Corporate Governance, Value Creation and Growth

-

The Bridge between Finance and Enterprise

Corporate Governance, Value Creation and Growth

-

The Bridge between Finance and Enterprise

This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

© OECD 2012

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgement of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to *rights@oecd.org*. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at *info@copyright.com* or the Centre français d'exploitation du droit de copie (CFC) at *contact@cfcopies.com*.

Foreword

Credible and well functioning capital markets is a prerequisite for the development and sustainability of a vibrant private enterprise sector. And the prime policy objective is to make sure that corporations get access to the capital they need for innovation, job creation and growth. For this to happen markets need to have a robust framework of corporate governance rules and regulations that provides investors with confidence in the system and entrepreneurs with the incentives to develop their businesses. To ensure an efficient link between finance and enterprise is particularly important in the aftermath of the financial crisis when policy makers are looking for reforms to unleash innovation and productivity for sustainable growth. It is also essential for many developing and emerging markets where new generations of enterprises should be given the opportunity to access external capital, which will make it possible for them to realize their full potential and contribution to economic growth. However, when shaping the framework we must also take into account important structural developments in the financial and corporate sectors and make sure that rules and regulations are well adapted to current and future conditions. To address these issues, the OECD Corporate Governance Committee and the Capital Markets Board of Turkey organised the meeting “Corporate Governance, Innovation and Value Creation” on 1 February, 2012 in Istanbul.

This volume includes the presentations that were given in the Istanbul meeting and examines the role of corporate governance arrangements in providing right incentives to contribute the value creation process within the private enterprises and the implications of the differences in ownership structures on corporate governance practices and frameworks. It also addresses these global changes from emerging markets’ perspective and the distinguishing features of these economies that shape their capital markets, corporate structures and corporate governance landscape.

The key messages emerging from the discussion in the meeting and chapters included here can be summarised in three points;

- First, the financial and corporate sectors have undergone profound changes in the last decade that reshape the policy environment for corporate governance. In financial markets these changes including the decrease in public listings, increase in delistings, a growing role of private pools of capital and the rise of exchange traded funds, high frequency trading and indexing influence the effectiveness of existing corporate governance frameworks. In addition, the corporate sector depends more on intangible assets in the process of innovation and value creation at firm level. These developments in both financial and corporate sectors merit serious attention in the discussions on the design of corporate governance practices aiming at improving economic efficiency and growth through private enterprises.

- Second, most of the corporate governance debate has been focused on the dispersed ownership structure rather than corporations with a concentrated ownership structure. This is unfortunate, since the latter category dominates the corporate sector around the world not

only when it comes to non-listed companies but, with some country exceptions, also listed companies. Therefore, the role of controlling owners in innovation and value creation need to be taken into account more explicitly when shaping the corporate governance frameworks.

- Finally, the corporate and financial sector structures in emerging markets vary from those of advanced economies. They have also faced significant changes over the last decade. Together with the financial markets, the global economy has been reshaped by the extensive shift of wealth towards emerging economies. This also raises the question about the expected future shortage of equity capital in emerging markets due to low investment in listed equities in these countries and the demographic changes in developed economies. To facilitate access to capital for fast growing companies in emerging markets without hampering their entrepreneurial drive will be important in order to ensure a stable and sustainable path of development.

On behalf of the OECD Corporate Governance Committee and the Capital Markets Board of Turkey, we would like to thank all the contributors to the meeting and this publication; Mats Isaksson, Erik Vermeulen, Daniel Sachs, Colin Mayer, Karl Hofstetter, Alessio M. Pacces, Rolf Skog, Marco Langendoen, Maria Helena Santana, Ranjit Ajit Singh and Hüsnü M. Özyeğin. We would also like to thank all meeting participants that during the open and stimulating discussions provided informed and highly valuable comments. Finally, we would like to thank Bekir Safak and Serdar Celik for providing much of the analytical input on which the meeting rested.

We believe that this publication presents the collective effort and a sound basis for further exploration of the links between corporate governance, value creation and economic growth.

Marcello BIANCHI
Chairman
OECD Corporate Governance Committee
Director, CONSOB, Italy

Vedat AKGIRAY
Chairman
Capital Markets Board of Turkey
IOSCO Emerging Markets Committee

Table of Contents

Foreword………………………………………………………………………………….. 3

Overview and issues

By Mats Isaksson, Head of Corporate Affairs, OECD………………………………………... 7

Part I: Outside Capital and Inside Value Creation

Introduction

By Marcello Bianchi, Chairman, OECD Corporate Governance Committee; Director, CONSOB, Italy…………………………………………………………………………………... 13

Chapter I. **Entrepreneurship and innovation in listed companies: What is the role of corporate governance?**

By Erik P.M. Vermeulen, Professor of Business & Financial Law, Tilburg University; Vice President at the Corporate Legal Department, Corporate and Financial Law Group, Philips International B.V………………………………………………………………………………… 15

Chapter II. **The Impact of an emerging European corporate bond market on corporate governance**

By Daniel Sachs, CEO, Proventus AB…………………………………………………………. 22

Chapter III. **Regulating for value creation: What is the link between market confidence and contractual freedom?**

By Colin Mayer, Professor of Management Studies at the Saïd Business School, University of Oxford………………………………………………………………………………………. 29

Part II: Ownership Structures and Corporate Governance: Will One Size Fit All?

Introduction: What makes controlling ownership different?

By Karl Hofstetter, Professor Zurich University; Group General Counsel and Member of the Board of Directors, Schindler Holding AG…………………………………………………………… 37

Chapter IV. **Corporate control and incentives in a dynamic perspective**

By Alessio M. Pacces, Professor of Law and Finance, Erasmus School of Law, Erasmus University, Rotterdam………………………………………………………………………… 41

Chapter V. **One size for all? - The European Union experience**

By Rolf Skog, Ministry of Justice, Sweden; Secretary to the Swedish Securities Council…….. 47

Chapter VI. **Long-term or short-term shareholdership: Does it really count?**

By Marco Langendoen, Counsellor of Legislation, Company Law, Ministry of Security and Justice, The Netherlands……………………………………………………………………… 51

Part III: The Emerging-Market Perspective

Chapter VII. **Brazilian perspective**

By Maria Helena Santana, Chair, Securities Commission of Brazil and IOSCO Executive Committee…………………………………………………………………………………….. 59

Chapter VIII. **Malaysian perspective**

By Ranjit Ajit Singh, Chairman, Securities Commission Malaysia……..……………………… 63

Chapter IX. **Business perspective**

By Hüsnü M. Özyeğin, Chairman of the Executive Board of Fiba Holding and Board of Trustees of Özyeğin University……………………………………………………………….. 67

Annex: Agenda of the Meeting…...……………………………………………………………. 70

Overview and issues

By

Mats Isaksson
Head of Corporate Affairs, OECD

This volume is an important reminder that all those corporate governance rules, regulations and practices that we discuss are not a goal in themselves. They are supposed to be means to a greater end. Be it minority rights, mandatory bids, or independent directors, the rules and regulations that we put in place should serve a purpose. And it is against this purpose and these objectives that the quality of any corporate governance system should be evaluated. So, we need to find a benchmark against which we can assess new regulations and evaluate existing ones.

From a public policy perspective, this benchmark consists of three core criteria against which we can evaluate the effectiveness of individual corporate governance rules. The criteria are closely linked to the investment process and the ability of the financial sector to serve the needs of the real economy. The first criterion is that corporate governance rules should ensure that new business opportunities get access to capital. For this, the rules must be credible enough to make investors take money out of their mattresses and invest in equity. But they must also be designed to provide company founders and entrepreneurs with the right incentives to seek external funding for innovation and growth. Just as investors may keep their money in the mattresses, some entrepreneurs would rather keep their companies in the tool shed or at least out of the public domain. Sometimes at a cost in terms of lost business opportunities and growth.

Second, corporate governance rules should ensure that capital is efficiently allocated among corporations. That is to say that the rules should reward investors who contribute to bringing new and genuine information to the market. They should also discourage any opportunities for pure rent-seeking. Only then will equity prices provide the best possible information about a corporation’s potential. And only then can we be sure that capital is allocated to those who can make the best possible use of it. A market where everyone is rewarded for trying to second guess everybody else, obviously does not meet this criterion.

Finally, the last criterion is that a good corporate governance system should reward competent monitoring of corporate operations once the resources are allocated among them. This requires both a long-term commitment and a lot of talent among owners. A corporation is not a self-playing piano. It requires a tremendous amount of work to keep it innovative, dynamic and on the cutting edge. Where do we find shareholders with the incentives and skills to carry out this very demanding but also pivotal task?

Looking at these criteria, it is easy to see that the corporate governance system affects every step and aspect of an economy's investment process. At the first stage, corporate governance is all about creating an environment for access to capital. At the second stage, focus is on efficient allocation of capital between competing ends. And at the third stage, corporate governance should encourage competent monitoring of investments once they are in place.

We know from history that nothing is more important to economic prosperity than the level and quality of investment. This is also why corporate governance from a public policy perspective, never should be seen as a static zero-sum game whose main objective is to regulate how different parties to the company should split a given set of assets or a given result. The economic objective is to make sure that the rules serves the purpose of innovation, value creation and growth.

This dynamic, economic and growth-oriented approach to corporate governance is well-reflected in the three sections of this volume. The first section addresses the process of value creation within the corporation and analyses how that process is influenced by different financial and contractual arrangements. It also analyses the merits of contractual freedom and the balance between strictly mandatory rules on one side and a more enabling corporate governance environment on the other side. We are also reminded that both capital markets and the corporate world are constantly evolving. So, what is an efficient corporate governance rule at a certain point in time may no longer be efficient as circumstances change; as financial markets evolve, as new instruments appear and as corporate structures develop.

The second section focuses more closely on the role of owners; in particular, controlling owners who hold large stakes in individual companies that they actively monitor, sometimes at a considerable cost. In the early days of the corporate governance debate, Berle and Means saw controlling owners as a straightforward solution to the corporate governance problem. Yet that section of their book is seldom quoted. Most of the academic community got carried away in a different direction. This is unfortunate, because worldwide, companies with concentrated ownership is actually the rule, not the exception. So it is obvious that the shaping of corporate governance rules and regulations need to take the incentives and dynamics of large and sometimes controlling owners into account.

Last but not least, it is inevitable that a growth-oriented and dynamic approach to corporate governance will lead us to the emerging markets, with their sometimes unique corporate governance structures and saving patterns. Today's extensive shift of financial assets towards emerging markets is one of the main factors that change the global capital markets. However, contrary to developed economies, investors in these economies have a relatively low appetite to buy listed equities. Because of this and demographic trends in developed economies, long term projections point toward a shortage of equity capital for enterprises in emerging markets. By 2020 this may amount to more than 10 trillion USD and, if nothing is done, it may very well create an obstacle to entrepreneurship, growth and better paid jobs. Improvements and adaption of corporate governance practices will play a key role in bridging this equity gap by creating a robust and credible investment environment for both domestic and foreign equity investors. These issues are discussed

in the third section. It addresses the particular needs of businesses in emerging markets and how companies that are often semi-informal or privately held can gain access to the capital they need by adopting a more institutional structure, without losing their entrepreneurial spirit and flexibility.

Part I: Outside Capital and Inside Value Creation

Introduction

By

Marcello Bianchi
Chairman, OECD Corporate Governance Committee; Director, CONSOB, Italy

The OECD is the international standard setter on corporate governance. Notably, the Committee on Corporate Governance adopted the Principles on Corporate Governance at the end of the 1990s and updated them in 2004 after a wave of financial crises around the world.

The OECD committee is also an important forum for an ongoing dialogue among policy makers on corporate governance from member countries, and increasingly from non-member countries. The committee seeks not only to maintain its leading instruments, but also to provide instruments for better implementation of the Principles.

We are convinced that the financial crisis put corporate governance systems under stress by raising a number of challenges not only for an effective implementation of the Principles, but also more broadly, for the role of corporate governance rules and practices with respect to the common need to restore confidence in financial markets and to promote economic growth.

The Committee has been very active in the analysis of the implications of the crisis on corporate governance since the first turmoil in 2008 and decided to respond to these challenges by a number of new initiatives. It considers an update of the Principles and has developed new instruments for policy dialogue, namely a systematic peer review to address some new aspects of corporate governance looking at the implementation of the Principles in a number of member and non-member countries.

The Committee has also decided to launch a project on corporate governance, value creation and growth that aims to identify new approaches which can provide recommendations, even provocative ones, to policy makers and market forces. This project started with the exploratory seminar held in Istanbul on 1 February, 2012 and will be developed to face the new landscape created by the crisis.

It applies at the company level, challenging behaviours of many of the major players, and for regulators, challenging the existing balance between the costs and benefits of regulation. It is also true for scholars and standard setters, challenging the cultural milestones of corporate governance, both on the side of academic consensus and on the side of principles and standards that had been adopted. This means that the foundation of our knowledge of corporate governance has to be reconsidered in some way.

Under the application of the static approach, we cared more about the distribution of wealth and in particular the risk of misappropriation of wealth created within companies rather than the process of value creation. With the exception of the debate on the stock options, which was oriented to the goal of value creation, we had some failures in the implementation of these instruments.

A more general issue has prevailed in the traditional approach with regard to corporate governance. There was explicit or implicit pressure towards a single model of corporate governance; hence, the role of contractual freedom and in general diversity has been neglected. In addition, listed companies that make up the framework where we apply the principles and rules of corporate governance have been considered as a closed, stable world with the turnover attributable to the process of going public and going private believed to be a sort of natural evolution in the life of a company. In fact, the attitude towards listing on regulated markets can change dramatically, including in the short term. Benetton, for example, went public about 20 years ago but now intends to go private. Indeed, a wave of going private has occurred in Europe and all around the world. So we must consider all factors that can affect the attitude towards listing and the aspects that can affect this process, including the cost of regulation, the limits of contractual freedom, and the competition from alternative capital sources and trading facilities. Only if we consider all these aspects we will understand how to think about corporate governance in a new way and identify what is useful for policymakers to move towards a new approach to corporate governance.

Chapter I

Entrepreneurship and innovation in listed companies: What is the role of corporate governance?

By

Erik P.M. Vermeulen
Professor of Business & Financial Law, Tilburg University; Vice President at the Corporate Legal Department, Corporate and Financial Law Group, Philips International B.V.

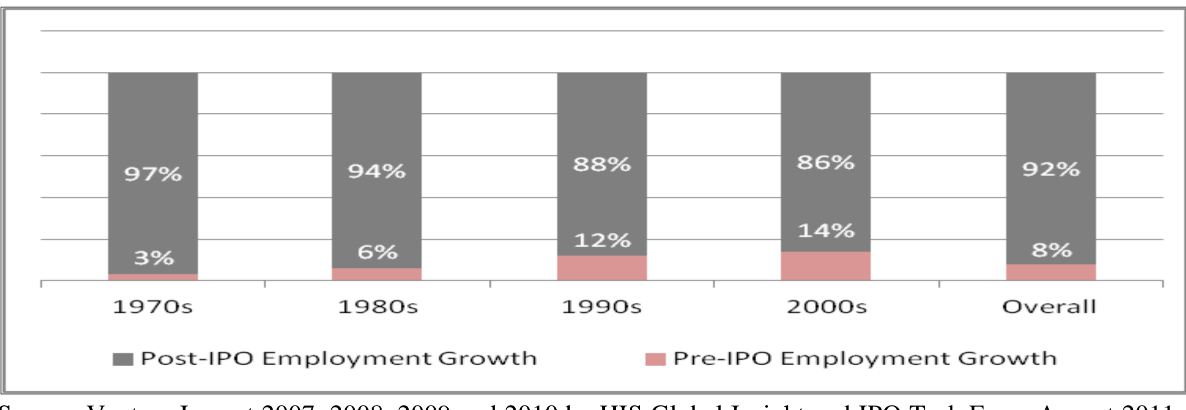
In the aftermath of a financial crisis, policy makers introduce measures to stimulate entrepreneurship and innovation in order to boost economic growth and job creation. To this end, they seek to develop technology clusters in which small and medium-sized (non-listed) companies can be simply started and nurtured into bigger listed ones. This thinking fits well with the life cycle concept of a company (see Figure 1.1). It typically starts with turning an idea into a start-up company. The start-up attempts to raise capital from both private investors and venture capital funds. These investors support the start-up by contributing money and services, which brings the company to the next stage of its development. Ideally, this continues until the moment that the private investors and venture capital funds decide to exit the portfolio company by floating it on a stock exchange. Beyond the initial public offering (IPO), the company loses its "start-up" feel, becomes less responsive to disruptive innovation and will eventually disappear. What is worth mentioning is that the IPO also brings about changes in the mindset of policy makers. Before the IPO the focus is on deregulation and the facilitation of an innovative and entrepreneurial business environment. The IPO triggers a regulatory response from policy makers in order to enhance investor confidence in financial markets.

Figure 1.1. **Life Cycle of Companies**

There is something to the regulatory "post-IPO" approach. Shareholders in listed companies are often unable to monitor their investments closely, giving executive directors and managers ample opportunity to act self-interestedly at the expense of investors and other stakeholders. Arguably, strict mandatory company law and listing rules as well as "comply-or-explain" corporate governance codes are needed to reduce the information asymmetries between shareholders and stakeholders on the one hand and the directors and managers on the other. Indeed, it is widely acknowledged among regulators and academics that principal-agency based regulation is crucial for the development of robust financial markets, which, in turn, make IPOs an attractive financing means for fast-growing non-listed companies. Still, there are problems with pushing the so-called principle-agency based regulation too far. For instance, strict corporate governance rules and regulations have induced fast-growing companies to rethink their IPO intentions, which arguably hampers the growth potential of promising start-up companies. If life after an IPO becomes too costly, more high potential companies will choose to remain non-listed. This trend was recently confirmed in a *Business Week* article that stated that "CEO of a listed company" had become the least popular job in Silicon Valley. Apparently, potential CEOs increasingly prefer assisting start-up companies in the familiar surroundings of their respective "garages" to entering the bureaucratic and overregulated world of listed companies.

A decline in the number of listed companies could seriously jeopardize long-term economic growth. Policy makers should not forget that listed companies are still the key to entrepreneurship and innovation. Consider Nokia's role in the emergence of a high-tech cluster in Finland. But there is more. When it comes to job creation, listed companies are also important. Indeed, recent empirical research indicates that post-IPO employment growth is significantly higher than pre-IPO employment growth (see Figure 1.2).

Figure 1.2. **IPOs and Job Creation**



Source: Venture Impact 2007, 2008, 2009 and 2010 by HIS Global Insight and IPO Task Force August 2011 CEO Survey cited in "Rebuilding the IPO On-Ramp", IPO Task Force, 2011

The introduction of "scaled regulation" could mitigate the hidden costs of the application of a strict corporate governance framework. What does "scaled regulation" mean? It is regulation that can be adapted according to the different stages of the life cycle of companies after the IPO. For instance,

it provides "young" listed companies with a legitimate basis to deviate from the "one-size-fits-all" corporate governance framework. Deviation from these rules could, for instance, be necessary to maintain the entrepreneurial incentive structure in a company. Google or Zynga are two examples of listed companies that successfully deviate from the one-share-one-vote governance system. Both companies employ multiple-voting shares, giving the founders voting rights in excess to the cash-flow rights. Corporate governance experts argue that these deviations from the one-share-one-vote principle deter IPO investors. However, Google and Zynga offer some anecdotal proof that investors do not shy away from multiple voting shares if they believe that it gives the founders a strong incentive to stay closely involved in the future development of their fast-growing companies.

We have seen that strict rules and regulations arguably have a detrimental effect on the number of IPOs. There is also empirical evidence that seems to indicate that the mere introduction of scaled corporate governance rules and regulations will not automatically lead to more IPOs. Looking at venture-backed IPOs in 2011, we see that some countries attract more IPOs than other countries. Why is that? A closer look at the sample shows that the existence of an IPO ecosystem rather than robust listing rules and regulations matters. For instance, NYSE Alternext, an alternative stock market for high tech companies in Europe, has been relatively successful in attracting IPOs. Approximately 200 companies are listed on NYSE Alternext. Interestingly, 90% of the firms are listed in Paris, 9% in Brussels and only 1% in Amsterdam. Different IPO ecosystems, rather than different legal rules and regulations, explain why Paris is outperforming its Brussels and Amsterdam counterpart. A network of underwriters, lawyers and other advisors are responsible for the differences in the success ratio of the respective Alternext units. Thus, in order to ensure a smooth transition between the pre-IPO and post-IPO stage in a company's life cycle, the existence of a well-developed network/ecosystem is considered more essential than the introduction of more rules and regulations that address corporate governance issues.

So far, we have focused on corporate governance rules and regulations as a barrier for IPOs and the growth potential of non-listed (high potential) companies. More troubling is the notion that a stiff corporate governance framework hampers the competitiveness and innovative capacity of listed companies. Let's look again at Google. Founded in 1998, Google is still a relatively young company. Yet, it is already losing its start-up feel. Talented employees leave the "aging giant" for hotter start-up companies. Other big listed companies struggle to bring new innovative ideas to fruition. Initiating open innovation strategies through which listed companies partner with and sometimes even acquire smaller non-listed companies is usually viewed as a successful "healthy aging" model in the life cycle of a listed company. An often-mentioned example of a listed company that understands the concept of open innovation is Cisco. Yet, many of its acquisitions have failed, indicating that more is needed to turn a large and sluggish listed company around.

Is there a role to play for corporate governance? As discussed, corporate governance tends to focus on the protection of shareholders and stakeholders. In a new research project, which is still work-in-progress, we try to determine whether there is a correlation between corporate governance structures and entrepreneurship/innovation in listed companies. Entrepreneurship and innovation are measured in terms of "corporate venturing activities". Corporations with strong corporate venturing

units are generally looking for synergies between their businesses, venture capital funds and start-up companies. Intel is a good example. It puts itself in the market as an attractive partner that, at the request of entrepreneurs or venture capital funds, provides advice to start-up companies and assists them in the development of the new technology. Through an independent and supportive attitude Intel hopes to develop partnerships that can lead to a joint development of new products for new markets.

Figure 1.3. **Top-10 Companies with Strong Corporate Venturing Units**

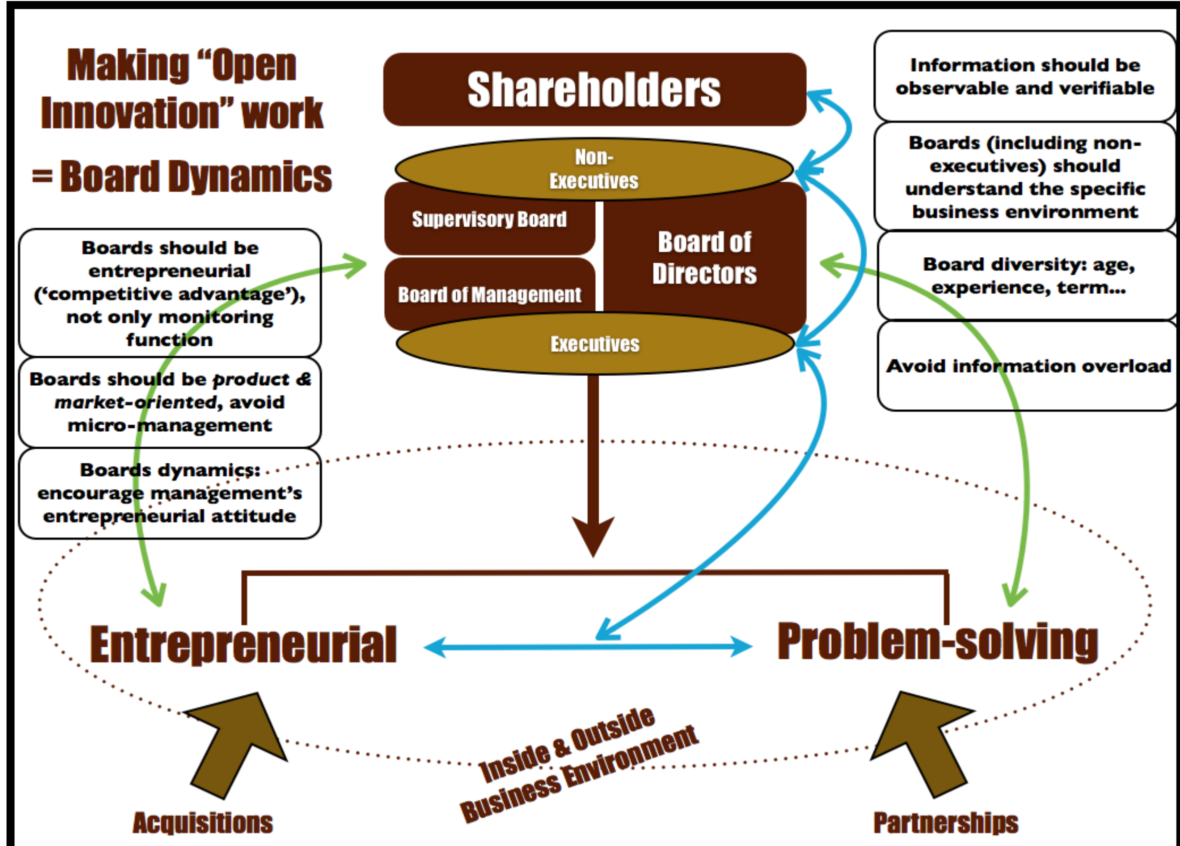
Company	Fund name + purpose	Size ($m)
Tencent 腾讯	**Industrial Collaboration Fund** - Search for new content and services.	1500
Chesapeake Energy	**Chesapeake NG Ventures** - dedicated to identifying and investing in companies and technologies that will replace the use of gasoline and diesel derived primarily from OPEC oil with domestic oil, natural gas and natural gas-to-liquids (GTL) fuels.	1000
Comcast	**Comcast Ventures** - investing in the next generation of entertainment, communication and digital technology.	750
LVMH	**LVHM Asia** - looking for opportunities in Asia in the wake of the economic slowdown in the Eurozone.	640
Merck Be well	**Merck Global Health Innovation** - investing in breakthrough healthcare solutions.	500
SAP	**SAP Ventures** - combining start-up agility with the might of the world's leading enterprise software company.	350
intel	**Ultrabook fund** - help accelerate the next revolution of personal computing.	300
Baxter	**Baxter Ventures** - strenghtening the company's history of innovative "firsts" in medical therapies.	200
BMW	**BMW iVentures** - help develop opportunities for BMW's new "i" sub-brand for electric vehicles.	100
AstraZeneca	**Medimmune Ventures** - As the wholly-owned venture capital arm of AstraZeneca, MedImmune Ventures invests in private companies that develop small and large molecules, vaccines, pharmaceutical technologies and platforms	100

Source: GlobalCorporateVenturing, Company Websites, Reuters, Database 500 Corporate Venture Capital Organizations

Looking at a hand-collected dataset of 500 listed companies that have established strong corporate venture capital units (see Figure 1.3), we find that their corporate governance structures are not only focused on shareholders and stakeholders but also on innovative products and markets. They endeavour to surprise their customer-base with new technologies that stand apart from the competition. More interestingly, these entrepreneurial and innovative listed companies do not necessarily follow a pre-defined regulatory framework. What is very important in corporate governance (and what will drive innovation and more importantly entrepreneurship) is a strong focus on board dynamics and practices. From a board dynamics point of view, it is essential that

boards are entrepreneurial, challenge management decisions, identify risks and opportunities, and network with governments and society. As rightly stated in the Financial Times article "Corporate boardrooms are in need of education", well-balanced boards that are product and market-oriented can actually be a competitive advantage for companies. It is these board dynamics that can make open innovation work (see Figure 1.4). Microsoft's CEO, Steve Balmer, emphasizes the importance of product-oriented boards in the January 2012 issue of *Business Week*: "If I had to do it all over again, I would dedicate more time to watching over the development process of products rather than just issuing a vision to the company."

Figure 1.4. **Creating Entrepreneurship in Listed Companies**



Our data shows that "board dynamics" cannot be captured in a one-size-fits-all framework. If we look at the top-10 companies with strong corporate venturing units, we see that it is a daunting task to define best-practices. For instance, the number of women on the board varies significantly among the respective companies. The percentage of women on a board ranged from 30% to 0% (Figure 1.5). The same goes for the board size, which ranged from 19 members to 8 members (Figure 1.6). Levels of board independence ranged from 94% to 32% (Figure 1.7). Another interesting finding is that in the majority of these companies the CEO is the board chair (Figure 1.8).

So let's look at the corporate governance structures of some of these companies in more detail. We already mentioned Intel. Intel established a corporate venture capital fund that attempts to spur the development of the new Ultrabook computer. Another example is LVMH, which set up a corporate venturing unit that should pave the way for marketing initiatives in Asia. The third example is BMW and its corporate venturing efforts in developing electric vehicles. The corporate governance structures of these companies are completely different. BMW is a family-controlled company. The board includes employees, but also people that are specialized in law, economics and finance. A significant part of the board comes from the automotive industry which enables the board, as Steve Balmer puts it, to watch over the development process of products. Intel, with its widely dispersed shareholders, is another board that consist of people who know the industry. Arguably, the clear focus on products and markets contributed significantly in making 2011 a very successful year for these companies despite the financial crisis.

LVMH employs multiple voting shares. The family has 47% of the shares but controls 63% of the voting rights. Even though this does not fit with the current corporate governance trends towards the one-share-one-vote system, the particular corporate governance structure does not seem to border the investors. LVMH gives their "minority" investors the opportunity to become more engaged by applying for a membership to their loyalty programme. Shareholders who are interested in LVMH and their products are offered special discounts. The board puts a lot of effort in engaging shareholders by making them aware of the product range of LVMH. Another interesting observation is that most companies in this top-10 go to special investor conferences which have a clear focus on products and product-markets. The presentations at these events are not so much about financial statements, but rather about new products and innovations. This is in stark contrast to listed companies that comply with the legal corporate governance requirements: disclosing quarterly financials and organizing annual general shareholder meetings.

Figure 1.5. **Women on the Board**

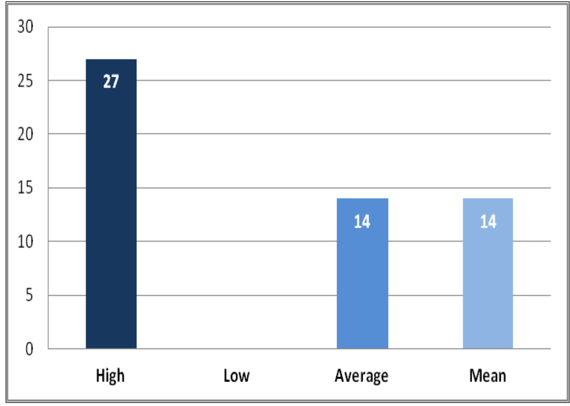


Figure 1.6. **Board Size**

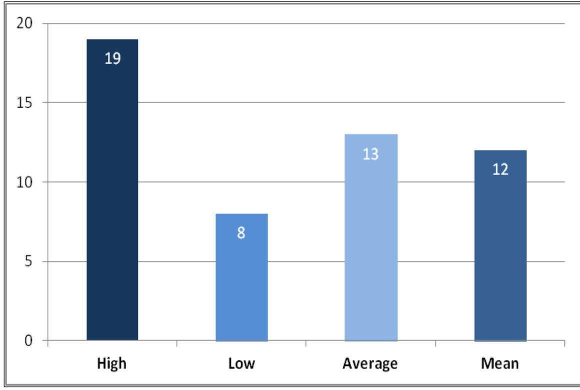


Figure 1.7. **Director Independence**

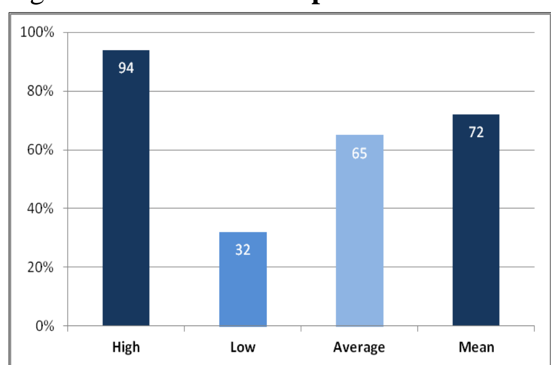
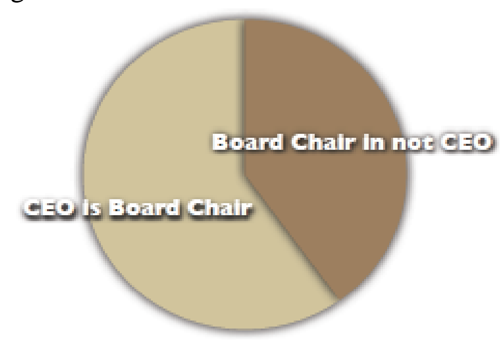


Figure 1.8. **Board Chairs**



We can take some general lessons from this section. The first is about IPOs. The question is not about more or less regulation, but about smarter regulation that adapts itself to different phases of a company's life cycle. Moreover, policy makers should not only focus on introducing rules and regulations, but also on the development of an ecosystem in which the rules are accepted and applied by underwriters, lawyers and other advisors.

The second lesson is about creating entrepreneurship in large listed companies. Corporate governance should not only focus on reducing principal-agent problems. There is more to corporate governance than increasing shareholder or stakeholder value. A focus solely on these issues will crowd out entrepreneurship in listed companies. It will over-regulate them, making their organizations bureaucratic and short-term oriented. Corporate governance has an important role to play in promoting entrepreneurship and innovation in listed companies. It is time to redirect the corporate governance discussion to the importance of board dynamics. Well-balanced boards should dedicate more time to the development process of products instead of following a pre-defined one-size-fits-all rulebook.

Chapter II

The Impact of an emerging European corporate bond market on corporate governance

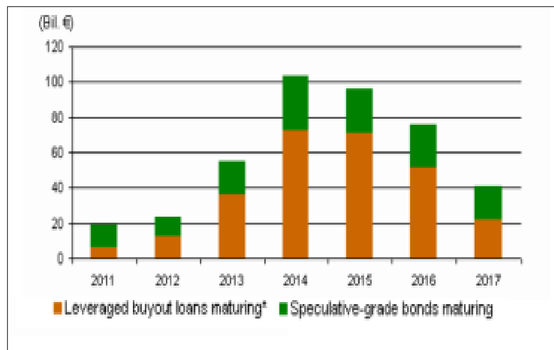
By

Daniel Sachs
CEO, Proventus AB

This section will address the impact of the changes in the capital market and specifically the emerging corporate bond market that we see in Europe and the impact of that on corporate governance.

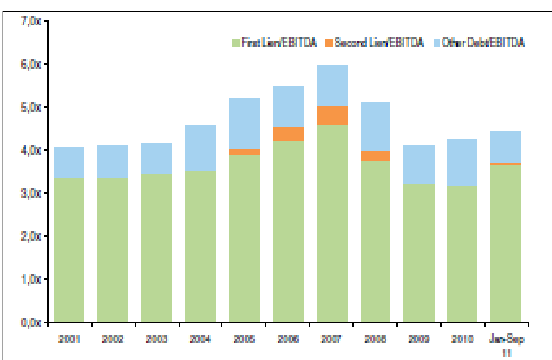
First, I will examine what is happening in the European corporate funding market. Right now, there are many discussions on capital squeeze and that is clear when we look at the demand for capital. The Figure 2.1 shows what is underlying the demand for capital, which are enormous needs for refinancing in the coming years. The next three to four years will see a lot of capital needed just to refinance maturing loans and bonds. The Figure 2.2. shows that many of these loans and bonds were put into place at a time when we accepted higher leverage than we do today. So in many of these cases, it will be a question not only of refinancing but also of finding new risk capital, and there will be cases of restructuring.

Figure 2.1. **Estimated Maturity Profile of European Leveraged Loans**



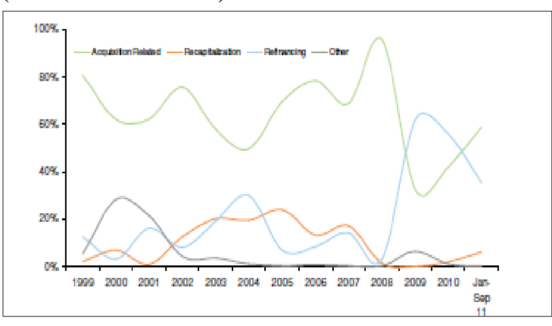
Source: S&P

Figure 2.2. **Pro Forma Debt/EBITDA Ratios**



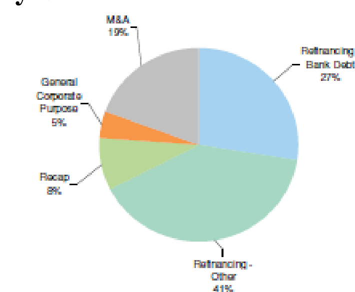
Source: S&P

Figure 2.3. **Deal Purpose Diversification (based on volume)**



Source: S&P

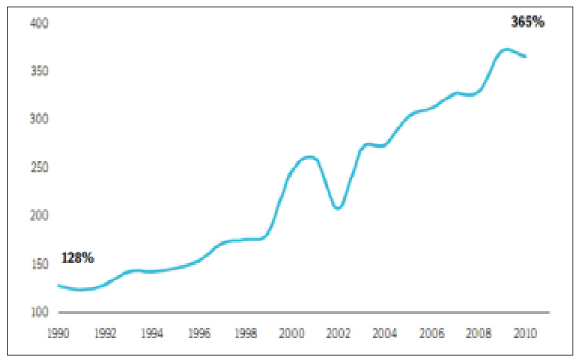
Figure 2.4. **High Yield Issuance Q1-Q3 2011 by Use of Proceeds**



Source: S&P

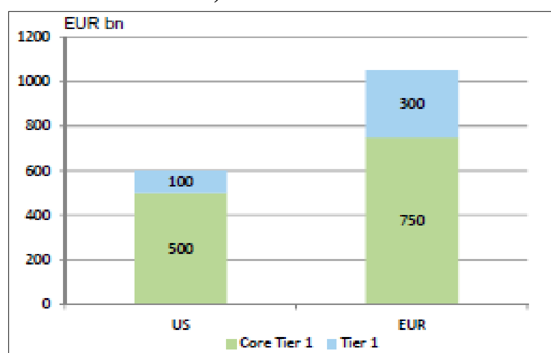
The consequence of this can also be seen on the Figure 2. 4. Three-quarters of the funding raised in 2011 went to refinancing old loans, so there is very little room for expansionary capital, acquisitions, add-on investments, working capital and so on. The need and demand for capital will continue to grow in the coming years. As Figure 2.5 shows, European bank balance sheets have tripled in relation to GDP in the last 20 years – this is not sustainable, banks need to deliver. There is also new regulation, Basel III. In stress tests, the number that is being mentioned is EUR 115 billion in new capital needed in banks. The Figure 2.6. shows that in 2019 when Basel III should be fully in place, the number will actually be ten times that. At present banks are not raising new capital but rather are shrinking their balance sheets; that is part of the capital squeeze issue.

Figure 2.5. **European Bank Assets to GDP (%)**



Source: SEB

Figure 2.6. **Basel III Impact (Estimated Shortfall in 2019)**



Source: SEB

In addition, there is considerable crowding out from sovereign balance sheets. A number of countries in Europe need refinancing, and they often take precedence over corporations.

Looking at the equity side, a McKinsey examined the share of equities in global asset management and funds. In 2010 it was 28%, and they predict it will be 21-22% in 2020. Part of the reason for

this is the emergence of new markets, but two other reasons affect Europe very critically. One is demography: the aging population means that people will go from saving to spending, which will push down equity participation. The other is regulation, not Basel III but Solvency II, which puts pressure on insurance companies and pension funds to reduce their risky assets.

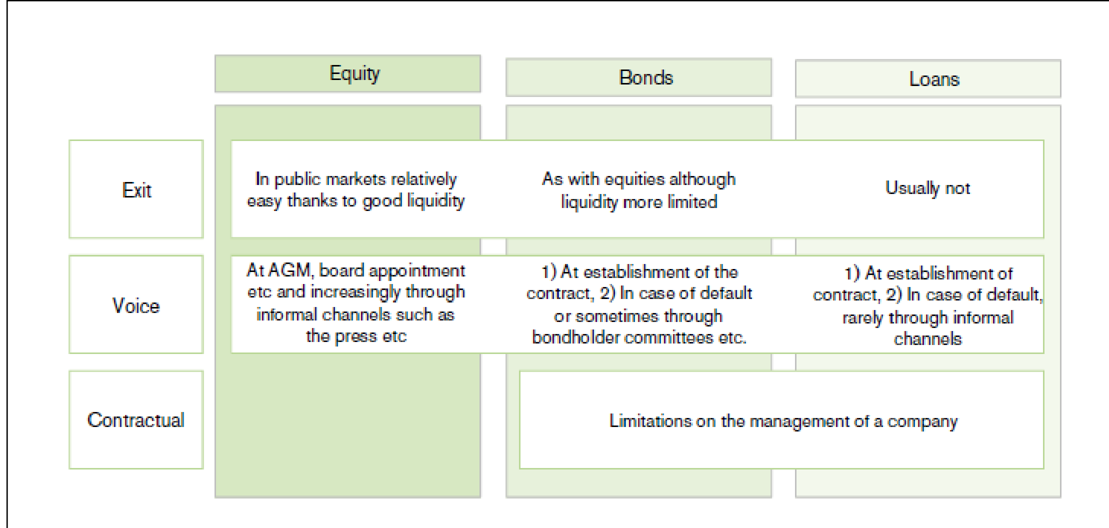
A relevant point is that equity markets are primarily secondary markets. The amount of rights issues in the last five years on the Stockholm Stock Exchange, for example, is equal to one day of trading per year, so less than 1% of the market is actually money that goes into companies; the rest is circulating in the secondary market. It is important to make the distinction between financial markets, which includes all types of trading of financial instruments – primary as well as secondary, and funding markets, which are a very small piece of financial markets. From a governance and a funding point of view, it is the funding that we need to look at, not the financial markets as a whole.

It is the same for private equity: 94% of funds raised in private equity go towards buyouts, so towards secondary markets and buying and selling of companies. Only 6% goes towards investing in companies. There is estimated an equity gap of USD 10 trillion for the developing world and of USD 3 trillion in Europe.

It is clear that banks will have a decreasing share of funding of companies in Europe, and equities are unlikely to fill the gap on their own. We will need a much more liquid, active and transparent market for funding outside the banking system – a bond market primarily but also a more active private-loan market. Bonds might be a more efficient form of financing at this time from an allocation point of view, looking again at demography and of what is happening on pension funds' balance sheets. Equities in European pension funds have already decreased significantly. Bonds may also be more efficient from a governance perspective in terms of forming a community of informed and motivated financiers for mid-sized companies. And to state the obvious, the market for funding mid-sized companies and the functioning of the market for that funding will be crucial for growth and for the formation of jobs and for innovation.

If the bond markets will need to be more important and play a greater role in capital markets, what impact will this have on corporate governance? Taking a well-established perspective of exit and voice, as two main instruments to act as a shareholder or stakeholder in corporations: in terms of exit, as shown in Figure 2.7 below, the dynamic goes from right to left in the sense that we have very low liquidity, limited possibilities to exit in the loan market, even though in the short term there is a secondary loan market because of the deleveraging: hedge funds buying loan portfolios from banks, loan markets are typically not liquid. Bonds have liquidity theoretically, but it is a very inefficient market owing to their low transparency and liquidity, whereas equities typically are quite liquid and well-developed, transparent markets.

Figure 2.7. **Equity vs. Debt Instruments**



The next dimension, voice, runs the other way, from left to right. Shareholders have a voice on Annual General Meetings, on rights issues, etc. But bondholders and lenders have a much stronger and more detailed voice, especially in the establishment of loan contracts. The establishment of loan contracts and their terms is typically a very detailed form of influence and executing governance over a company. Equities are typically perpetual instruments, and they are standardised and regulated mainly by law. Legally, they are not very complex instruments, whereas bonds and loans are legally complex. Bonds are limited in time and regulated mainly by contract. A bond issuance typically involves a 400- or 500-page prospectus regulating the details, which is not the case for shares.

The loan contract is the tool for voice. Lenders have influence via contracts, most of which is in the negotiation of terms. A bond contract has detailed regulation on information requirements and board observer rights, etc. Perhaps most important from this perspective, however, is the issue of covenants. There are two types of covenants. One is maintenance covenants, which are typically financial covenants saying the company cannot have an indebtedness higher than *x*, it must have earnings of at least *y*, it must have a debt-service capacity at a certain level, and so on. These are typically checked quarterly, and a breach of a covenant constitutes a default. The other type of covenant is what we call incurrence covenants, which are digital covenants saying you are either complying or not, so it can refer to a change of control, it can state that there should be no additional indebtedness, it can be limitations on dividends or investments, and so forth.

Thus a loan contract can mean that the influence of lenders can be very detailed in ways that a shareholder can never have influence on a company. Part of what is strengthening the bond market is that creditor rights are actually strengthening.

The implications of this are several. One of them is that somehow, counter intuitively perhaps, bondholders and creditors might have a much greater influence on a company than shareholders. Another is that in a corporate governance system shareholders typically govern to maximise potential given a certain level of risk. Whereas bondholders govern to minimise risk because they already have a set return, they know what their return will be if the company performs and the only risk for them is default. So they govern to minimise risk, and this is a very different dynamic.

The terms in a contract, if there is a constructive dialogue, are not there so that bondholders and creditors can say no to everything; they are there to make sure there is a dialogue. As soon as there is a covenant breach, there is a dialogue between creditor and company talking about what has actually happened, how do they deal with it, etc. It makes it possible for the bondholders to ensure that the risk of the company has not changed dramatically without their having a say. One consequence is that it will be a benefit for managers and boards to have a closer relationship with bondholders and creditors in the long run and to have an ongoing discussion.

Combining the loan contract and the greater role of bonds, what impact will this have? First, bondholders and creditors will be new and more active players. Second, the landscape will evolve such that there will be all different shapes of bond holders and lenders such as in the stock market, with everything from long passive owners in bonds to activists, to restructuring specialists and so on, present in the bond market. Many companies are learning the lesson that it pays off to have as close a relationship to bondholders and creditors as to shareholders.

One of the reasons for this is that the valuation of bonds has a much greater influence on a company than the valuation on shares. If shares go down, the direct risk to the company is that it could be taken over -- though mostly a risk for shareholders, it can be a risk for management as well -- and also that the currency of own shares becomes less valuable to make acquisitions with.

If bonds go down, implicitly the cost of funding has gone up. If a bond issued at 5% goes down by 50%, the market says that the true cost of capital for the company is 10%. So next time the company is refinanced, that lack of trust will immediately end up on the income statements as a higher interest rate. Thus the link between the performance of bonds and the company is much greater. The risk in this context is that when bondholders have a greater influence (and they have a lower tolerance for risk than shareholders), there will be a lower tolerance for risk in the governance of the corporation.

I have seen many cases where constructive bondholders guide the focus of value creation. Two examples are Swedish media company Metro and European travel group Thomas Cook. Metro was making acquisitions at a very high rate, the shareholders and the board could not control management, and they came into a very difficult position four years ago where they had to refinance themselves. They refinanced through a bond issue, the terms of which – because bondholders did not want to step into the situation as they wanted to make sure the risk was limited – put the company on a very tight path. Today the company is very profitable, and the shareholders have made a lot of money and benefited greatly from the governance of bondholders.

Thomas Cook was technically bankrupt in late 2011, but it has raised money in the short term and has put longer-term funding structures in place. The history of the company features a very fragmented shareholdership, with no-one really having a check on management. The current discussion between bondholders, creditors and management will ensure again that there is a tight but constructive path to profitability that will also benefit shareholders over time.

In conclusion, non-bank debt funding will be crucial to address the financial needs of mid-sized companies in Europe and around the world. Debt instruments have interesting potential as tools for corporate governance, not least in what is needed at the moment: an informed and motivated group of financiers for mid-sized companies with the potential to grow. The debt contract has the potential if rightly applied to be a positive influence on the management of a company for value creation. In all, we can see that new debt investors will be crucial for funding for mid-sized companies, and this will change the dynamics of corporate governance. From a corporate governance perspective it is important to understand this dynamic.

In terms of policy, the current focus on tax regulations and tax discussions is very much focused on the stimulation of equity. Regulators want the balance to change from loans to equity. When looking at that, it is useful to return to the point about financial markets versus funding markets. If your equity is stimulated and 99% of equity is actually circulating in the secondary markets, there might be a paradoxical effect at the same time of a disincentivised emerging bond market, which is crucial for funding mid-sized companies. So taking this approach, talking about tax neutrality between equity and loans might actually put a brake on funding for mid-sized companies and therefore have a dampening effect on growth and employment. I am not saying equity is not important, but equity cannot close this gap alone and therefore equity should not be the sole focus.

Another point is that politicians, regulators and especially market actors need to focus on how to develop the bond market in Europe, how to develop a transparent and well-functioning bond market. There are three aspects to this. One is transparency and liquidity, again because there are no trading statistics today in the bond market. It means we cannot build indices, it is hard to build broader independent research and advice, and so on. That dampens the market and decreases liquidity. The second aspect is legal regulation. We need much more active trustee functions. We need the kind of self-regulation we have in the stock markets, which is non-existent in the bond markets. And -- coming back to the 400 or 500 pages -- we need standardised contracts. It is impossible for most investors to understand what they are investing in today, which is of course a challenge. Finally, how do we widen the circle of bond investors? One part of this is that the institutions today have very underdeveloped investment policies when it comes to bonds. A lot of institutions can buy shares in a company but cannot buy bonds in that same company because they have much stricter regulations on their bond investment side. The other side is how do we widen the circle to include more retail investors?

Under any scenario, we will need this market to develop. It will have an impact on governance and therefore for the OECD and for other people who engage in the debate on the development of corporate governance, this aspect of governance will be very important in the future.

Chapter III

Regulating for value creation: What is the link between market confidence and contractual freedom?

By

Colin Mayer
Professor of Management Studies at the Saïd Business School, University of Oxford

Europe and North America have experienced what confident markets and freedom of contracting are all about, but not perhaps in the sense that they might have hoped for. There is a widely held view that corporate governance is about enhancing shareholder value, protecting shareholder interests and ensuring that firms act in the interest of their shareholders. That is often reflected in policy recommendations. We have only to go back to what happened in the East Asian crisis and the observations that were made then from the IMF and Alan Greenspan about the impact of crony capitalism and what those countries needed to do to break up their traditional corporate relationships and move over to a US/UK-style dispersed system.

That did not look like such a good idea in light of the bursting of the tech/dotcom bubble four years later. At the point, the response was to argue that we need to strengthen our corporate governance standards, ensure that there is better accountability, and better information through corporate accounts. Countries adopted this with relish but what we found four years ago at the onset of the financial crisis, was that those which adopted it most zealously, notably the UK and the US, performed the worst. Furthermore, the companies that had adopted "the best corporate governance arrangements" were those that performed the worst during the financial crisis. Those that aligned their managerial incentives with their shareholders displayed the greatest degree of risk-taking and those with "best systems of corporate governance" in the traditional sense, for example with independent board directors, had the worst record of failures during the crisis.

Corporate governance is not about enhancing shareholder value. It is about enhancing economic growth, entrepreneurship, innovation and value creation. We do not actually care about shareholder returns or shareholder value per se, except insofar as they contribute to achieving these objectives. This concerns all aspect of corporate governance that we typically talk about in relation to: the structure of company boards - independent directors, induction and servicing of new board members; the conduct of boards in terms of risks, audit committees, risk management committees, and the determinants of executive compensation, executive compensation committees and shareholder voice over executive compensation; and relationships between investors and firms - information, transparency, shareholder activism, and shareholder engagement in corporate activities. It is directly related to the policies being promoted at national and international levels in regard to the development of better legal systems and contractual rights, stronger investor

protection, more say on pay, more power given to shareholders in terms of putting up shareholder resolutions and more creditor rights.

The correct focus of corporate governance therefore should not be on enhancing shareholder value per se, but on how one structures these aspects of corporate governance in terms of ownership, boards and remuneration to achieve the right balance between the degree of control that investors are exercising and the degree of commitment they are showing to firms, with a view to attaining the firms' objectives.

The implication is that what is suitable for one country is not necessarily suited for another country, what is appropriate for one industry is not for another, and what is suited for one firm within an industry is not for another. What we need is diversity and contractual freedom. Regulation should be designed to enhance markets, but not in the process to undermine the delivery of that contractual freedom. In that regard, prescriptive regulation can be particularly damaging.

We have only to think about the advice that has been given or what people have regarded as being the most appropriate forms of corporate governance at various stages over the last 40 years. In the 1980s it was the Japan model of good corporate governance that was widely advocated. But when Japanese banks went into crisis in the 1990s, they did not look so good. We then turned to the US with its promotion of technological innovation during the 1990s, and that seemed to be the right model of corporate governance until the tech/dot com bubble burst and created a crisis at the beginning of the last decade. Then people said, it is the UK model, with its balance between principles and rules and greater emphasis on principles, that was the appropriate form of corporate governance -- but this did not look too good after the financial crisis.

Now we say perhaps it is Sweden or it is China, or perhaps it's none of them at all. In fact, there is no one best system of corporate governance, at least not at all stages and at all times. The UK is a good example. The UK initiated the rules that have given rise to the corporate governance codes. It promoted independent directors, auditors and remuneration committees well before many other countries. It has a dispersed share-ownership system, the most active market for corporate control of any country in the world, increasing institutional activism and some of the strongest creditor rights anywhere. And its performance has been very poor.

One of the factors contributing to this is what has been going on in equity markets over the last few years or decades. Some 30-40% of trades in Europe are high-frequency trades; in North America they are between 60% and 70% of all trades. The average holding period of equities has declined from 8 years some 70 years ago to 4 years 30 years ago to less than a year now. This has been exacerbated by growth in the market for corporate control. What this is doing is essentially to shorten the horizon of shareholders. It imposes increasingly short horizons on those running companies, and a reduced commitment of shareholders to corporate long-term investment decisions.

A survey of the attitudes of executives in companies worldwide a number of years ago emphasises some of these aspects. There were two sets of questions. The first was, to what extent does the company's interest align with those of the stakeholders broadly speaking in the company, or are

shareholders given priority over others? The survey found that in the UK and the US 70-80% of executives thought their companies' interests were essentially shareholder-oriented. In the case of France and Germany, those figures were about 20%, while 80% thought their companies' interests were aligned with stakeholders broadly speaking. In the case of Japan, the orientation with shareholder interest was thought to be the case in just 3% of companies.

The second set of questions asked, what would happen if the company experienced a serious financial crisis? What would be the corporate priorities? Would they be on maintaining dividends or maintaining employment in the firm and cutting dividends if need be? In UK and US firms, 90% of executives thought their companies would put priority on maintaining dividends. In France and Germany that figure was 30-40%, and in Japan it was only 3%. In the remaining 97% of companies in Japan, the executives thought they would put priority on maintaining employment.

Why does this matter? It reflects the degree of commitment that a company or its investors show to different parties, to employees and to shareholders. Commitment to shareholders is high in the UK and the US, while commitment to other stakeholders, suppliers and customers is relatively low. In the case of France, Germany and Japan, much more emphasis is placed on employee and other stakeholder commitments. This matters because it elicits different levels of commitment on the part of stakeholders. It elicits higher employee, supplier and purchaser commitment in France, Germany and Japan, but it leaves companies exposed to expropriation by those stakeholders. In the case of the UK and the US it leaves stakeholders exposed to expropriation by shareholders in relation to the shortening time horizon of shareholder interest.

In a nutshell, corporate governance arrangements are all about achieving the appropriate balance between the degree of commitment and control to different parties. The implications for the design of corporate governance is that all aspects of corporate governance, design, ownership, shareholder control, board structure and incentives should be focused on getting that balance appropriately related to corporate activities. Corporate governance is about the design of these features of the firm and ensuring that they promote corporate activities and values.

One should be careful in drawing implications for the design of codes and legislation. What the OECD has done in terms of the design of its codes has been very important in improving corporate governance around the world. What needs to happen now is to appreciate the risks as well as benefits of having codes and to assist countries with implementing appropriate governance arrangements. There are three potential risks of excessively prescriptive codes.

First, there is a problem of identification, an inappropriate focus on particular forms of governance that turn out to not be the right approach; for example, the focus on dispersed ownership in response to the Asian crisis 15 years ago. Fortunately Asian countries ignored that advice. Had they followed it, we would have had a truly global financial crisis a few years ago. The focus on high-powered incentives in banks before the financial crisis contributed to that financial crisis.

A second issue concerns unintended consequences. Prescriptive rules have effects that are not anticipated; for example, in terms of the relationship between independent directors and the performance of banks before the crisis.

Third, they create too much homogeneity and thereby exacerbate rather than mitigate the risks of systemic crisis because countries and companies adopt similar practices. So when something goes wrong in one country, it is a cause of failure in many companies and many countries.

The role of the OECD in the future should be to help countries identify the impediments between getting the balance right between commitment and control, what promotes the appropriate structure of boards, controls, and incentives, and what are the deficiencies in financial institutions, laws, taxation, and public institutions

I would like to cite a few examples - first, the promotion of entrepreneurship. Silicon Valley is an incredibly successful example of how to create a networking and mentoring laboratory which has played a key role in the development of entrepreneurship in the US. The intermediation role performed by general partners between investing institutions and companies is critical. Elsewhere there is not that sort of intermediation between the financiers and the firms. Therefore, venture capitalists complain that there are too few profitable proposals, and entrepreneurs complain that there is inadequate finance, and they are both right, because there is no willingness on the part of investors to commit or an ability on the part of entrepreneurs to demonstrate that they can commit. Therefore, entrepreneurship takes very different forms in countries around the world and one has to appreciate that in putting forward policies to promote it.

Entrepreneurship is important but so is the next stage - the development of small and medium-sized enterprises. Bond markets are significant, but banks are also very important because of the relationships they can have with borrowers and the greater degree of flexibility they can have in determining contractual arrangements with their borrowers. In the past the UK had one of the best banking systems, which helped to promote it as the workshop of the world during the Industrial Revolution. But local relationships between banks and firms were undermined and commitment by banks to local industries in the form of long-term financing dried up.

A third example is takeovers which are regarded as a critical element of corporate governance arrangements. The UK, and to a certain extent the US, have very open markets in takeovers. They are thought to promote efficient allocation of resources and encourage managerial incentives. They certainly create an immense amount of shareholder wealth but they have a serious problem in the way in which they undermine commitments to other stakeholders. In the case of the Kraft-Cadbury acquisition a couple of years ago, for example, there was a promise on the part of Kraft that they would maintain employment, and one week after the acquisition they closed the Somerdale plant. That is an illustration of how corporate governance can dramatically affect stakeholder relationships and commitments to different parties.

A fourth example concerns managerial and executive remuneration. As mentioned above, in the case of the financial crisis there was a very close relationship between the failure of banks and the

alignment of managerial incentives with those of shareholders. The reason is simply that by aligning executive incentives with shareholder interests what one is doing is essentially encouraging banks and other companies to take greater risks because shareholders get the upside gains but they do not take the downside losses. The creditors take those downside losses, and there is a conflict between the interests of shareholders and creditors. Therefore, extending the control of shareholders potentially undermines the degree of commitment to creditors, which is exactly the problem that occurred in the financial crisis.

As a final example, shareholder activism is widely heralded around the world as the solution to corporate governance problems. There is strong evidence in the UK and other parts of the world that it indeed does create large shareholder returns and enhances value for the activist funds. What is required for successful engagement is a great deal of knowledge on the part of the activist funds about the companies they are engaging with. It is very much like the role of general partners in entrepreneurship and venture capital finance: it requires someone to intermediate between those who are investing on the one hand and those who are managing on the other. When shareholder institutions have that knowledge, they can reap significant gains from their interventions. But again, regulation can seriously impede the process; for example, insider trading rules have impeded the functioning of institutional activism.

To conclude, in all cases we need to determine the appropriate balance between commitments and control that is necessary for the promotion of corporate activities. Regulation can interfere with that: it can undermine the process by, for example, providing protection for investors at the expense of commitment to other stakeholders.

Countries should be assisted in identifying where failures exist in providing the right balance that is necessary for promotion of investment and growth. This cannot be achieved through broad codes. Codes have been very successful, but we need to go to the next phase if we are to develop a more detailed understanding of the required relationships. That knowledge can be used to inform countries how they need to adapt their systems.

To be specific, what I would regard as the most valuable agenda for the OECD is first to find out and understand what is going on around the world. The differences in the nature of relationships in different countries and different markets -- for example, the growth of institutional investment around the world -- are very important, but we know little about them at present. Next, it is necessary to understand and analyse what has happened, how these markets operate, and what are the differences that exist in terms of entrepreneurship and innovation in different countries, in different markets and in different firms. Once we have that knowledge, we can think about the design of policies to promote the appropriate balance between commitment and control, to identify the extent to which we want to promote market protection as against freedom of contracting and to determine the impediments to the achievement of the goals of entrepreneurship, innovation and growth.

Part II: Ownership Structures and Corporate Governance: Will One Size Fit All?

Introduction: What makes controlling ownership different?

By

Karl Hofstetter
Professor Zurich University
Group General Counsel and Member of the Board of Directors, Schindler Holding AG

Mainstream corporate governance has been geared towards issues with public companies and dispersed shareholders. The problem has always been the agency issue. The question has been: how can managers be reined in, in the interest of shareholders overall? There is nothing wrong with that focus. Dealing with the agency issue in public companies was a very important development, and we have made progress worldwide in focusing on this. The only problem is that perhaps this was too limited a view. There is more to corporate governance than this.

The agency model is based on neo-classical equilibrium thinking. As Austrian economist Ludwig von Mises pointed out, this kind of economic model is static. There is a danger that the entrepreneur is being squeezed out. Clearly, that problem is not there when there is a controlling owner -- particularly when there is a founding owner or when a family takes over a company from its founder and leads it through the next generation. These companies with controlled ownership have always been underestimated in terms of the number they represent. Indeed, controlled companies are even more important in number around the world than the classic public company with a dispersed shareholder structure. These companies have also been underestimated in terms of their performance. Studies show that companies with a controlling shareholder, particularly when a family is involved, perform rather better than public companies. So there is good reason to also focus the corporate governance debate on companies with that type of structure.

There are many types of controlled companies. The family-run company is just one example, and it is perhaps the most important and interesting in the emerging economies. In Turkey, 98% of listed companies are thought to be family-run or -dominated; that is not unusual in emerging economies, where family companies are very important even among listed companies. There are other types of majority ownership, however, like state ownership. In China, all of the major companies are dominated by or feature majority control by the government. That poses very particular governance issues, different from the ones that arise in family companies. In China it is mainly a question of separating politics from business, which is not the case in family companies.

There is a third important category of a parent company controlling a listed subsidiary. That also has opportunities and risks that are slightly different than in family companies.

One thing that is particular and perhaps separates family companies in a positive way from the rest of the pack. There is at least a chance there that those companies are run with a long-term view in

mind. Empirical evidence supports this, and it is logical because families hold shares for generations. Looking at the relative performance of family companies, the numbers are quite good. Among listed companies on the Swiss Stock Exchange, about half are family companies and their performance from 1990 to 2005 was an astonishing 60% better than the rest of the companies.

It is obvious that those families have an interest in monitoring the company closely and investing in monitoring, so there is a monitoring advantage. They also have the power to monitor effectively. An entrepreneur would typically do that. Warren Buffet, for instance, runs Berkshire Hathaway in a very close way. The same could be said for entrepreneurs like Bill Gates and the founders of Google.

While there is the control and monitoring aspect, there is also a driving, dynamic, entrepreneurial side. Families tend to have that entrepreneurial side but they also have less incentive to cheat. Which is not to say such things do not happen: Parmalat, for instance.

There is perhaps a last aspect that should not be underestimated, the “soft factors”. Quite a few studies show that families run their companies not just with profit interests in mind, but also with pride and commitment. These things help stabilise the organisation and perhaps make it possible to have mutual commitments ("implicit contracts") between the capital investor, the workforce and the customers.

Many factors play in the direction of good, long-term performance of a family-controlled company. Nevertheless, there are risks that we should not underestimate. There is the potential for “tunnelling”, transfers of resources away from the company or investments in unrelated businesses, as in the case of Parmalat. There is also a danger of diluting the equity of minority shareholders through the control of the shareholders meetings, for example by issuing new shares to family members at favourable conditions.

Another risk is what I call entrenchment; it can arise in connection with the succession of families from generation to generation. Grooming the successor becomes an issue and this is an area that the law does not and perhaps cannot address adequately. Crisis situations are similar, where perhaps the founder is a problem but cannot be removed because he controls the company. In entrenchment situations, indirect influence, through a board of independent directors, would have to work towards optimal solutions.

Controlled transactions are a third risk area, for example the sale of a company. Should it be possible for the shareholders to command a control premium? I believe (as I will show later) that control premiums make sense. Dual-class shares are tied in with that issue and should therefore not be prohibited by law. A separate topic is the going private transaction, where there is a risk that if majority shareholders take a company private they will benefit at the cost of minority shareholders because they have inside access. These matters should be considered in a controlled company structure and addressed in corporate governance rules.

For 20 years I have been with Schindler Holding, based in Switzerland, and present in more than 100 countries. Elevators and escalators is the core business, and many other businesses were sold off so we could concentrate on the core. It boasts 44,000 employees, USD 15 billion in market capitalisation and impressive performance over the last 25 years. Schindler is one of the best performing listed companies in Switzerland, and it is family owned. Some 70% of the voting rights and almost 50% of cash flow rights or equity are in the hands of the family, so there is a slight dual-share structure. The company is run by the fourth active generation after it was founded in 1872. The family has always put a strong emphasis on the control premium if they ever decide to sell. A discussion arose once when the Swiss legislature wanted to prohibit the control premium, and Schindler proposed a rather innovative solution under Swiss law where companies may opt out of the control premium prohibition. Many other companies also did this.

What is corporate governance at Schindler? What are the issues, and how do we resolve them? We have a ten-member board, six of whom are independent. That is very important in a family company or a company with a majority shareholder. It is good to have a majority of independents, particularly if the family is also involved in the management. The control function of corporate governance is important. Also in family companies there is the potential for abuse, even though it might be less pervasive than with managers. But an external eye is also needed. Even founders can lose their vision for the company at times and need outside inspiration, so having a board with strong independence can be helpful. The board committee is dominated by the family, thus the family has an entrepreneurial function through the committee and the largest family shareholder is also the chairman of the board and is very active everyday at the company.

There is an issue with related-party transactions that is an objective risk. How do we control that? Disclosure is the answer: as a listed company we have to disclose all related-party transactions. When concerns about a transaction arise, the compensation committee reviews them because it is completely independent.

Again, soft factors go a long way in explaining why family companies perform well. The Schindler culture is of a strong, active chairman who runs the board committee. He was formerly the group CEO and has run the company for 30 years. Succession planning -- something we have been thinking about for some time at the board level -- is underway. The Chairman has relinquished the CEO function but is still controlling the company from the position of board committee chairman.

Values have been a clear driver all along in this company. Legal compliance, quality and safety issues are constantly discussed. The chairman cares about these matters and is not just looking at profits. “Profit is a result, not a goal,” is his mantra. That is twisting the shareholder value concept in a reasonable and successful way, which leads to perhaps even better long-term results, and the company’s stock market performance seems to confirm this.

The mandatory bid/control premium issue is something on which I have drawn some flak in my writing. It is a bit provocative but is an interesting issue. I think controlled premiums make sense, and I believe in the opt-out solution in Switzerland (in the EU, controlled premiums are prohibited).

I think it is a better rule, because it is more conducive to family companies listing on the stock market.

There has always been a traditional view that control premiums reflect the potential of the acquirer to take "private benefits of control" from the company and that is why she/he is willing to pay more for the control. There could be another explanation, however, namely that the seller is not willing to sell the shares unless she/he is able to garner a premium over the shares of the minority shareholders and that a control premium is a deferred-compensation device for his or her special contributions, such as monitoring and engagement as a shareholder in a way that minority shareholders would never do; there are costs to that and an incentive is needed. Majority shareholder families are usually under-diversified because so much of their wealth is tied up in one company, so economically speaking that also deserves to be compensated. There is also legal or public-relations exposure, and it can be argued those too deserve compensation. There is an economic case for saying that a control premium is justified because it compensates, in a deferred manner upon sale, the majority shareholders for what they have done for the company and what the minority shareholders have not been doing.

If we buy that argument, we can also argue that dual-class shares make sense because they allow for a growing company to issue new share capital without losing control. The control from the perspective of the family makes sense in two ways: it allows the family to run the company further in an entrepreneurial way, but it also allows them to keep the claim on a future control premium. Dual-class shares might thus have an additional explanation, and legislators and regulators should be very careful in prohibiting these types of things following the slogan "one share, one vote". In not prohibiting dual-class share structures, the EU has at least changed its mind over recent years. Twenty years ago everyone was calling for one share, one vote but empirical evidence and conceptual rethinking have led to a mitigation of the dogmatic view; this also safeguards the incentive of companies with a control structure like family companies to stay listed or become listed.

In conclusion, one size does not fit all. This is particularly so with regard to family companies with very different corporate governance issues and it makes sense for a regulator to leave space for that institutional investors should be wary of that too. We should not underestimate the role today’s institutional investors and proxy advisors play with their corporate governance ratings. They also have a tendency to push for the same in every company, but they too should learn that one regime is not best for all companies.

Family and controlled companies deserve a regulatory playing field so that the markets can sort out which arrangement is good and which is bad. Imposing concepts that are geared towards public companies on family companies can lead to the prohibition of control premiums and dual-class shares and thereby dissuade family companies from even going public, which is certainly not what the economy overall should want. As mentioned before, not every controlled company is the same. We should look at the category of owner (families, state or parent company) and make differentiations with regard to that too. Regulatory regimes and investor demands should be sensitive to these differences and leave room for proper differentiations.

Chapter IV

Corporate control and incentives in a dynamic perspective

By
Alessio M. Pacces
Professor of Law and Finance, Erasmus School of Law, Erasmus University, Rotterdam

The subject of this chapter is entrepreneurship; Entrepreneurship and corporate governance. Entrepreneurs do things that have not been tried before. Their function in society is precisely to meet new challenges by embarking in uncertainty – a course of action whose odds cannot be calculated with any precision. The challenge for us, practitioners and academics, is to identify how corporate governance can support entrepreneurship. This is challenging as well because we do not know how to support something that is uncertain. Entrepreneurship is based on knowledge that is not possible to describe, let alone communicate.

This chapter will start by addressing why entrepreneurship matters in the governance of the corporate enterprise. It will then discuss why tenure of corporate control is needed to support entrepreneurship. Control tenure is just one condition to support entrepreneurship. By definition an entrepreneur is somebody who has ideas, some of which may prove successful, but he or she needs funding in order to implement those ideas. Therefore, it is equally important that control tenure can be accepted by financiers. This will lead me to the role of private benefits of control in reconciling this tension. Finally, I will conclude by pointing to a few implications for corporate law.

Why does entrepreneurship matter? Of course, for innovation. However, it should not be overlooked that a major implication of entrepreneurship is competition. Here competition is to be understood not in the way neo-classical economic theory portrays it or in the way we normally teach it – comparative statics and deadweight losses. Rather, what I mean is the competition between standards, between different ways to do things. It is also the competition between different ways to use products, such as the competition between Microsoft and Apple that has been going on over the past 30 years.

Because entrepreneurship can radically change the way firms interact with each other, it can dramatically affect economic growth. Normally, people do not like to face uncertainty. Uncertainty is something we don't know how to deal with. Entrepreneurs are exceptional because they accept dealing with this unmanageable phenomenon, and their challenge is to convince financiers that their ideas are worth investing in. The task of convincing financiers is daunting for entrepreneurs because they cannot fully disclose their ideas. For one, if they have very structured ideas on how to do certain things and manage to convince somebody to support them, their ideas could be stolen. But another reason is that entrepreneurs normally do not have very clear ideas about how they will deal with uncertainty. They tend to *believe* they will be successful, but they are usually not very good at

communicating to other people why success will eventually come. In fact, entrepreneurs meet many failures before being successful, or in between success stories. One iconic example is the late Steve Jobs, who faced so many failures. This is typical of an entrepreneur's story. The problem is that many if not most entrepreneurs just fail. It is virtually impossible to specify a rule or a set of rules distinguishing successful entrepreneurs from those who will never make it.

What are the consequences of entrepreneurship for corporate governance? One the one hand, there is the problem of how to give funding to these strange people, the entrepreneurs, who are not the easiest people to work with. On the other hand, the conditions for funding should not be overly imposing because that could kill entrepreneurs' initiative.

Crucially, these conditions include the ability of the financiers – directly or through their board representatives – to remove the entrepreneur from office. Why is this a problem, at least potentially? Because, in order to pursue their vision, entrepreneurs need tenure. Entrepreneurs tend to overestimate the odds of their success; otherwise, they wouldn't engage in developing uncertain activities. Therefore, financiers need to be happy with letting them work the way they like. This implies that a high rate of failure be accepted. And success, if it ever comes, might come only in the long term. Twenty years ago Apple had just 3% of market share in personal computers; fifteen years ago it was close to bankruptcy; today it is one of most profitable companies in the world. The Apple example shows that vision is not only important at the initial stage of development. Steve Jobs contributed to Apple's success more on its return as a CEO than at start-up as a founder and a manager. Jobs did not have tenure. Temporary failure forced him to leave the company. Eventually, he returned to rescue it. Nobody knows what would have happened had he stayed in Apple. Investors who had believed in his entrepreneurial talent (at Apple and elsewhere) have enriched themselves.

The feedback on entrepreneurship and the returns from it both materialize in the long term. The problem for corporate governance is that a lot can go wrong in the mid-term, when ideas start taking form and begin showing financial results. Different types of opportunism can occur at this point. One kind is shareholder opportunism. Assume that the best practices of corporate governance are implemented and the management is performing an entrepreneurial function. Then the management will not be protected from a hostile takeover when their innovative ideas start taking shape and further potential becomes visible in the market for corporate control. In this situation, it would be a good idea for the shareholders to auction the company off to the highest bidder. This is a way to take advantage of the previous investments of the entrepreneurial management that has been partly successful. Yet there is another way to look at this matter from just the opposite perspective. As Professors Arlen and Talley have argued in the US, when management faces a takeover threat that they cannot fend off with legal instruments, they may deliberately take value-destroying actions in order to prevent an insurgent from taking over.

How do we get out of this conundrum? We may just offer tenure to those who are in control and want to perform an entrepreneurial function. Tenure is a way to grant entrepreneurs a deferred compensation, which is contingent on their ideas being successful (and profitable for shareholders). Recall that entrepreneurship ultimately means dealing with uncertainty. The immediate

consequence of uncertainty is that if an entrepreneur has to contract with a financier, there will always be a part of his or her investment that cannot be contracted upon for the simple reason that uncertainty is not contractible. Tenured control is initially worth something only to an entrepreneur committed to playing this game. If ideas turn out badly, the value of control will be nil. Only if ideas turn out successfully, the value of control may become high enough to reward the initial investments by the entrepreneur. The crucial question becomes then who should get this value. The function of tenure is not just to give effective discretion to the entrepreneurs in control of a company, but more importantly to allow entrepreneurs to secure a deferred compensation from the opportunism of investors without having to threaten, or worse to implement, value-destroying actions to protect their controlling position. Control tenure is ultimately a way to support the bargaining power of the management *vis à vis* the shareholders in the event of an (actual or potential) change in control.

That brings us to the next problem: how can control tenure be acceptable to financiers? Financiers do worry that those who are in control take advantage of them in two ways. Professor Roe described them very effectively. One is stealing and the other is shirking. Controllers steal by diverting (part of) the company's value. There has been a lot of progress in policy making in the area of stealing, so I do not want to speak too much about it. If controllers are not sufficiently committed not to steal, however, there is hardly any way financiers can accept to give money and control to would-be entrepreneurs. The other problem – shirking – is instead a structural one. The idea that management may misuse discretion for their ends lies at the core of the principal-agent perspective, which is the mainstream approach to corporate governance. The management or whoever is in control of the company's assets, if given tenure, might use it simply to enjoy life instead of to create value. But we want these people to create value. We want it as a matter of public policy, and financiers particularly want it because they like to put their money to good use.

So, how do we deal with this problem? There are some classic ways. The first is, essentially, "skin in the game:" equity ownership aligns incentives. This fundamental intuition goes back to the way Jensen and Meckling presented the problem almost 40 years ago. Increasing the ownership interest of management unambiguously reduces agency costs. Indeed, 100% ownership would be the perfect solution. Unfortunately that would also mean that there is no equity financing, but entrepreneurs need outside equity for a number of reasons (including that, by definition, they have little capital on their own).

Another way to cope with agency problems is reputation. However, young entrepreneurs may have no reputation at all. With more reputation an entrepreneur may need to put less of his or her own capital in the venture in order to attract external funding. Reputation and capital cannot solve the problem entirely. Actually, there is no ultimate solution. In the presence of separation of ownership and control, the management will have always an incentive to care more about their own interest than of the interest of financiers.

I believe that private benefit of control can add the deferred compensation perspective to this framework. Private benefits of control can incentivize entrepreneurs by providing them a reward for the hidden value they uncover. In the absence of private benefits most of this value, which is

uncertain and therefore not contractible, would be allocated to the financiers while the entrepreneur could enjoy it only in proportion to the little capital he or she had been able to contribute in the first place. At the same time, this value is nil until entrepreneurship has proven successful, if success ever comes. It is precisely this characteristic that allows reconciling the tension between the interests of entrepreneurs and financiers. Initially, financiers should not worry about the entrepreneur enjoying private benefits of control so long as they do not reduce the value of their investment. At this stage, the entrepreneur can enjoy private benefits simply as a psychic satisfaction of making progress towards success. The entrepreneur attaches some idiosyncratic value to starting up a new venture or to dramatically restructuring an existing one. This is a value that markets cannot yet understand, let alone price. But if the entrepreneur is right in his or her assessment, this value will boost eventually the returns to financiers as well.

More important is the second stage, the moment in which the investment has proven successful but at the same time its value has become kind of exhausted. At that moment, the deferred compensation of the entrepreneur needs to be cashed in. The right place to do this is the market for corporate control, which, however, must work differently in this setting from how it is commonly understood. When we want to protect a long-term project that may prove right or wrong, and if it proves right it will be as innovative as to change the way firms compete with each other, then the market for corporate control cannot simply allocate companies to the best available manager as the most optimistic view of hostile takeovers would predict. The entrepreneur would have never accepted the deal in the first place if shareholders could eventually expropriate his or her investment by auctioning control off to the highest bidder. The entrepreneur, as I have argued, would have rather secured a premium for parting with control by requesting control tenure. When there is control tenure, hostile takeovers cannot occur and the market for corporate control needs to be implemented by negotiated transfers. Negotiated transfer and control premiums are typically observed in concentrated ownership structures. Entrepreneurship may just explain why controlling shareholdings are the prevailing ownership structure all over the world; but also, where we do not observe a lot of ownership concentration, why we experience anyway more managerial entrenchment that standard theory would predict.

The corporate governance literature interprets private benefits of control in a way that is different, less benign, but ultimately not incompatible with what I have just illustrated. Private benefits of control are typically understood as a trade-off in how the controlling agent extracts rewards. One way is to enjoy life, shirk, to put in less effort than would be optimal from the perspective of financiers. This corresponds with shirking. Professor Colin Mayer once called these ‘distortionary’ private benefits of control. They arise from a distortion of management choices, shaped by the personal interest of the controlling agent as opposed to the interest of the shareholders. The other way to extract rewards from control is misappropriation of shareholder value, which can be called ‘diversionary’ private benefits of control. These are the two standard ways to look at private benefits of control. Now, there is either dispersed ownership, where value diversion is kept under control by a number of contractual commitments and legal rules, but potentially there is managerial shirking which cannot be policed by law. Or there is enhanced monitoring by large owners, which comes at a cost because monitoring needs to be compensated by something and this something is

most likely diversion of value. It is a form of garden-variety stealing that financiers accept in exchange for enhanced monitoring.

I doubt that this is the full story of corporate governance, particularly because we observe much more concentrated ownership than a simple story of value diversion would warrant. When entrepreneurship plays a role in corporate governance, there must be a third category of good or – as I called them – 'idiosyncratic' private benefits of control at play. These also justify concentrated ownership. This is the idea I have been working on for almost a decade. Sweden is a typical example, where there is concentrated ownership without any value diversion actually occurring or even ever being heard of. Swedish companies still have concentrated ownership though. In this way, the good private benefits of control can be protected with stable, tenured control. The easiest way to achieve this protection is with concentrated ownership, for two reasons. First, the risk of giving tenure to a controlling agent is that he or she will enjoy life instead of creating value; but this is less likely to happen the more the controlling agent has skin in the game. In order to secure this effect, significant ownership and cash-flow rights are needed. This, of course, places a constraint on the amount of external equity that can be raised by the entrepreneur. In other words, the idiosyncratic private benefits of this kind need to be substantially self-financed.

But there is another reason why entrepreneurship in corporate governance requires most often concentrated ownership. This, particularly in Europe, has to do with corporate law. The process of separation of ownership and control can be distorted by legal rules because entrenchment may simply be not available under the applicable legal system. This is for instance the case when there are restrictions on deviations from one share, one vote. Many jurisdictions feature these restrictions, although such deviations are rarely banned altogether. However, in Israel there is now a debate on eliminating all possible deviations from the one share, one vote principle -- particularly pyramids, which are currently the only way to deviate from one share, one vote in the Israeli legal system. Disallowing departure from one share, one vote makes it more difficult for corporate governance to support entrepreneurship.

This chapter does not claim that entrepreneurship matters in all corporate governance situations. Rather, the point is that there is no one-size-fits-all solution. Entrepreneurship may matter in start-up as well as in established, listed companies. The necessary condition to protect entrepreneurship in the corporate governance of a listed company is to support control tenure. How can this be implemented? It is best left to individual companies to decide in their articles of association. Contractual freedom may mean different things. However, corporate charters are not so imaginative: they hardly depart from the default arrangements under the pertinent corporate jurisdiction. Therefore, the problem of giving contractual freedom to companies would not be solved simply by scrapping all mandatory rules in corporate law.

This is an issue I am currently trying to work out together with Professors Gilson and Enriques in a paper we are writing on takeover law. The first issue to decide is, what are the right default rules? There are different criteria. There are of course the majoritarian default rules that save transaction costs, but also the rules that force parties to disclose information. Particularly if those in control want to have the right to tenure, to say 'no' to hostile takeovers, it is important that they contract for

it with outside investors. In other words, they have to pay the price for control tenure (entrepreneurs will do it so long as they expect the value of control to increase in the future). Thus it is advisable to tilt the balance of default rules against those seeking entrenchment. That speaks in favour of a bold shareholder choice rule that becomes the default rule for deciding on takeovers, unless management contracts explicitly for the right to fend off an unwelcome bid. Similarly, as far as the control premium is concerned, those who want the right to a control premium should contract for it explicitly. What we have now in Europe as a Mandatory Bid Rule should become a default rule.

To conclude on how to support entrepreneurship by increasing contractual freedom, a couple of other issues are worth mentioning. Many companies are already established and listed and they are governed by the current system of legal rules. If introducing new rules – or just more contractual freedom – upsets the entitlements of managers, controlling shareholders or investors in these companies, this could create a lot of problems from a perspective of political economy. Legal reform, however efficient, is likely to be opposed by the constituencies having vested interest in the status quo. Whether this problem concerns investors, management or controlling owners, strong resistance may prevent policy-makers from implementing changes that are dynamically beneficial, because for instance these changes can support entrepreneurship in companies that are still to be established. So the political economy problem is crucial and must be taken into account. It would be useful to think of a regulatory dualism solution, where existing companies have at least the option to continue being governed by the status-quo regime.

The second problem with supporting entrepreneurship by increasing contractual freedom is that, even after we have decided what the default rules should be, it would be equally important to define a menu of rules that companies may just pick off the legal rack when they need them. These would be rules that, instead of being just opted out of by companies where entrepreneurship matters, can be opted into by the same companies seeking to create value in some new way, which differs from how the other companies do it. But for this to work, we need to take stock of existing experiences and not to create a menu of rules and options out of our imagination. Experience tells that investors are sceptical of contractual innovation in corporate governance. New contract terms are accepted and priced by financial markets only if they are sufficiently popular to generate network effects.

Chapter V

One size for all? - The European Union experience

By

Rolf Skog
Ministry of Justice, Sweden; Secretary to the Swedish Securities Council

The fundamental principle within the European Union is that production factors (labour, capital, goods and services), in order to be utilized in the most effective way, should be able to move freely across the borders of member states. As a consequence, there is also a free right of establishment within the union. Individuals and companies in one member state have the right to set up and run operations in another member state on the same terms and conditions as the citizens and companies of that member state.

Freedom of establishment implies, of course, that member states set aside rules that discriminate on the grounds of nationality. This, however, is not enough. Real freedom of establishment also implies, according to the EU, that differences between the rules of member states, national rules, should not be too large, e.g. in relation to company law and corporate governance. The European Treaty stipulates that the Commission should work towards a harmonisation of national company law. Hence, already in the early 1960s, the Commission started an extensive work programme to create not identical, but similar, regulations on company law within the member states. This was done by proposing harmonisation directives, and to some extent harmonisation recommendations, to be issued by the Union and directed to the member states.

EU directives are binding on member states in the sense that national regulation must conform to the demands of the directive within a stated period of time. If a member state does not comply, it risks sanctions. The same does not apply to recommendations, however. The company law harmonisation effort was driven with great momentum and from, the Commission's perspective, success, during the 1970s and 1980s. During the 1990s it emerged that member states' interest in harmonisation was limited, and negotiations became extremely lethargic. The harmonisation process began to languish, but slowly regained momentum, and it lives on. At present, a dozen company-law directives have been issued, as well as a couple of company law recommendations.

The harmonization process has both advantages and disadvantages. Harmonising company law can facilitate cross-border cooperation, but harmonisation comes at a price. There is always a risk of hampering legal development in individual member states and ultimately petrifying company law.

EU harmonization efforts within corporate governance, through ignoring differences in company ownership and governance structures in different member states, runs the risk of diluting control

and hence actually hindering an active ownership function within a company. I shall cite three examples. The first concerns the possibility of a company to issue shares and other instruments for raising risk capital, which provides differing rights to participate in the company decision-making process.

Shares in a company have equal rights unless the shareholders have prescribed otherwise in the by-laws or articles of association. But how much freedom should a company have to issue multiple classes of shares with different rights to influence the company? In the vast majority of countries, the legislature originally handed over complete responsibility to the companies themselves to decide this. Shares could be issued without any voting rights whatsoever, and even non-voting shares were accepted. This is still the situation in many countries outside Europe, e.g. the US. In Europe, certain countries permit companies to issue shares with whatever voting rights they wish; likewise, shares completely without the right to vote. Some countries permit differences in voting rights within certain boundaries set by the law, whereas others do not allow any differences in voting rights.

From a corporate governance perspective, in countries that allow shares with different voting rights, or multiple voting rights, the presence of controlling owners in listed companies often correlates strongly with a holding of such shares. What, then, is the Commission's attitude to this very fundamental corporate governance issue? The issue was brought into the spotlight in the autumn of 2005, when the Commission took a remarkable initiative. The commissioner at the time responsible for company law and corporate governance, Charlie McCreevy, declared that he wished to see the principle "one share, one vote" implemented within the Union. What lay behind this initiative is unclear, but there was no mistaking its seriousness. The Commission would draw up a recommendation of the proportionality between capital investment and influence in listed companies. The recommendation would be preceded by a comprehensive survey of various "control-enhancing mechanisms" and a review of all available economic research on the connection between such mechanisms and company performance. The commissioner was convinced the survey would show that the majority of countries, especially those within the Union, already applied the principle of proportionality between capital investment and influence, and that the economic science would show a negative relationship between discrepancies from this principle on the one hand and performance on the other.

Strengthened by applause from British institutional investors and media, the commissioner awaited the study's findings. The reality, however, proved itself to be much more complex than he had first believed. The survey showed that the principle of proportionality between capital investment and influence lacked empirical foundation. On the contrary, control enhancing mechanisms were to be found in almost all countries around the world. In certain countries they took the form of shares with different voting rights; in others, they took another form. Furthermore, the scientific research was unable to support any negative correlation between discrepancies from the alleged proportionality principle and company performance. Certain studies even suggested the opposite, that control enhancing mechanisms had a positive effect on company performance. As the results of the studies gradually became known, the commissioner became more nuanced in his statements. Eventually, he abandoned the planned recommendation.

Thus as it stands at the moment, member states are free to regulate the question of shares with varying characteristics, like voting rights. But has the Commission really changed its point of view? There are many who, like me, are doubtful. This is already, unfortunately, enough to hold back legal development in member states.

The second issue concerns to what extent a controlling owner should be permitted to realise the value of a company's specific investment through decisions relating to the composition, competence, working methods, etc. of the board. Again, shareholders should be free to elect whichever board members they think are most competent. In this area too, however, we have seen with reference to the financial crisis, among others, a number of EU initiatives diluting the role of controlling shareholder rights. In a recommendation to the member states in 2005, the Commission advocated that there should be a set number of "independent members" on the boards of all listed companies. Independent from the management and independent from large shareholders. In 2011 the Commission took a second and giant step, proposing a directive aimed at financial companies with far-reaching demands regarding the nomination of board members, the composition of boards, the competence of board members, the working methods of the board, etc. In 2012, similar demands will most likely be introduced, in a directive proposal concerning also non-financial companies.

My third and final example concerns the market for corporate control. Using the British takeover regulation, the Takeover Code of 1968, as a model, in the mid-1970s the Commission presented a draft directive regarding takeovers. The rest of the member states at that time, however had never heard of takeovers, so the draft was shelved. Ten years later, it was time to return to the topic and, after many years of intensive negotiations, the takeover directive was finally agreed in 2004. In light of an extremely dispersed ownership structure within the individual companies and, at that time, rather weak minority protection rules in the UK Companies Act, the takeover code in Britain already included this mandatory bid rule. Anyone acquiring a sufficient number of shares to gain control in a UK public company was liable to table a bid for the remaining shares. The offer price should be at least the equivalent of the higher price the owner in question paid for shares in the controlling bloc within the last six months. In other words, the remaining shareholders should be given the opportunity to leave the company and be part of an eventual control premium.

For the continental European member states, the notion of a mandatory bid was a foreign concept. The ownership structure of listed companies in these countries was often relatively concentrated, and the trading of large blocks of shares was not uncommon. Nevertheless, the Commission intended the mandatory bid rule to be an essential contribution to the harmonisation of takeover regulation within Europe. Hence, the takeover directive posits that in all member states a mandatory bid rule must exist.

How, then, can one explain that the Commission's work to harmonise national rules in the area of company law and corporate governance in this way actually appears to counteract strong ownership and monitoring within a company? Should the opposite not be the case? I believe that one important reason is that the Commission quite simply has failed to analyse exactly what corporate governance fundamentally entails and instead became stuck in simple models often taken from institutional investors and organisational lobbies, above all in the British capital market. The British discussion

on corporate governance began earlier than in any other European country, and the British measures relating to corporate governance have surely come about with good reason as regards Britain. This does not mean, however, that that particular debate and those specific measures are relevant for other countries. In the UK, the ownership structure in the majority of large listed companies is characterised by great disparity and an absence of a controlling owner. Furthermore, companies have traditionally lacked a defining line between the board of directors and the management. It is against this background that one can partly see the suspicion with which the British regulators traditionally regarded ownership control and partly those specific measures which during the last decades have proceeded to, despite everything, bring about an element of control over an otherwise extremely independent management team. The traditionally scant regulation of corporate governance matters in the UK Companies Act is also an important explanation for the legal development within corporate governance during the last few decades, especially in the form of corporate governance codes.

In continental Europe, the structure of ownership in a listed company appears quite different. The majority of listed companies actually have a controlling owner, who also has a significant influence on the composition of the board of directors. The principal agent problem between owners and management does not exist to the same extent as in the UK and the US. Despite these fundamental differences, the Commission appears in its work on corporate governance to a large extent to have taken inspiration for its proposals in the British debate, without reflecting over the connection between ownership structure and governance. In the eyes of the Commission, the diversity in corporate governance structures and practices, which currently exists across member states, seems to be not so much an occasion for learning but a distortion that needs to be fixed. This has, in my opinion, been damaging to the development of corporate governance in the rest of Europe.

Finally, in the EU green paper on corporate governance published in 2011, the Commission speaks of the need for owners. Or, to be more exact, the need for long-term and stable owners. Does this not imply that the Commission has now arrived at an understanding of what corporate governance really is about? I am not so sure. The Commission now appears to be prescribing that all member states should order institutional investors to adopt a stewardship code, again modelled on the British rules. As regards the fundamental question on the idea of controlling ownership, it appears that not much has really happened.

Chapter VI

Long-term or short-term shareholdership: Does it really count?

By

Marco Langendoen
Counsellor of Legislation, Company Law, Ministry of Security and Justice, The Netherlands

The future of corporate governance is important for at least two reasons. The first concerns the increasing complexity of the economy. There are new types of companies, capital structures and value creation; the delisting of companies is also a relevant trend. Second and perhaps more important, there is a need to restore trust: trust in companies and trust in corporate governance as an essential element of value creation. The lack of trust after the financial crisis not only applies to the financial sector, it also reflects on the trust in companies in general. Therefore, it is very important to consider how to organise corporate governance in the future.

The OECD Principles start with an important message: the corporate governance framework was developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets. This principle I.A is important, but it also a challenge to comply with. Do our corporate governance systems really create the right incentives? I will try to illustrate the complexity of this matter with a discussion that is currently taking place in the Netherlands about whether company law regulation should introduce rewards for long-term or engaged shareholders, rewards in the form of extra dividend or extra voting rights. The question of long-term sustainability is important when it comes to restoring trust in the system. In this regard, it is interesting that the OECD conclusions on the financial crisis stated that "*shareholders have been largely passive and reactive in exercising their rights, in many cases voting in a mechanical manner, relying on proxy voting advice and generally failing to challenge boards in sufficient number to make a difference*." Also, the Dutch monitoring committee has spoken of the need to improve shareholder engagement. Thus the Dutch case may provide some more clarity on the question: will the "carrot" work? Should long-term shareholders be rewarded with extra dividends or extra voting rights?

Before turning to this case, it is important to note that Dutch listed companies usually have a more dispersed shareholder base than most European continental countries, with an average 75% of foreign investors. So Dutch companies usually do not fear controlling shareholders, but rather activist minority shareholders aiming to contest the strategy of the company. The question of whether long-term shareholders should be rewarded is based on at least three presumptions: (i) long-term is good, short-term is bad; (ii) long-term shareholder is long-term value creation for the company and (iii) a long-term shareholder is an engaged shareholder.

Let us put these presumptions to the test. From a corporate governance perspective, companies prefer a stable shareholder base. This makes it more likely that the strategy of the board generates sustainable support from the shareholders. So long-term seems to be good at first sight. The presumption is that short-term shareholders lead to a short-term focus. This is less desirable because it does not contribute to long-term and sustainable growth of companies and society as a whole. Short-term investors may lead to volatile market prices for shares, and the value of the company on the stock market may no longer reflect the underlying real value of the company. Volatility may also be stimulated by the speed of transactions, incentives for intermediaries to increase the number of transactions and the rise of high-frequency traders. On the other hand, short-term shareholders contribute to a better market price of the shares, and companies profit from good liquidity and marketability of the shares. A roundtable in the Netherlands with market participants concluded that the best result for companies may be to have the best of both worlds: a mixed group of shareholders, with a stable basis of long-term shareholders and enough short-term shareholders to keep the marketability and share price at level. Again, high-frequency traders may distort conclusions on the average period of shareholders.

If a mixed shareholder base is indeed the best solution, we should put the presumption to the test that long-term shareholders are engaged shareholders as well. But what do we want to reward? Is being a shareholder for a certain period sufficient, or do we require engagement as well? What kind of engagement? Is voting in a general meeting sufficient, or is a dialogue with management needed? Not every long-term shareholder is an engaged shareholder or the other way around. This is also shown by the conclusion of the OECD that shareholders remained rather passive during the financial crisis. Also, many pension funds have a passive investment strategy for the longer term and their voting behaviour is often influenced by proxy advisors. Dialogue with management usually focuses on the long-term strategy, but not necessarily so; it may also involve short-term decisions. The conclusion is a mixed picture: the assumptions may be true, but there is no sound economic basis and therefore it could be interesting to get more empirical evidence of successful companies and the key success factors.

As regulators, we also need to look at the possible downsides or risks of loyalty rights, which exist because rewarding long-term shareholders may reduce the marketability of the shares. The extra rights are not reflected in the share price because the buyer does not enjoy these extra rights. The value of long-term shares in case of selling is the same as the value of short-term shares. The risk is that minority shareholders are being locked up in the company. Another risk might be less protection for minority shareholders. Dividends become less predictable because the amount depends on the number of long-term shareholders. Also, loyalty rights may affect the balance between the board and the shareholders and may become a form of protection for the board. As noted elsewhere in this volume, the one-size-fits-all approach is not the best one because loyalty rights may affect different companies in different ways. For family companies and others with concentrated ownership, loyalty rights strengthen the concentration of power, whether that is good or not, and it may weaken the protection of minority shareholders. Another risk is the interference with regulation; this is an example of an incentive that we should bear in mind when we start thinking about new regulation. Even if long-term shareholdership is rewarded by companies, institutional investors like pension funds and insurance companies may behave differently, because

for example the Solvency II regulations may hinder long-term shareholdership. The higher the investment in a company, the higher the risk of concentration and the higher the required capital buffers. These institutional investors that we expect to be focused on the long term and to show engagement in the company in fact face incentives for the diversification of their portfolios and for passive investment strategies.

Thus, there may be other possible measures to stimulate a long-term focus that do not have these downsides. We could look at regulations like Solvency II or we could include long-term incentives in payment structures, which is quite a developed way of dealing with long-term focus -- and the area of remuneration seems to be the most developed when it comes to long-term incentives. We could try to ensure that larger shareholders have enough influence on the board or prohibit asset-stripping, which is part of an EU directive, or emphasise shareholder responsibility for their voting behaviour in practice. Or develop a comply-or-explain system for institutional investors regarding their participation in the general meeting. Importantly, we should try to remove obstacles for exercising shareholder rights, for example by facilitating cross-border voting. Maybe it would be wise to do nothing and trust, on the assumption that shareholders become automatically engaged because engagement in itself leads to higher returns than passive investments. This is as an illustration of the complex nature when we as a regulator are asked whether long-term shareholdership should be rewarded.

What should be the way forward? First, a reality check should be done for regulatory decisions. This would not necessarily be an economic check because it could also involve other incentives such as the solvency regulations. The problem is that political decision making often stops at the presumptions mentioned above. If long-term is good and short-term is bad, why shouldn't we reward long-term shareholders with extra rights? Our task as corporate governance specialists, and also the task of the OECD when revising its principles maybe in a few years, is to investigate the incentives and to do this reality check. We need to find out whether the principles and regulations affect different types of companies and countries in an efficient way. The OECD peer reviews are very useful in this respect; for example, the recent peer review on related-party transactions showed very interesting differences between countries where companies usually have controlling shareholders and countries with dispersed ownership. Discussions would also be useful on long-term growth and risk management as two key factors in restoring trust in corporate governance. In the Netherlands, the corporate governance principles say there should be effective redress. A recent survey investigated reasons why Dutch companies did or did not hold directors liable in certain cases for mismanagement. The outcome of the survey was that boards are influenced not only by costs but also very much by personal relationships and in particular moral reasons, punitive elements and expected ethical standards. Thus the reasons may also be psychological and, although the interest of the company should be paramount, the practice is different. Also, the fact that the company does not hold a failing director liable in court does not necessarily mean that there is no effective redress because companies may have good reasons to conclude that a cost-benefit analysis does not justify a court procedure. Effective redress may take place in other ways; for example, when a director is dismissed and a company is financially compensated by lowering the exit remuneration scheme.

The second message flexible corporate governance principles are often better than strict rules. This may be self-evident -- but the Dutch case of loyalty rights shows that a one-size-fits-all solution can be problematic and compared with legislation, corporate governance principles or codes have the advantage of flexibility. Companies have the possibility to adapt the application of the principles to their specific circumstances, and in 2011 the Dutch monitoring commission of the corporate governance code warned explicitly of over-regulation when principles are too easily copied by the legislature.

Last but not least, it is tempting to respond to the problem of the financial crisis with new strict legislation. However, this is not necessarily the right way to restore trust. Restoring trust should come from market players and regulators, and it should provide incentives for responsibility of market players and for being transparent about the corporate governance decisions they make. So a bottom-up approach is better than a top-down one. Related to this, there should be a focus on comply-and-explain. This idea is not new, but it is especially relevant for the discussion about corporate governance in the coming years.

A few closing comments should be made. First, we can benefit from the advantages of the flexibility of a corporate governance code only when we accept that the good explanation for not applying a principle has the same value as compliance. If we want 100% compliance for all principles, we can use the instrument of legislation and in fact we already use codes as legislation when we require companies to comply with all principles. And this is important to keep in mind when analysts use an approach saying that only 65% of the companies comply with principle A or B.

Second, how corporations comply with the principles is necessary to consider. This may also be true for non-listed companies; the focus on listed companies in the past few years may not be sufficient considering the new types of companies or new capital structures; also, the delisting may continue. Turning back to the example of stimulating long-term sustainability of companies, the Dutch corporate governance code says that the remuneration structures shall promote the interests of the company in the medium and long term. If most companies say they comply with this principle, we do not know whether they really have a focus on the long term. The Dutch corporate governance code also states that the remuneration report of the board shall explain *how* the chosen remuneration policy contributes to the achievement of the long-term objectives of the company and its affiliated enterprises. This is an example of a principle that stimulates companies to explain how they comply with a long-term focus. The monitoring commission has identified a number of goals that reflect long-term objectives of the company such as market share, strategy development, risk reduction and shareholder value.

The third comment is on comply-and-explain: explain is more important than comply. Explaining makes choices of strategy for individual companies more transparent and enables companies to focus on the specific circumstances. The system of a monitoring commission in the Netherlands, and in a number of other countries, is very useful in this respect. The monitoring reports give insight into the explanations a company gives for non-compliance but also for the way they do comply. Explanations are essential for restoring trust, not only in the direction of shareholders but

also to the general public. Boards should feel responsibility for making clear their choices in the company's strategy and explaining to the outside world in a clear manner why they did so. Also, shareholders could think about their main priorities in their voting behaviour when it comes to the strategy of the company. Since as regulators we often ask companies to comply or explain corporate governance principles, in the coming years we may also need to ensure we comply with the OECD principle I.A that provides guidance for the development of corporate governance frameworks.

Part III: The Emerging-Market Perspective

Chapter VII

Brazilian perspective

By

Maria Helena Santana
Chair, Securities Commission of Brazil and IOSCO Executive Committee

This chapter will start by describing the legal and regulatory framework that existed in Brazil before 2002, when the Novo Mercado was created by the stock exchange Bovespa, and the problems that prevailed there at the time. Novo Mercado is a premium listing segment on the stock exchange, and its requirements are targeted to improve corporate governance, investor protection and disclosure. Next, I will summarise the types of remedies that were chosen to address the types of problems observed, which constitute the main Novo Mercado rules. It is not a typical set of corporate governance rules, although it was largely influenced by the dominant concepts and prescriptions in this field. Finally, I will analyse both how the adoption of these corporate governance provisions has influenced the Brazilian market and whether there is already some kind of outcome after 10 years.

Brazilian public companies, as in many jurisdictions and especially in emerging markets, tend to be closely held, with one shareholder or a group holding the majority of the voting rights. When the Novo Mercado was established, there was no market for IPOs in Brazil. Very large companies had the option of seeking a listing, normally on an American exchange if they wanted to raise capital by issuing shares in the market. Smaller companies had no option, however, since the domestic market had no depth and foreign investors had no appetite for investing directly in the Brazilian market. Bovespa hired a group of experts to identify the causes of this situation. They found there was a perception on the part of investors that Brazil’s legal and regulatory environment did not ensure them minimum rights, that the rights they had could not be easily enforced and that informational asymmetry was prevalent.

In terms of voting rights, companies could issue up to two-thirds of their capital in non-voting shares, and the vast majority used that limit. Therefore the controlling shareholders could leverage their positions without losing control of the company, keeping only 17% of the total share capital. Practically all of the outstanding shares in the market were non-voting. There were no tag-along rights for minority shareholders and the mandatory bid was not in the law at the time, so in sale of control transactions huge premiums were paid for the shares of the controlling bloc compared with the market price or the minority shareholder’s shares. Tunnelling in self-dealings by controlling shareholders was considered a huge problem, worsened by weak enforcement of management and board members’ fiduciary duties. To complete the picture, and only to mention the main problems, minority shareholders could be squeezed out in tender offers to delist the companies, to take the companies private, and would receive much less than the fair value for their shares. Of course, as

market prices for the shares were depressed, almost no company would use the market for equity financing. The public companies' investments were funded by retained profits or otherwise were basically limited to the long-term credit provided by the Brazilian National Development Bank, a public bank. This certainly did not seem to be a capital market able to finance development and innovation and to create value for the economy.

After an unsuccessful attempt to change the corporate law and mitigate some of these shortcomings, the private sector, led by the stock exchange, decided to implement self-regulatory rules. The rules were inscribed in a contract to which companies could voluntarily adhere, but then became binding on those that decided to subscribe it. It is not comply-or-explain although it is self-regulation: it is a binding agreement. That contract, and its corresponding listing segment at the stock exchange, was the Novo Mercado, and its main rules were designed to address the issues cited above. First of all, according to the Novo Mercado rules, a company can issue only one class of shares, with one vote each. The rules grant tag-along rights to all the shareholders at the same price paid for the controlling shareholders' shares. Control premiums, therefore, are not possible. In the case of delisting, the tender offer must be made at a price equivalent to the economic value of the company, as calculated by a minority-appointed expert firm. Disclosure is greatly improved, including for all related-party transactions. And very importantly, private enforcement is hugely facilitated by the requirement that the company, its controlling shareholders, and its board and management agree to submit to arbitration to solve any conflicts or claims. There is also a provision on board composition, requiring 20% of independent directors on the boards, and a prohibition on staggered board elections. At the time, activist international shareholders were very critical of the fact that the rules did not require a majority of independent directors and that the Novo Mercado did not require an audit committee of the board, for instance. Those players seemed to give great importance to the adoption in Brazil of exactly the same types of rules applicable in the developed markets.

Ten years have passed since the reform began. Changes have been mainly market-driven because companies had the discretion to adhere or not to the Novo Mercado. The Brazilian corporate law has also improved. In addition, the CVM, the Securities Commission of Brazil has significantly improved some rules, elevating disclosure and investor-protection levels. Last but not least, in 2010 Brazil fully adopted the International Financial Reporting Standards. Yet the turning point, and the main driver of the vigour and strength that the Brazilian capital market has displayed, is the Novo Mercado. In other words, corporate governance and investor protection are at the centre of this success story. Brazil has succeeded in making it possible for its firms to go public with a domestic market listing, at least for medium to large companies. For SMEs, it's a different story still to be written.

It can be useful now to look at the Novo Mercado's corporate governance rules from the point of view of their possible ability to help companies innovate and create value in the long run. It has only been a few years since its inception, and I have not collected data to support the views I will present now, but I hope these thoughts can at least be a starting point to such reflections.

Since the Novo Mercado companies can issue only one class of voting shares, and given that Brazil's economy has seen a growth spurt, a number of firms without a controlling shareholder have

emerged. They have evolved in the direction of a more dispersed share ownership after having issued shares to an extent that diluted the original controlling shareholder. The sheer fact that they needed capital to grow, and to seize opportunities that Brazil and the global market were offering, is very positive. But even better is to see that these companies' ability to grow is no longer limited by the resources that the entrepreneur could provide without having his dominant position diluted. Entrepreneurs or their families are now, as some of them have publically declared, fairly comfortable in the position of being a minority shareholder in the companies they founded.

That said, it is important to take account of some developments that do not seem to differ, unfortunately, from what has happened in the most developed markets. Some companies, mainly among those that are now widely held, are cases of a business model based on acquisitions, or they are acquisition machines. Their growth is driven not by the development of innovation, for instance, but by the purchase of businesses delivering to the short-termist investors that dominate the market. What they want is an upside in the very short term. Many companies were designed by investment bankers; one example is the roll-up structures to consolidate specific sectors. Moreover, when the firms evolve in the direction of dispersed ownership, in many cases the entrepreneurs or their families end up selling their remaining stakes and leaving the company. Management remuneration is also starting to be an issue in Brazil, for better and for worse. The remuneration levels have gone up, and the use of share-based policies is predominant among dispersed-ownership companies. The packages also can be quite complex. So the numbers game, or "to cook the books" -- the infamous earnings-management practices -- are a type of risk that is now very present in the Brazilian market. How are such companies equipped to invest in innovation and in creating value in a sustainable manner? One could say that the adoption in Brazil of pro-investor type of governance rules does not favour long-term commitment with value creation and, more than that, entrepreneurship: the willingness to make risky investments that will take time to mature, if at all. The other part of this picture is that before the Novo Mercado, and the improvements it brought in corporate governance and investor protection, without access to external equity financing, only a few firms could commit the resources needed to invest in research and development for the term necessary. This type of investment requires equity capital, not debt, to be feasible. And the cost of equity in a bad corporate governance and investor protection environment is much higher, if the resources are made available at all.

The shortcomings of the Brazilian regulatory framework for investors were a phenomenal obstacle. They had to be removed, investor protection and transparency had to become a feature of the market, or Brazil would have continued without potentially innovative companies. The discussion on how to balance investor protection on the one hand and incentives for the attraction of long-term shareholders on the other, is a tough one. As a country that badly needs investment in innovation, Brazil stands to benefit from any formula that succeeds in reaching that balance. The Brazilian corporate law has mechanisms that were originally designed to facilitate the oversight of the controlling shareholder by the minority. These provisions ensure minority shareholders the right to elect board members on a separate vote. They ensure some proportional representation on the board as well, through cumulative voting and the right to include candidates on the company's proxy, for any shareholder with more than half a percentage point of the capital stock. That provides an incentive for relevant positions to be built through acquisitions in the market, since there will be an

opportunity to influence the composition of the board. Indeed, that has often happened. Value investors become relevant shareholders and truly monitor and influence the company's strategy. Some value funds have even teamed up to become majority owners of widely held firms and, in fact, perform as controlling shareholders. Yet, in the Brazilian experience, the possibility of a control premium, or the absence of tagalong rights, has tended to deter more strategic investors from building up relevant positions in a firm. This also tends to depress share prices, increasing the company's cost of capital.

In any case, in my view, a board composed of a majority of members representing relevant shareholders, controlling or not, is superior to one with a majority of independent directors. Ensuring the more strategic investors the opportunity to influence the company's strategy, providing some rights as in the Brazilian law and accepting as good practice the potential dominance of the board proportionally to their stakes, is one possible way of giving incentives for the accumulation of relevant long-term positions in public companies. Independent directors are important contributors in a board dynamic because of their arms' length position towards the company and their independence. But the presence on the board of directors elected by relevant shareholders can improve the chances that a firm actually invests in long-term projects.

Chapter VIII

Malaysian perspective

By

Ranjit Ajit Singh
Chairman, Securities Commission Malaysia

One of the major challenges for many countries in Asia, given the dominance of China and India, is to find an economic growth path that will create a complementary structure to these two major giants. Malaysia is no different. The Malaysian government is focusing on a new economic model, and is very clear in its aspirations for Malaysia to become a developed market.

The equity market in Malaysia is the largest, in terms of number of listed companies in Southeast Asia, the second-largest market capitalisation after Singapore and the third-largest bond market in Asia. We have a strong global niche in the Islamic capital market: approximately 60% of global sukuk (the Islamic equivalent of bonds) are issued out of Malaysia, and the country has the largest number of Islamic funds in the world.

Strengthening the growth path and development of the capital market continues to play an important role. Malaysia had a ten-year Capital Market Masterplan after the Asian financial crisis and in 2011, launched its second Capital Market Masterplan, which sets a very clear structured process for the development of the market. The theme for the current Master plan is *Growth with Governance*. The goal is to promote economic growth and vibrancy of the market, while addressing concerns about the efficacy of markets in the aftermath of the global financial crisis. Growth is only sustainable in an environment where it is underpinned by a proper system of accountabilities and good governance, including appropriate internal controls, risk management, etc. Strengthening corporate governance is therefore a continuous item on our agenda.

The Asian financial crisis had a major impact on the Malaysian capital market. Indeed, many of Malaysia’s efforts in strengthening corporate governance arose following some high-profile transgressions by a few public listed companies (PLCs) around that time. That set in motion a chain of efforts where the Securities Commission with the support of the government, industry and other stakeholders undertook reforms to improve the corporate governance environment. Among Malaysia’s corporate governance milestones was the publication of the High-Level Finance Committee Report on Corporate Governance in 1999. This was followed by the introduction of the Malaysian Code of Corporate Governance in 2000. During the same period, the Report on the Observance of Standards and Codes was also undertaken by the World Bank, which led to further corporate governance enhancements taking place in Malaysia. Another key development was the setting up of the Minority Shareholder Watchdog Group. This was a particularly important initiative

given that there was little shareholder activism at the time. The Watchdog Group has since played a very significant role in highlighting corporate governance problems that may appear in PLCs.

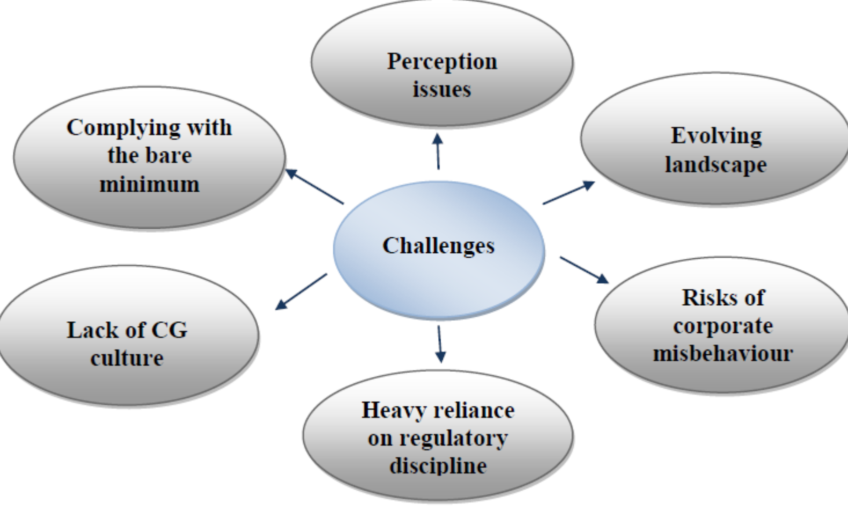
Over the years, Malaysia's corporate governance framework has been continuously strengthened through amendments to securities and companies laws and regulations. Whistleblowing provisions were introduced, where external auditors' have a mandatory requirement for whistleblowing. This has been very effective in highlighting problems in PLCs and the auditors have taken their role very seriously in this regard. Other aspects included introducing qualifications for directors and strengthening the role of audit committees. The Securities Commission's enforcement powers have also been widened, not just to criminal actions but also for civil remedies, restitution abilities and administrative actions, including requiring a restatement of PLC accounts if the Commission is of the view that they were not prepared in accordance with accounting standards. One of the most significant changes was the setting up of an independent Audit Oversight Board in 2010 to oversee the auditors of Public Interest Entities (PIEs), protect investors' interests and promote confidence in the quality and reliability of financial statements of PIEs.

There have been several other initiatives, including the recent publication of the Corporate Governance Blueprint (Blueprint) in 2011. When the Commission was formulating the Blueprint, we were particularly cognizant that there were certain challenges Malaysia faced as an emerging market, and arguably similar challenges may faced by many other emerging markets globally as well. One of these is the perception issue. Unfortunately, one scandal in an emerging market is one too many. Clearly, there is a need to be able to set high standards of corporate governance, particularly to attract and retain foreign institutional investor interest and participation.

Another prominent issue is a tradition of heavy dependence on regulatory discipline. While regulatory discipline is important, it is no substitute for the need for companies to govern themselves responsibly. The challenge ultimately is to internalise a culture of good governance in companies, and for them to recognise the value that good governance provides beyond mere box ticking.

The Blueprint focuses on key aspects of the corporate governance ecosystem. In Malaysia, corporate governance is approached in the context of three disciplines: regulatory discipline, self-discipline and market discipline. We regularly communicate to the industry that we would like to reduce reliance on regulatory discipline and place much more emphasis on self- and market discipline mechanisms. Our philosophy is to introduce no more regulation than necessary and to create the incentive structures and the behaviours that will promote better self- and market discipline.

Figure 8.1. **Key Challenges Faced by Emerging Markets**



There are six broad areas of reform in the Blueprint. The first is empowering shareholders. As we had made significant efforts in this area previously, the reforms focus primarily on enhancing shareholder participation and voting at general meetings. Recommendations include facilitating the voting through proxies and mandating poll voting for related party transactions. The other areas relate to reinforcing companies' commitment to shareholder rights and take active steps to ensure information is made available to shareholders on how these rights can be exercised.

The second area concerns the role of institutional investors. Malaysia has a very strong institutional investor base with total assets under management of approximately USD37 billion. Enhancing the role of institutional investors in the arena of corporate governance is a very major aspect of creating market discipline. One of the areas that we are working on is the introduction of a new stewardship code for institutional investors, and an umbrella body for institutional investors to promote responsible ownership.

The third area, which is extremely critical, is the board's role in governance. The thrust of the Blueprint is to amplify the role of boards to become more active and responsible fiduciaries. There is a whole range of recommendations that have been put forward, including a mandatory formal board charter, limitation on the tenure of independent directors, reduction in the number of directorships in listed companies that directors may hold etc. We have established a registry of qualified people that is kept by the private sector, the Malaysian Association of Company Directors. There is also a requirement for an annual assessment by the board of the independence of directors. We are working very closely on this issue with the private sector and relevant industry bodies. Another recommendation featured in the Blueprint is to promote greater diversity in the board composition of PLCs. The figures show that women continue to be under-represented forming only 8.2% of all directors on boards of PLCs, and we have set a target for women participation on boards to reach 30% by 2016.

In relation to the boards' role, we also reviewed the issue of directors' compensation, and found that the compensation levels were relatively low given the responsibilities and risks that directors assume. The Blueprint recommends that a study be undertaken by the private sector in this regard. Further, the Blueprint limits the number of directorships held by individual directors to five PLCs, and recommends instituting a continuing professional education program for directors.

Improving disclosure and transparency is another major theme in the Blueprint. The recommendations include shortening the submission period for quarterly and annual reports and moving towards integrated reporting and disclosure of the company's commitment to the environmental, social and governance (ESG) agenda.

The fifth area looks at the role of gatekeepers and influencers, and how to create an environment where professionals such as auditors, corporate advisors, company secretaries, the media and minority-shareholder watchdog groups can play a much greater role. A couple of specific recommendations have been made. One is to extend the whistleblowing provisions to corporate advisors and company secretaries, and indeed to enhance company secretaries' governance role. We are also looking at introducing a corporate governance training programme for the media and financial journalists. The other recommendation is to enhance internal codes of conduct for advisors to prevent abuse of market-sensitive information, and to promote integrity and ethical conduct.

Finally, the public and private enforcement aspect is another key area. Given that the cost to the market of over-dependence on regulatory discipline is disproportionate to the benefits, it is important to facilitate private enforcement actions. This can be done by way of statutory derivative actions or even petitioning the courts in cases where the affairs of the companies have been conducted in a manner that is prejudicial to shareholders. In Malaysia, we are looking at creating a funding mechanism, possibly by third parties, to help finance litigation and are also examining whether the regulator can be empowered to initiate action on behalf of shareholders for oppression or unfair prejudice.

We expect to have a new Code of Corporate Governance launched shortly as the first major deliverable of the Blueprint[1]. The aim is to create a much more internalised commitment to governance and to embed a culture of good corporate governance, addressing the key components of the corporate governance ecosystem to strengthen self and market discipline.

[1] The Malaysian Code of Corporate Governance 2012 was launched on 29 March 2012.

Chapter IX

Business perspective

By

Hüsnü M. Özyeğin
Chairman of the Executive Board of Fiba Holding and Board of Trustees of Özyeğin University

I would share a case study of Credit Europe Bank, a bank in the Netherlands of which I am the sole shareholder. I am the sole shareholder in Fiba Holding, which is the sole shareholder of Credit Europe Bank. This bank has branches and subsidiaries in the Netherlands, Germany, Switzerland, Belgium, Russia, Romania and Dubai. In Turkey we operate under the name of Fiba Banka. We have been applying the corporate governance rules in the Netherlands, especially since 2008. In 2008, after being the chairman of the banks that I owned, I relinquished my chairmanship in Credit Europe Holland, and our board appointed a Dutch banker as the chairman of the bank. That was our first display of corporate governance. The Western European regulators have become increasingly demanding, especially in recent years after the Lehman crisis. Financial institutions especially had been witnessing substantial changes in corporate governance, both from the Basel Committee and the European banking authorities, sometimes with accelerated public pressure. In the Netherlands, for instance, after two banks failed, the regulatory authorities and the media put pressure on the government to increase corporate governance rules. In Eastern Europe, we see a time gap in the implementation of regulations; nevertheless, Eastern European corporate governance models continue to take shape along the Western government rules. We are also observing that an institutionalised corporate governance structure has become a precondition for access to the capital markets; for example, the due diligence process of major quasi-governmental lending institutions such as the Dutch Development Bank (FMO), the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC), require corporate governance standards. Furthermore, obviously, the rating agencies also analyse the corporate governance practices before they assign their ratings.

The Dutch banking code, and the Dutch corporate governance code -- also known as Tabaksblat -- are the main guidelines for our banking group. Cross-border implementation is also obligatory under Dutch rules. Local regulators also embrace corporate governance as a value creator. Our corporate governance standards ensure that responsibilities and authorities of all stakeholders are aligned. None of the boards, shareholders, employees or other stakeholders have overriding power. We have assigned independent supervisory board members, and currently we have two independent board members out of seven, but by the end of December 31, 2012 we plan to have a 6 member board with 3 independent board members. Independent supervisory board members also have cross-border responsibilities, as we operate in ten countries. Board meetings are physically held in different countries each time. In other words, we have a board meeting in Moscow, Amsterdam, Bucharest, Switzerland and Turkey in one year, so our board members are also acquainted with the respective local managing boards. We reassessed the supervisory board, or the board of directors --

a managing board that is basically the top management of the bank, with a focus on a clear distinction in roles and the segregation of executive and non-executive roles as laid down in corporate governance book. We redefined the responsibilities and authorities of corporate governance in a nominations committee, audit and risk committee, remuneration committee, compliance oversight committee. Most of the board committees are chaired by independent board members.

We introduced new limitations on remuneration. From now on, 50% of the bonuses to management will be paid in the form of shares that can be cashed out over a period of three to five years. In general, variable pay in a year can never exceed 100% of one year's fixed income. We also enhanced our conflict-of-interest policy. Related-party transactions are subject to approval of the independent board members. We organise regular board meetings on different subjects; training on corporate governance has been delivered by highly reputable academics. We also started external board evaluations: the quality of the functioning and cooperation within the boards must be assessed externally at least every two years. We also organised our first external assessment by esteemed academics.

We believe it is possible to combine a strong corporate governance structure with continued value creation. To achieve this, we focus on transparency. Clashes between corporate governance requirements and commercial ambitions can be minimised by promoting full transparency in the organisation. Internal and external transparency should be part of the corporate culture, because open communication channels and information sharing are crucial in creating confidence and cohesion in board rooms. Credit Europe Bank was recently mentioned in several publications and sector reports as displaying the best practice in terms of reporting and giving well-motivated explanations when applying the rules of the Dutch banking code. Furthermore, in a study by KPMG at the behest of the Dutch state monitoring committee, Credit Europe banks scored in the highest tiers and were recognised for demonstrating leading practices in transparency and public disclosure. In our experience, executive board should act as a communication channel in the organisation. It should have open communication channels with the supervisory board. Furthermore, it should facilitate direct communication between supervisory board members and subordinates. In our annual budget meetings, for example, we invite not only top managers to the board, but also their subordinates to prepare their business plan to the full board.

For external transparency, websites, annual reports and press releases must be effectively used to share information. Open communication vis-à-vis regulatory authorities should be part of the corporate culture. Regular training sessions have also been very useful in increasing cohesion in the board room and keeping expertise at a high level. Regular training about changing regulations are the best way to remember that there is always room for improvement in the corporate governance area. This is especially valid for independent board members. It helps to protect corporate governance standards while promoting entrepreneurship in the organisation. Similarly, training about risk management facilitates effective communication of corporate governance standards without jeopardising value creation. A proper definition of risk appetite is extremely important in taking strategic decisions, and formal training is very useful in creating a common understanding about risk management.

With board members I have attended three training programs about corporate governance and risk management during the last two years. We make use of external sources, not only for training, but also for evaluation of board members' performance. Strong corporate governance is no longer an option; it's an obligation. Regulators and lenders expect to see a high level of corporate governance standards in institutions. Our challenge is to make strong corporate governance a value creator. Corporate culture is very important: strong corporate governance structure can coexist with entrepreneurship and value creation if the corporate culture is correctly set. The composition of boards also is very important; shareholders and other board members have the responsibility to identify candidates with the necessary technical and communication skills. In our experience, it is very useful to introduce new candidates to each board member before assigning them to the supervisory board. Independent and non-independent members must have the necessary expertise and commitment to facilitate value creation and to protect the interests of all shareholders. I received the decree of the capital markets board, dated 30 December 2011, and I believe it was prepared very professionally and is on a par with the best practices in the Western world.

I have a few comments about the decree proposed, or already announced, by the Capital Markets Board of Turkey. One of them is about Article 4.3, which requires that the board should be composed of at least five members. I suggest that at least for the first group of companies under Article 5, defined as companies with a market capitalisation of at least TRY 3 billion, there should be at least seven board members. With only five members, it will be difficult to have enough board members to serve on board committees, such as the corporate governance nomination committee, audit and risk committee, renovation committee and compliance oversight committee. Second, there should also be a requirement that board members should attend corporate governance training sessions at least once a year in order to be exposed to ever-changing regulations and requirements of corporate governance. Third, I suggest that this decree, when it is amended, should also have a requirement or recommendation to have at least one women board member. Europeans are pushing for this; the Central Bank of Holland is urging us to have a woman board member. I am proud to say that Credit Europe Bank had a woman CEO, Özden Başaran, a Turkish national in Amsterdam, as of 1994. She was the first woman CEO in the history of the Dutch banking system.

I have a couple of other comments. One is about the pay of independent directors. I would suggest that the independent director should be paid a respectable minimum amount per month. Typically, she/he will spend at least 12-15 working days to carry out the duties. I also suggest that there should be a maximum amount, because I have witnessed, not in my own group but in another company, an independent director being paid too much and basically, unfortunately, losing his independence.

Annex: Agenda of the Meeting

Corporate Governance, Innovation and Value Creation

- Exploratory Roundtable -

1 February, 2012
Ceylan Intercontinental Hotel
Istanbul, Turkey

09.00-09.15 Welcoming Remarks

Dr. Vedat Akgiray, Chairman, Capital Markets Board of Turkey and IOSCO Emerging Markets Committee

09.15-09.30 Introduction and Overview

Mr. Mats Isaksson, Head of Corporate Affairs, OECD

The original and most fundamental policy objective of corporate governance is to facilitate innovation, value creation and economic growth through private enterprise. The main tool for this is to create a legal and regulatory framework that provides growing companies with access to capital, that ensures efficient re-allocation of productive resources between competing ends and promotes competent monitoring of corporate long term performance. Through these key functions, the design of the corporate governance framework influences every step of the investment process and must therefore be a key element of any public policy for economic growth and job creation. In the coming years however, the corporate governance landscape will be challenged by important developments in both the corporate and financial sectors. Many of tomorrow's successful companies will look different from the traditional smokestack blue-chip corporation. They will be geographically mobile, more human capital intensive and more dependent on intangible assets and organizational know-how. Also the financial markets are undergoing profound changes in the way capital is cumulated and invested. The increase in institutional ownership and the reach of private pools of capital are only two examples. How well the legal and regulatory framework for corporate governance adapts to these developments will be decisive for the corporate sector's ability to create value, new jobs and economic growth. This perspective on corporate governance is particularly important to many emerging market economies that are currently in the process of developing standards that for a long time may influence the conditions for corporate expansion and entrepreneurial drive in the private sector. As stated in the OECD Principles of Corporate Governance: "*To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities.*"

09.30-00-11.00 Sessions 1: Outside Capital and Inside Value Creation

An effective corporate governance framework should provide incentives for a process of continuous discovery and innovation. It should provide prices as a tool for efficient resource allocation and support the original creation of wealth rather than rent seeking. This session will address the process of value creation within the corporation and discuss how corporate governance arrangements can provide key resource providers, such as founders, controlling owners, managers and outside capital providers with the right incentives and financial instruments to contribute to this process. It will also analyse the merits and limitations of contractual freedom in public companies.

Introduction: Mr. Marcello Bianchi, Chairman, OECD Corporate Governance Committee; Director, CONSOB, Italy

Dr. Erik Vermeulen, Professor of Business Law & Finance, Tilburg University; Vice President at the Corporate Legal Department, Corporate and Financial Law Group, Philips International B.V.
Entrepreneurship within Public Companies – How does it work?

Mr. Daniel Sachs, CEO, Proventus AB
The Impact of an Emerging European Corporate Bond Market on Corporate Governance

Dr. Colin Mayer, Professor of Management Studies at the Saïd Business School, University of Oxford
Regulating for Value Creation – What is the Link between Market Confidence and Contractual Freedom?

11.00-11.30 Coffee Break

11.30-13.00 Sessions 2: Ownership Structures and Corporate Governance – Will One Size Fit All?

In a number of instances, policy making in corporate governance has assumed a situation of dispersed ownership where the battle for power is a zero sum game between dispersed owners on the one hand and incumbent management on the other hand. This, so called principal-agent approach has its merits but it also has an important weakness: Many, if not most, listed companies around the world actually have a controlling (or dominant) owner; dispersed ownership being the exception. And it is increasingly recognised that these differences in ownership structure may have implications for regulatory design. This is particularly important in a dynamic context where the objective is to support entrepreneurs aiming to create value under genuine uncertainty. This session will provide examples of how differences in ownership structures may call for differences in corporate governance arrangements among listed companies. It will take a new economic look at the concept of private benefits of control and experiences with regulatory convergence within the European Union.

Introduction: Prof. Dr. Karl Hofstetter, Group General Counsel and Member of the Board of Directors, Schindler Holding AG
What Makes Controlling Ownership Different?

Dr. Alessio M. Pacces, Associate Professor of Law and Economics, Erasmus School of Law, Erasmus University, Rotterdam
Corporate Control and Incentives in a Dynamic Perspective

Dr. Rolf Skog, Ministry of Justice, Sweden; Secretary to the Swedish Security Council
One size for all - The EU Experience

Mr. Marco Langendoen, Counselor of Legislation, Company Law, Ministry of Security and Justice, the Netherlands
Long Term or Short Term Shareholdership: Does it really count?

13.00-14.30 Lunch

14:30-16.00 Session 3: The Emerging Market Perspective

Increasingly important driver for change in the global corporate landscape are the many fast growing corporations in emerging markets. And as these companies mature, countries are facing a need to shape those corporate governance standards that for a long time will influence the conditions for access to capital, expansion and entrepreneurial drive in their private sector. When doing this, it is important that regulators and policy makers have a well founded understanding of how corporate governance policies can be designed with a view to support innovation, entrepreneurship and economic growth. This may be particularly important for fairly mature companies, where the next step in their development will require external equity capital. This session will discuss the main characteristics of corporate structures in emerging markets and the key corporate governance features that follow from existing ownership and contractual arrangements. On this basis, the session will discuss the costs and benefits of current corporate governance arrangements and attitudes for market dynamics and value creation. Special attention will be given to the fast growing companies' issue of access to capital and the regulatory challenge to "institutionalize" a corporate governance framework that facilitates the sustainability of entrepreneurship and value creation.

Introduction: Dr. Vedat Akgiray, Chairman, Capital Markets Board of Turkey and IOSCO Emerging Markets Committee

Ms. Maria Helena Santana, Chair, Securities Commission of Brazil and IOSCO Executive Committee

Mr. Ranjit Singh, Managing Director, Securities Commission Malaysia

Mr. Hüsnü M. Özyeğin, Chairman of the Executive Board of Fiba Holding and Board of Trustees of Özyeğin University

16:00 Concluding Remarks

Dr. Vedat Akgiray, Chairman, Capital Markets Board of Turkey and IOSCO Emerging Markets Committee

Mr. Mats Isaksson, Head of Corporate Affairs, OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16