of financial statements

While a number of initiatives have been taken by the Government and the various professional institutes to make the financial statements valuable in terms of disclosure and accuracy, a lot more effort is needed. Shareholders need assurance of the integrity of financial and other statements made in company reports. They need to be assured that well accepted accounting standards and conventions have been followed in the preparation of financial statements. The Government established the National Advisory Committee (NAC) on Accounting Standards by amending the 1956 Act. NAC is a high level independent committee of experts mandated to make recommendations to the Government on accounting standards.

The standard-setting process needs to be reviewed and strengthened. To expedite the issue of accounting standards on certain key topics, such as consolidation of subsidiary company accounts, segment reporting of results, and so on, the Institute of Chartered Accountants of India has accelerated the issue of exposure drafts and related processes, but more may have to be done on an ongoing basis. Accounting standards in India are on par with international accounting standards.

With several Indian companies accessing global capital markets and with increasing participation of global players in the Indian capital markets, there is rightly a move to present company accounts under international standards and generally accepted practices. Barring a few notable exceptions, however, Indian companies continue to follow different accounting practices in respect of their "Indian" accounts and the "GAAP accounts". Except where specifically prevented by Indian law or professional pronouncements, there would appear to be no justification for following this practice. Shareholders and investors in India would like to see accounts presented to them on compatible conventions, with explanatory notes for variations mandated by Indian law or custom.

Whistle blower

There is a debate in the country to develop the concept of whistle blower in the legal framework. The concept was introduced in the listing agreement of listed companies as a non-mandatory requirement. It is worthwhile to consider the extension of the concept to companies with large public interest. This is particularly essential as a cross check in a system where the trend is to de-regulate, free the companies of state control and encourage self-regulation. The provisions of the Sarbanes Oxley Act and Australian law that contains some provisions on this concept are being examined.

E. Shareholder democracy and protection of minority interests

This issue has been subject matter of political debate in the country owing to some large corporate frauds in recent years in the capital market where small investors were the big sufferers. The minority shareholders have also suffered from oppression by majority shareholders and have been demanding measures to curb this practice. The government has introduced a series of measures and steps to improve shareholder democracy, participation and protection of minority interest. An Investor Education and Protection Fund has been set up that educates shareholders of their rights and helps their cause apart from representing them in court disputes.

Given the desirability of developing a healthy mix of share ownership structures as an integral part of capital markets reform and upgrading, there is a strong case for sending appropriate signals to minority shareholders that their interests will be duly taken care of. At the same time, there is a view that in a competitive market place, each player should take care of his or her own interests, and should not expect any special hand-holding or other safety props. Clearly, given the disparate strengths and skills of various players in the field, this is far too ideal a situation to deserve any detailed debate. Every country and every society does call for and provide some form of cover to protect its own interests. The legitimacy of minority shareholder protection stems from this basic premise.

The efficacy of a monitoring system needs improvement. Experience shows that vested interests back voices for minority protection. The best solution lies in corporate governance initiatives, like strengthening independent directors, independent auditors and independent regulators and so on, to protect the interests of all shareholders.

Conclusion

Globalisation has opened up an array of opportunities for corporate India. For it to emerge successful from this new tryst with destiny, there are no easy options available and the Indian corporate sector must necessarily turn to good governance in its pursuit of competitive excellence in a challenging international business environment. India has ambitions of moving to the world economic centre stage. It realises the need for a strong corporate sector, which promotes growth. Good corporate governance is crucial in the long term as it is essential for creating a credible and professionally driven business system that has the potential to transform living conditions for the vast majority of the population. There is an ongoing need for constant review and course correction that could keep the country in the pink of health in terms of its corporate excellence. This task needs to be addressed by a judicious mix of legislation, regulation and persuasion. With growing maturity and competitive imperatives, it should be possible to gradually reduce legislative interventions and increase regulatory compliance with, and self-induced adherence to, the best practices in this field. Till then, however, legislation to ensure at least certain minimum standards is inevitable.

Schedule – 1

List of forms to be filed with Registrar of Companies

Form No.	Subject
1	Declaration of Compliance with the Requirements of the Act on Application for Registration of a Company
1A	Application form for availability of names
1AA	Particulars of person(s)/director(s) charged/ specified/ for the purpose of clause (f)/(g) of Section 5
1AB	Consent of the person charged by the Board with the responsibility of complying with the provisions of the Act
1AC	Particulars of person(s)/director(s) removed for the purpose of clause (f)/(g) of Section 5
1AD	Application to Regional Director for approval of change in Registered Office of the company within the same state
1B	Application for the Approval of the Central Government for conversion of a Public Company into a Private Company

Form No.	Subject
2	Return of Allotment
2A	Memorandum containing salient features of prospectus
2B	Nomination Form
3	Particulars of Contracts relating to shares
4	Statement of the Amount of Rate per cent of the Commission payable in respect of Shares/Debentures and of the number of Shares/Debentures for which persons have agreed for a commission to subscribe for absolutely or conditionally
4A	Declaration of Solvency in respect of Buy-back of securities.
4B	Register of Securities bought back by the company
4C	Return in respect of Buy-back of Securities
5	Notice of consolidation, division, etc./increase in share capital/increase in number of members
7B	Share transfer form
7BB	Counter receipt and transfer
7C	Extension of time under section 108(1-D) of the Act
7D	Approval of the Central Government for acquisition of shares under section 108A
7E	Form of intimation to the Central Government of the proposal to transfer shares under section 108-B/Form of application for approval of the Central Government for transfer of shares of foreign companies under section 108-C
8	Particulars of debentures/charges created / modified / satisfied by a company registered in India.
10	Particulars of a series of debentures, containing or giving by reference to any other instrument, any charge to the benefit of which the debenture-holders of the said series are entitled <i>pari passu</i> , created by a company registered in India and also of any issue of debentures in a series
12	Chronological Index of Charges
13	Register of Charges
15	Notice of Appointment of Receiver or Manager
16	Notice to be given by Receiver/Manager on ceasing to act as such
17	Memorandum of Complete Satisfaction of Charge
18	Particulars of registered office or change thereto
19	Declaration of compliance with the provisions of section 149(1)(a), (b) and (c) of the Act
20	Declaration of compliance with the provisions of section 149(2)(b) of the Act

Form No.	Subject
20A	Declaration of compliance with the provisions of section 149(2-A) or 149(2-B)
21	Notice of the Court's/Company Law Board's Order
21A	Annual Return to be filed by a company not having a share capital
22	Statutory report
22A	Consent by Shareholder for shorter notice
23	Registration of Resolution(s) and Agreement(s)
23AA	Notice of Address at which Books of Accounts are maintained
23AB	Statement containing salient features of balance-sheet and Profit and Loss Account, etc. as per section 219(1)(b)(iv)
23B	Notice by Auditor
23C	Application to the Central Government for Appointment of Cost Auditors
24	Application to Central Government for increasing the number of Directors of Company
24A	Application to the Central Government for obtaining the previous approval for entering into contracts with the company for the sale, purchase or supply of any goods, materials or services, pursuant to proviso to section 297(1)
24AA	Notice by the interested directors
24B	Application to the Central Government for obtaining prior consent for the holding by certain persons, of any office or place of profit in a company
25A	Application to the Central Government for approval of appointment/re-appointment and remuneration payable to Managing/Whole-time director(s) or Manager
25B	Application to the Central Government for approval to amendment of provision relating to managing, whole-time or non-rotational directors
25C	Return of Appointment of Managing Director/Whole-time Director/Manager
26	Application to the Central Government for increase in remuneration of Managing Director/Whole-time Director/Manager
29	Consent to act as a Director of a Company
32	Particulars of Appointment of Directors and Manager and changes among them
34	Register of Directors, Managing Directors, Manager and Secretary, etc.
34AA	Application for giving loans to other bodies corporate beyond prescribed limit under section 370
34B	Application to the Central Government for Purchase by Companies of Shares of other companies under section 372.

Form No.	Subject
35	Notice to dissenting shareholders
35A	Information to be furnished in relation to any offer of a scheme or contract involving the transfer of shares or any class of shares in the transferor company to the transferee company
37	Application by an existing joint stock company for Registration as a limited/private limited/an unlimited company
38	Application by an existing company (not being a Joint Stock Company) for Registration as a Limited/an Unlimited Company
39	Registration of an existing company - List of members
40	Registration of an existing company as a limited company. Statement specifying certain particulars
41	Registration of an existing company as limited company.
42	List of the names, addresses and occupation of the directors, and the manager, if any, of the existing company, not being a joint stock company
36	Receiver's or manager's abstract of receipts and payments
44	Single form for a Foreign Company
49	Return of alteration in the (a) Charter, Statutes or Memorandum and Articles of Association (b) address of the Registered or Principal Office, and (c) Directors and Secretary of a foreign company.
52	Notice of (a) alteration in the names and addresses of persons resident in India Authorised to accept service on behalf of a foreign company, (b) alteration in the address of principal place of business in India of a foreign company, (c) list of places of business established by a foreign company in India, (d) Cessation to have a place of business in India.
55	Particulars of charge (a) on property in India created by a Foreign Company after the 15 th January, 1937
56	Particulars of charge (a) subject to which property in India has been acquired by a foreign company after the 15 th January, 1937
57	Particulars of an issue of debentures in a series by a foreign company
58	Particulars of series of Debentures containing or giving by reference to any other instrument, any charge (a) to the benefit of which the debenture-holders of the said series are entitled pari passu created by a foreign company.
59	Particulars of Modification of charge (a) created by a foreign company.
60	Memorandum of complete satisfaction of charge (a) created by a foreign company.

Schedule – 2

List of matters requiring approval of Central Government

Section	Particulars
17(2)	Alteration of Memorandum of Association – change of registered office from one State to another.
25(1)	Power to grant license for registration of associations having charitable objects as limited purposes
25 (8) (a)	Alteration of memorandum of a section 25 company
58A(8)	Grant of time or exemption in respect of payment of deposit
81(1A)	Further issue of capital by passing of ordinary resolution
81(4)	Conversion of government loans into shares
108A	Acquisition of shares beyond 25% of the paid-up equity share capital of the company.
117B(4)	Disposal of petition filed by the Debenture Trustee if the assets of the company are insufficient to discharge the principal amount of debentures
144(4)	Order for immediate inspection of Company's Register of Charges
149(2B)	Commencement of business by a public company
163(6)	Order for immediate inspection of annual return or direction to deliver abstract of it to the person requiring it
167	Power to call general meeting and give directions
198(4)	Remuneration to managerial personnel in case of loss, etc.
205(1)	Payment of dividends without providing for depreciation
208(3)	Payment of interest out of capital
211(3)	Exemption from compliance of Schedule VI
224(3)	Power to appoint auditor where no auditor is appointed at AGM
224(7)	Removal of auditor by company before expiry of his term with prior approval of Central Government
233B (2)	Appointment of cost auditor
239(2)	Inspector's power to investigate and report on the affairs of a body corporate
240(1)	Exercise of power by inspector for requiring body corporate to furnish information
240(2)	Examination on oath by inspector
250(11)	Institution of prosecution for violation of matters relating to transfer of shares or debentures

Section	Particulars
259	Increase in number of directors beyond 12
268	Amendment of provisions relating to MD, WTD, manager and directors.
269	Appointment of managing/whole time directors or manager
309(3)	Remuneration of managerial personnel exceeding the limits set out in the Act
309(4)	Remuneration to Directors by way of commission exceeding 1% or 3% of the net profits, as applicable
309(5B)	The company shall not waive any excess remuneration paid to any director unless permitted by Central Government
310	Any provision relating to manager or director requires Central Government approval
314(1B)	Directors holding office or place of profit
396A	Disposal of books and accounts of amalgamated company
424A	Reference to tribunal by a Government company which has become a sick company
439(5)	Presentation of the winding up petition by Registrar
448(1)(b)	Appointment of body corporate as company Liquidator
581ZL(4)	Investment by a producer company in excess of the prescribed limits
637B	Condonation of delay

NOTES

1. “Lakh” means “100,000” (*e.g.* ten lakh is equivalent to one million).
2. **“Private company”** means a company that has a minimum paid-up capital of one lakh rupees or such higher paid-up capital as may be prescribed, and by its articles,
 - a. restricts the right to transfer its shares, if any;
 - b. limits the number of its members to fifty, not including-
 - persons who are in the employment of the company; and
 - persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased;
 - c. prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company; and
 - d. prohibits any invitation or acceptance of deposits from shares other than from its members, directors or their relatives:
 - provided that where two or more persons hold one or more shares in a company jointly, they shall for the purposes of this definition, be treated as a single member.
3. **“Public company”** means a company that –
 - a. is not a private company;
 - b. has a minimum paid-up capital of five lakh rupees or such higher paid-up capital, as may be prescribed; and
 - c. is a private company which is a subsidiary of a company that is not a private company.
4. One “crore” equals ten million.
5. Section 252 of the Companies Act, 1956.
6. A statutory form required to be filed with the Registrar of Companies when a director vacates office and a new director is appointed or term extended.
7. This Register is maintained under Section 303 of the 1956 Act.
8. Section 198(1) of the Companies Act, 1956
9. Section 309 (3) of the Companies Act, 1956
10. Section 309(4) of the Companies Act, 1956
11. As notified by the Government of India with effect from 24 July 2003 *vide* its powers under Section 310 of the Companies Act, 1956.
12. KMB Report on Corporate Governance.

Chapter 11

KYRGYZ REPUBLIC: CORPORATE REGULATIONS *

by

Nazul Abdrahmanova **

Introduction

Questions of corporate governance are urgent for large companies (corporations), where the owners cannot participate in company management directly. In the Kyrgyz Republic, joint stock companies are such companies.

There are three trade organisers of the securities market (stock exchanges) in Kyrgyzstan today: the closed-end JSC “Kyrgyz Stock Exchange” (established in 1995 in Bishkek, the capital); the closed-end JSC “Exchange Trading System” (established in 2000, in Osh); and the closed-end JSC “Central Asian Stock Exchange” (established in 2004, in Bishkek). At present, out of the three stock exchanges in the country, only the Kyrgyz Stock Exchange lists companies’ securities. As of 1 January 2005, only six issuers are listed at the Kyrgyz Stock Exchange. However, it is necessary to note that the securities of all open joint stock companies should be traded through the trading systems of the stock exchanges according to the Decree of the Kyrgyz Republic’s President of May 1999.

In the Kyrgyz Republic, the principles of corporate governance have been introduced into all joint stock companies, and the question of whether they are listed or not is not of fundamental importance.

1. General overview of joint stock companies in the Kyrgyz Republic

At present, there are 1 592 joint stock companies in the country, of which 331 are closed-end joint stock companies and 1 261 are open joint stock companies. Their shareholders are more than 400 000 physical and legal persons. Most of them became shareholders as a result of mass privatising of state ownership.¹

It is necessary to note that the government possesses more than half of the shares let out by joint stock companies. That is because the shares of the largest joint stock companies still belong to the government.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

** State Commission on the Securities Market under the Government of the Kyrgyz Republic.

1. According to the legislation of the Kyrgyz Republic, open joint-stock companies are companies whose shares circulate with limitations, and the closed-end joint-stock companies are companies whose shares circulate only among their shareholders, or groups of persons, previously defined.

The total cost of stock registered by joint stock companies in the Kyrgyz Republic at the end of 2004 is more than 31 billion soms (about USD 750 million). In 2004, the share issue of the joint stock companies' shares totalled 1.2 billion soms (more than USD 28 million), representing 1.3% of the GDP. The difficult conditions under which the joint stock companies operate in the country and the small volume of the shares market explain the small capitalisation of the Kyrgyz enterprises' shares.

Table 11.1 **Structure of distribution of joint stock companies' shares according to shareholders (in %)**

The Government (State Committee on State Property of the Kyrgyz Republic)	Social Fund of the Kyrgyz Republic	Legal persons (domestic)	Physical persons (domestic)	Legal persons (foreign)	Physical persons (foreign)
58,37	7,52	7,23	9,77	14,57	2,55

It should be noted that small joint stock companies prevail. In fact, more than 70% of Kyrgyz joint stock companies have a nominal capital of less than 1 million soms (USD 23.000).

The allocation of joint stock companies according to activity shows that the majority of these companies are in the industrial sector, and 32% are in other sectors, such as construction (17%), agriculture (7%), finance (5%), trade, transport and communications.

Kyrgyz joint stock companies can be divided into two groups: those formed as a result of privatisation of state enterprises and newly founded companies. About 69% of 1592 joint stock companies were formed as a result of privatisation.

2. Regulation of corporate relations

National legislation is a key influence on the effectiveness of the corporate governance system. These laws are:

- Civil Code of the Kyrgyz Republic (1996);
- Law of the Kyrgyz Republic on Joint Stock Companies (2003);
- Law of the Kyrgyz Republic on Accounting (2002);
- Law of the Kyrgyz Republic on Bankruptcy (1997); and
- Special laws on Banks and Bank Activity in the Kyrgyz Republic (1997), on Investment Funds (1999), and on the Organisation of Insurance in the Kyrgyz Republic (1998).

The government plays a very important role in building an effective system of corporate governance in the country. At present, according to the Law of the Kyrgyz Republic on Joint Stock Companies, the State Commission on the Securities Market (SCSM) of the Kyrgyz Republic regulates corporate relations. Regulation of corporate governance is carried out in the following ways:

- Development and adoption of legal acts in the relevant field;
- Monitoring of joint stock companies' activities in the corporate field;

- Supervision of joint stock companies' compliance with legislation on corporate relations, the securities market and protection of shareholder rights;
- Rendering consultations and recommendations to joint stock companies on corporate governance issues; and
- Development and introduction of measures for popularising good corporate governance.

3. Historical background of the existing system of corporate governance

The system of corporate governance in the Kyrgyz Republic was noticeably influenced by the following historical factors:

- The majority of joint stock companies (69%) were created by the transformation of state enterprises as a result of mass privatisation.
- In many joint stock companies, employees became shareholders during privatisation. Now under management, these shareholders tend to block their rights, as employees-shareholders think it is much more important to keep their jobs and remuneration, than to use their shareholder rights to the full extent.
- Very often, directors of the privatised companies became the main owners of the companies, which led to an unhealthy merging of management and ownership, to the disadvantage of the other shareholders.
- The government is still the largest shareholder of big companies. For minority shareholders, it is very difficult to resist the majority shareholder, particularly if it is the government.

4. Legislative conditions of the Kyrgyz Republic for practicing corporate governance

In this section we shall highlight some legislative conditions that exist in the Kyrgyz Republic for applying and practicing corporate governance.

The legislation, which regulates questions of corporate governance, is aimed at protecting shareholder rights and specifies strict requirements on the disclosure of information by companies. It should be pointed out that the legislation regulates all joint stock companies, irrespective of whether they are open, closed-end, public or non-public.

Shareholder rights

The registration and assignation of shareholder rights in open joint stock companies is carried out by specialised organisations that have been licensed for this task.

The legislation assigns all property and non-property rights to shareholders, corresponding to the OECD principles of corporate governance. With regard to other rights, it should be stressed that the legislation specifies the right of shareholders to take up shares issued by companies in a privilege order.

The right to vote

Shareholders have the right to participate and vote in the general shareholder meetings.

The system for exercising shareholder rights on voting in the stockholder meeting fully corresponds to OECD principles of corporate governance. The shareholders are informed of stockholder meetings through the mass media.

The right to participate and vote in stockholder meetings is exercised by shareholders both personally and through their representatives. Representatives of shareholders in stockholder meetings act according to the instructions specified by power of attorney and drawn up in written form.

Each share of a joint stock company gives shareholders an equal measure of rights. Foreign shareholders have the same rights as domestic shareholders. The rights provided by ordinary and preferred shares, including voting on these shares, are clearly secured by Kyrgyz national legislation.

Transparency and information disclosure in the Kyrgyz Republic

Information disclosure

The legal texts provide for the following basic tools of information disclosure:

- Financial statements;
- Annual and quarterly reports on securities;
- Prospectus of the securities issue; and
- Information on the essential facts of the financial and economic activities of the issuer.

Reports on securities include information such as: general data on the issuer, management bodies, and owners with 5% or more of the shares; data on the capital, securities of the issuer, and on received profit and dividends; information on the registrar and auditor of the company, and on meetings of the issuer; and also financial reporting by the issuer.

Statements on the essential facts are submitted to the SCSM and should also be published in the printed mass media. Statements on the essential facts concerning the financial and economic activities of the issuer may include information on: changes in the management structure, the board of directors, or in the list of shareholders who own 20% or more of the capital, the reorganisation of the issuer, its affiliated and dependent companies, the charged or paid incomes on securities of the issuer, repayment of securities, etc.

5. Current situation in corporate governance and issues of its development

Regarding the situation of corporate governance in the Kyrgyz Republic, it should be noted that an adequate legislative base has been created in the country, which at present allows companies to carry out their activities according to good corporate governance practices. Work to further improve this legislation is proceeding. However, the existence of an adequate legislative base does not guarantee good corporate governance. Corporate governance in the Kyrgyz Republic can be classified as less than successful, and there are objective reasons for that. Problems concerning good corporate governance practices include:

- Insufficient protection and exercise of shareholder rights;
- Incompetence and passiveness of shareholders;
- Ineffective management of shares owned by the government (clear mechanisms for managing shares owned by the government need to be developed);
- Insufficient transparency and disclosure of information; and
- Ineffective work by company management.

Present issues concerning the development and implementation of good corporate governance practices have much to do with the conditions under which corporate governance was introduced in the Kyrgyz Republic:

- Mass privatisation, as a result of which managers and employees of companies became their main shareholders;
- Weak financial markets, which keep shareholders from using indirect tools to exercise their control;
- Difficult financial situation of the majority of joint stock companies;
- Weak management in many enterprises;
- Lack of knowledge of the law by a major part of the shareholders;
- The wish of individual shareholders to have a large presence in joint stock capital with the purpose of taking control of the company's activity;
- Weak legal infrastructure, not ensuring the protection of shareholder rights;
- Weak participation of investment funds and other institutional investors in the enterprises' capital; and
- Weak participation of the private sector in policy development for the regulation of corporate relations.

6. Improvement of corporate governance in the Kyrgyz Republic

A system of corporate governance has been developed in the Kyrgyz Republic. However, as there are still many problems in this area, it is necessary to make a special effort to improve corporate governance, which is impossible without a well coordinated policy for interaction between state management bodies and the private sector.

For the purpose of improving corporate governance. it is necessary to:

- have the government improve the quality of corporate governance rights;
- increase the transparency of joint stock companies' activities, including the universal transition of joint stock companies to International Accounting Standards;
- improve the system of disclosure of financial and other information, which is to be disclosed by the joint stock companies to their shareholders and potential investors;
- create conditions for promoting greater financial and operational transparency of a company's activity, and define the volume of financial, operational and other information that should be disclosed by the joint stock companies to their shareholders and potential investors;
- develop a system of state and non-governmental supervision of compliance with investors' rights and interests protected by law; and
- introduce a regulating system of corporate relations in the private sector; also develop extrajudicial examination of disputes in corporate relations and establish different market institutions.

For improving corporate relations in the future, the following practical steps should be taken:

- differentiate joint stock companies according to their means of attracting funds, *i.e.* public and non-public companies;

- differentiate between public and non-public companies with regard to supervision and information disclosure requirements, *i.e.* strengthen the regulation of public companies and weaken regulation for non-public companies;
- work out and apply a code of ethics and internal guidelines for the company, regulating how the company's management should operate; and
- establish the institution of board of directors. (If it is a public company, hold consultations, training sessions, and "round table" discussions for members of the board on urgent questions of management and supervision in joint stock companies; also, create and keep a register of independent directors, which will allow minority shareholders to choose highly professional members of the board and increase the quality of supervision of management by shareholders.)

Chapter 12

LEBANON: HOW IS PROFESSIONAL MANAGEMENT MONITORED?*

by
Dr. Fouad Zmokhol**

The Lebanese case

There is no doubt that corporate governance involves both the private and the public sectors.

The public sector should provide the necessary infrastructure and ensure that there is a conducive business environment and a healthy investment climate for private enterprise to grow and prosper.

Since there is a huge gap between the private and the public sector in our country, we have decided, as a start, to focus on our companies' internal functioning and then focus on the relationship between private entities aiming to apply corporate governance principles and practices.

Some of the major problems we encountered were the lack of enforcement capacity, the absence of awareness and different ownership structures dominated by small and family owned businesses. The cost of good corporate governance played a negative role as well.

On the other hand, I have noticed that most managers agree with corporate governance principles, but they would like to see the others take the first step.

Our strategy was to determine existing corporate governance features, and provide alternative best practices, taking into account the critical deficiencies of our system.

The most difficult process has been, and will remain, changing the attitudes and behaviour of our people so as to remove certain barriers.

Corporate Governance

I would state that the main purpose of corporate governance is:

- to define the relationship between those who own capital and those who control it; and
- to maximise the company's value.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

** Managing Director of the Zimco group (Lebanon) and Member of the Board of the Lebanese Businessmen Association (RDCL).

The debate on corporate governance is taking place all over the world. Corporates seize this issue in the hope that this will help them attract foreign investment. In fact, the issue of corporate governance is much more important than simply getting international investment. The need and demand for high standards of governance ethics and social responsibility are key aspects of the globalisation debate. They do not affect just big businesses or institutions (listed companies), they concern all of us, especially non-listed companies that dominate our economies. We should all voluntarily follow corporate governance rules.

The issues of transparency, accountability, equity, integrity and responsibility are instruments of not only “corporate governance” but also of “professional excellence”.

Globalisation

We have to recognise that globalisation offers us both strength and opportunity in a free world. It increases the need of our businesses to remain robust to face external challenges. A company that operates globally cannot achieve sustainable, earning-oriented growth without the trust of domestic and international markets.

The rules of corporate governance have helped us to:

- set up a system of management and supervision, with stricter internal audit controls;
- clearly separate the roles of the chairman, the CEO and the board of directors;
- clearly separate the roles of the audit and consultancy functions (not carried out by the same organisation); and
- stress the importance of non-financial capital, such as human capital, social capital, and cultural capital.

The proposed combined code for board members indicates that:

- The board must meet regularly.
- The board should have a formal agenda of matters on which it specifically should take decisions.
- All directors should have access to the advice and services of the company board’s secretary.
- All board directors should bring independent judgement to bear on issues of strategy and performance resource.
- Every director should receive appropriate training when he is appointed to the board of the company.

Training

It is vital that a minimal training programme should be designed and administered for all directors (both executive and non-executive) that covers key aspects of good corporate governance and directorial responsibilities.

Recruitment

In our country, too many directors are still chosen for their name or reputation, rather than for what they can bring to the board and to the company. I would recommend that directors be recruited through independent search firms rather than through personal contacts.

Creativity and innovation

A primary goal of corporate governance ought to be to create a culture of creativity; innovation and entrepreneurship to protect our businesses from obsolescence.

Mastering the dynamics of innovation will help us meet many of the challenges of globalisation. We should empower our people, and see every single person in our organisation as a source of ideas and innovation.

Role of ethics

According to the OECD principles of corporate governance, ethics is one of the core values of corporate governance. The Lebanese Businessmen Association has made a big effort to address this concern and published a code of business ethics in February 2004. This code was signed and adopted by all our members. It was then distributed to most other organisations, with the aim that they will adopt and implement it.

We are strongly mobilised for demanding moral conduct in public life and in the activities of the public sector in Lebanon. Implementing ethical and transparent practices in the private sector would put Lebanese companies on par with the best companies in the developed countries on one hand, and could serve as a model for the public sector on the other.

Conclusion

We cannot adopt a “one size fits all” approach; we need to develop a good structure and system, as well as appropriate processes and practices, and values and strategies.

Most of our managers have understood that capital will flow to their companies not just because of technology or resources, but also because of good corporate governance practices. It will make their companies visible on the radar screen of not only domestic investors but also on that of foreign investors.

Our companies should become social institutions whose competence extends far beyond ensuring the well-being of their equity owners, by providing security and the good life to our employees, dealers, customers, vendors and subcontractors.

We must recognise that today we are living not in an economy of hands or heads alone, but also in an economy of hearts. Our governance systems need to be recast so that they touch also the hearts and not only the minds.

We should thus all pursue the development of a good corporate governance framework and adopt the triple-line approach of profit, people and the planet.

And we should all be convinced that our country’s economy depends on the drive and efficiency of our companies.

Chapter 13

MACEDONIA: RECENT DEVELOPMENTS*

by

Samir Latif** and Dr. Gregory F. Maassen***

Introduction

This analysis provides an overview of recent corporate governance developments affecting non-listed joint stock companies in Macedonia. The report summarises the findings of corporate governance surveys, reviews the latest legal developments in commercial legislation affecting corporate governance standards, and describes the steps that have been taken by the Macedonian government, the donor community, and the private sector to improve corporate governance standards of Macedonian non-listed joint stock companies. The authors would like to acknowledge Janet Katz, Bob Singletary, Wade Channel and Darrel Brown for their contribution to research papers and surveys used for this paper. The statistical analysis of joint stock companies in this paper is derived from a research paper written by Tom Carson and Gregory Maassen for the OECD and USAID in 2003.

The OECD has played an important role in recent corporate governance developments in Macedonia. On 19 June 2003, the OECD participated in the “National Conference on the OECD White Paper on Corporate Governance for South Eastern Europe” organised by the Ministry of Economy and the Macedonia Corporate Governance and Company Law Project (USAID – CG&CL project).¹

The conference, held in Skopje, presented the official Macedonian translation of the White Paper as part of a drafting process that would ultimately result in a new company law in May 2004. The 5th OECD South Eastern Europe Corporate Governance Roundtable was held on 10-11 June 2004 in Ohrid, Macedonia, in co-operation with the Macedonian Corporate Governance Council (established in January 2004), the Ministry of Economy, and the USAID – CG&CL Project. During this conference, the Macedonian delegation introduced a new company law based on OECD corporate governance principles and EU company law directives.

* The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the OECD or its Member countries, USAID, the Macedonia Corporate Governance Project, the Emerging Markets Group, the Rotterdam School of Management, or of member organisations of the Macedonian Corporate Governance Council.

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1. Macedonia's New Corporate Governance Standards

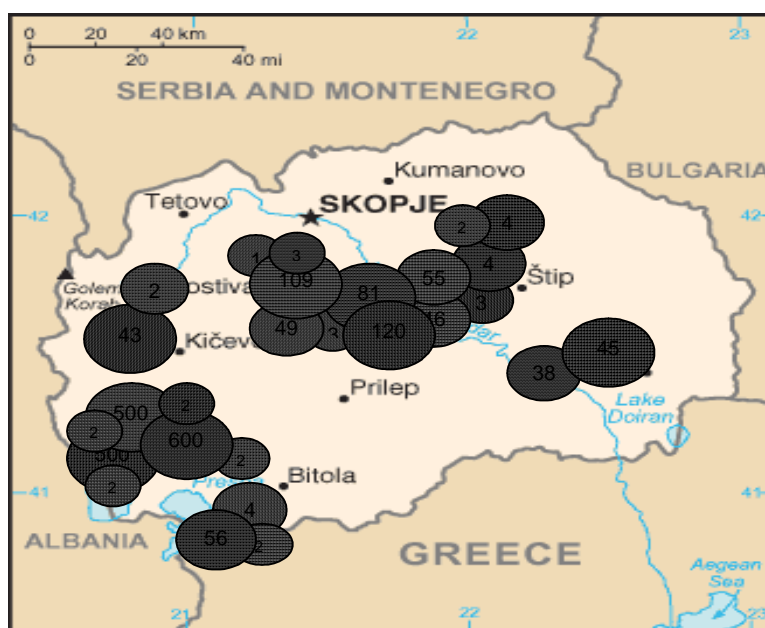
Long-term efforts to improve the investment regime paid off last year in the adoption of a new law governing corporate governance standards of joint stock companies (listed and non-listed) and other commercial legal entities. On 30 April 2004, the Macedonian Parliament passed the Law on Trade Companies in the second and final reading. This law brings substantial improvements to the legal climate for shareholders and investors, both through improvements to the old law and through the introduction of a more inclusive law-making process.

The 2004 law was developed under unusual circumstances. While the existing 1996 law was still fully in force, a new company law had been passed by Parliament in 2002. However, prior to its implementation, the Government changed and decided not to implement the 2002 law. As an interim measure, Parliament passed motions to extend the application of the 1996 Law on Trade Companies – first to 30 June 2003, then to 31 December 2003 and again to 30 April 2004 to enable a team of legal professionals to draft a new law. The 2004 company law thus replaces both the 1996 and 2002 versions and complies with the EU company law directives and OECD corporate governance standards.

Public consultations on corporate governance standards

After the passage of the law at the first reading in Fall 2003, the Ministry of Economy organised public consultations throughout Macedonia (see figure below). Based on these hearings, various modifications were made to the law and a new draft was released in January 2004. A second round of public hearings was held in February 2004 to give stakeholders an opportunity to examine the law and to verify whether the drafting committee had accepted their comments and suggestions during earlier consultations. This highly participatory approach led to improvements in the drafts of the law and acceptance of modern corporate governance standards by the business community. As a result, the new law actually represents a consensus between the public and private sectors.

Figure 13.1. Public debates on corporate governance and the 2004 company law



Source: USAID CG&CL Project – Public Education Report (2005).

The number of participants is placed in circles in the graph. Each circle indicates one public debate or conference.

The extensive public consultations represent a much needed departure from top-down approaches that so often result in low implementation and acceptance of corporate governance standards. By including the business community in the legislative process, lawmakers have ensured a sense of ownership that hopefully will lead to better, quicker implementation of corporate governance standards in Macedonia. The process leading to the introduction of these standards can serve as a model for other legal reform and business development efforts in the region.

The introduction of new corporate governance requirements

The new law provides for leading edge requirements for joint stock companies (whether they are listed or non-listed) with respect to:

- The disclosure of the companies' operational and general financial status;
- Disclosure of executive compensation and non-executive board remuneration;
- Cumulative voting when provided by the charter of the company;
- Limitations on the number of directorships of directors and managers;
- Disclosure and regulation of large transactions and related party transactions;
- Protection of shareholders during reorganisations (merger, acquisition and division);
- Rights of minority shareholders;
- Shareholders' right to information about the company; and
- Accounting requirements that are in line with international financial reporting standards.

Given the scope of the new company law, the law also introduces the following important aspects that indirectly can affect the activities of Macedonian non-listed joint stock companies:

- ***National electronic commercial register:*** A new national, electronic and publicly accessible commercial register is being created that will be maintained at the Central Registry. Shareholders of non-listed joint stock companies will no longer have to rely on manual searches of court files.
- ***Streamlining of the business registration process:*** A framework is being established that will reduce the lead time and processing time for business registrations. The new framework is structured in a manner that will support the eventual removal of registration courts from the business registration process. This is a cutting-edge change that places Macedonia well ahead of its neighbours in introducing business-friendly reforms.²
- ***Legal mandate for the one-stop shop:*** In addition to streamlining business registration, the law mandates the enactment of regulations in support of a one-stop shop. The purpose is to consolidate business filing, licensing and application requirements so that the steps required for a business to become and continue to be operational are minimised. The ultimate goal is to enable a company to deal with all administrative requirements in one place at one time. An added benefit is found in removing unnecessary administrative burdens from the courts, thus enabling the courts to concentrate their resources more effectively on resolving commercial disputes.

These and other improvements have resulted in a new regime that, once implemented, will lower entry and administrative costs for investors and shareholders of non-listed joint stock companies. In addition, the improved corporate governance provisions of the law introduce protections that will make minority investment much more attractive, which can be expected to have a positive impact on domestic capital markets. At the same time, greater transparency requirements and accounting standards have been introduced to improve creditworthiness for Macedonian companies. Despite these positive developments, the principal challenge for Macedonia is to ensure that all the good laws will be put into practice (EBRD, 2004:6).

Additional work is needed to complete the overall regime. Drafting committees continue to work on improving regulations, and there is a continued need for extensive public, shareholder and company education programmes to ensure that the obligations and rights of various stakeholders are understood and compliance is achieved. As noted by the EBRD (2004:5), general reform priorities for Macedonia “are to improve effective implementation and enforcement of existing legislation. For example, the regulator should be given sufficient independence and resources to carry out its mandate; the competence of the judiciary system in adjudicating corporate governance related disputes should also be enhanced.”

2. Shareholder Agreements

Amendment 292 on shareholder agreements

A persistent corporate governance issue, mitigated by the new company law, has been the signing of shareholder agreements in Macedonia. Based on the (old) 1996 company law, management of joint stock companies was allowed to sign shareholder agreements with employees of the company, who were by default also shareholders of the company. These agreements were used to transfer basic rights of minority shareholders to the management of the company, such as the right to vote during general meetings of shareholders, the right to dividends and the right to transfer shares. Usually the duration of an agreement according to the old company law was five years.

One quarter of Macedonian joint stock companies, which are mostly non-listed companies, had signed agreements with their shareholders in 2003 (USAID CG&CL Project: 2004). The main reason companies chose to sign shareholder agreements is that they would provide for “more efficient work” and “better share management.” The main reason why companies chose not to sign shareholder agreements is that there was no need to sign these (36%), or because shares were held by relatively few people (11%). The majority of companies (52%) were likely to seek a renewal of the shareholder agreements if the new company law allowed this. In signing the agreements, the shareholders gave management the right to vote during annual shareholder meetings in 71% of the companies where agreements were signed. Other rights given to management include the right to appoint members of the board of directors (4.9%) and the right to transfer (sell or assign) their shares (6.8%).

Limitations on the transferability of shares

These findings supported the decision of the drafting committee of the 2004 company law and the Ministry of Economy to amend Article 292 of the 1996 company law in July 2003. The amendment prohibits managers and directors of joint stock companies to sign shareholder agreements with employees possessing shares of the company. The amendment helps to ensure that shareholders/employees are protected against abusive voting rights agreements with management under the rules of the 1996 law. Further measures have been taken in the new 2004 company law to abolish the practice of shareholder agreements between managers and shareholders/employees of the company.

3. Board Independence

Greater independence requirements of directors

The new company law requires non-listed joint stock companies to have a minimum number of non-executive and independent directors on their board of directors. According to Article 367 of the law, the number of non-executive members of the board of directors shall be greater than the number of executive members. Since the same article states that the board of directors shall have at least three members, the board of directors must have as a minimum two non-executive directors. In addition, Article 367 of the law states that when the board of directors has up to four non-executive directors, at least one shall be independent. When the board of directors has more than four non-executive members, at least one-fourth should be independent.

The definition of independent directors

With this requirement, the new Macedonian company law adopts the definition of the latest OECD White Paper for South Eastern Europe. Although the White Paper does not provide for a clear definition of the independence of directors, it does refer to some basic principles used elsewhere to define board independence:

“An independent director is a non-executive board member who, by virtue of his position *vis-à-vis* the company, its shareholders and its management, brings great impartiality and objectivity to the board’s deliberations. It is generally felt that in order to qualify as independent, a board member should not have (or be perceived to have) an inherent conflict of interest with the company or those close to it. He/she should have no business or contractual relationship (other than a service agreement as a board member) with the company and should not be under the undue influence of any other board member or group of shareholders” (OECD, White Paper 2003:71).

The decision of the drafting committee to follow the OECD principles was based on an understanding that an Anglo-Saxon definition of board independence - as used in the Higgs report for example - would be less useful for Macedonia. Few qualified individuals would be able to meet the stringent independence requirements, which would result in a shortage of individuals qualified to become independent directors. According to article 3, Section 1:25 of the company law, an independent director is a natural person who, and whose family members:

- Has not had any material interest or business relation with the company directly as a business partner, a member of the management body, supervisory body or an officer of the company within the five preceding years;
- Has not within the five preceding years received and does not receive from the company any additional income;
- Is not a relative of any of the members of the management body, supervisory board or the officers of the company; and
- Is not a shareholder who owns more than one tenth of the shares in the company or who represents a shareholder who owns more than one tenth of the shares in the company.

4. New Voting Requirements

Cumulative voting

An innovation in the new law is the right of shareholders to elect directors with cumulative voting, when this is provided by the charter of the company (Article 344, Clause 2). The drafting committee of the new company law was aware that cumulative voting is only effective when minority shareholders organise themselves to vote collectively on candidates for the board of directors. This assumes that minority shareholders:

- Have the resources and skills to campaign for the election of candidates for the board of directors;
- Have the willingness to be actively engaged in contacting other shareholders prior and during the general meeting of shareholders;
- Have a good understanding of the company law; and
- Are able to strategically use cumulative voting.

According to Article 283, Clause 6 of the company law, each shareholder has access to the list of shareholders in the Central Securities Depository. With this list, they can contact other shareholders and discuss the election of members of the board of directors. Unfortunately, shareholders are not authorised to copy the list. This technical problem hopefully will be resolved with the introduction of the new securities law.

More information on the candidates of the board of directors

Macedonian non-listed companies are subject to disclosure requirements normally found only in Western corporate governance codes that regulate listed joint stock companies. Article 344, Clause 3 of the new company law states that all shareholders be provided the following information about candidates for the board of directors (supervisory board) at least seven days prior to their election at a general meeting of shareholders:

- Age, gender, education and other professional qualifications;
- Working experience;
- Companies in which the candidate is and/or has been a member of the management body or the supervisory board;
- Other “important” positions held by a candidate;
- The number of shares owned by the candidate in the company and in other companies; and
- Any loans of the company and other liabilities towards the company.

Information on members of the board of directors

New to non-listed joint stock companies in Macedonia is the requirement that the annual report of the company disclose the earnings of each member of the management board and executive and non-executive members of the board of directors. This includes information on the salary, allowances, bonuses, insurance and other rights (Article 384, Clause 7).

5. Shareholders' access to information

Shareholders' right to information

The new Macedonian company law has established greater information rights for shareholders. Article 406 establishes a "right to information" that authorises any shareholder to obtain information at the general meeting of shareholders about the company's state of affairs and its relations with other companies, if such information is related to the items on the agenda of the general meeting of shareholders. In addition, the shareholder who is denied the information may request in writing that his/her question and request, as well as the reasons for the denial, be entered into the minutes of the meeting. The shareholder, who has been denied the information, may also request court enforcement of his right of information. The claim of the shareholders should be filed within fifteen days as of the date of convening the general meeting of shareholders.

In more detail, Article 319 defines which by-laws, regulations and documents should be kept by the company at its head office at any time, and Article 320 defines the shareholders' right to information. According to the new Macedonian company law, a shareholder of a non-listed company is entitled to inspect the by-laws, regulations and the documents of the company at the its registered office in the manner stipulated by the company charter. Shareholders are also entitled to have access to the minutes and the resolutions of the meetings of the management bodies through the non-executive members of the board of directors and/or the supervisory board.

Notice requirements

A non-listed joint stock company may require the shareholder requesting inspection to provide advance notice of the inspection within no more than three days prior to the date of the intended inspection. The company may require the shareholder to cover the cost of the requested copies, which may not be higher than the administrative cost thereof.

In the event that the company does not allow the shareholder to carry out the inspection and copy the by-laws, regulations and documents, the shareholder may submit a request to the court in order to obtain access to the by-laws, regulations and documents. The request should indicate the by-laws, regulations and documents that the shareholder wishes to inspect or receive, as well as the form in which these should be delivered. The court, within eight days as of the submission of the request, should decide whether to order the company to allow the shareholder to inspect the by-laws and the documents to which the proposal pertains and/or to supply the shareholder with a transcript of the by-laws, regulations and documents, at the expense of the company.

The confidentiality of information

Shareholders have the obligation to protect confidential information of the company. A shareholder is not authorised under the new company law to publicly announce and/or present such information, unless the shareholder presents it to other shareholders when exercising certain rights as determined by law, the company charter and/or company by-laws and regulations, before a competent body and/or in the event the information has already been publicly announced.

6. Interlocking Directorates

Limitations on interlocking directorates

Executive and non-executive directors of Macedonian non-listed companies are subject to directorship limitations normally found only in Western corporate governance codes that regulate listed joint stock companies. Article 346 of the company law states that a non-executive member of the board of directors or a member of the supervisory board may not be appointed to more than five boards of directors as a non-executive member, or to more than five supervisory boards of Macedonian joint stock companies (companies having a registered office in the Republic of Macedonia), at any one time. An executive member of the board of directors or a member of the management board may not be elected as an executive member of a board of directors, or a member of a management board of other Macedonian joint stock companies, except in banks, insurance companies, and other companies as provided for by law. An executive member of the board of directors, or a member of the management board, may not be elected as a non-executive member or a member of the supervisory board in more than five other Macedonian joint stock companies.

7. Major Transactions

The definition of major transactions

According to Article 455 of the company law, a major transaction is any transaction (or a series of related transactions) with a value of 20% or more of the book value of all assets of the company. The following transactions are exempt from this requirement:

- Transactions that are concluded to acquire common shares or bonds convertible into shares of the company; or
- Transactions that are concluded within the regular course of business of the company.

In addition, the law gives companies the opportunity to define any transaction as a major transaction in the charter of the company. For example, any transaction involving more than 10% of the book value of all assets of the company can be a major transaction according to the charter of the company.

The approval of major transactions

The company law uses three thresholds to determine the value of assets and the approvals needed to conclude a transaction:

- ***Transactions with a value of $\leq 20\%$ of the total book value of assets:*** According to Article 455, Clause 1 of the company law, management is normally authorised to approve a transaction with a value of $\leq 20\%$ of the total book value of assets (and that is not related to a major transaction), unless the charter of the company determines otherwise (Article 455, Clause 1 of the company law). Any transaction with a greater value requires the approval by the board of directors/supervisory board, or the general meeting of shareholders, before it can be concluded, unless the transaction is concluded within the ordinary course of business of the company or when the company acquires common shares or bonds convertible into shares of the company with the transaction.
- ***Transactions with a value of $> 20\% \leq 50\%$ of the total book value of assets:*** According to Article 456, Clause 2 of the company law, any transaction that meets the criteria for a major

transaction with a value equal to or greater than 20%, but not more than 50%, of the book value of all assets of the company, cannot be concluded by the management of the company without the approval of all the members of the board of directors/supervisory board, unless the transaction is concluded within the ordinary course of business of the company or when the company acquires common shares or bonds convertible into shares of the company with the transaction. The general meeting of shareholders may also be authorised to approve such a transaction when this is provided by the charter of the company. The general meeting of shareholders can adopt the resolution by a majority vote which may not be lower than the majority of the voting shares represented at the general meeting of shareholders, unless the charter stipulates a greater majority (Article 456, Clause 3 of the company law).

- **Transactions with a value of > 50% of the total book value of assets:** Any transaction that meets the criteria for a major transaction with a value greater than 50% of the book value of all assets of the company must always be approved by the general meeting of shareholders before it can be concluded, unless the transaction is concluded within the ordinary course of business of the company or when the company acquires common shares or bonds convertible into shares of the company with the transaction. The resolution can be adopted by a majority vote that is not less than two thirds of the voting shares represented at the general meeting of shareholders, unless the charter stipulates a greater majority (Article 455, Clause 1 of the company law). See also the Tables 13.1-13.3 below.

Table 13.1 The approval of major transactions ($\leq 20\%$)

Value of assets as a percentage of the total book value of assets of the company:	The transaction is to be concluded within the regular course of business of the company:	or	The company acquires common shares or bonds convertible into shares of the company with the transaction:	or	The transaction is defined as a major transaction by the charter of the company:	Who can approve the transaction?
= 20%	Yes		Yes		No	Management
= 20%	No		No		No	Management
= 20%	Yes		Yes		Yes	Board of directors or supervisory board or general meeting of shareholders
= 20%	No		No		Yes	Board of directors or supervisory board or general meeting of shareholders

Table 13.2 The approval of major transactions ($\geq 20\% \leq 50\%$)

Value of assets as a percentage of the total book value of assets of the company:	The transaction is to be concluded within the regular course of business of the company:	or	The company acquires common shares or bonds convertible into shares of the company with the transaction:	or	The transaction is defined as a major transaction by the charter of the company:	Who can approve the transaction?
> 20% = 50%	Yes		Yes		No	Management
> 20% = 50%	No		No		No	Board of directors or supervisory board
> 20% = 50%	Yes		Yes		Yes	Board of directors or supervisory board or general meeting of shareholders
> 20% = 50%	No		No		Yes	Board of directors or supervisory board or general meeting of shareholders

Table 13.3 The approval of major transactions (> 50%)

Value of assets as a percentage of the total book value of assets of the company:	The transaction is to be concluded within the regular course of business of the company:	or	The company acquires common shares or bonds convertible into shares of the company with the transaction:	or	The transaction is defined as a major transaction by the charter of the company:	Who can approve the transaction?
> 50%	Yes		Yes		No	Management
> 50%	No		No		No	General meeting of shareholders
> 50%	Yes		Yes		Yes	General meeting of shareholders
> 50%	No		No		Yes	General meeting of shareholders

The board of directors/supervisory board and major transactions

The board of directors/supervisory board plays an important role in the approval process of major transactions in the new company law. In summary:

- The board of directors/supervisory board should approve by law transactions with a value of 20% or more, but not exceeding 50%, of the book value of all assets of the company before these can be concluded;
- The transaction must be approved by all members of the board of directors/supervisory board before it can be concluded;
- If the transaction is not or cannot be approved by all members of the board of directors/supervisory board, the general meeting of shareholders should approve the transaction before it can be concluded by a majority vote which may not be lower than the majority of the voting shares represented at the general meeting of shareholders, unless the charter stipulates a greater majority;
- As soon as the general meeting of shareholders is requested to approve a major transaction, the board of directors/supervisory board should determine the value of the assets involved in the transaction(s);

- As soon as the general meeting of shareholders is requested to approve a major transaction, the board of directors/supervisory board should provide the following information in writing to the general meeting of shareholders at least 21 days prior to the meeting (see also Article 456, Clause 5 of the company law):
 - A statement that explains that the general meeting of shareholders is requested to approve a transaction;
 - A statement that explains that the general meeting of shareholders has the authority not to approve the transaction;
 - A recommendation by the board of directors/supervisory board to the general meeting of shareholders to approve or not approve the transaction;
 - The parties involved in the transaction;
 - The beneficiaries of the transaction;
 - The value and nature of assets involved in the transaction; and
 - The financial terms of the transaction.

The general meeting of shareholders and major transactions

The tables above indicate that the general meeting of shareholders plays an important role in the approval process of major transactions. In summary:

- The general meeting of shareholders by a majority vote, which may not be lower than the majority of the voting shares represented at the general meeting of shareholders, can approve by law transactions with a value equal to or greater than 20%, but not more than 50%, of the book value of all assets of the company when the board of directors requests the general meeting of shareholders to approve the transactions;
- The general meeting of shareholders by a majority vote that shall not be less than two thirds of the voting shares represented at the general meeting of shareholders should approve by law transactions with a value greater than 50% of the book value of all assets of the company before these can be concluded; and
- The general meeting of shareholders by a majority vote which may not be lower than the majority of the voting shares represented at the general meeting of shareholders can approve by law transactions that have been defined by the charter of the company as a major transaction and that, according to the charter, need approval from the general meeting of shareholders before these can be concluded.

8. Related Party Transactions

The definition of related party transactions

New in the Macedonian company law is the introduction of related party transactions. According to Article 457 of the 2004 company law, a related party transaction is:

“Any transaction (including but not limited to a loan, credit, pledge and/or guarantee) in which a member of the management body and/or supervisory board or the manager is an interested party, including the officers and/or a shareholder who together with related parties own 20% or more of the company's voting shares, and/or a person who has the authorisation to provide

mandatory instructions to the company, shall be considered as related party transaction and shall be effected by the company pursuant to a procedure in compliance with the provisions of this law.”

A party is defined as a related party if such a person, his/her representative, spouse, parents, children, brothers/sisters from both parents and/or from one parent only, adoptive parents, adopted children, and/or any related party (hereinafter: “interested party”):

- Is a party to such transaction, a beneficiary thereof, a representative and/or intermediary in such transaction; and/or
- Individually and/or jointly owns 20% and /or more of the shares of the legal person that is a party in the transaction, a beneficiary thereof, a representative and/or intermediary in such transaction; and/or
- Is a member of the management or the supervisory body of the legal person which is a party in the transaction, a beneficiary thereof and/or representative in such transaction, and/or is an officer in such legal person; and/or
- If so stipulated by the company charter.

The law provides an exemption to the procedures for related party transactions when:

- The company is a single member company and that single member also represents the company in a managerial capacity;
- All shareholders of the company have an interest in the transaction;
- Pre-emptive rights are exercised by shareholders; and
- A company’s shares are acquired and/or redeemed.

Notification requirements

The new Macedonian company law has introduced notification requirements of management. According to Article 458, a company is obliged to notify and seek approval of the general meeting of shareholders of any transaction that is entered within two years of the company’s founding and that involves the acquisition of assets that are owned by the founders and that have a value that exceeds one tenth of the charter capital of the company.

In addition, Article 459 requires the disclosure of any interested party in a company's transactions. All interested parties are obliged to notify the board of directors, or the supervisory board of:

- The companies in which they alone and/or together with related parties possess 20% and/or more of the parts or voting shares;
- The companies in which they perform certain managing duties; and
- Current and/or potential transactions known to them, in which they act or may act as interested parties.

The approval of related party transactions

The new company law also introduces procedure for the approval of related party transactions. According to Article 460, any related party transaction shall be subject to approval by the board of directors or supervisory board and/or the general meeting of shareholders.

- **The board of directors/supervisory board:** The resolution to approve a related party transaction can be approved only by a majority of votes of the members of the board of directors or the supervisory board who do not have an interest in the transaction.
- **The general meeting of shareholders:** The general meeting of shareholders has the authority to approve the transaction when all members of the board of directors or the supervisory board are interested parties. The general meeting of shareholders also has the authority to approve the transaction if the number of disinterested members of the board of directors or the supervisory board is less than the quorum requirement for a meeting of the board of directors or the supervisory board pursuant to the company charter. In addition, the general meeting of shareholders has the exclusive authority to approve a related party transaction by a majority vote of all disinterested shareholders who own voting shares if:
 - The value of assets involved in such transaction and/or series of related transactions is 2% and/or more of the book value of the company’s assets, based on the company’s most recent audited financial statements and/or based on the offered price in the case of purchasing property;
 - A transaction and/or related transactions involve the issue pursuant to subscription and/or the sale of shares that represent more than 2% of the company’s common shares outstanding in that period and the common shares into which securities previously issued in series and convertible into shares can be converted; or
 - A transaction and/or related transactions involve the issue pursuant to the subscription of convertible bonds, which may be converted into common shares and which represent more than 2% of the company’s issued common shares, and if at the same time the common shares previously issued in series may be converted into shares.

9. Macedonian Joint Stock Companies

Introduction

In a country with just over two million residents, Macedonia has a relatively large number of joint stock companies (606) that have emerged from the privation process in the 1990s. As of August 2003, approximately 452 joint stock companies can be defined as “working companies.”

Table 13.4 Active joint stock companies in Macedonia³

Registered joint stock companies	606
Additional non-registered joint stock companies	24
Total number of joint stock companies	630
Non-valid joint stock companies ^a	(178)
Active joint stock companies in Macedonia	452

a) 178 joint stock companies were excluded from the census because they were under bankruptcy proceedings or bankrupt (38); not active (1); under strike and not operating (4); repeatedly listed in court registration lists (13); no longer existing (55); changing company status from joint stock company to limited liability company (31); branch offices of a central registered company (14); or researches were unable to confirm or obtain accurate data (22). 416 of 452 companies participated in the census.

Source: USAID CG&CL Project (2004).

For the most part, joint stock companies are involved in manufacturing and processing. To a lesser extent, companies work in construction, transport and activities involved with agriculture and natural resources (mining, fishing, forestry).

A large proportion of the joint stock companies in manufacturing (processing) are located in the eastern part of the country (43.6% of this sector). In Skopje, companies are active in finance and services (77% of all companies in this sector), construction and transport (35%), and wholesale/retail (46%). In the southwest region of the country, a high proportion (41%) of companies specialise in agriculture and natural resources.

The northwest region is not especially noted for a high proportion of any specific type of activity, though 21% of the restaurants and hotels are registered there. Overall, processing and manufacturing represents at least 50% of all registered activities in each region, except Skopje.

Macedonian joint stock companies employ just under 100 000 full-time employees and have issued approximately 1.37 million shares to some 268 000 shareholders who most often are also an employee or former employee of the company.

Table 13.5 **General characteristics of joint stock companies in Macedonia**

Location	Skopje	28.40%
	Northwest	11.30%
	Southwest	24.50%
	East	35.80%
Primary activity of company	Agriculture and natural resources	7.70%
	Processing and manufacturing	54.10%
	Construction and transport	12.30%
	Wholesale and retail	12.00%
	Hotels and restaurants	5.80%
	Finance and services	8.20%
Number of employees	10 or less	10.60%
	11 – 50	24.80%
	51 – 150	30.00%
	151 – 500	24.80%
	501+	9.90%
Plans for external investment	No plans for external investment	20.90%
	Foreign investment only	17.30%
	Domestic investment only	26.70%
	Mixed foreign and domestic	30.80%
	Do not know/no answer	4.30%

Source: USAID CG&CL Project (2004).

Macedonian joint stock companies and foreign investment

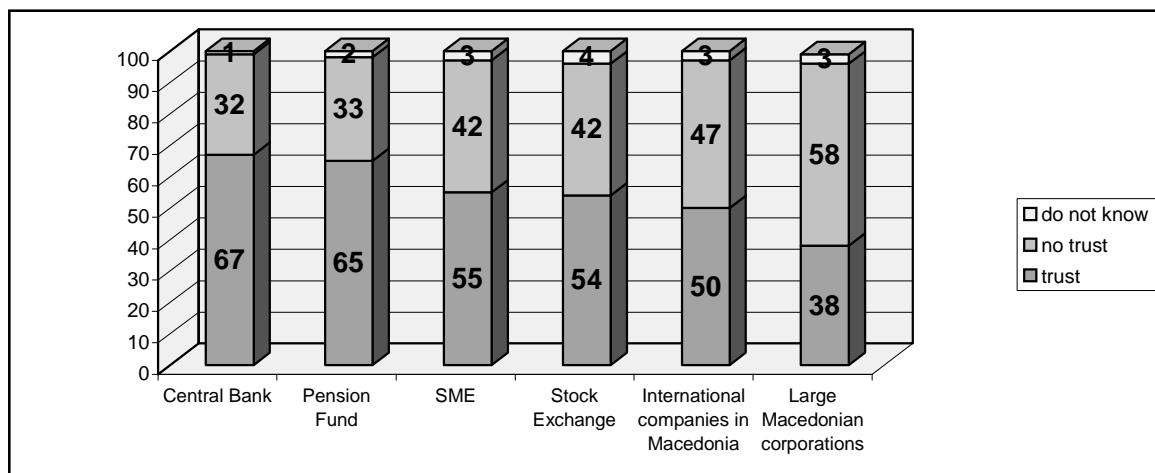
Although a majority (75%) of joint stock companies in Macedonia plan to seek external investment for the company in the future, and nearly half (48%) are looking for foreign sources of investment, most companies had no prior external investment experience. A majority (76%) of Macedonian joint stock companies has never received external investment. Among companies planning for foreign investment in the future, only 24% previously attracted foreign investment. In summary, many joint stock companies expect to attract external investment, but have limited experience in doing so.

Joint stock companies seeking foreign external investment appeared to be only marginally better informed than other companies about developments in company law. This runs contrary to the expectation that joint stock companies seeking investment would be more aware of the need to have a higher understanding of developments in corporate law than those that do not seek investment. As a result, the Ministry of Economy and the Macedonian Corporate Governance Council developed a comprehensive training programme for directors and managers of joint stock companies and other constituencies (accountants, appraisers, lawyers, notaries, judges and others) to ensure that private sector participants understood the importance of corporate governance and compliance with the 2004 law in attracting financing.

Trust in Macedonian joint stock companies

One problem working against the objective to mobilise private savings is the low level of confidence most Macedonians have in private sector institutions. Data for this discussion come from a general population survey on attitudes toward private sector issues (USAID CG&CL Project, 2003). As shown in the figure below, public confidence in large Macedonian corporations – mostly non-listed joint stock companies – is low in comparison to other institutions. Overall, 38% state they have trust (“some” or “very much”) in the largest domestic companies compared to 58% who do not. Trust is much higher in the SME sector (55% “trust”) and in international corporations operating in Macedonia (50% “trust”).

Figure 13.2 **Trust in private sector institutions in Macedonia**
Data: General Population Survey (N = 800)



Source: USAID CG&CL Project (2003).

Another interesting observation is that the experience of investing in Macedonian companies through the stock exchange does not appear to lead to increased levels of confidence. Trust in the Macedonian Stock Exchange is moderate, at 54% of those who know there is a stock exchange. With respect to their opinions about trust in the private sector, shareholders did not differ significantly in their opinion compared with non-investors.

10. The Board of Directors of Macedonian joint stock companies

The governance structure of Macedonian joint stock companies

Two out of five joint stock companies (170) have a one-tier board of directors, where all board members meet together to govern the company. A typical non-listed joint stock company with a one-tier board might be:

A metal processing company employing 230 full-time employees. The board of directors for this hypothetical company has five members: two executive and three non-executive directors. They meet nearly every month (on average, nine times a year). Board meetings usually last two and half hours. The executive directors almost always attend board meetings. Most of the non-executive members usually attend, though they may miss a few meetings. Board members frequently ask questions during the meetings and almost always vote. Minutes are kept.

A total of 224 companies operate with a two-tier board of directors– 54% of all companies. A typical joint stock company with a two-tier board might be:

A transportation company operating with 270 full-time employees. There are four members on the supervisory board. They meet four times a year, usually for two hours each time. Nearly all of the board members attend the supervisory board meetings. Supervisory board members frequently ask questions, and they always vote. Minutes are almost always taken. The management board in this company meets monthly. Four or five times a year there are joint meetings with the supervisory board. Management board members always vote, and minutes are taken.

Profiles of board members in joint stock companies

Overall, 92% of all joint stock companies with one-tier boards of directors have one to three executive directors. Most have one to three non-executive directors (49%) or four to seven non-executives (43%). For many companies with a one-tier board, the board has four to seven members (81%). Many supervisory boards in joint stock companies with a two-tier board have three members (37%) or five (22%). In total, 76% of joint stock companies with two-tier boards have at least five members on the supervisory board.

Board meetings

On average, one-tier boards of directors meet nine times a year. In 43% of the companies, the board meets two to seven times a year, and in 39%, the board meets seven to 12 times a year. The board meets monthly in 21% of all companies with one-tier boards. The supervisory board meets once a year in companies with a two-tier board. In 61% of the companies with a two-tier board, the board meets two to six times a year, and in 10.3%, the board meets seven to 12 times a year. Just 3.6% of joint stock companies with a two-tier board meet 13 or more times a year.

- **One-tier boards:** There is no relation between the number of board meetings and the average length of the meeting. The average length of the board meeting does not decrease if the company holds them more frequently. Executive members of the board attend all meetings in 86% of the companies. In another 9%, at least half of the executive board members attend. Non-executives attend less frequently. In 54% of the companies, all attend, and in 39% at least half attend. Board members vote during board meetings in 97% of the companies with one-tier

boards. In most companies, board members always ask questions (61%) or at least usually do (34%). In all but four of these companies, minutes are kept of the board meetings.

- **Two-tier boards - the supervisory board:** Generally, board meetings last one hour (40%) or two hours (41%). In a few cases, board meetings last three or more hours (16.5%). The more frequently these companies hold supervisory board meetings, the more likely they are to be longer in duration. Twenty-three companies held between seven to 12 supervisory board meetings per year and in 30% of these companies the meetings lasted three or more hours. For those that held 13 or more supervisory board meetings a year, in half of these companies the meetings lasted three or more hours. Members ask questions in most of the companies during supervisory board meetings (52% “always,” 31% “usually”). Supervisory board members vote in 93% of all two-tier boards and minutes are kept in most meetings (92%).
- **Two-tier boards - the management board:** Joint supervisory / management board meetings normally occur two to six times a year in 44% of all companies with two-tier boards. In 20%, these joint meetings occur once a year, and in 10%, they occur at least seven times a year. In another 26% of the companies surveyed with two-tier boards, the company representative did not answer the question. Board members vote during these meetings and minutes are kept (96% of two-tier companies). Management board meetings are reported to be “very effective” (62%) or “somewhat effective” (35%) for similar reasons as the supervisory board meetings.

Board composition

Similar to one-tier boards, two-tier boards rarely elect consultants or suppliers as directors on the supervisory board. Auditors and family members of the directors are also rarely elected. In contrast to the one-tier boards, employees and shareholders are not members of the supervisory board for a majority of two-tier boards (65% and 68%). Employees are on the board in 35% of companies, and shareholders are on the supervisory board in 33%.

11. General Meetings of Shareholders

The annual meeting of shareholders

According to the Macedonian company law, joint stock companies must hold an annual meeting of shareholders no later than three months after the preparation of the annual accounts, the financial statements and the annual report on the operations of the company for the preceding business year, not later than six months after the end of the calendar year, and not later than 14 months as of the last annual meeting. In total, 62% of the joint stock companies have held an annual meeting of shareholders at least once a year between 1998 and 2003. In contrast, 29% of companies have held fewer than one per year, and 6% have held no annual shareholder meetings (the remaining 2.4% did not answer the question).

Of those surveyed, 76% of all companies had held their 2003 annual shareholder meeting. Most, 53% of the 326 companies that had held their meeting in 2003, did so in May. Another 34% held their annual meeting earlier in the year. Another 11% did so after the May deadline established by the company law (in June or July 2003).

Nearly one out of four companies did not hold their annual meeting (24%, or 101 companies) in 2003. The main reasons why they did not do so include:

Strike or bankruptcy proceedings	22%
The company is in transition (undergoing restructuring)	14%

Auditor's report was not ready	11%
"Other" reasons	11%
No need for one	10%
No revenue and absence of most of the shareholders	5%

Other reasons included: the shareholders were already informed and did not request a meeting; there is only one shareholder; or the status of shares was being changed. Another 13% did not provide a reason why the annual shareholder meeting was not held. In 43% of the cases there was no such meeting when the government was the majority or super-majority shareholder, and in 27% of the cases there was no meeting when management and the board of directors held a majority or super-majority.

Table 13.6 **Percentage of joint stock companies that did not hold the annual meeting of shareholders in 2003 by status of minority position**
Data: All joint stock companies (N=416)

Classification of status of minority position	% not holding annual meetings of shareholders
90% held by single class of shareholder (53 joint stock companies)	17
90% held by management and board of directors (6 joint stock companies)	50
Minority rights restricted (104 joint stock companies)	18
Minority rights unrestricted (239 joint stock companies)	22
Did not provide enough information about shares (14 joint stock companies)	21
Total 416	23% ^a

a) 1.4% (7) joint stock companies stated they did not know if the company held an annual meeting of shareholders in 2003. Source: USAID CG&CL Project (2004).

The organisation of annual shareholder meetings

Companies generally organise their annual shareholder meeting in accordance with the Macedonian company law. This is verified in the manner they notify shareholders of the annual meeting. Nearly 95% of the 390 joint stock companies that held an annual shareholder meeting notified all their shareholders of the meeting. In most cases, companies placed notifications of the annual meeting in daily newspapers (78%). Of those surveyed, 50% of the companies notified shareholders at least 21 days before the meeting (in compliance with the law), and another 34% did so well in advance of this, 22 days before or more. Only 16% failed to notify their shareholders according to the legally specified period.

In general, for the 76% of companies that held them, this presents a positive impression of the way joint stock companies conduct their annual shareholder meetings. Many of the companies that did not hold the annual meeting were going through transition due to restructuring or had a limited number of shareholders. In the latter case, they felt little need to hold the annual meeting even though required by law. Other findings are also positive:

- In nearly all joint stock companies that hold the annual meeting of shareholders, the agenda is provided along with the notification of the meeting (95%).

- Shareholders may ask the company to add additional items to the agenda (92%).
- Shareholders ask questions during the meetings and vote in nearly 99% of the meetings.
- Nearly all joint stock companies that held the annual shareholder meeting kept minutes of the meeting. However, this does not mean that all shareholders received these minutes. A majority of shareholders (54%) rarely or never ask to receive copies of the minutes. Another 23% sometimes do. In total, 85% of the shareholders do not request the minutes as an expected and normal procedure following the annual meeting.

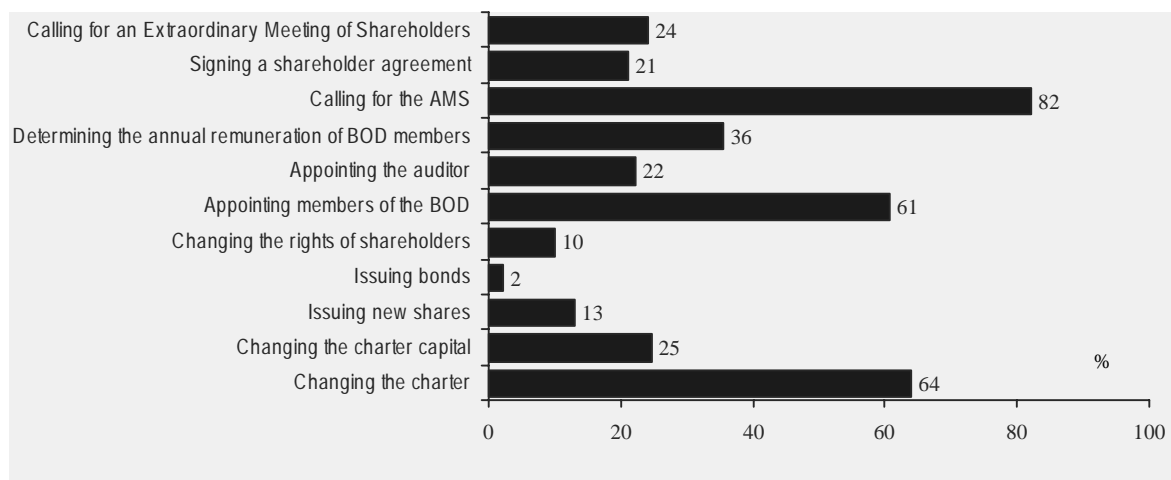
The quorum for annual meetings of shareholders⁴

Between 1998 and 2003, 26 companies did not hold an annual meeting of shareholders. Another 10 “do not know”. The remaining 380 companies held annual meetings at least once in these years. Among these companies, nearly half of all shareholders (47%) “always attend.” The remaining half (47%) “usually attend.” In only 6% of the companies, shareholders “usually do not” or “never” attend the annual meetings.

Decisions made by joint stock companies

Decisions made most frequently include calling the annual meeting of shareholders of joint stock companies (82%), changing the charter (64%), and appointing new members to the board of directors or supervisory board (61%).

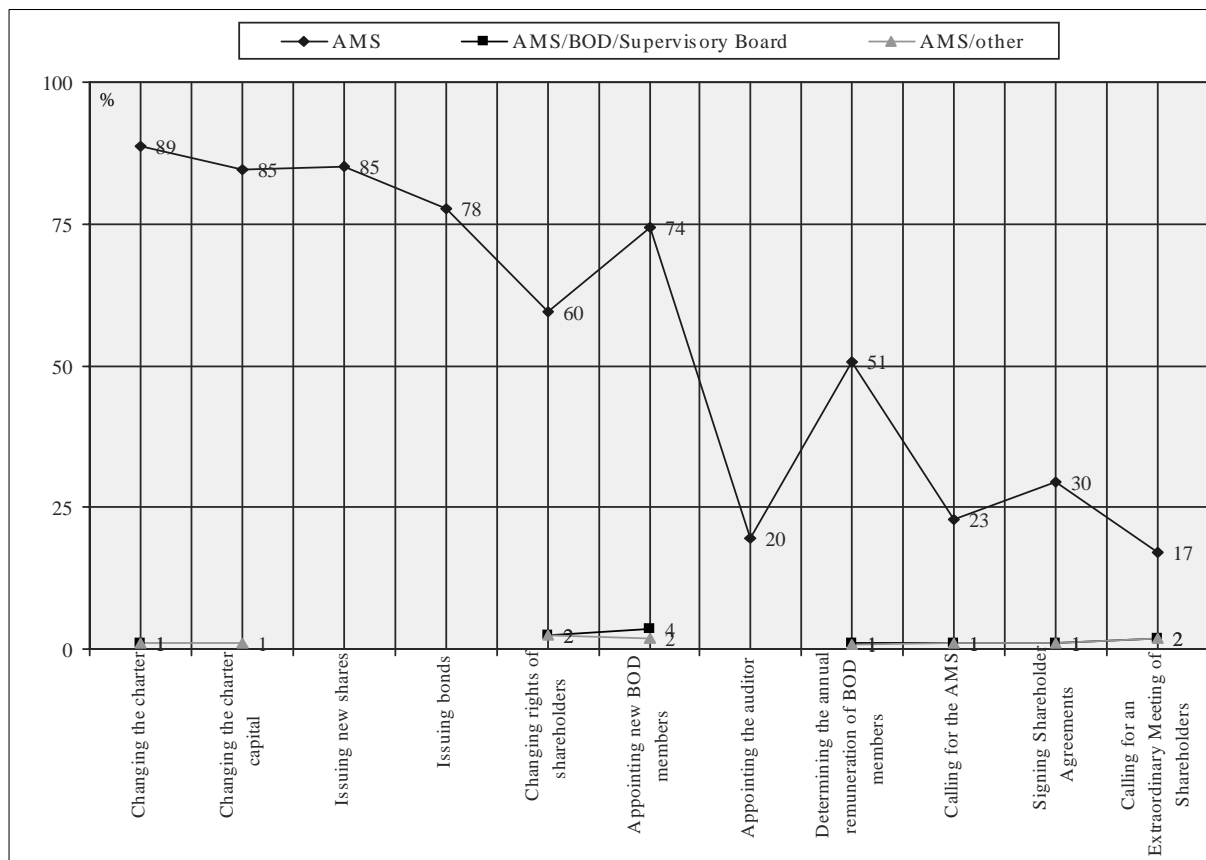
Figure 13.3 **Types of decisions made by companies between 1998-2003**
Sample: All joint stock companies (N=416)



Source: USAID CG&CL Project (2004).

The general meeting of shareholders approved in a majority of the companies changes to the charter, the charter capital (a decision made by few companies), and the rights attached to shares. Other decisions made related to the issue of new shares or bonds (decisions made by few companies), the appointment of new directors to the board of directors or supervisory board, and the approval of the annual remuneration of members of the board of directors or supervisory board.

Figure 13.4. **The percentage of decisions approved by the general meeting of shareholders between 1998-2003**
 Sample: All joint stock companies (N=416)

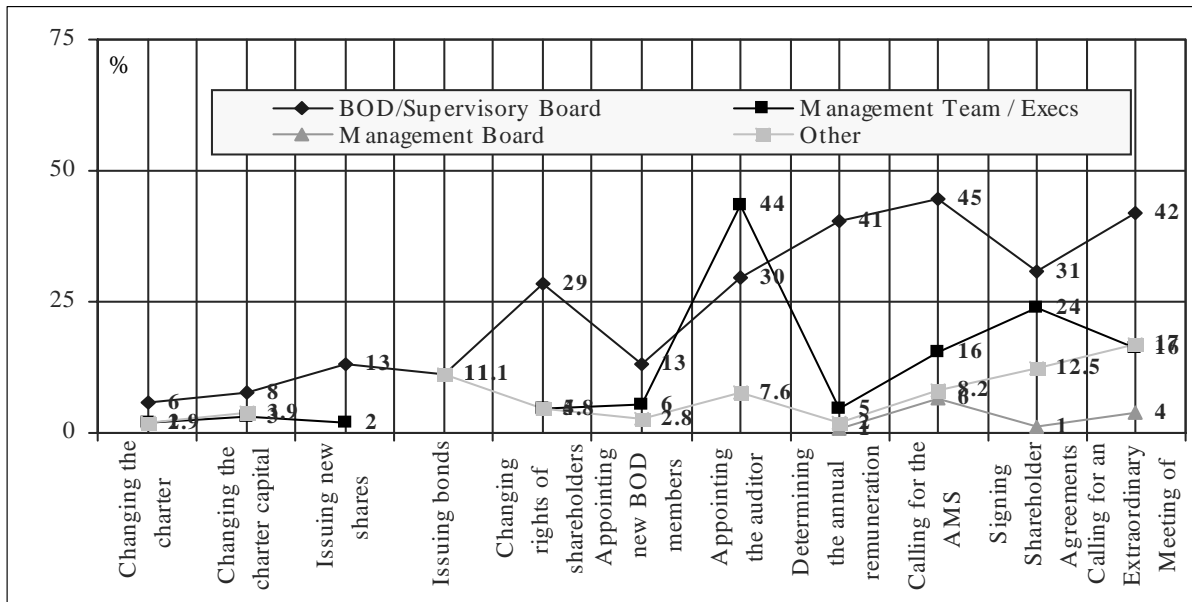


Source: USAID CG&CL Project (2004).

Decisions that are made less frequently are more likely to be incorrectly approved under the company law. Although the general meeting of shareholders is empowered to decide on the following two decisions, the general meeting of shareholders was usually not involved:

- *Appointing an external auditor*: This was decided by the board of directors or supervisory board or others in 80% of companies - the general meeting of shareholders decided on the appointment of the external auditor in only 20% of the joint stock companies; and
- *Determining the annual remuneration of members of the board of directors and supervisory board*: 49% of companies decided this through the board of directors or by others. The general meeting of shareholders made this decision in 51% of the companies.

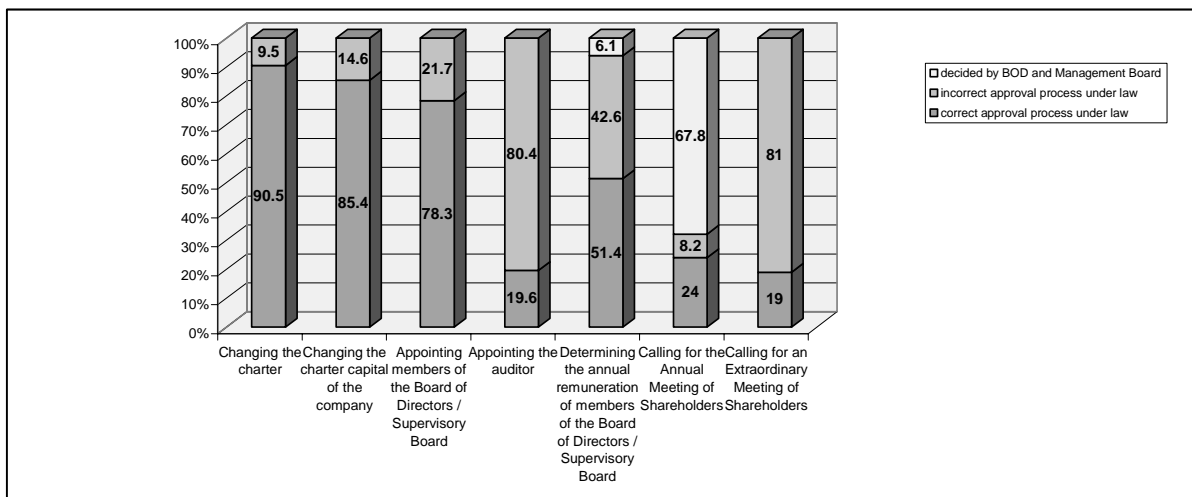
Figure 13.5 The percentage of decisions approved by other bodies of the company between 1998-2003
Sample: All joint stock companies (N=416)



Source: USAID CG&CL Project (2004).

Shareholder meetings were called by the board of directors or supervisory board (45% for the annual meetings of shareholders; 42% for extraordinary meetings among the few companies that called for them). The management team, along with the executive directors of the board of directors, called the meetings in 16% of companies.

Figure 13.6 Evaluation of decision-making under the Macedonian company law
Data: All joint stock companies (N = 416) Source: USAID CG&CL Project (2004).



Decisions made by joint stock companies and foreign investment

Similar to the overall trend among joint stock companies in Macedonia, companies seeking foreign investment rarely followed correct procedures when this concerned the more intimate financial affairs of their companies:

- Only 21% followed the correct procedure in appointing the external auditor by having the annual meeting of shareholders approve this decision;
- 54% of companies seeking foreign investment followed the correct procedure when determining the annual remuneration of members of the board of directors or supervisory board;
- Only 76% of companies seeking foreign investment held an annual meeting of shareholders for 2003 as of July of that year (6.5% of companies seeking foreign investment have never held annual shareholder meetings or “do not know” if they have); and
- Only between 50% to 63% of the companies correctly notified shareholders of the annual meeting of shareholders. Between 31% and 40% of the companies notified shareholders less than 21 days before the meeting in companies seeking foreign investment. However, the agenda was correctly sent along with the notification of the annual meeting in 96% of all joint stock companies.

12. Ownership Control

Management control in Macedonian joint stock companies

Managers hold shares in 40% of all joint stock companies. Only employees and the government own shares in a higher proportion of the companies. Non-executive directors, including supervisory directors, hold shares in 25% of the companies. Overall, management, non-executive directors (in one-tier boards) and supervisory directors of two-tier boards (combined) have shares in 51% of all joint stock companies. In most cases, neither management nor the non-executive directors or supervisory directors have given up voting rights for the shares they hold, except in very few cases.

Management is most likely to hold majority positions in the companies in which they work. This is not clearly the case for non-executive directors or supervisory directors. In 9.4% of companies, non-executives, including supervisory directors, have a majority position (in 4.1% of these companies, this is even a super-majority position.) However, non-executive directors and supervisory directors are almost as likely to hold minimal stakes in these companies.

Table 13.7 **Shareholder position of management and non-executive board members**
Data: All joint stock companies (N=416)

Shareholder position	Management	Non-executive directors and supervisory directors	Combined
A. Minimal (<10%)	6.0%	8.7%	4.6%
B. Minority (10% <50%)	12.3%	6.7%	12.0%
C. Majority (50% - <75%)	13.0%	5.3%	18.8%
D. Super-majority (75% +)	9.1%	4.1%	15.4%
(C + D) Majority + (50%+)	22.1%	9.4%	34.2%

Source: USAID CG&CL Project (2004).

When the shareholdings of both management and non-executive directors or supervisory directors are combined, the percentage of control increases. The combined management / non-executive / supervisory block holds a majority status in 34% of all joint stock companies and a super-majority in 15% of all companies. These shareholdings usually retain voting privileges.

Corporate governance and state ownership

A concern stated in the OECD White Paper on Corporate Governance for South Eastern Europe is the corporate governance practices of companies in which the government is a majority shareholder. The data from Macedonia show that the government has great opportunities to implement internationally accepted corporate governance standards in companies given its ownership interest in many Macedonian companies. Most companies followed correct procedures for some key decisions, but some did not for other decisions:⁵

- Correct procedures were followed in deciding on changing the charter in 91% of cases where the government has a majority position and in 75% of cases where it has the super-majority.
- Correct procedures were followed in the decision to change the charter capital in 75% of the cases where the government holds a majority position. There is only one company in which the government holds a super-majority and the company decided to change the charter capital. The correct procedure was followed in this case.
- The decision to issue new shares was incorrectly decided upon in 56% of companies where the government holds a majority position. There is only one case where a company in which the government holds a super-majority issued new shares. In this case, the correct procedure was followed.
- The decision to change the rights attached to shares was incorrectly decided upon in 50% of cases where the government holds a majority share. In the one case where the government holds a super-majority position in a company that changed the rights attached to shares, the correct procedure was not followed.
- The selection of new members to the board was done correctly in 77% of companies where the government holds a majority position, and in 91% of cases where the government has a super-majority.
- Deciding upon the annual remuneration of board members was done incorrectly in 77% of companies where the government holds a majority position and in both cases where the government has a super-majority and this decision was made.
- Appointing the external auditor was incorrectly decided upon in 81% of companies where the government holds a majority position and in the one case where the government has a super-majority and the company appointed a new auditor.
- Shareholders were notified less than 21 days before the annual meeting of shareholders in 11% of companies where the government holds a majority position, compared to 23% of companies where the government has the super-majority. In 17% of the cases where the government holds a majority position, the correct procedures were not followed for notifying shareholders of the annual meeting of shareholders. This compares to 50% of companies where the government has a super-majority.
- The agenda was distributed correctly in nearly all cases where the government holds a majority (94%). This was less true where the government has a super-majority (69% correct).

- Less than 50% of shareholders attended the previous annual meeting of shareholders in 34% of companies where the government has a majority. In 26% of these companies, at least 50% of the shareholders were represented by proxy at the last annual meeting of shareholders. However, 57% of these companies did not answer this question or did not know the answer.
- In 8% of companies where the government holds a super-majority, less than 50% of shareholders attended the last annual meeting of shareholders. For 8% of these companies, a majority of shareholders were represented by proxy at the last annual shareholder meeting. Again, most companies (69%) did not answer this question.

Conclusion

Based on the (old) 1996 company law, managers of non-listed joint stock companies were allowed to sign shareholder agreements with employees of the company, who were by default also shareholders of the company. These agreements were used to transfer basic rights of minority shareholders to the management of the company, such as the right to vote during general meetings of shareholders, the right to dividends and the right to transfer shares. Usually the duration of an agreement was five years according to the old company law.

Although this practice deprived minority shareholders from their basic rights, it also preserved a unique shareholder base in Macedonia. While a consolidation of power in the hands of management has taken place in many post-communist countries, Macedonia continues to have approximately 260 000 shareholders (more than 10% of the adult population) who increasingly understand the economic benefits of shares and who are becoming increasingly eager to voice their rights.

With the introduction of new corporate governance legislation in 2004, Macedonian non-listed companies are subject to disclosure requirements normally found only in Western corporate governance codes that regulate listed joint stock companies. Minority shareholders have greater access to information, are able to organise into voting blocks, and are better protected during major transactions and related party transactions. The new company law also curtails shareholder agreements and imposes greater liabilities on management and directors when they do not comply with the law.

Although the legal framework for corporate governance of non-listed joint stock companies has dramatically improved, the implementation of the new standards remains a challenge. As observed by the EBRD, the principal challenge for Macedonia is to ensure that all the good laws are put into practice. This challenge requires that management of non-listed companies better understand the importance of corporate governance to attract financing. Shareholders require continuing education about their rights while the judicial system needs to be prepared to take up a new challenge through specialised commercial courts.

NOTES

1. See www.maccorpgov.com.mk for more information on the USAID Macedonia Corporate Governance and Company Law Project.
2. A simplified registration for small suppliers: The new law also creates a new category of small-scope commercial activity that will allow, for example, street vendors to register with local authorities, instead of registration courts, and removes the requirement for these vendors to comply with complicated book keeping standards.
3. Statistical information on joint stock companies in Macedonia is based on a census among 452 active joint stock companies in 2003. Although the survey did not distinguish between listed and non-listed joint stock companies, the large number of non-listed companies in the survey appear to dominate the findings of the survey. In addition, in the absence of stringent listing requirements in Macedonia and a rapidly decreasing population of listed companies due to tax legislation, a limited number of approximately twenty Macedonian “Blue Chips” resemble the status of a listed company. Those companies that were listed during the survey were listed due to tax legislation and were not subject to additional listing requirements or corporate governance requirements. As such, it may be assumed that the findings are representative for non-listed joint stock companies.
4. Data from the Corporate Governance and Company Law Project, results from the Private Sector Attitudes Baseline Survey (June 2003), which asked shareholders about the effectiveness of annual shareholder meetings. Of the 139 respondents who own shares, 78% stated they have not attended an annual shareholder meeting in the previous two years. Most (70%) stated they “were not getting the information they need to understand the duties and privileges of being a shareholder.” And, 88% stated they are interested in receiving this information.

On the positive side, among those respondents in the general survey who attended an annual shareholder meeting in the previous two years, two out of three reported they were provided financial information about the company at the meeting. About the same number reported that they voted during the annual meeting, either on appointing members to the board of directors and/or on accepting the annual financial report.
5. These refer to circumstances that the general meeting of shareholders should approve decisions according to international corporate governance standards.

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Chapter 14

MEXICO: CORPORATE GOVERNANCE PRACTICES*

by
Sam Podolsky**

Corporate governance practices of non-listed companies

This paper presents an overview of corporate governance practices in non-listed large (the first 100) companies in Mexico. We have divided these companies, based on their majority stock ownership, into two categories: companies owned by Mexican nationals and foreign owned companies.

1. Corporate governance in companies majority owned by Mexican nationals

A. Ownership

Close to 100% of these companies are either controlled by the founder family or by an acquirer, also family owned.

B. Composition of their board of directors

Less than 2% have more than eight principal board members. They are legally allowed to have a substitute member per principal board member. Principal and substitute members attend board meetings mostly at the same time.

The number of board members is directly related to the number of founders, and second and third generation family members; different stockholders (almost one per stockholder) who do not belong to the controlling family; and, in rare cases, financial stakeholders who have a representative board member.

C. Financial transparency

Mexican Law requires every board of directors to have a *Comisario* named by the Stockholders Assembly. The *Comisario* is responsible to the stockholders for his/her opinion on the accuracy of the financial statements of the corporation. There is no requisite for independence at the *Comisario* level. It is very common, and even expected, for companies of relevant size to have as the *Comisario* a representative member of their external auditing firm.

The applicable law on issues of transparency is the *Ley de Sociedades Mercantiles* (Corporate Mercantile Law), which is more than half a century old.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

** *Gobernanza Corporativa* – Mexico.

2. Corporate governance of companies in Mexico, majority owned by foreign corporate investors

A. Ownership

Foreign owned non-listed corporations do not have any different corporate governance law requirements than those applicable to Mexican family-owned businesses. By having invested in Mexico, foreign owned corporations are expected by law to comply as if they were Mexican.

B. Composition of their board of directors

Contrary to what would be expected – considering that the ownership of these corporations is also ruled by foreign corporate governance principles – foreign owned corporations do not apply corporate governance practices in their local investments at the board level.

Less than 3% have more than eight principal board members. Their board is formed by one or two corporate representative executives, local management, and external advisors. If Mexican investors exist, they normally have a representative member on the board.

External advisors who are members of the board are the only potential possibility for independence, if there is to be any independence at all. These boards of directors resemble more an advisory board concept.

Corporate representatives who are board members normally have additional fiduciary representation.

C. Local financial transparency

Foreign owned non-listed companies also have a *Comisario* on their board of directors and at their stockholder assembly. In almost 100% of the cases, their *Comisario* is a member of their external local auditing firm. These companies have no more transparency at the local level than comparable Mexican family-owned businesses.

3. The impact of corporate governance on non-listed corporations, as a result of the trend in Mexico to become a highly financially globalised economy

Within the last 20 years, Mexico has almost completely removed any barriers to foreign investment and imports of goods and services.

Key Mexican corporations became, and still are, a major target for foreign investment acquisitions. Many large, oligopolistic Mexican family-owned and controlled retail companies shifted to foreign ownership. Some good examples are: Cifra to WalMart, Home Mart to Home Depot, and Benavides drugstores to a Chilean group. The privately owned banking/financial sector is now mostly foreign owned (e.g. Banamex-Citibank, Bancomer-BBVA, Serfin-Santander, Bital-HSBC, Comermex-Scotiabank).

Some foreign acquisitions are being sold back to local nationals, too, as a result of unsuccessful ventures. Examples are Carrefour, recently re-sold to the Mexican Chedraui Supermarket Group, and Iusacell, the ex-Verizon and Vodaphone cellular venture in Mexico that was sold to the Mexican Salinas-Pliego group.

Globalised ownership trends and their corporate governance practices in Mexico have not yet had a noticeable impact with regard to the development of corporate governance practices locally. Companies

either adopt the way foreign corporations are managed at the board level, as previously presented, or they go back to the way Mexican family-owned corporations operate at the board level.

The impact of the Sarbanes-Oxley Act remains to be seen; most likely this will affect internal controls and business processes, but not any other corporate governance practice of importance.

4. The impact of global professional management practices on corporate governance practices of non-listed corporations in Mexico

There is a clear trend to shift from family members to key professionals. Exceptions still are the chair of the board of directors, board membership, and CEO positions. In these cases, it is now common to see “Ivy –League school” trained family members in these crucial positions.

State-of-the-art management is rapidly being integrated into the business culture of these corporations in Mexico. Corporate business ethics and local social responsibility are becoming more important issues in the “local advertisement” efforts of these firms, probably in order to comply with their family or with their parent company’s global image.

5. The impact of the privatisation of key government-owned corporations on corporate governance practices of non-listed corporations in Mexico

Ex-government-owned oligopolies and monopolies, which were privatised before the late 1990s, were sold to private investors, and then became family-owned or one-controlling partner oligopolistic or monopolistic corporations (examples are Telmex, the banking sector, the railroads, some airports, most highways).

When privatising companies in Mexico, the new trend of the government is to request IPOs and the obligation to list the companies on the Mexican Stock Exchange.

With the exception of privatised corporations that were listed, corporate governance practices, where implemented, follow the source of capital, but not at international standards.

In privatising, Mexico has not yet made important demands for the implementation of advanced state-of-the-art corporate governance practices.

6. The impact of risk or seed capital on Mexico’s corporate governance practices

Risk or seed capital is, unfortunately, almost non-existent in Mexico today, and it is highly difficult to obtain for new private ventures or for non-listed companies. There is no strong legal structure specifically designed to clearly and effectively protect risk or seed investors for new ventures from abuse.

Since 1995, credit for corporate financing has been almost null in Mexico. ADRs and the few listings of some Mexican family-owned corporations in the Mexican or US Stock market was mainly a move to meet a financial need due to a lack of credit, and should not necessarily be seen as representing a real alternative. Compliance with local corporate governance principles by these companies has not yet been legally and fully enforced.

As a result of the demands placed on corporate governance by the Sarbanes-Oxley Act, companies are now expected to become unlisted again, apparently for reasons of cost. A more definitive study on this subject is needed.

7. Corporate governance in Mexican non-listed companies: the near future

A new law for listed and key non-listed companies is being examined by the Mexican congress for approval. It is a very modern new law, formulated by the Mexican Ministry of Finance and pending final approval by congress. The law aims to enforce strict corporate governance principles, rules, obligations, and controls.

With respect to the non-listed corporate financial market, the new law makes it possible to create a new type of company called *Promotora de Inversión* or “PI” (Investment Promoter Corporation). The objective is to legally promote formal entrepreneurial efforts, for example by attracting risk and seed capital, and to encourage important family-owned businesses to adopt, at their will, a much more open and transparent approach. Among many other things, the new law demands full disclosure (legal governance, constituency, financial transparency, and partnership agreements).

While allowing PIs to adopt, at their own discretion, corporate governance rules, the new law also provides for a three-year period during which PIs can gain expertise before deciding to be listed in the Mexican stock market (many other additional requisites also need to be fulfilled).

With regard to today’s family-owned businesses, the main objective of the new law is to provide them with incentives to develop a much stronger financial investment market for non-listed companies.

8. Liabilities of stockholders

Every (100%) family-owned large company in Mexico is a limited liability corporation, which means that, in a worst case scenario, stockholders would only lose their investment, with no personal additional liability. The same applies to foreign owned non-listed companies.

9. Compliance

Compliance is more important than business practices at the board level. It is normal practice to have an official board meeting once a year, instead of bi-annual or quarterly meetings. It is also quite common to have a yearly stockholder assembly or meeting to comply with the requirements of the Mercantile Corporate Law. Quite often these meetings are only “paper meetings” and do not happen in reality. When more than one family owns a company, or there is more than one major stockholder, or if a financial stakeholder is represented at the board level, the company tends to function normally, and corporate governance transparency practices tend to be applied.

In conclusion

Mexico, as most countries today, has no legal corporate governance rulings specifically applicable to large non-listed companies. Financial disclosure, internal control, transparency, liability of management, fiduciary roles, and the rest of today’s corporate governance concerns are not yet fully addressed, either for listed or non-listed companies.

A new Mexican Stock Market Law has been submitted to the congress, which represents a tremendous step towards developing, implementing and enforcing a modern corporate governance concept. This new law, if approved as originally formulated and no major changes are made, will allow non-listed companies to voluntarily embrace and apply various corporate governance principles and other new practices to its business operations, management, and culture.

Chapter 15

MOROCCO: PUBLIC POLICY FRAMEWORK*

by

Amina Benjelloun**

A country's corporate governance framework includes institutions, rules and mechanisms set up to govern relationships between those who manage companies (insiders) and those who invest in those companies.

Often corporate governance is considered to be important for listed companies, which raise capital among external investors. In developing countries, including Morocco, economies are mostly made up of non-listed small and medium size companies (SMEs), held by families, the state or foreign companies whose shares are rarely traded on the local market.

In general, it has been proven that good corporate governance is essential for making economic development efforts successful. Corporate governance is all the more important as most developing countries are committed to ambitious reforms in which corporate governance plays a major role.

1. Moroccan corporate governance system: specificities and issues

The Moroccan economy is mainly made up of SMEs and family enterprises; to a smaller extent it also includes big state-owned or privately owned companies.

Indeed, SMEs represent 95% of Morocco's productive base and contribute very positively to job creation (more than 50% of private sector jobs) and to economic growth (40% of local production and 51% of local private investment).

Listed companies are very few (54 companies). The Moroccan capital market has small trading volumes and does not carry much weight in the national economy.

In general, the Moroccan economy shows strong ownership concentration, no split between ownership and control, and many cross holdings.

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

** *Chargée de Mission* for the Prime Minister of Morocco.

A. *Role of corporate governance in non-listed companies*

Good corporate governance should allow non-listed companies to achieve the following objectives:

- Obtain access to financing sources at lower cost, bearing in mind that external financing needs are growing while traditional financing sources are decreasing or drying up;
- Attract efficient human resources;
- Create a climate of trust among shareholders and dialogue among stakeholders (employees, clients, suppliers, creditors, administration); and
- Develop and consolidate competitiveness and investment growth.

Good corporate governance enhances a country's economy as a whole by directing financial resources efficiently towards sectors that contribute most to economic growth and by encouraging local and foreign investments.

Quality corporate governance is therefore a core challenge for developing economies and requires an efficient governance framework for listed as well as non-listed companies.

2. **Non-listed companies: jurisdictional and institutional environment in Morocco**

At present, Morocco has at its disposal many laws to govern its trade and financial environment. Most of these laws address, either explicitly or implicitly, corporate governance issues, including the implementation of specific instruments that play a main role in corporate governance, such as:

- A trade code that clarifies the definition of goodwill, regulates commercial contracts and organises bankruptcy and liquidation.
- Corporate laws, and in particular a law for joint stock companies that reinforces shareholder protection (especially for minority shareholders), clarifies responsibilities, introduces dual-administration with a management committee and a supervisory board, and lays down very demanding criteria for the selection of directors.
- A law on pricing and competition that establishes free entrepreneurship and access to markets and any economic activity. It ensures fair competition among economic players by restricting dominant position abuses and forbidding non-transparent commercial practice. The law also foresees the establishment of a national body in charge of competition oversight.
- Bilateral and multilateral free-trade agreements with many countries (*e.g.* European Union, the US, Turkey, and African and Arab countries) that give access to new markets and encourage Moroccan companies to adopt international standards.
- An investment charter, combined with less stringent currency exchange regulations, that provides tax incentives and reinforces the opening up of the national economy.
- A reform of laws for the banking sector that now restricts banks from financing their own shareholders or a same client (risk division coefficient) and puts in place more severe prudential rules, linking bank loan approvals to good corporate governance (transparency, performance...).
- New structures based on consultations and partnerships with operators to foster support for companies, such as regional investment centres, a national agency in charge of promoting the development of SMEs.

- Global or sector-based support funds to facilitate access to financial means for companies.
- Industrial property law that stimulates companies' development, in particular in areas of innovation and creativity.
- A new work code that clarifies relationships between employees and employers and gives better social visibility to local and foreign investors.
- Trade court law that is distinct from the former jurisdictional process, where courts had general competencies to address all cases; currently, trade cases fall under specialised jurisdictions.
- A public market code based on transparent and competitive invitations to tender, which is already being enforced.

3. Lessons for public policy

Public policy has an important role to play in the improvement of corporate governance in non-listed companies in Morocco. For example, public policy can help to:

- Launch an efficient awareness and communications campaign on the principles, behaviour and positive impacts of good corporate governance practices on competitiveness, with a focus on non-listed companies; circulate success stories based on good governance.
- Implement actively the existing legal and regulatory framework and, where necessary, reinforce it (*e.g.* the national body in charge of competition oversight set up in 2001 has not yet started to function). At the same time, information campaigns on the legal and regulatory framework could compensate for the lack of knowledge among operators.
- Promote greater transparency among non-listed companies thanks to the circulation of reliable financial statements:
 - Put in place greater incentives for companies to appoint advisors, auditors and accountants, as they also play a major role in internal decision making.
 - Set up a centralised balance sheet agency and circulate information by sector. The Moroccan central bank, with the assistance of the International Finance Corporation (IFC), has launched a study to develop an appropriate tool for facilitating access to the financial statements of companies.
- Improve company-business partnerships and stress the importance of good corporate governance practices in the jurisdictional system (especially trade courts) for the benefit of the economy as a whole (competence of judges, reactivity in case handling, etc.).
- Improve and simplify conditions for access to financing, for example by:
 - Changing company-bank relationships. Banks have a great role to play in meeting companies' financial needs and promoting good corporate governance practices. A long-term relationship between non-listed companies and banks based on mutual trust should be put in place. Banks should hence strengthen their assistance, advisory and coaching role, which would lead to greater involvement on their part and to better appraisal and follow-up of investment projects. Banks should also strengthen their internal rating systems in order to improve decision taking in terms of credit approvals and setting rates based on in-depth risk assessment. The regional office of the IFC is now conducting a study in Morocco to assist banks in setting up scoring-rating systems. To make such accurate risk appraisal possible, the financial statements of companies need to show greater transparency, and the banks themselves and their regional subsidiaries need to have better corporate governance practices.

- Developing venture capital. In addition to bringing in funds, venture capital brings in strategy, management and financing advice, with the final goal of creating value. Passing a new law that provides a regulatory framework and fiscal incentives for venture capital should be speeded up in Morocco. Some non-listed Moroccan companies have already opened up their capital to external financial shareholders (venture capital) and are setting up contracts or shareholder agreements. These agreements oversee the implementation of good corporate governance rules (*e.g.* concerning strategic decisions, appointment and departure of managers, transparency, protection of minority interests).
- Raise awareness regarding financial markets and their advantages: adopting good corporate governance principles can help non-listed companies to be listed on the stock market and benefit from other financing sources.
- Improve the dialogue between companies and the state, with the aim of minimising the informal sector and developing a competitive private sector.

Conclusion

Good corporate governance in non-listed companies is a major challenge for developing countries due to the predominant role that these companies play in their economies.

Good corporate governance represents a common challenge for governments and companies: for governments because of the economic and political reforms this entails, and for companies because of the efforts that they have to make to improve their management practices.

Good corporate governance requires good political governance and, conversely, achieving the objective of overall improvement for the country as a whole requires competitive companies, the basis for national economic growth.

Chapter 16

**VENEZUELA: PROMOTING A NATIONAL AGENDA BASED ON ETHICS,
TRANSPARENCY AND ACCOUNTABILITY***

by

Sonia de Paola de Gathmann **

Since our creation in 1957, almost 50 years ago, the *Asociación Venezolana de Ejecutivos* (AVE, Venezuelan Association of Executives (www.ave.org.ve)) has strived to be the national reference for best corporate and managerial practices, based on models specifically designed and adapted to our local realities.

Over the last few years, and despite the difficulties that we have been experiencing as a country, we have assumed the responsibility of delivering a message to the people, to our government, to the governments of our region (Andean and Latin American) and to the international community: the message is that the managerial sector in Venezuela is doing its share of analysis and evaluation of corporate practices for the development of the country.

We have been working to promote corporate governance, locally and internationally, through the AVE Corporate Governance Committee (www.ave.org.ve/comitegc), created with the commitment of our board of directors and with the participation of relevant sectors of our country – banking, small and medium size companies, large companies that quote their shares on the stock exchange, and also non-listed big family-owned companies.

Internationally, we participate in the Latin American Corporate Governance Round Tables, and have acted as the national interlocutor of CAF (Corporación Andina de Fomento, www.cafir.org) in the Corporate Governance for the Andean Region project.

Locally, as members of the National Network of Competitiveness (CONAPRI - *Comisión Nacional para la Promoción de Inversiones*, www.conapri.org) we have led the corporate governance effort, and have called on the acting parties and made inter-institutional alliances to promote the subject. At the same time, through the AVE Committee, we have collected and examined documents (www.ave.org.ve/gobiernocorporativo) related to the current Venezuelan norms that are applicable to the principles of corporate governance as defined by the OECD.

As members of the Assessment Council of the National Securities Commission (www.cnv.gov.ve), which was set up to strengthen capital markets, we participated in the process that resulted in an

* The views in this paper are those of the author and do not reflect the views of the OECD or its Member countries.

** General Manager of the *Asociación Venezolana de Ejecutivos* (AVE).

agreement of self-regulation by the issuing entities with regard to corporate governance, made formal in the Venezuelan official gazette (www.tsj.gov.ve) No. 327286 of 17 February 2005.

While all this activity has been developed in a context that focuses mainly on listed companies, we are well aware that our market is mainly constituted by non-listed companies: SMEs (small and medium size companies) and also large non-listed companies.

We are convinced of the need to develop efficient and useful tools for introducing good governance practices in these companies, so as to increase their competitiveness, reduce operational risks, better respond to globalisation challenges, obtain financing sources at lower costs and, as a result, improve local competitiveness.

The SME sector constitutes 95% of the Venezuelan market and 90% of the country's industry, and is one of the main generators of employment in the country.

That is why, together with the *Confederación Venezolana de Industriales* (CONINDUSTRIA, www.conindustria.com), which represents the SME sector in Venezuela, we are taking this initiative with a clear objective in mind: bringing the corporate governance issue to the whole SME sector and carrying out the first national assessment of corporate governance in Venezuela.

We pay attention also to large non-listed companies, given the unquestionable importance of their participation in local business and development, and also their capacity to serve as models for the rest of the economy.

In the *Asociación Venezolana de Ejecutivos*, we are convinced that corporate governance not only increases the value of capital markets where large companies act, but also models the exchange system in which small and medium size companies play an important role – after all, they represent over 90% of the business community in Venezuela.

For us at AVE, every organisation or company, whether big, medium or small, public or private, profit or non-profit, all will be more competitive to the extent that they adopt good corporate governance practices.

Introduction

Venezuela and the local and regional context

It is no secret that Venezuela has suffered one of the greatest institutional and social crises of its history. The last five years have shown a decline of the Venezuelan economic sector due to an investment environment with high risk and local and foreign investors with little reliability.

Under these conditions, it could be supposed that an issue such as corporate governance would have little importance and not be considered one of the country's priorities. However, in an increasingly global world, it is essential not to overlook issues such as corporate governance, as this is very important for the integration of Venezuela into the global economy.

At the same time, the business community is showing an increasing interest in everything related to corporate governance as a means for strengthening and promoting the growth of their businesses. This is why, at the *Asociación Venezolana de Ejecutivos*, we think it is important to follow the global impetus given to corporate governance and see this as an opportunity to introduce corporate governance into the Venezuelan context and adapt it to our country's specific needs.

We can say that the main challenge facing the leadership of the countries in Latin America, particularly Venezuela, is the design of an economic policy with long-term objectives, previously agreed between the different sectors and parties of society. One of those objectives is adapting our markets to the international requirements and standards accepted today in order to achieve greater global competitiveness of our local market.

However, even when it is recognised that applying good corporate governance is important for developing the markets and strengthening the capacity of a country, many companies, mainly the Latin American ones, resist promoting information disclosure and transparency, and also resist the independence of directors and the protection of minority shareholders, offering them equal treatment and allowing them to participate actively in the management of the company.

In addition, the high percentage of family-owned businesses (small, medium and big) in the region does not contribute to the diffusion of good corporate governance practices, since many of these businesses might feel that they would have to disclose confidential information and lose the autonomy of their management.

We believe that one of the main reasons for the resistance of markets to corporate governance is lack of information and little comprehension of the benefits that the companies would obtain from good corporate governance practices.

The majority of studies and initiatives regarding corporate governance have focused on listed companies with capital open to public investment. However, the great majority of Latin American companies, including those in Venezuela, are small and medium size companies which, according to recent data from the International Labour Organization, created 98% of employment in 2003.

Good corporate governance is necessary – and in many cases essential – not only for large listed companies, but also for the others which constitute the corporate sector and represent over 90% of the companies of the region. While the great majority of these are small and medium size family businesses, the big family businesses with closed capital should also be mentioned, as they occupy a big space in our region, and play an important role in local business transactions and in local communities.

Taking all this into account, we consider that the approach to corporate governance should be extensive, and focused on informing small and medium, as well as large, companies about the benefits that the application of good corporate governance brings for increasing corporate growth and strength.

Corporate Governance in Venezuela

Up until now, corporate governance has been developed and treated in Venezuela through common legal mechanisms, such as laws, ordinances and rulings.

The Asociación Venezolana de Ejecutivos (AVE) has made an inventory of the legal norms in force in the country applicable to corporate governance, which constitutes a set of laws that more or less cover the principles of good corporate governance as defined by the OECD.

The AVE Corporate Governance Committee, which was constituted to promote and develop corporate governance in Venezuela, is carrying out the task of collecting and disseminating information on the issue. The Committee has the commitment and active participation of the board of directors of AVE, as well as of representatives of the different sectors of the business community in our country: banking, the service industry, small and medium size companies, big companies that quote their shares in the capital markets and also large non-listed family-owned companies.

Through the Committee, we have involved different parties and created inter-institutional alliances to promote corporate governance.

As a member of the National Competitiveness Network, where public and private sector players interact, we are heading the corporate governance project with the firm belief that good corporate governance has a direct impact on business plans and on the competitive position of institutions that adopt corporate governance principles.

The call for adopting good governance practices has led to joint action by multilaterals, regulating instances, issuing agents, securities markets operators, unions, and institutions of the different economic sectors, both public and private.

Corporate governance norms have been approved based on agreements between the issuers and regulators, such as the proposal submitted by the Venezuelan Association of Securities Issuers (*Asociación Venezolana de Emisores de Valores*, AVESEVAL) to the CNV (National Securities Commission). This proposal, which concerns corporate governance principles, refers to independent directors and criteria for their selection, as well as the establishment and functioning of an audits committee.

Internationally, and as a member of the Latin American Corporate Governance Network, we participated in the Latin American Corporate Governance Round Tables. At the local level, we provided support for the Guidelines for an Andean Corporate Governance Code, incorporating the institutional synergy of the Venezuelan Corporate Council of Audits (*Consejo Empresarial Venezolano de Auditoría*, CEVA).

From the positive exchange that was possible internationally through the Latin American Round Tables, one of the main lessons learned was that principles of good governance are not, and cannot be, a strait jacket, that they must be adapted to each region, according to its particular characteristics. Therefore, it is necessary to develop approaches for dealing with issues such as corporate governance for state-owned companies and, most of all, for small and medium size industry and family-owned businesses, which dominate in Latin America, and in the majority of emerging economies.

Our Association is fully aware of this reality, which is reflected in the work of our Corporate Governance Committee:

“...in the AVE Corporate Governance Committee we permanently monitor local and international developments in corporate governance, and through all of our members we act as articulators and promoters of initiatives [in this area]...Corporate governance concerns not only open capital or public companies, but all kinds of companies, due to its unquestionable benefits in terms of competitiveness and creation of higher value...and because it generates confidence.”

Pedro I. Sosa Mendoza
Director and Legal Advisor of the Board of Directors of AVE
Coordinator of AVE Corporate Governance Committee

The coordinator of our Corporate Governance Committee tells us that “corporate governance generates confidence”, and confidence is a transversal element in the economy.

For us at AVE, corporate governance is ***inclusion, co-operation and competitiveness*** and, as we have stated before, it is necessary, even mandatory, not only for large companies acting in capital markets, but also for the rest of the companies of the corporate sector because:

- They must act as business partners with large companies.
- They obtain financing from the banking sector, which is subject to very specific rules relating to corporate governance, and which increasingly sets conditions of “good governance” for the recipients of their funds.
- Good governance practices encourage the formalisation of administrative and/or family protocols that will support the professionalism and sustainability of business in the long term.
- They generate employment and help reduce poverty, which is a critical problem in our Latin American region.
- The exercise of good corporate governance increases the value of companies in terms of their competitive positions and therefore increases the competitiveness of the country.

1. Local parties talk

A. *The regulator*

Comisión Nacional de Valores (CNV, National Securities Commission): “We accompany the AVE in their effort to bring corporate governance practices to non-listed companies: a country needs to build reliability and this is achieved not only through public companies traded in the capital market ... it is achieved through the totality of its companies.”

Aída Lamus
President CNV 1995-2005 (www.cnv.gov.ve)
AVE Forum: Let`s talk about corporate governance
Caracas, December 2004

B. *The issuer*

Asociación Venezolana Emisores de Valores (AVESEVAL, Venezuelan Association of Securities Issuers): “The practices proposed by corporate governance tend to benefit all the shareholders, those who purchase in the stock exchange, as well as those who represent small groups with participation in a company, or even members of a family.”

Francisco Palma,
Director AVESEVAL
AVE Forum: Let`s talk about corporate governance
Caracas, December 2004

C. *The operator*

Bolsa de Valores de Caracas (BVC, Caracas Stock Exchange): “One of the critical problems facing Venezuela is the lack of investments...and the lack of transparency, although this is not the only obstacle hindering investments...in this matter, the adoption of corporate governance practices may be a significant contribution...”

Nelson Ortiz
President BVC
(www.caracasstock.org)

D. The promoter

Comisión Nacional para la Promoción de Inversiones (CONAPRI, National Commission for the Promotion of Investments): “In Venezuela, the capital market is small in comparison to the size of the economy, and, during the last years, investments have been reduced...for this reason, good corporate governance has an important role to play now in encouraging and strengthening the markets, and in promoting investments...”

Dinorah Singer
Investment Promotion Manager CONAPRI
(www.conarpi.org)
AVE Forum: Let`s talk about corporate governance
Caracas, December 2004

E. The SME

Confederación Venezolana de Industriales (CONINDUSTRIA, Venezuelan Federation of Industries) “...95% of the industrial sector in Venezuela is represented by small and medium size industry...we, as the federation representing the country`s industrial chambers (90% of the sector), have decided to join AVE in the effort to integrate corporate governance into the whole company, and to jointly create spaces for discussion throughout the country, as well as to support the development of local quality standards for SMEs as motivation for taking the path of rational management and competitiveness proposed by corporate governance.”

Juan Francisco Mejía
Executive President of CONINDUSTRIA (www.conindustria.org)
AVE Forum: Let`s talk about corporate governance
Caracas, December 2004

F. The workers

Internacional Labour Organization “... 98% of the work opportunities in Latin America during the year 2003 were generated by SMEs...and 100% of the new companies created in the same period were small and medium [size companies]...”

ILO Report 2003

The corporate and business world in Latin America has peculiarities which in some cases may be difficult to understand: the capital structure theories do not always function as expected; our financial markets are not sufficiently developed; there is not always access to the funds and financing methods that are necessary for financing development, growth and new projects.

In these “imperfect markets”, the relation between the adoption of good corporate governance practices and the value they add to the companies is not immediate; even, in many cases, the perception may be exactly the inverse: having appropriate corporate governance may be “expensive” for the company.

This helps to explain why many companies in our region are reluctant to get involved in corporate governance. As we previously said, this resistance is due to a lack of information, which means that we should focus less on listed companies and more on the wide range of non-listed companies that participate in our economies.

The approaches used for introducing corporate governance practices into this sector must be different, as this requires that these practices be adopted in less-developed markets which have not enough long-term financing options and in which property is highly concentrated.

2. Non-listed companies

A. SMEs: small and medium size companies

There are few large companies not only in the stock exchange but also in the country as a whole, while SMEs have the greatest share of the corporate world.

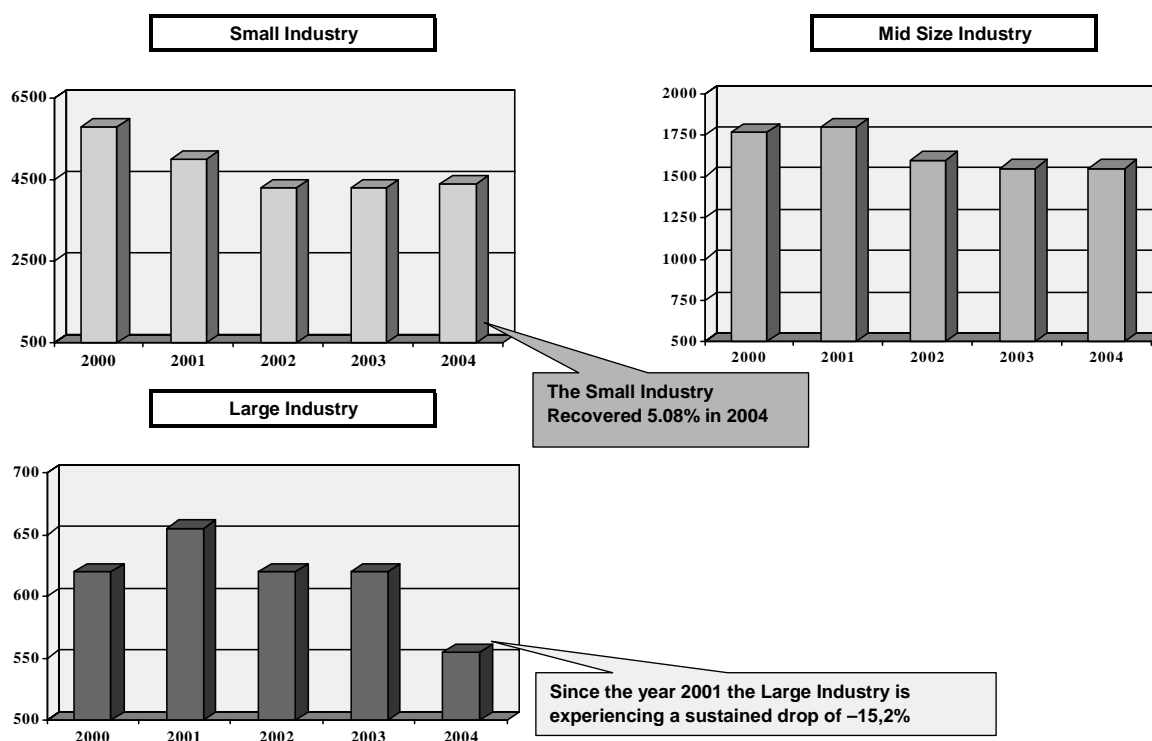
During the period 2000 to 2004, while big industry shows a sustained drop, small industry shows a recovery of 5% during 2004, and medium size industry retains its participation share (see Figures 1 and 2).

All the SMEs are linked to the production system and are a part of the competitive system of the big companies. Although each company has its own characteristics, the association between them (big, medium and small companies) brings competitiveness to the country and its economy (see Figure 3).

In this manner, the SME sector brings productivity and diversification to industries and services and, at the same time, is a significant generator of employment and job opportunities (see Figure 4).

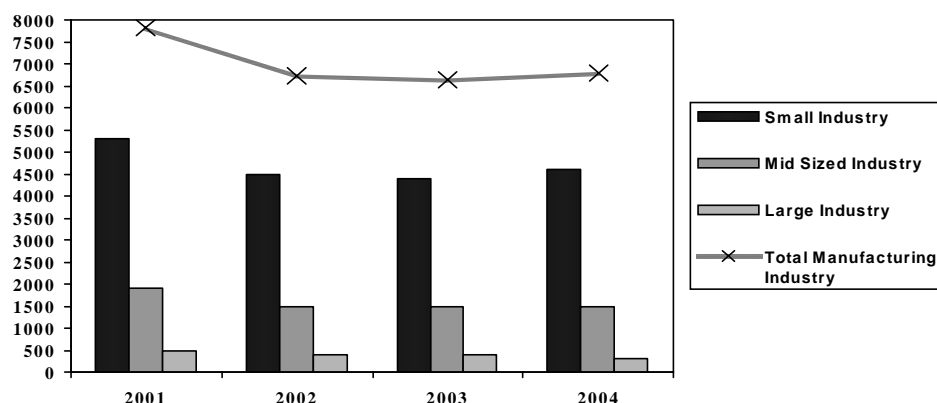
Therefore, everything oriented towards improving the productivity, performance, competitiveness and development of SMEs is not only desirable but also necessary.

Figure 16.1 Sector evolution 2000-2004



Source: *Conindustria*. Industrial Directory 2004 (National Institute of Statistics), February 2005.

Figure 16.2 Comparison of total of business establishments by industrial sector



Source: Conindustria, Industrial Directory 2004 (National Institute of Statistics), February 2005.

Figure 16.3 Total distribution of business establishments

Year	Total Manufacturing Industry	Large Industry More than 100	Mid Sized Industry 51 to 100	Mid Sized Industry 21 to 50	Small Industry 05 to 20
1996	12.771	766	561	1.964	9.46
1997	11.64	847	518	1.771	8.499
1998	11.117	765	467	1.934	7.951
1999	11.198	6323	486	1.832	8.157
2000	8.431	638	437	1.389	5.973
2001	7.831	665	506	1.384	5.276
2002	6.702	631	476	1.228	4.455
2003	6.623	627	451	1.169	4.376
2004	6.787	564	437	1.19	4.596

Source: Conindustria, Industrial Directory 2004 (National Institute of Statistics), February 2005.

Figure 16.4 Employment distribution

Year	Total Manufacturing Industry	Large Industry More than 100	Mid Sized Industry 51 to 100	Mid Sized Industry 21 to 50	Small Industry 05 to 20
1996	469.372	257.176	40.544	67.064	104.588
1997	464.857	275.048	38.038	60.808	90.965
1998	449.636	254.873	33.907	66.977	93.879
1999	419.956	230.699	36.187	63.044	91.126
2000	369.801	216.239	36.076	60.208	67.278
2001	357.372	223.609	36.043	44.916	52.804
2002	320.194	201.82	33.042	39.092	46.24
2003 (*)	288.338	208.297	33.296	39.44	46.803
2004 (*)	295.477	187.368	32.263	40.148	49.156

Source: Conindustria. Industrial Directory 2004 (National Institute of Statistics), February 2005.

The *SME* sector is searching strategic associations in order to move forward in the internationalisation process. It has understood the need for broadening its information, presenting its financial statements and implementing mechanisms that are clearer and more transparent with regard to its administrative management and the management of its board of directors.

The sector must also work with the financial system, which is its main financing mechanism and which constantly “encourages” its clients to use good corporate governance practices.

It is also possible to identify a significant number of medium size companies that could attract investments and, therefore, are thinking of attracting capital from sources that are different from the financial sector. These companies may start thinking of participating in capital markets, and corporate governance has turned into a first level tool for increasing the competitiveness of these companies. For them, corporate governance is the path they should follow in order to become better companies and have greater success in their participation in capital markets.

B. The family-owned SME

It should be mentioned that besides their size, SMEs share another characteristic which is both a challenge and an opportunity for the development of good corporate governance: their family ownership structure and, therefore, their concentrated equity structure.

Half of the ownership of Venezuelan SMEs is concentrated in the hands of members of the same family: “56% of the companies are integrated by an individual shareholder or a partner, only 14% have three or five partners and the remaining 30% only have two partners” (INSOTEV industrial sector poll).

Having a family structure is not only an important feature for the company’s management, requiring a “family protocol” to manage the family-company relationship, it also determines how the business will be financed.

Corporate governance can provide invaluable support in all these areas: helping to establish protocols for managing the company-family relationship, promoting the professionalism of management and the value of having external directors, as well as transparency and reliability, which give greater recognition to these companies and improve the perception that the business community in which they operate has of them. Eventually, this will make these companies into a valid option for obtaining development capital through external investment, and even enable them to participate in capital markets.

Corporate governance can also contribute positively to family-owned companies in terms of succession issues. Statistics show that the inability to solve succession dilemmas is the determining factor why only 15% of all family-owned companies (including big, medium and small ones) reach the third generation. In Venezuela, as well as in Latin America and in the majority of emerging economies, family businesses are very important, no matter if these are big companies or small retail businesses. However, 70% of these do not surpass the third generation and from the remaining 30%, only 50% reach the third generation. As family-owned companies are very important in these economies, it is essential to ensure their sustainability and growth over time, and in this aspect corporate governance may have an important contribution to make.

In Venezuela, the Asociación Venezolana de Ejecutivos has assumed the challenge of promoting corporate governance not only for companies quoted in the stock exchange, but also for all companies interested in improving their competitiveness.

CONINDUSTRIA, the main entity representing 95% of Venezuela’s industrial sector, has joined AVE in this effort to introduce corporate governance in order to ensure the success of corporate management dynamics.

It is the beginning of a process that will help to improve transparency, management practices, disclosure and accountability, and therefore improve competitiveness.

Encouraging SMEs to accept external guidance to improve their management practices has not been easy. However, this can be done, and CONINDUSTRIA has made a significant contribution to this alliance and to the corporate governance effort through its *CONINPYME* programme (www.coninpyme.com) for implementing quality management practices

In order to bring corporate governance to the entire SME sector, our goal is to move forward with the creation of specific principles for SMEs and carrying out the first national diagnosis of corporate governance for SMEs. Then we can start thinking about developing a quality “standard” for proper SME governance and incite SMEs to take the path of rational management and competitiveness.

Note: For more information on SMEs in Venezuela, a valuable and updated reference, which was used as a bibliography for the preparation of this document, is the SME Observatory-Venezuela, Inter-American Development Bank, Sustainable Development Department.

C. Large companies

When we took a look at the SME sector, we found both qualitative and quantitative information about its structure and behaviour. This is a sector with governmental policies oriented towards financing, technological development, labour and business training, export management and development, production, etc.

This is not always the case with large non-listed companies.

Here it is necessary to distinguish between two different groups of companies: large state-owned companies and large private companies that voluntarily keep their capital stock closed.

In the case of state-owned enterprises (SOEs) in Venezuela, we may mention the gas companies, the mining and metallurgic companies, such as ALCASA and VENALUM, some companies in the electric power sector, such as CADAFE, and, of course, Petróleos de Venezuela (PDVSA), which is a special case due to the sensitivity surrounding matters related to the oil sector in our country.

For this group, the tendency to adopt or not to adopt corporate governance practices has much to do with the public policy context and the strategic interests defined for each sector.

However, we firmly believe that in any case corporate governance adds value in terms of transparency, reliability, credibility, elements always necessary for the success of governmental policies.

Also, it increases competitiveness, which will lead to a better perception of the “country label” as a whole:

“...It is not only about transparency, professionalism, incorporation of external directors...it is also about having access to capital...capital markets are an excellent financing source; less expensive and secure...and the participation of this large company shall contribute to our emerging markets, making them stronger and larger...more attractive, more competitive...”

Aída Lamus,
President Nacional Securities Comisión (Comisión Nacional de Valores) 1995-2005

On the other hand, there are large private companies, in most cases family-owned, which have restricted capital stock owned by a limited group of shareholders, generally members of the same family. Although these companies may participate in capital markets by issuing bonds, they do not issue shares.

In this group, the motivation for adopting corporate governance practices is associated with the perception that the companies have of the value that this type of approach may add to their business. This could include specific incentives that encourage the decision to issue shares as a financing source; then, the incorporation of these companies into the capital market could contribute to the development of local and regional capital markets.

According to recent studies by McKinsey, the main challenge for large Latin American family-owned companies is to compete with corporations that act globally in the region. Like SMEs, they will need to adjust their strategies and implement more professional management models in order to avoid that family problems turn into business problems.

In practice, family-owned companies are usually viewed cautiously in developed markets, fearing that their administration pays more attention to the owners' interests than to those of the company.

However, in less developed markets, such as ours, these may be valid investment alternatives if they are successful and are able to establish adequate management boards.

Again, all these aspects related to family protocols, professionalism of management and the board of directors, succession protocols and monitoring mechanisms, disclosure and management accountability, etc. are areas where corporate governance can be very useful, contributing to the success of these companies, to which are added the intrinsic strengths of family-owned models:

- historical proximity and experience in local environments;
- capacity to adapt to changes in those environments;
- structure that provides for rapid decision-making, a vital aspect in our unstable regions;
- loyalty of their employees, based on traditions and shared values; and
- commitment to regional realities, which favours communication and interaction with local governments.

“...I have no doubt that corporate governance is useful for the large private company... not only for the professionalism of management and the incorporation of directors, managers and employees who, not being members of the family, are focused on the business's growth instead of the capital remuneration received by the shareholder...but it is also essential to have access to capital markets, either directly or indirectly.

I strongly believe that the systematic and serious exercise of corporate governance will turn large family-owned companies into an extraordinary alternative for attracting international partners, who shall find in these companies, with their background, understanding and adaptability to the local environment, the clarity and access to information they need in order to take the financial risk of investing in our countries.”

Juan Simón Mendoza Giménez
First Vice President of AVE
Founding member of the Corporate Governance Committee of AVE
Executive Director of *Empresas Polar*
(www.empresas-polar.com)

The above statements are made by the executive director of the country's main private industrial group, market leader in Venezuela and Colombia, with successful operations in five other Latin American countries, and acting in strategic partnerships with multinational corporations.

Founded in 1941, *Empresas Polar* today has 28 industrial plants and 150 000 commercial points in Venezuela alone, and has generated 19 000 jobs directly and more than 150 000 jobs indirectly.

During the year 2004, it contributed 2.9% of the non-oil fiscal income to the local economy and 1.4% to the country's labour force.

It is a Venezuelan company with 100% private capital, which is non-listed but participates in capital markets by issuing bonds.

Eventually, large family-owned companies will need access to capital markets as a valid financing alternative, whether directly by issuing shares or by trading commercial papers, and attracting investment partners. In any case, and given the different alternatives offered to investors, corporate governance adds value to the competitive position of any company, making it into a better option.

In conclusion, let us consider that the capital market in Venezuela is not developed enough to encourage a generalised adoption of corporate governance practices by the business community, in any case not on the terms under which these practices were adopted by those participating in capital markets and reinforced through special norms.

Because of this circumstance, we are convinced that promoting the adoption and exercise of corporate governance practices within the framework of non-listed companies shall have a very important effect on the economy and, more generally, on the way business is done in Venezuela.

ANNEX 1

IFC METHODOLOGY

Commitment to Good Corporate Governance

1. **Ownership structure.** Please provide a chart setting out the important shareholdings, holding companies, affiliates and subsidiaries of the company, indicating *ultimate beneficial* ownership and percentages of shares held by each.
2. **Governance structure.** Please provide a chart setting out the governance structure of the company, indicating the principal organs of the company's governance and to whom each reports (including the Shareholders Meetings, the Board of Directors, any Board committees, senior management, internal audit, external audit and principal management units).
3. **Major transactions and material events.** Please provide a timeline of major transactions and material events for the past five years (in particular, corporate acquisitions, mergers, restructurings and sales or purchases of major assets, etc.).
4. **Organic documents.** Please provide an English translation of the company's charter and other organic documents.
5. **Policies relating to corporate governance.** What written policies, codes or manuals have been elaborated that set out the company's approach to governance, the respective roles, responsibilities and composition of the Board, disclosure and transparency practices, and treatment of minority shareholders? Please provide IFC with English translations.
6. **Corporate events calendar.** Does the senior management and the Board approve an annual calendar of corporate events, including Shareholders Meetings and meetings of the Board of Directors?
7. **Company corporate governance code.** Does the company have a Corporate Governance Code (or "Policy" or "Guidelines") that outlines the governance practices of the company and, in particular, the role of the Board? What are the company's procedures for monitoring its compliance with the Corporate Governance code?
8. **Country corporate governance code.** Are the board and the senior management familiar with the voluntary code of corporate governance for the country (if such code exists)? Does the company comply with all those provisions of the code that are applicable to unlisted companies? Are there any explanations where it doesn't?
9. **Code of Ethics.** Does the company have a code of ethics? Please provide IFC with an English translation. What employees are subject to it? How are the company's ethical precepts communicated to employees? How is compliance overseen and enforced?

10. **Compliance responsibility.** Is a Board member or senior manager explicitly charged with responsibility for ensuring that the company complies with the law, its charter and its policies regarding corporate governance (i.e. the role of the Board, transparency and disclosure, treatment of shareholders), and code of ethics?
11. **Shareholders agreements.** Please provide details and translations of any shareholders' agreements or other informal arrangements among all or some shareholders.
12. **Succession planning.** What has been the history of succession of the chief executive officer? Does the company have a *written* policy concerning succession planning? How much longer does the current chief executive intend to remain in this position? Has a successor been identified and agreed upon by the family?
13. **Family tree and share ownership.** Please provide a family tree and accompanying explanation indicating the name, residence, occupation, birth-date and share ownership of each family member. Which family members are currently employed or are likely to be employed by the company or its subsidiaries in the foreseeable future? Which generation of the family has effective control of the company (founder, siblings, cousins, or later generations)?
14. **Family shareholding blocs.** Is there an informal arrangement or formal shareholders' agreement that aggregates the family members' shareholdings into one or more shareholding blocs? Are the family's shareholdings owned by intermediary entities, such as one or more family trusts, foundations or holding companies, or do individual family members own the shares separately?
15. **Family/non-family senior management.** Which members of the senior management are members of the controlling family and which are non-family managers?
16. **Family-member employment.** Does the company have a *written* policy concerning family-member employment and related human resources issues, such as recruitment, promotion and employment-termination for family members?
17. **The next generation.** Is it expected that management will continue in the next generation of the family when the current generation reaches retirement? Does the family have plans for how the next generation of the family will be prepared for working in the company? How will family members be selected to work in the company or will all family members have the right to work in the company?
18. **Non-family share ownership.** Does the company have a *written* policy concerning non-family share ownership?
19. **IPO readiness.** In terms of governance practices, is the company close enough to best practices among listed companies to qualify to make an IPO or, at least, access the public debt markets?

Structure and Functioning of the Board of Directors

1. **Establishment of a Board of Directors.** Does the company have a Board of Directors, which meets according to a regular schedule? What has been the company's historical experience with its Board of Directors? When was the Board established? How often does it meet?
2. **Board policies.** Please provide English translations of any policies or by-laws relating to the Board of Directors.
3. **Agenda and minutes.** Is an agenda prepared and distributed in advance of Board meetings? Are minutes prepared and approved after the Board meetings?
4. **Current Board membership.** Please provide a list of the current members of the Board with summary CVs indicating, at a minimum, their affiliations with the company, management and controlling shareholders, and other companies on which such persons sit as Board members.
5. **Composition of the Board.** As a practical matter, how is the composition of the Board of Directors determined? Are there any shareholder agreements or provisions of the company's charter that specify which shareholders appoint directors? Are there any informal understandings?
6. **Non-family and "independent" Board members.** Does the Board include non-family members? Are these non-family members "independent" of the controlling family, of other significant shareholders and of the senior management? (See IFC model definition of "independent".) Who are the independent members of the Board of Directors and how were they selected? What compensation do independent (and other) directors receive for their services?
7. **Skill mix.** What sorts of business and other experience are represented on the Board? What efforts are made to ensure an appropriate mix of skills and experience among Board members?
8. **Functioning of the Board.** Does the Board of Directors serve the classic functions of a Board (providing guidance to and monitoring the performance of the senior management for the benefit of all shareholders) or is the Board's primary function to act as a meeting of shareholders or a meeting of senior family members?
9. **The Board and the management team.** Are senior managers members of the Board or do they, in any case, routinely attend Board meetings? What is understood as the role of the Board vis-à-vis management, particularly with respect to the following?
 - Setting strategy and vision of the company;
 - Selection of CEO and senior management;
 - Oversight of internal controls, external audit and preparation of financial statements;
 - Major capital expenditures and large-value transactions; and
 - Human resources policy.

10. **Audit and other standing committees.** Does the Board of Directors have an audit committee or other standing committees, such as nomination, compensation or conflicts of interest? How are these committees established? Do they have written terms of reference? Who sits on them, and how do they function?
11. **Conflicts of interest and related party transactions.** Does the company have any special rules and procedures regarding Board review of transactions that involve conflicts of interest and related parties? Please provide a summary of these rules and procedures and a table of related party transactions reviewed by the Board or committees of the Board over the past three years.
12. **Board evaluation.** Does the Board conduct self-evaluations or other reviews of its effectiveness? How are such reviews conducted and with what frequency?
13. **The Board and the family.** What is understood as the role of the Board vis-à-vis the family?
14. **Advisory Board.** If the Board does not include outside members, or if no Board exists, does the company have an Advisory Board of independent professionals that is consulted on a regular basis? If such Advisory Board exists, who are its members and how were they selected?

Internal Control Environment; Transparency and Disclosure

1. **Internal audit and internal controls.** Please describe the company's internal controls and internal audit process. Does an independent external auditor review this system periodically? Does the company possess an internal audit function? How is it organized and to whom does it report? Is the internal auditor responsible for testing the company program for compliance with laws and regulations and company policy? Does the external auditor report on the adequacy of the company's system of internal controls?
2. **Information dissemination.** Please summarize the company's policies and practices with respect to the preparation and dissemination of periodic financial and non-financial information about the company. Who in the company is responsible for the preparation and approval of this information? Do lenders and outside shareholders receive this information? What are the company's policies with respect to dissemination of information concerning occasional material events?
3. **External audit and external auditors.** Are the annual financial statements audited by independent external auditors and approved by the shareholders' meeting? How are the external auditors selected? To whom, in form and in practice, are the external auditors responsible? Is it the company's policy to rotate the external auditors? Is the external auditor a recognized accounting firm? Who, in the company, has access to the working papers and management letters ("deficiency letters" or "recommendation letters") prepared by the external auditors?
4. **Financial reports.** How often does the company prepare financial reports (quarterly, biannually, or annually)? Are these reports approved by the board?
5. **Shareholders agreements.** Are shareholders' agreements with or among the controlling shareholders disclosed to all shareholders? Are shareholders' agreements registered with the securities regulator?

6. **Disclosure to interested parties.** How does the company ensure that all financial stakeholders of the same class (e.g. the controlling family, minority shareholders and lenders) are treated equally with respect to financial statements and other information on the company and have equal access to the same sets of accounts? How does the company ensure equitable treatment of all shareholders in the release of financial and non-financial information, including company strategy?

Treatment of Minority Shareholders

1. **Ultimate beneficial ownership.** Does the company keep a record of *ultimate beneficial* owners of all shareholdings, which is disclosed to all shareholders?
2. **Differentiated classes of equity and quasi-equity securities.** Please outline the principal terms of, and differences in voting rights and cash flow rights between the company's various classes of equity and quasi-equity securities. Are there any "founder shares"? What are the characteristics of these?
3. **Shareholders Meetings.** Does the company have an Annual General Shareholders Meeting? If so, please provide a timetable for the annual meeting. When is the agenda provided? Are all shareholders provided with all material information in advance of shareholders' meetings? How can minority shareholders add items to the agenda? Under what circumstances does the company hold Extraordinary Shareholders Meetings?
4. **Attendance and results of Shareholders Meetings.** Please provide a summary of the attendance and results of all Shareholders Meetings (annual and extraordinary) for the past three years, including the shareholders represented, agenda items and record of votes.
5. **Related party transactions.** Please provide a table of related party transactions and other operations of the company that required shareholder approval over the past three years.
6. **Changes of control.** What would be the treatment of minority shareholders in the event of a change of control of the company? Are there tag-along rights for minority shareholders that require the new controller to make an offer to purchase their shares at the same price and conditions?
7. **Minority shareholder nomination of Board members.** What mechanisms, if any, permit minority shareholders to nominate members of the Board (cumulative voting, block voting, etc.)? Have such rights been exercised in the past?
8. **Special voting procedures.** Are there any types of transaction or events that require some sort of special voting procedures (such as supermajority approval by the shareholders, or majority vote of minority shareholders)?
9. **Transfer of shares.** What are the company's policies with respect to the sale and transfer of shares, either by the family shareholders or by the minority shareholders?
10. **Family Council.** Are there formal or informal mechanisms for coordinating the participation of family-member shareholders in the governance of the company? If the number of family members is large or if a substantial proportion of the family members are not working in the business, has a Family Council been established?

CORPORATE GOVERNANCE PROGRESSION MATRIX FOR FOUNDER/FAMILY – OWNED (UNLISTED) COMPANIES

ATTRIBUTES	LEVEL 1 <i>Understanding the need to professionalize the Company</i>	LEVEL 2 <i>First concrete steps toward best practices</i>	LEVEL 3 <i>Implementation of best practices</i>	LEVEL 4 <i>Leadership</i>
<p>A. COMMITMENT TO CORPORATE GOVERNANCE</p>	<ul style="list-style-type: none"> - The basic formalities of corporate governance are in place including: <ul style="list-style-type: none"> - Board of Directors; - Annual Shareholders' meeting; - Shareholders and shareowners identified and recorded. - Board member or high-level company executive explicitly charged with responsibility for improving corporate governance practices. 	<ul style="list-style-type: none"> - Written policies established addressing key elements in family firm governance: <ul style="list-style-type: none"> - Succession planning ; - Human resources and family-member employment; - Non-family-member share ownership. - Management/Board approves annual calendar of corporate events. 	<ul style="list-style-type: none"> - Corporate Governance policy covers: <ul style="list-style-type: none"> - Role of Board vis-à-vis management; - Long-term planning for corporate governance of company commensurate with business plan. 	<ul style="list-style-type: none"> - Applicable corporate governance, accounting, auditing and internal controls, and shareholder information practices are equivalent to those in place at best practice public companies (i.e. little would need to be done to qualify to make a public offering). - Company fully complies or explains any deviations from all applicable provisions of voluntary code of best practices of the country (some elements of which may be applicable only to public companies).
<p>B. STRUCTURE AND FUNCTIONING OF THE BOARD OF DIRECTORS</p>	<ul style="list-style-type: none"> - Board of Directors constituted and meets periodically. 	<ul style="list-style-type: none"> - Board Meetings held according to a regular schedule, agenda prepared in advance, minutes prepared and approved. - Non-family members (probably company executives or ex-executives) appointed to the Board and core competency (skill mix) review of Board conducted, or advisory Board of independent professionals established and consulted on a regular basis. 	<ul style="list-style-type: none"> - Board composition (competencies/skill mix) adequate to oversight duties. - Annual evaluation conducted. - Audit Committee of non-Executive Directors established. - Directors independent of management and owners appointed to the Board (perhaps "graduated" from the advisory Board). 	<ul style="list-style-type: none"> - Audit committee composed entirely of independent directors. - Nominating Committee established. - Compensation Committee established.

ATTRIBUTE	LEVEL 1 <i>Understanding the need to professionalize the Company</i>	LEVEL 2 <i>First concrete steps toward best practices</i>	LEVEL 3 <i>Implementation of best practices</i>	LEVEL 4 <i>Leadership</i>
C. INTERNAL CONTROL ENVIRONMENT; TRANSPARENCY AND DISCLOSURE	<ul style="list-style-type: none"> - Adequate accounting and auditing systems in place including: <ul style="list-style-type: none"> - Adequate internal accounting and control system periodically reviewed by independent external auditors and Quarterly financial reports prepared by internal accounting and approved by the Board; - Annual financial statements audited by independent external auditors and approved by Shareholders' Meeting. 	<ul style="list-style-type: none"> - Accounting and auditing performed in accordance with highest national standards and audit performed by recognized accounting firm. 	<ul style="list-style-type: none"> - Accounting, auditing and internal control systems up to international standards. 	
D. SHAREHOLDERS	<ul style="list-style-type: none"> - All shareholders kept informed of company policy, strategy and results of operations. - Annual shareholders' meetings held. 	<ul style="list-style-type: none"> - Shareholders provided with all material information and detailed agenda in advance of shareholders' meetings. 	<ul style="list-style-type: none"> - Family council established (if number of family members large or substantial portion are not working in the business). 	<ul style="list-style-type: none"> - Company in position to quickly implement all aspects of best practice code with respect to shareholders when company to go public.

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ANNEX 2

AGENDA FOR THE INTERNATIONAL EXPERTS MEETING ON CORPORATE GOVERNANCE OF NON-LISTED COMPANIES

Objectives of the meeting

The purpose of this meeting is to discuss the challenges and opportunities for corporate governance in non-listed companies, particularly what specific implications they have on public policy.

The ultimate objectives of the meeting are:

(i) Review current practices and developments in corporate governance of non-listed companies as well as their driving forces;

(ii) Identify how the public policy framework can support good corporate governance practices of non-listed companies, remaining sensitive to those elements that might pose a regulatory burden for non-listed companies; and

(iii) Discuss the future work programme for this new activity, including issues for in-depth analysis/discussion as well as the expected outputs.

Scope

In this work, “non-listed companies” refers to 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 (relative to their economy) companies that are by choice unlisted but that have financial stakeholders (equity and/or creditors) beside 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.

Background

This project is a natural follow-up to the use of the OECD Principles of Corporate Governance in countries where non-listed and often family/founder-owned companies play a central role. Non-member countries in the emerging markets, transition economies and MENA region with a relatively small number of listed companies have shown a particular interest in trying to understand better to what extent the OECD Principles may be relevant to non-listed companies. More specifically, this activity will focus on the corporate governance challenges and opportunities for non-listed companies that may be seeking access to outside capital, but that do not have publicly traded shares. The work will draw extensively on experiences from the Regional Corporate Governance Roundtables.

Guidelines for chairpersons, speakers and panellists

Chairpersons are requested to actively engage participants in discussion and present a synthetic conclusion. Keynote presentations will be delivered within 20 minutes each, while discussants will have 5-10 minutes each. All speakers are invited to keep their presentations within the proposed time limitations in order to leave ample time for debate and discussion.

During the last session, chairpersons will present brief conclusions from the different sessions. This will also constitute an opportunity for participants to discuss the next steps in furthering the program.

DAY 1

<p>Opening remarks</p> <ul style="list-style-type: none"> • His Excellency Mr. Tomoyuki ABE, Ambassador of Japan to Turkey • Mr. Dogan CANSIZLAR, Chairman and CEO, Capital Markets Board of Turkey <p>Introductory remarks: The opportunities and challenges for corporate governance of Non-listed Companies, Mr. Mats ISAKSSON, Head of the Corporate Affairs Division, OECD</p>
<p>Part 1: What are the corporate governance characteristics of NLCs?</p> <p>Chairperson: Michiel L. ALEWIJNSE, CEO, Alpheios Consulting & Coaching for Change, Mimech Holding b.v., Netherlands</p> <p>Key note presentation on legal forms/ownership patterns, Mr. Erik VERMEULEN, Lecturer, Faculty of Law, Department of Private Law, University of Tilburg, The Netherlands</p>
<p>Session a: What are different ownership and control structures of NLCs?</p> <p><i>Panel discussion on: (i) What are the various means and techniques for allocation of influence, also for minority shareholders (e.g. rights of first refusal, shareholder agreements, blocking rights, and information rights)? (ii) How are voting rights and cash-flow rights distributed? (iii) Is there a need for minority shareholder protection in NLCs, (e.g. of buy-outs, squeeze-outs, and exit)? (iv) If so, what are the governance challenges?</i></p> <ul style="list-style-type: none"> • Dr. Fernando LEFORT, Professor, Pontificia Universidad Catolica de Chile • Mr. Vittor CANCIAN, Senior Legal Counsel/ABP Investments, Netherlands • Mr. Alum BATI, Honorary Legal Advisor to the British Ambassador of Azerbaijan, Patner, Salans Law Firm, Azerbaijan • Mr. Andres BERNAL, Corporate Governance Programme Manager, Confecámaras, Colombia <p>OPEN DISCUSSION</p>
<p>Session b: How is professional management monitored?</p> <p><i>Panel discussion on boards and management: (i) What is the evolving role of the board versus shareholders in monitoring management in NLCs that are majority owned? (ii) Do NLCs make use of committees? (iii) How are boards composed (e.g. dependent and independent directors) to fulfil a meaningful role?</i></p> <ul style="list-style-type: none"> • Ms. Guler MANISALI-DARMAN, Member, International Chamber of Commerce Finance Committee • Mr. Igor BELIKOV, General Director, Russian Institute of Directors • Mr. Charnchai CHARUVASTR, President, Thai Institute of Directors • Dr. Fouad R. ZMOKHOL, Member of the Board of the Lebanese Business Men Association (RDCL); Managing Director, ZIMCO Group, Lebanon <p>OPEN DISCUSSION</p>

Session c: What are the transparency requirements for NLCs?

Panel discussion on disclosure: (i) What are the requirements for financial/non-financial information for investors? (ii) How does the provision of information work in NLCs where shareholders have full access to the books? Does this work? What are the challenges? (iii) How is confidential information contained? (iv) What should be given to company registrars or other authorities and why?

- Mr. Phil BARRY, Taylor Duignan Barry Ltd., New Zealand
- Mr. Mokhtar AZMAN, Managing Director, Khazanah Nasional Berhad, Malaysia
- Mr. Samir LATIF, Corporate Governance Council, FYROM
- Mr. Thomas PLETSCHER, Member of the Executive Board of Economie suisse, the Swiss Business Federation

OPEN DISCUSSION

Part 2: What are the driving forces for changing corporate governance practices in NLCs? What lessons can be learned from investors and companies?

Chairperson: Mr. Mike LUBRANO, Unit Head, Investor and Corporate Practice, Corporate Governance Department, International Finance Corporation (IFC)

Keynote presentations: Prof. Thomas W. HALL, Assistant Professor of Finance, Department of Finance and Economics, University of Alabama in Huntsville, United States

Mr. Stijn CLAESSENS, Senior Adviser, Operations and Policy Department
Financial Sector Vice-Presidency, The World Bank

Session a: Access to capital and implications for corporate governance

Panel Discussion on: (i) What are the key financing sources and evolving patterns of financing? (ii) What are the implications for corporate governance? (iii) How are investment and lending decisions made? (iv) What requirements exist to accommodate various types of outside capital? (v) Do creditors or banks exercise a significant influence on corporate governance?

- Mr. Jean-Bernard THOMAS, Chairman of the Corporate Governance Task Force, European Venture Capital Association (EVCA)
- Mr. Stefan PETRANOV, Chairman of the Board of Directors, “Zlaten Lev Capital” Fund Management Company, Bulgaria
- Mrs. Botan BERKER, Managing Director, Fitch Ratings - Istanbul, Turkey

OPEN DISCUSSION

DAY 2

Part 2: What are the driving forces for changing corporate governance practices in NLCs? What lessons can be learned from investors and companies?

Session b: Succession planning and conflict resolution

Panel Discussion on: What are the governance challenges for (i) facilitating succession and (ii) conflict resolution among owners, the board and professional management?

- Mr. Bengt HALLQVIST, Director, BIM KEM AB, Jacto SA, Brazil
- Mr. Leo GOLDSCHMIDT, Director, European Corporate Governance Institute
- Mr. Anders LINDSTROM, Family Business Network, Sweden
- Mr. Rahma HAMEED, Director of Company Affairs, Kingdom of Bahrain

OPEN DISCUSSION

Part 3: How can the public policy framework support good corporate governance of NLCs? What lessons can be learned for public policy?

Chairperson: Mr. Mats ISAKSSON, Head of the Corporate Affairs Division, OECD

Panel Discussion on: (i) How can the legal/regulatory/policy environment support effective governance of NLCs? (ii) What characteristics of the policy environment pose a regulatory burden? (iii) Where can private contracting substitute for market regulation? (iv) What are the trade-offs of the private vs. regulatory approach?

- Prof. Ulrich SEIBERT, Ministerial Counsellor, Ministry of Justice of Germany
- Ms. Amina BENJELLOUN, Charge de Mission, Office of the Prime Minister, Morocco
- Mr. Zheng Jun ZHANG, Associate Professor, Development Research Center (DRC) of the State Council of China
- Ms. Nazgul ABDRAHMANOVA, Division of Regulation of Capital Market and Institutional Investors, State Commission on Securities Market, Kyrgyz Republic

OPEN DISCUSSION

Follow-up actions and conclusions

Discussion on issues of interest to family-owned businesses

Keynote address: Michiel L. ALEWIJNSE, Chairman, Family Business Network, Netherlands

ANNEX 3
LIST OF PARTICIPANTS

**PARTICIPANTS LIST FOR INTERNATIONAL MEETING
ON CORPORATE GOVERNANCE OF NON-LISTED COMPANIES**

19 -20 April 2005

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