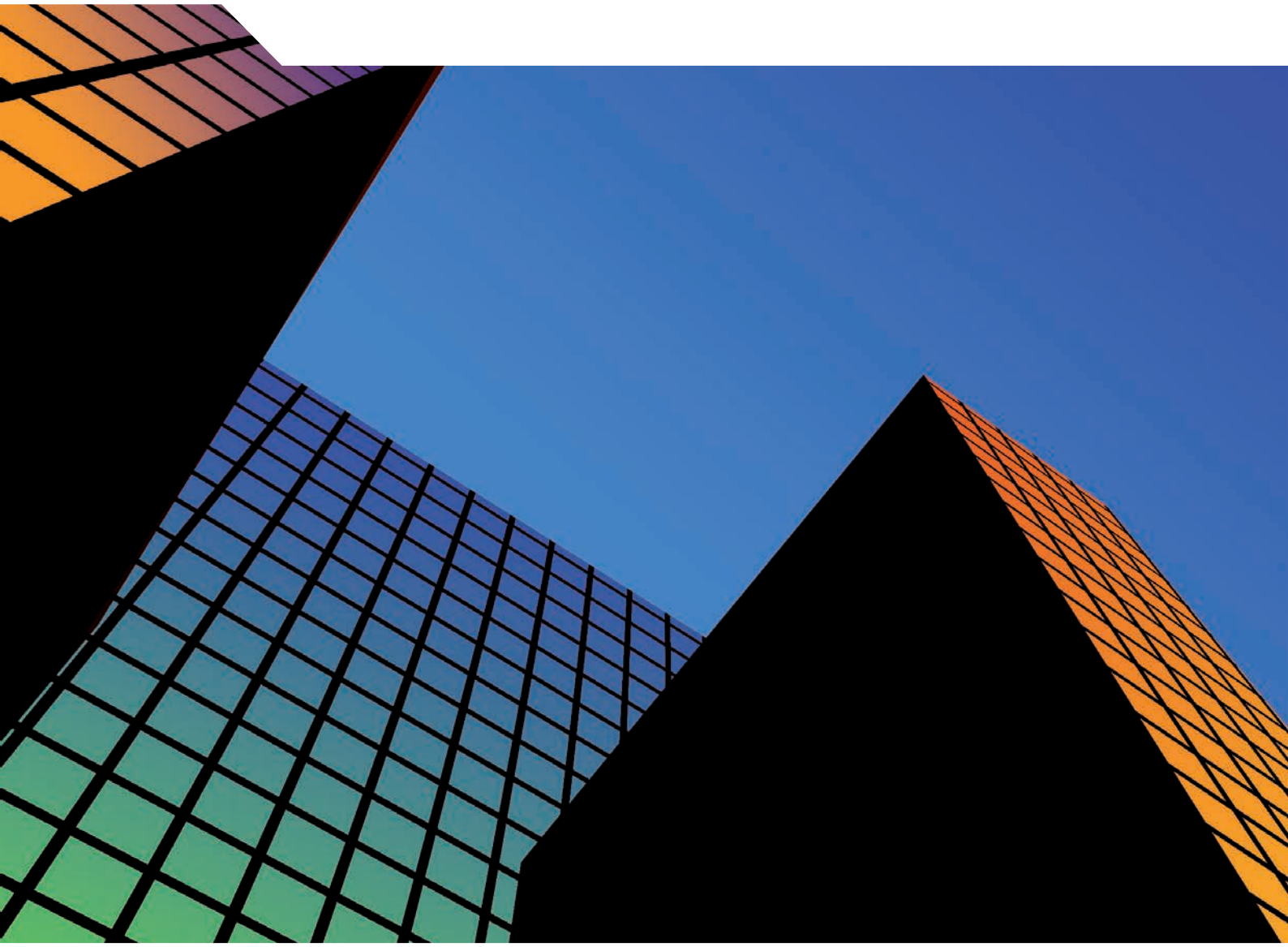
Corporate Governance

Supervision and Enforcement in Corporate Governance



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Foreword

This report presents the results of the OECD's fifth peer review based on the OECD Principles of Corporate Governance. The report covers the corporate governance framework and practices relating to the supervision and enforcement, both public and private, in the specific areas of i) *related party transactions (RPTs),* ii) *takeover bids and* iii) *shareholder meetings. It covers 27 jurisdictions.*

The report is based in part on a questionnaire that was sent to all participating jurisdictions in June 2012. In a second stage, supervision and enforcement practices in Brazil, Turkey and the United States were reviewed in more detail based on consultant reports (for Brazil and the United States) and a questionnaire and visit by the OECD Secretariat (for Turkey). The purpose of the case studies is to highlight national practices that may be of wider interest and particularly useful as a reference. The report was prepared by Mats Isaksson, Winfrid Blaschke, Héctor Lehuedé and Akira Nozaki.

The OECD corporate governance peer review process is designed to facilitate effective implementation of the OECD Principles and to assist market participants, regulators and policy makers. It is carried out through an exchange of experiences and expertise that provides participants with an overview of existing practices and approaches and an opportunity to identify good practices that can stimulate and guide improvements. The reviews are also forward looking, so as to help identify key market practices and policy developments that may undermine the quality of corporate governance. The review process is open to OECD and non-OECD jurisdictions alike.

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Executive summary

This report reviews the supervision and enforcement of corporate governance arrangements in the areas of *i)* related party transactions (RPTs), *ii)* takeover bids and *iii)* shareholder meetings, in 27 of the jurisdictions that participate in the OECD Corporate Governance Committee. Against the background of the OECD Principles of Corporate Governance, it describes how various jurisdictions have chosen to implement the Principles relating to supervision and enforcement.

The report analyses the arrangements for, and implementation of, public supervision and enforcement, primarily by securities regulators, in these fields, as well as private supervision and enforcement through, for example, shareholder lawsuits, and the interactions between public and private means of supervision and enforcement. It is based upon a general survey of participating jurisdiction, complemented by three country studies illustrative of different supervision and enforcement systems (Brazil, Turkey and the United States).

The review finds that a lack of independence and/or resources constrains the ability of many securities regulators to supervise and enforce corporate governance standards, as many securities regulators are less well-endowed than banking regulators, and corporate governance is not typically among the priority areas for supervision and enforcement.

Private supervision and enforcement (through shareholder lawsuits for example) can complement public supervision and enforcement, but in most countries are seldom used, except in some cases to obtain injunctions. A number of countries have, with some success, introduced arbitration procedures for corporate governance disputes.

The balance between public and private supervision and enforcement differs significantly by jurisdiction, depending upon the effectiveness of the regulator and the efficiency of the legal system in handling corporate law cases. In many jurisdictions, complaints to the regulator are considered the most effective enforcement mechanism.

Almost all jurisdictions lack public oversight of abusive related party transactions apart from the supervision and enforcement of disclosure requirements. Enforcement in this area is thus often in the form of shareholder lawsuits alleging breach of fiduciary duties.

The supervision and enforcement of rules on takeovers and mandatory bids typically involve an interactive process between market participants and the supervisory authority. In some countries with mandatory bid rules, exemptions granted by the regulator have proved controversial and were challenged in court.

Rules regarding shareholder meetings are frequently supervised and enforced through private means, although public authorities can also be involved, in some cases through attendance (physically or electronically), at shareholder meetings.

The case studies of Brazil, Turkey and the United States reveal sharply differing approaches to supervision and enforcement in the reviewed areas, with Brazil and Turkey relying largely on public enforcement, whereas in the United States private enforcement plays a much more important role than in the other two countries. The significant influence of private enforcement remains rather unique to the US, however, as its strong private enforcement infrastructure is not easily transferable to other jurisdictions.

Chapter 1

Public and private supervision and enforcement practices in 27 jurisdictions

This report presents the results of the fifth peer review based on the OECD Principles of Corporate Governance. The report is focused on the corporate governance framework and practices that relate to the supervision and enforcement in the specific areas of i) *related party transactions (RPTs),* ii) *takeover bids and* iii) *shareholder meetings.*

Chapter 1 of the report summarises public and private supervision and enforcement practices in the 27 jurisdictions that participated in the review. It is based upon a questionnaire that was sent to all participating jurisdictions in June 2012, discussions in the OECD Corporate Governance Committee in November 2012 and April 2013, as well as conclusions from the three in-depth studies of supervision and enforcement practices in Brazil, Turkey and the United States contained in Chapters 2-4.

1.1. Background to the review

Without effective supervision and enforcement, the letter of law and regulations have little meaning. This is fully recognised in the opening chapter of the OECD Principles, which emphasises the need for an effective legal and regulatory framework. The importance of effective supervision and enforcement for sound corporate governance was also underlined in the Committee's report from 2009 on *The Corporate Governance Lessons from the Financial Crisis*.

The quality of regulatory oversight and the role of enforcement have also been addressed in the Committee's thematic reviews following the financial crisis, notably in the review on board practices, where the Committee examined enforcement of director liability for breach of duties and in the Committee's third review, on related party transactions. It has also been dealt with extensively by the OECD Asian and Latin American Corporate Governance Roundtables.

An increased focus on the quality of supervision and enforcement in corporate governance has led to changes and reforms in many jurisdictions. Beyond staff resources and skills, the effective division of responsibilities and lines of communication between agencies have also been subject to discussion. Reform efforts have also led to a demand for a better understanding of useful country experiences, good practices and the interplay between various parts of the judicial system. Against this background, the Corporate Governance Committee agreed in April 2012 to undertake a peer review dedicated to country experiences with supervision and enforcement in corporate governance.

1.2. Scope of the review

The review covers both private and public elements of supervision and enforcement. The reason is that all jurisdictions apply a mix of the two elements and that they in some or several areas differ in the relative weight given to the two approaches. Hence a fair and full picture of a system's effectiveness and robustness requires that the functioning of both approaches is understood, in order to give the reader of the report the ability to assess the relevance of different approaches to their specific economic and legal circumstances.

Public supervision and enforcement refers to public functions involved with *i)* market surveillance and supervision of market participants, and *ii)* the imposition of sanctions for breach of laws and dishonest behaviour. Key actors of public enforcement typically include securities regulators, prosecutors and in some cases stock exchanges functioning as public authorities. Prudential oversight does not fall within the scope of the review.

Private supervision and enforcement refers to the functions performed through civil lawsuits, such as shareholder complaints, shareholder derivative suits and class actions, but also alternative dispute resolution mechanisms (ADRs) or other means of shareholder and stakeholder enforcement and means of obtaining redress. Key actors of private enforcement may include individual shareholders and stakeholders, self-regulatory organisations and institutions to which supervision and regulation is delegated by

government or regulators, private-sector stock exchanges, associations of industries, shareholder associations, etc. Other actors of private enforcement may include judicial courts, lawyers and associations of minority shareholders.

The Review covers twenty-one OECD member countries, together with **Argentina; Brazil; Hong Kong, China, India; Indonesia;** and **Singapore**. For all participating jurisdictions, a general overview of supervision and enforcement practices is provided. For three jurisdictions (**Brazil**, **Turkey** and the **United States**), a more detailed review was carried out in order to highlight either particular aspects of the supervisory and enforcement framework, or country specific circumstances that may influence the choice of approach. **Brazil** and **Turkey**, for example, with largely owner-controlled companies, are two jurisdictions that rely primarily on public enforcement, whereas in the **United States**, with its many widely-held companies, private enforcement is frequently used as well. **Brazil** is one of the countries where the stock exchange also plays an important role in the supervision and enforcement of corporate governance rules (see Chapter 2).

In order to limit the scope of the review, and to provide concrete examples with respect to key corporate governance issues, it was agreed that the review should cover three aspects of the Principles, which have attracted particular interest, namely *i)* disclosure and monitoring of **related party transactions**, *ii)* the market for **corporate control** and *iii)* effective shareholder participation in the **general shareholder meeting**. Questionable practices in those areas, and supervisory and enforcement measures to address them are described in Chapter 5.

1.3. The perspective of the Principles

This review makes reference to both the more general principles for the design and functioning of the regulatory framework, laid out in Chapter 1 of the Principles, and the more specific principles addressing the issues of related party transactions, the market for corporate control and shareholder participation in the general shareholders meeting. In terms of the more general principles for the design and functioning of the regulatory framework, the following three principles from Chapter I, *Ensuring the Basis for an Effective Corporate Governance Framework*, are used as reference.

- Principle I.B: "The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable."

The annotations add that policy measures should be designed with a view to their overall costs and benefits, taking into account the need for effective enforcement, including the ability of authorities to deter dishonest behaviour and to impose effective sanctions for violations. When codes and principles are used as a national standard or as an explicit substitute for legal or regulatory provisions, market credibility requires that their status in terms of coverage, implementation, compliance and sanctions is clearly specified.

- Principle I.C: "The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served."

The annotations to the Principles note that effective enforcement requires that the allocation of responsibilities for supervision, implementation and enforcement among different authorities is clearly defined so that the competencies of complementary bodies and agencies are respected and used most effectively. When regulatory responsibilities or

oversight are delegated to non-public bodies, it is desirable to explicitly assess why, and under what circumstances, such delegation is desirable. It is also essential that the governance structure of any such delegated institution be transparent and encompass the public interest.

- Principle I.D: "Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained."

  The annotations to Principle I.D note that:

  As the number of public companies, corporate events and the volume of disclosures increase, the resources of supervisory, regulatory and enforcement authorities may come under strain. As a result, in order to follow developments, they will have a significant demand for fully qualified staff to provide effective oversight and investigative capacity which will need to be appropriately funded. The ability to attract staff on competitive terms will enhance the quality and independence of supervision and enforcement.

1.4. Public and private supervision and enforcement

The legal and regulatory corporate governance framework should contribute to effective and credible markets. This requires that laws and regulations provide proper incentives to promote the long-term performance of the corporation. But also that actual market practices are supervised, and that violations of laws and rules can be effectively sanctioned through administrative and criminal procedures.

Supervision, whether public or private, is of course necessary to detect possible wrongdoing in the first place. Where there is no supervision in some form, either by regulatory authorities or by private actors such as shareholders, other market participants, stock exchanges, or even journalists, wrongdoing will remain hidden, and there will be no basis for enforcement action.[1]

Enforcement relies on courts, regulators and procedural rules that determine *ex post* whether violations have occurred. Enforcement has effects beyond the scope of individual and corporate wrongdoers, influencing the overall credibility of the regulatory system before all market participants. Effective enforcement requires the availability of effective, proportionate and dissuasive sanctions in the event of non-compliance. A track record of effective enforcement is likely to increase the deterrence effect.[2]

Supervision and enforcement can be carried out both through private initiatives and through public mandate. This section provides a discussion about the general principles and elements of public and private supervision and enforcement, followed by a discussion about the relationship and interplay between public and private supervision and enforcement.

Public supervision and enforcement

The key actors in public supervision and enforcement normally include securities regulators, prosecutors, and in some cases stock exchanges functioning as public authorities. In some jurisdictions, other authorities may be charged with enforcement in defined areas, including government ministries or local authorities. As these authorities typically have a wide mandate, which in the case of securities regulators includes the prudential supervision of financial intermediaries, as well as market conduct, and in some cases consumer protection, the supervision and enforcement of corporate governance

standards is for most authorities only one among many responsibilities, and not always a priority.

In a comprehensive study for the EU, the European Commission (2009) found that market-wide monitors (financial market authorities and/or stock exchanges) mainly monitor the availability of information on corporate governance. In some cases, they also perform some analysis of the informative value of corporate governance statements and publish the results thereof. The study also found that financial market authorities tend to be more active monitors than stock exchanges, and that monitoring by market-wide monitors is more common in member states where block holders are widespread and where there is limited ownership by institutional investors (e.g. Spain). In such member states, the monitoring by market-wide monitors balances the limited monitoring activity by shareholders.

The replies to the peer review questionnaire provided a wealth of information on the organisation, including composition and terms of appointment of the board, and the financing arrangements of the authorities in charge of public supervision. These are summarised in Figure 1.1. and Tables 1.1.-1.4. below. In most jurisdictions covered by the survey, the competent authority in charge of enforcement is indeed the national or regional securities regulator.

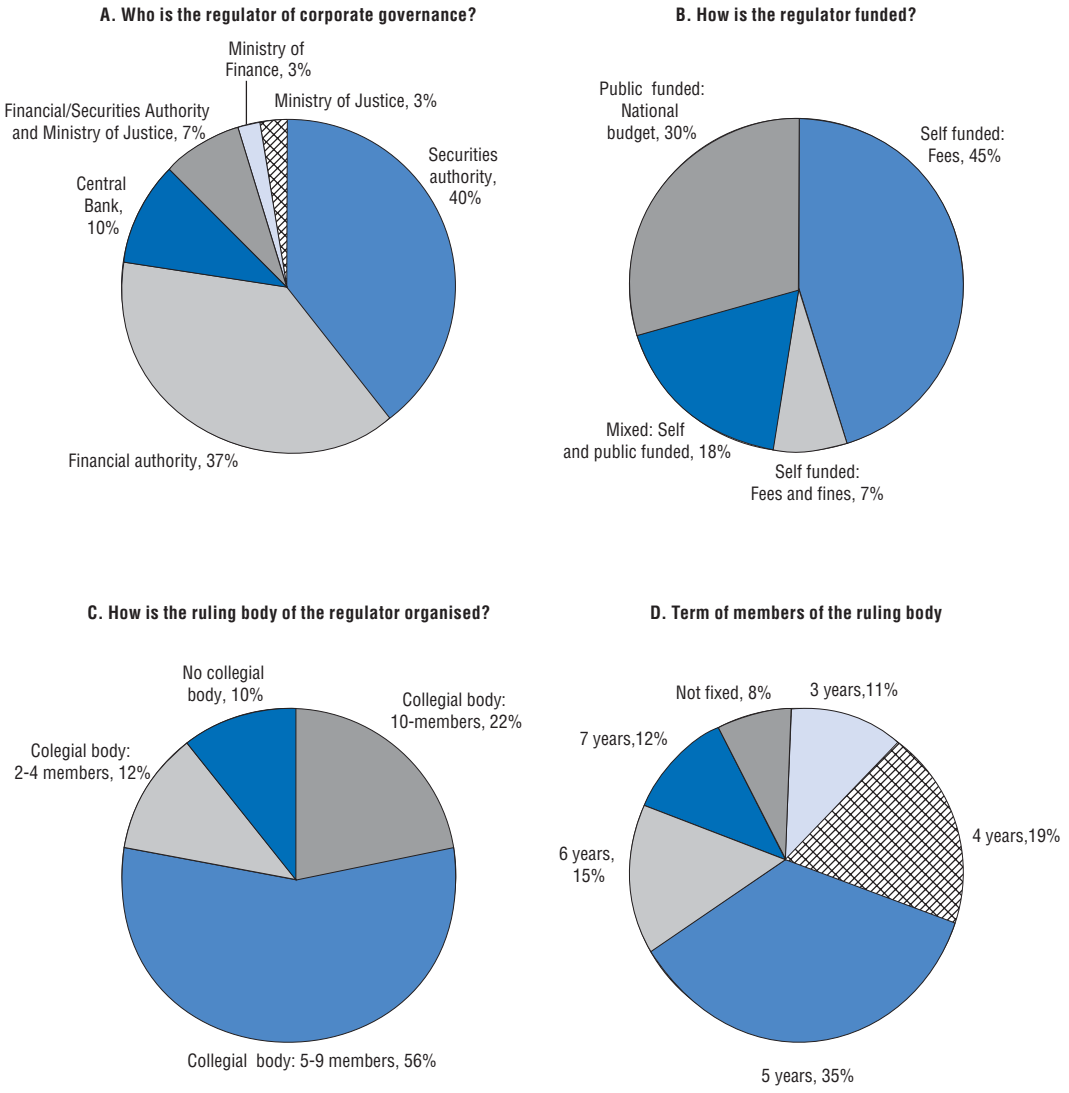
Securities regulators often face difficulties in fully implementing Principle I.D ("Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained"). In many countries, securities regulators are for example less independent and less well-resourced than banking supervisors, especially in cases where the latter are attached to the central bank. A lack of independence and/or resources constrains the ability of securities regulators to supervise and enforce corporate governance standards.[3]

IMF experience shows that regulators face significant challenges in implementing their enforcement plans.[4] The Fund's experience with assessing enforcement by securities regulators around the world, drawn from the large number of FSAPs conducted over the years, is summarised in an IMF working paper (Carvajal and Elliott, 2009): "A combination of the need for extensive resources, strong institutional and political support, and a supportive legal environment make enforcement a particularly difficult challenge and has proven insurmountable in many jurisdictions. In particular, we have found that capacity issues, including political will and adequate resources, have proven a stronger challenge to regulators in developing credible enforcement programmes than have gaps in the legal and regulatory framework."

The issue of political independence of the securities supervisor is typically addressed through the creation of a formal governing body (a board, council, or commission) whose members are given fixed terms of appointment that are staggered and designed not to coincide with the political calendar. The replies to the questionnaire revealed that only about half the jurisdictions surveyed did have such arrangements in place. In a number of jurisdictions, the head of the regulator, and sometimes his deputies as well, have no fixed terms of office (i.e. they serve at the mercy of the president or prime minister), or their term of office ends with the term of office of the president or prime minister (see Table 1.4.).

Securities regulators, as other authorities, can be financed either through the government budget or through fees from regulated entities, or in part through the

Figure 1.1. **Main public regulators of corporate governance**



Source: Country responses to the OECD peer review questionnaire.

imposition of fines on wrongdoers, or through a combination of the three. Each financing channel has its advantages and disadvantages. Government budget financing has the advantage of being less affected by factors such as stock exchange turnover, but gives the government (ministers or parliament) political leverage over the institution, and often results in staff reductions and/or salary cuts for staff, something that has been observed in several jurisdictions covered by the survey. Fees for regulated entities have thus become a more common way of financing for most regulators. Some regulators also keep part or all the fines they collect, but in most cases those go to the government budget. The survey results show that securities regulators in most jurisdictions are self-financed (mainly through fees), whereas the others are publicly financed or benefit from both means of financing (see Table 1.2).

Table 1.1. **Main public regulators of corporate governance: Overview**

Jurisdictions	Key regulators	
Argentina	CNV	The National Securities Commission
Australia	ASIC	Australian Securities and Investments Commission
Austria	FMA	Financial Market Authority
Belgium	FSMA	The Financial Services and Markets Authority
Brazil	CVM	Securities and Exchange Commission of Brazil
Canada (Ontario)	OSC	Ontario Securities Commission
Chile	SVS	Superintendence of Securities and Insurance
Czech Republic	CNB	Czech National Bank
Denmark		Danish FSA
Estonia	EFSA	Estonian Financial Supervision Authority
Finland	FIN-FSA	Finish Financial Supervisory Authority
France	AMF	Autorité des Marchés Financiers
Germany	Bafin	Federal Agency for Financial Market Supervision
	BfJ	Federal Ministry for Justice
Greece	HCMC	Hellenic Capital Market Commission
Hong Kong, China	SFC	Securities and Futures Commission
Hungary	HFSA	Hungarian Financial Supervisory Authority
Iceland	FME	The Financial Supervisory Authority, Iceland
India	SEBI	Securities and Exchange Board of India
	MCA	Ministry of Corporate Affairs
Indonesia	OJK	Financial Services Authority
Ireland	CBI	Central Bank of Ireland
Israel	ISA	Israel Securities Authority
Italy	CONSOB	Commissione Nazionale per le Società e la Borsa
Japan	FSA	Financial Services Agency
	SESC	Securities and Exchange Surveillance Commission
Korea	MOJ	Ministry of Justice
Mexico	CNBV	National Banking and Securities Commission
Netherlands	AFM	The Netherlands Authority for the Financial Markets
New Zealand	FMA	Financial Market Authority
Norway	NFSA	Financial Supervisory Authority of Norway
Poland	KNF	Polish Financial Supervision Authority
Portugal	CMVM	Securities Market Commission
Saudi Arabia	CMA	Capital Market Authority
	MCI	Ministry of Commerce and Industry
Singapore	MAS	Monetary Authority of Singapore
Slovak Republic	MOFSR	Ministry of Finance
Slovenia	ATVP	Securities Market Agency
Spain	CNMV	Comision Nacional del Mergado de Valores
Sweden	FI	Swedish Financial Supervisory Authority
Switzerland	FINMA	Swiss Financial Market Supervisory Authority
Turkey	CMB	Capital Market Board of Turkey
United Kingdom	FCA	Financial Conduct Authority
United States	SEC	Securities and Exchange Commission

Note: Main public regulators refer to those with a capacity of supervision and enforcement in corporate governance. This table shows that in all jurisdictions the securities regulator has a role in the supervision and enforcement of corporate governance of listed companies. The ministry in charge of the company law is also responsible for the corporate governance of listed companies in Germany, India, Korea and Saudi Arabia. In the United States, state laws are the primary source of corporate governance regulation, while the SEC and exchanges regulate certain corporate governance matters.

Another complication for securities regulators are implicit or explicit dual mandates, where regulators may on the one hand be in charge of supervision and enforcement, but on the other hand be trying to promote a country's (or city's) financial market. Such a dual

Table 1.2. **Budget and funding of main regulators of corporate governance**

Jurisdictions/key regulators		Form of funding	Main funding resource			Budget approval by:	
			National budget (NB)	Fines from wrongdoers	Fees from regulated entities	Government (Ministry of Finance, etc.)	Congress
Argentina	CNV	Public	●	(to NB)	–		
Australia	ASIC	Public	●	–	–		
Austria	FMA	Public	●	–	–		
Belgium	FSMA	Self	–	–	●		
Brazil	CVM	Self	–	–	●	Required	Required
Canada (Ontario)	OSC	Self	–	–	●		
Chile	SVS	Public	●	–	–		
Czech Republic	CNB	Self	–	–	●		
Denmark	DFSA	Self	–	–	●		
Estonia	EFSA	Self	–	●	●		
Finland	FIN-FSA	Self	–	–	●	Not required	Not required
France	AMF	Self	–	–	●		
Germany	Bafin	Self	–	–	●		
	BfJ	Public and Self	●	●	●		
Greece	HCMC	Self	–	–	●	Required	
Hong Kong, China	SFC	Self	–	–	●	Required	Required
Hungary	HFSA	Self	–	●	●		Required
India	SEBI	Public and Self	●	●	●		
	MCA	Public	●	–	–		
Indonesia	OJK	Public & Self	●	–	●		
Iceland	FME	Self	–	–	●		
Ireland	CBI	Self	–	–	●		
Israel	ISA	Self	–	–	●	Required	
Italy	CONSOB	Public and Self	●	–	●	Required	
Japan	FSA	Public	●	(to NB)	–	Required	Required
	SESC	Public	●	(to NB)	–	Required	Required
Korea	MOJ	Public	●	–	–	Required	Required
Mexico	CNBV	Self	–	●	●	Required	
Netherlands	AFM	Public and Self	●	●	●	Required	
New Zealand	FMA	Public	●	–	–		
Norway	NFSA	Public	●	–	–	Required	
Poland	KNF	Self	–	–	●	Required	Required
Portugal	CMVM	Self	–	–	●		
Saudi Arabia	CMA	Public and Self	●	●	●	Required	Not required
	MCI	Public	●	–	–	Required	Required
Singapore	MAS	Self	–	–	●		
Slovak Republic	MOFSR	Public	●	–	–		
Slovenia	ATVP	Self	–	–	●	Required	
Spain	CNMV	Public and Self	●	–	●	Required	Required
Sweden	FI	Public and Self	●	–	●		
Switzerland	FINMA	Self	–	–	●	Not required	Not required
Turkey	CMB	Self	–	(to NB)	●	Required	Required
United Kingdom	FCA	Self	–	–	●	Not required	Not required
United States	SEC	Public	●	–	●	Required	Required

Note: This table shows that out of 44 regulators (in 40 jurisdictions) 23 regulators (52%) are self-funded mainly by fees levied on the regulated entities. 13 regulators (30%) are fully funded by the government budget and 8 regulators (18%) are partly funded by both the government budget and fees from regulated entities. Seven jurisdictions also use fines as a funding source. In the United States, the SEC obtains fees from regulated entities, but the Congress determines the SEC's funding. The amount of funding received is offset by fees collected.
Source: Responses to the OECD peer review questionnaire.

Table 1.3. **Ruling bodies of main regulators of corporate governance**

Jurisdictions and key regulators		Ruling body in charge of corporate governance	Composition				
			Members incl. chair (current)	Representatives from specific entity			
				Government	Central Bank	Others public	Others private
Argentina	CNV	Board of Directors	5	–	–	–	–
Australia	ASIC	Commission	3-8 (5)	–	–	–	–
Austria	FMA	Executive Board	2	–	–	–	–
Belgium	FSMA	Supervisory Board	10	–	–	–	–
Brazil	CVM	The Board	5	–	–	–	–
Canada (Ontario)	OSC	Commission	9-15 (14)	–	–	–	–
Chile	SVS	Chairman	–				
Czech Republic	CNB	Bank Board	7	–	–	–	–
Denmark	DFSA	Securities Council	14	–	–	–	●
Estonia	EFSA	Management Board	3-5 (4)	–	–	–	–
Finland	FIN-FSA	Board	5	–	–	–	–
France	AMF	Board	16	–	●	–	–
Germany	Bafin	Executive Board	5	–	–	–	–
	BfJ		7	–	–	–	–
Greece	HCMC	Board of Directors	7	–	●	–	●
Hong Kong, China	SFC	Board of Directors	14	–	–	–	–
Hungary	HFSA						
Iceland	FME	Board of Directors	3	–	●	–	–
India	SEBI	The Board	9	●	●	–	–
	MCA						
Indonesia	OJK	Board of Commissioners	9	●	●	–	–
Ireland	CBI	Commission	10	–	–	–	–
Israel	ISA	Commissioners	10	–	●	–	–
Italy	CONSOB	Commission	5	–	–	–	–
Japan	FSA	Commissioner	–	–	–	–	–
	SESC	Commission	3	–	–	–	–
Korea	MOJ			–	–	–	–
Mexico	CNBV	Governing Board	13	●	●	●	–
Netherlands	AFM	Executive Board	3-5 (4)	–	–	–	–
New Zealand	FMA	Commission	5-11	–	–	–	–
Norway	NFSA	Board	5	–	–	–	–
Poland	KNF	Commission	7	●	●	●	
Portugal	CMVM	Executive Board	5	–	–	–	–
Saudi Arabia	CMA	Board of Commissioners	5	–	–	–	–
	MCI	Minister	–	–	–	–	–
Singapore	MAS	Board of Directors	9	–	–	–	–
Slovak Republic	MOFSR	Minister	–	–	–	–	–
Slovenia	ATVP	Directors and council	6	–	–	–	–
Spain	CNMV	Board	8	●	●	–	–
Sweden	FI	Board	8				
Switzerland	FINMA	Board of Directors	7-9	–	–	–	–
Turkey	CMB	Board	7	–	–	–	–
United Kingdom	FCA	Board	12	–	–	–	–
United States	SEC	Commission	5	P	–	–	–

Note: This table shows that out of 44 regulators (in 40 jurisdictions) 34 regulators have a collegial body for material decision making. In the United States, no more than three SEC Commissioners may belong to the same political party.

Source: Responses to the OECD peer review questionnaire.

Table 1.4. **Terms and appointment of the ruling body of main regulators of corporate governance**

Jurisdictions and key regulators		Ruling body in charge of corporate governance	Term	Re-appointment	Appointment by:	Approval by Congress
Argentina	CNV	Board of Directors	7	Allowed	National Executive Power	
Australia	ASIC	Commission	3-5		Governor-General	
Austria	FMA	Executive Board	Fixed		President	
Belgium	FSMA	Supervisory Board	6	Allowed		
Brazil	CVM	The Board	5		President	Required
Canada (Ontario)	OSC	Commission	Fixed		Lieutenant Governor in Council	
Chile	SVS	Chairman	Not fixed		President	
Czech Republic	CNB	Bank Board	6	Only once	President	
Denmark	DFSA	Securities Council				
Estonia	EFSA	Management Board			Supervisory Board of EFSA	
Finland	FIN-FSA	Board				
France	AMF	Board	5	No[1] (only once)	President[1]	
Germany	Bafin	Executive Board			President	
	BfJ				President	
Greece	HCMC	Board of Directors			Minister of Economy and Finance	Required[1]
Hong Kong, China	SFC	Board of Directors	Fixed	Allowed	HKSAR Chief Executive	
Hungary	HFSA					
Iceland	FME	Board of Directors	4		Minister of Economic Affairs	
India	SEBI	The Board			Ministry of Finance	
	MCA					
Indonesia	OJK	Board of Commissioners	5	Only once	President	Required
Ireland	CBI	Commission	7[1]		President,[1] Minister of Finance	
Israel	ISA	Commissioners			Minister of Finance	
Italy	CONSOB	Commission	7	Allowed	President	
Japan	FSA	Commissioner	Not fixed	–	Prime Minister	
	SESC	Commission	3	Allowed	Prime Minister	Required
Korea	MOJ					
Mexico	CNBV	Governing Board			Ministry of Finance, Central Bank, etc.	
Netherlands	AFM	Executive Board	4	Only once	Royal Decree	
New Zealand	FMA	Commission	5	Allowed	Governor-General	
Norway	NFSA	Board	6[1]		King in Council,[1] Minister of Finance	
Poland	KNF	Commission	5		Ministry of Finance, Central Bank, etc.	
Portugal	CMVM	Executive Board	5		Council of Minister's Resolution	
Saudi Arabia	CMA	Board of Commissioners	5	Only once	Royal Order	Not required
	MCI	Minister				
Singapore	MAS	Board of Directors			President	
Slovak Republic	MOFSR	Minister				
Slovenia	ATVP	Directors and council	6	Allowed	National Assembly	
Spain	CNMV	Board	4	Only once	Government, Minister of Economy and Finance	
Sweden	FI	Board	3		Government	
Switzerland	FINMA	Board of Directors	4	Twice	Federal Council	
Turkey	CMB	Board	5	Allowed	Council of Ministers	

Table 1.4. **Terms and appointment of the ruling body of main regulators of corporate governance** *(cont.)*

Jurisdictions and key regulators		Ruling body in charge of corporate governance	Term	Re-appointment	Appointment by:	Approval by Congress
United Kingdom	FCA	Board	3	Allowed	HM Treasury, Department for Business, Innovation and Skills	Not required
United States	SEC	Commission	5		President	Required

1. Denotes that it is applicable only for the chair of the ruling body.
Note: This table shows that many jurisdictions set forth a fixed term of appointment for members of the ruling body, which varies from three to seven years. Re-appointment is allowed in many jurisdictions, with France, Netherlands and Spain allowing only one re-appointment. In France, re-appointment of the chairman is prohibited.
Source: Responses to the OECD peer review questionnaire.

mandate does not have to be explicit (although it has been in many cases), but can be the result of initiatives to develop (or maintain competitiveness as) a financial centre, or (in the case of turnover-based fees) to maintain financing for the regulator. This can be a disincentive for strong supervision and enforcement of corporate governance standards, and it can lead other regulators to follow suit.[5]

Finally, enforcement authorities may rely to a significant degree on informal enforcement measures such as information requests, notice letters, or norm-enhancing reprimands, rather than formal measures judicial/criminal penalties and fines, administrative penalties and fines, or remedial orders. Such informal enforcement measures often require fewer resources and therefore tend to be more frequently used than formal measures.[6] At the same time, excessive reliance on informal enforcement may be counterproductive, if it reduces the deterrence effect associated with formal enforcement.

Private supervision and enforcement

The scope of private supervision and enforcement includes issues such as: deterrence capability of the legal and regulatory framework; favourable and convenient procedures for lawsuits and alternative dispute resolution; capacity and accessibility of legal experts, but conceptually even share pricing and voting by shareholders may have an impact on the effect of private enforcement.[7] Key actors of private enforcement may include individual shareholders and stakeholders, self-regulatory organisations and institutions to which supervision and regulation is delegated, private-sector stock exchanges, associations of industries, shareholder associations, etc. Other actors of private enforcement may include judicial courts, lawyers and associations of minority shareholders.[8]

Whereas private supervision and enforcement can be effective, it a can also suffer from distorted incentives. Private litigation can, for example, merely "transfer losses from one innocent group of shareholders to another innocent group", where penalties fall largely upon other shareholders rather than upon the managers responsible for violations of corporate governance rules, and lawyers obtain large fees.[9] It is not surprising then that, whereas the deterrence effect of public enforcement also works on smaller companies, private litigation is more often targeted at larger ("deep-pocketed") firms.[10] Some authors go further, arguing that "the litigation crisis makes it harder for new businesses to raise capital from outside investors and leads to suboptimal levels of risk-aversion among managers and directors" (Macey, 2008).

Leaving aside the various incentive problems, private enforcement is in many countries hindered by other factors, such as court systems unprepared to handle such complaints due to a shortage or absence of specialists, slow court procedures, and, as a result, business uncertainty. In those countries, private enforcement tends to be rare (except to obtain injunctions), so that investors largely rely on public enforcement, in the form of complaints to the regulator, who nowadays is usually required by law to follow up on complaints.[11] The downside to such a system is, however, that most regulators can only impose fines, so that a lawsuit may still be necessary to recover the losses for investors.

Some countries, such as the Netherlands with its "inquiry procedure" (see Box 1.1.), have found it useful to address such limitations through a combination of specialised business courts, mechanisms furthering the adoption of speedy and pragmatic solutions, and a focus on court-conducted/court-initiated settlements. Several countries have adjusted their court procedures for such cases in recent years, to find the right balance between effective private enforcement (and thus reduced agency costs) and the risk of abusive lawsuits by minority shareholders (often characterised by "professional" plaintiffs and boilerplate complaints). In Brazil, while several courts specialised in corporate law have been established, many conflicts are now settled through arbitration, notably for companies listed on the *Novo Mercado* (see Chapter 2).

Class action and derivative suits are most common in the United States, where they are the primary enforcement mechanisms for the fiduciary duty of loyalty imposed by state law, reflecting in part the substantial fee awards available, in case of success, to the lawyers pursuing the litigation (see the US in-depth study in Chapter 4). Other countries have created mechanisms similar to class action and derivative suits, but they are much less widely used. In Brazil, for example, the Public Prosecutor's office and other state bodies such as the securities supervisor, or investor associations (but not individual investors), can file collective lawsuits of liability for damages, similar to a class action, and derivative suits are also possible. One primary aim in many such lawsuits is to obtain injunctions to prevent further wrongdoing. Once an injunction is obtained, the trend in many countries is to turn to other resolution mechanisms such as negotiation or arbitration.

The EU (2009) study similarly showed that in most systems there are considerable legal and financial hurdles for shareholders to start legal proceedings, and, even in case of success, damages are awarded to the company and not directly to shareholders. Therefore, derivative actions were found to be rare in the European Union, especially in the sphere of corporate governance. Despite laws giving shareholders the right to launch an action against the company (e.g. for breach of disclosure requirements), in practice, the possibilities of shareholders are limited due to difficulties in proving causal relationships, unavailability of group or class actions, and/or inexperience of courts in hearing cases involving listed companies. Finally, the EU study found that in the EU shareholder engagement in private litigation is limited, even in jurisdictions with dispersed ownership and a strong institutional shareholder base like the United Kingdom.[12]

Private supervision and enforcement by actors such as self-regulatory organisations and (private-sector) stock exchanges may suffer less from litigation-related incentives, and they also have the advantage, already at the supervision stage, of focusing on the wider market rather than only one or the other individual company. At the same time, however, their incentives to supervise and enforce corporate governance standards may suffer from problems similar to the "dual mandate" issue in the case of public supervisors: on the one

Box 1.1. **Shareholder lawsuits: The Dutch inquiry procedure**

The Dutch Enterprise Chamber, a division of the Amsterdam Court of Appeals, as a specialised business court has jurisdiction in a limited number of corporate law cases. The court can be called upon when *i)* doubts arise as to whether a company is properly managed (the Inquiry Proceeding); *ii)* shareholders are dissatisfied with financial reporting and challenge the annual account; *iii)* there are conflicts regarding the removal of a company's Supervisory Board organised under the Structure Regime; or *iv)* a shareholder that owns at least 95% of the outstanding share capital seeks to freeze-out the remaining shareholders.

Upon request, the court may initiate an inquiry into the policy, management and conduct of business in a company when there are well-founded reasons to believe that a company is or has been managed improperly and incorrectly. Besides the public prosecutor (for reasons of public interest) and labor unions (for employees' interests), the most important constituency allowed to request an Inquiry Proceeding are shareholders (or depository receipt holders) alone or collectively owning at least 10% of the outstanding shares (or depositorty receipts, respectively) of a company or shares with a nominal value of EUR 225 000, or such lesser amount as is provided by the articles of association. Shareholders of large companies (issued capital over EUR 22.5 million) have access to the procedure if they hold 1% of the issued capital or EUR 20 million interest (market value).

In the first stage, a party may request an inquiry into the affairs of the corporation to determine whether the company has been mismanaged. If the Enterprise Chamber shares the applicant's concerns, it will appoint one or more individuals who will conduct an investigation and file a report with the court. In the second stage, the Enterprise Chamber may be requested to take certain measures provided that the independent investigator reports improper conduct and mismanagement to the court. The measures include *i)* the suspension or dismissal of board members; *ii)* the nullification or suspension of board or shareholder resolutions; *iii)* the appointment of temporary board members; *iv)* the temporary transfer of shares; *v)* the temporary deviation from provisions of the articles of association; and vi) the dissolution of the company. The company or the applicants may appeal to the Supreme Court on legal grounds. On appeal, the Supreme Court will not review the factual findings and background of the case.

hand, they are mandated to supervise and enforce, on the other hand they want to develop and promote the sector, rather than tarnish its reputation. Stock exchanges, most of them now for-profit organisations, are naturally keen on expanding their business, and self-regulatory organisations and industry associations often are more focused on warding off government regulation.[13]

Stock exchanges are often tasked with the supervision and enforcement of listing requirements. In those cases, the stock exchanges typically have the power to issue warnings, and, if, after repeated warnings, violations are not rectified, can order a delisting of the company's shares. In the jurisdictions that have replied to the peer review questionnaire, **Argentina; Brazil; Chile; Estonia; Hong Kong, China; Poland; Singapore; Sweden;** and **Switzerland** confirmed that they have delegated certain enforcement tasks (in the reviewed areas) to stock exchanges. In Brazil, for example, the securities regulator concluded a formal agreement with the stock exchange, making the latter its "first line of defense", through stock exchange supervision of disclosure by listed companies.

Box 1.1. **Shareholder lawsuits: The Dutch inquiry procedure** *(cont.)*

The Enterprise Chamber defined a number of situations in which there are reasonable doubts whether a company is properly managed. These situations include: *i)* a deadlock in the decision-making process of the company; *ii)* if management fails to disclose vital information to minority shareholders; *iii)* if conflicts of interests arise or are not properly countered by management; *iv)* if the company violates disclosure and accounting rules; *v)* if the company adopts an unfair dividend policy; *vi)* if assets are being removed or reallocated to the detriment of the shareholders or other stakeholders; and *vii)* if management's decisions are inconsistent with the rules of the Dutch Corporate Governance Code.

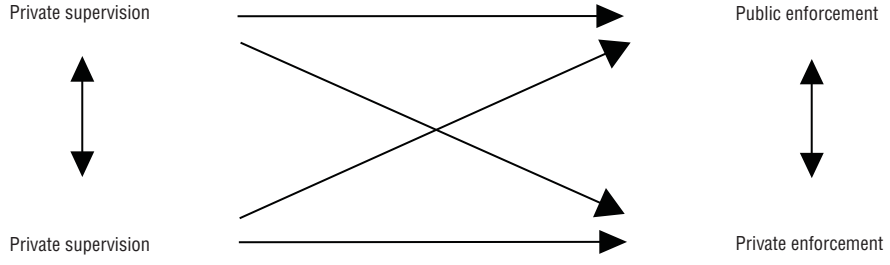
The Enterprise Chamber may at any stage of the proceedings, upon the application of the persons that requested the inquiry, order preliminary injunctions for the duration of the proceedings at most. Application for an injunctive relief has been the rule rather than the exception. The Enterprise Chamber has full discretion to order any preliminary remedy as it sees fit. In listed companies, the top three preliminary remedies are *i)* the appointment of independent board members; *ii)* the prohibition of voting on particular agenda items; and *iii)* the deviation from the articles of association. Suspending directors' and shareholders' resolutions are popular forms of injunctive relief in non-listed companies. Quite often, the Inquiry Proceeding assists the parties in overcoming their differences by promoting informal and supposedly efficient solutions. These non-formalistic remedies offer parties an additional round of after-the-fact bargaining either by themselves or under the supervision of independent observers. The principle of fast, informal and judge-initiated "mediation" or "conciliation" appears to be very attractive to minority shareholders. In many cases, after the injunctive relief, the company and its shareholders tend to follow the preliminary relief.

Source: Vermeulen, E.P.M. and D.A. Zetzsche (2010), "The Use and Abuse of Investor Suits: An Inquiry into the Dark Side of Shareholder Activism", *European Company and Financial Law Review*, Vol. 7, No. 1; *TILEC Discussion Paper* No. 2010-001; *CBC-RPS Paper* No. 1/2010, SSRN: *http://ssrn.com/abstract=1428901*.

The relation between public and private supervision and enforcement

Public and private supervision and enforcement do not have to be mutually exclusive, but can rather be complementary. Public supervision (based upon disclosure, regulatory reporting, inspections, or sometimes whistle blowing) can uncover potential wrongdoing, leading to public enforcement action, which in turn can become the basis for private enforcement. Similarly, private supervision, which typically requires a sufficient level of disclosure, can lead to private enforcement, which in turn can spur public enforcement authorities into action.

Figure 1.2. **Public and private enforcement and supervision**



Most studies of the relations between public and private enforcement have focused on the United States experience, reflecting the possibility for private actors to engage in securities class action litigation. A number of other studies focus on emerging markets, weighing the advantages and disadvantages of private and public enforcement in the face of weak legal systems and/or weak regulatory institutions.[14] The current survey indicates that their conclusions may be applicable to a wider set of countries and jurisdictions.

Competition between public and private enforcement can heighten the level of enforcement. Cox et al. (2003) highlight this effect by referring to the experience in the United States, where "high levels of private litigation can prompt public enforcers to be more active themselves: prosecutors and the SEC risk public criticism if they cannot show that they are doing as much as the private bar.[15] Increased public enforcement, in turn, spurs private litigation that piggybacks on the evidence unearthed". They further find that *i)* private suits with parallel SEC actions settle for significantly more than private suits without such proceedings; *ii)* SEC enforcement actions target significantly smaller companies than private actions alone; *iii)* private cases with parallel SEC actions take substantially less time to settle than other private cases; and *iv)* private cases with parallel SEC actions have significantly longer class periods than other private actions.

In the United States, there has also been a discussion of whether enforcement should become more centralised, in order to prevent "over-enforcement", whereas opponents contend that competition among enforcers helps to prevent "under-enforcement". In a recent paper, Park (2012) observes that the United States enforcement system reflects diverse industry, regulatory and public values, and that different enforcers play different roles in expressing these values, concluding that having a diversity of enforcers has advantages that may be worth preserving. A limitation of the scope for private enforcement can also have implications for public enforcement, if the public enforcers are not endowed with adequate resources, and/or their enforcement mandate is limited by law.

1.5. Supervision and enforcement in specific areas

General perspective

The topics covered by this peer review (related party transactions, the market for corporate control and effective shareholder participation in the general shareholder meeting), are typically covered in the company act, the securities act and/or in stock exchange listing requirements. In a few jurisdictions, no rules exist, or they are only included in corporate governance codes. Implementation of the applicable rules is thus mandatory in most cases. One would therefore expect that the rules would be enforceable in most jurisdictions. This is in contrast to corporate governance principles contained in the various corporate governance codes, which are commonly based upon the comply-or-explain principle and where the focus of enforcement, where it exists, is on compliance with the explanation requirement ("comply-with-explain").

Whereas the survey provided a significant amount of information on the various means of enforcement, as well as the authorities tasked with public enforcement, the (cross-country) survey revealed comparatively little information on actual enforcement cases in the specific areas covered by the review. In some jurisdictions, it is known that every year a significant number of enforcement cases are launched, but in most jurisdictions it can be assumed that (formal) enforcement actions (both public and private) in the mentioned areas are rare. It is sometimes argued that enforcement authorities may

have taken informal enforcement measures, which are not published and may not be included in official enforcement statistics.

Whereas supervision and enforcement regarding the three topics selected for the review, i.e. related party transactions, takeover bids, and shareholder meetings, differ somewhat in terms of the relative importance of the public and private actors involved, notably the extent of stock exchange involvement, all three areas have the potential to be supervised and enforced through both public and private means. While analysed separately, the three areas are in practice often related, for example in cases of takeovers of related parties, and relevant voting procedures at the general shareholder meeting.

The sections that follow summarise supervision and enforcement mechanisms in the jurisdictions that have responded to the (general) questionnaire. Practices in three jurisdictions (Brazil, Turkey and the United States) are analysed in more detail in Chapters 2-4.

Related party transactions

Around the world, the potential for abuse of related party transactions (RPTs) is viewed as an important policy issue, which is why it is addressed extensively in the Principles. The key Principles concerning related party transactions are spread across several Chapters including: The Equitable Treatment of Shareholders (III.A.2 and III.C); Disclosure and Transparency (V.A.5); and The Responsibility of the Board (VI.D.6). In addition, the individual principles noted above are underpinned by more general duties of the board (VI.A and VI.B).

Abuse of minority shareholders can be carried out in various ways, including the extraction of direct benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic biases in business decisions and a change in the capital structure through special issuance of shares favouring the controlling shareholder (OECD, 2007). As RPTs were recently investigated in the Committee's third peer review (OECD, 2012), the following section focuses more specifically on the issue of enforcement of the rules governing related party transactions in the jurisdictions covered by the survey. Some key findings and country practices that were presented in the 2012 peer review on related party transactions are summarised in Box 1.2.

Supervision and enforcement of disclosure of related party transactions. Principle V.A.5 specifies that disclosure should include, *inter alia*, material information on related party transactions. This is quite general and is covered by International Accounting Standard 24 (IAS 24) that is now widely adopted. Other jurisdictions have adopted local accounting standards that are broadly equivalent to IAS 24. All jurisdictions require publicly listed companies to disclose detailed information on RPTs in the annual reports, usually in the form of a corporate governance report. In some jurisdictions (e.g. **Argentina; Estonia; Hong Kong, China;** and **Israel**), immediate reporting is required for any significant RPT soon after its terms and conditions have been settled.

In the majority of jurisdictions surveyed, the supervision and enforcement of disclosure of RPTs can take place through both public and private means, mainly via the continuous surveillance of the disclosure materials by the securities regulator and/or the stock exchange. Administrative penalties are often used to support the disclosure regime (OECD, 2007). The supervision and enforcement of disclosure requirements provides, of course, the basis for the supervision and enforcement of abusive related party transactions, both public and private, as described in the following section.[16]

Box 1.2. **Peer review on related party transactions and minority shareholder rights**

In all countries reviewed in the RPT peer review, formal enforcement appeared to be weak. In many ways reliance is on market mechanisms that are based on extensive disclosure obligations about RPTs. This leaves shareholders open to posing embarrassing questions to the board and or selling their shares. In some countries such as **Belgium** and **France**, bad publicity was said to be an enforcement mechanism in itself, but the basis rests on the tight social structure among elites. Reputations might also be important in **India** where in the wake of the Satyam scandal many independent directors resigned.

Israel introduced some novel elements so that the securities regulator is able to financially support derivative suits in addition to class actions by individuals for breaches of duty by directors and damages stemming from RPTs. With respect to derivative suits, this support addresses the key issue that there is no financial incentive for shareholders to launch a process, the costs of which they invariably bear alone if the case is lost. More importantly, the resolution of such suits was facilitated by the establishment of a special department of one of the courts in charge of handling such cases. In its first decision in May 2011, one of them ruled that despite passing the approval process (audit committee, board and shareholder approval) a RPT still needed to pass a fairness test: the minority shareholders were entitled to the best possible price.

In all the reviewed jurisdictions, the securities regulators appear to scrutinise disclosures of material RPTs and to request improvements if necessary. As an example, the **Israeli** regulator reviewed 470 transactions in 2010, 93% of which were approved. In both **Israel** and **Italy**, the securities regulators also scrutinise whether shareholders have been correctly classified as interested or disinterested.

Source: OECD (2012), *Related Party Transactions and Minority Shareholder Rights*, OECD Publishing, doi: *10.1787/9789264168008-en*.

In many jurisdictions, the securities regulator is charged with supervising and enforcing the compliance with disclosure requirements on RPTs. The exceptions are **Hong Kong, China;** and **Singapore,** where the stock exchange plays a primary role in this area. In other jurisdictions (**Brazil**, **Estonia**, **India**, **Japan**, **Korea** and **Switzerland**), the role of the stock exchange is complementary to that of the securities regulator. In **Germany**, the review is conducted in collaboration with a private body (the Financial Reporting Enforcement Panel, see Box 1.3).

In order to allocate resources appropriately during the review process, regulators in some jurisdictions take a risk based approach by identifying companies with high potential for abusive practices (for example **Brazil, Poland, Portugal** and **Turkey**). Since it is hard to continuously monitor RPTs, in particular those performed outside the regulated markets, the securities regulator usually relies on the information provided by investors and whistleblowers in deciding whether to pursue further investigations (**Australia**, **Brazil** and **Canada**). As cross-border listings are prevalent in many jurisdictions, international co-operation among regulators is also of great importance.

In some jurisdictions (e.g. **Australia; Canada; Chile; Hong Kong, China; Italy; Poland;** and **Singapore**), shareholder approval is required for large transactions or those not on market terms. A notice containing detailed information about the transaction (often along with an opinion from the independent financial advisor) must be disclosed within a

Box 1.3. **The two-tier accounting enforcement procedure in Germany**

Germany has established a two-tier accounting enforcement procedure for publicly traded companies, with two accounting enforcement bodies. This procedure has been in place since 2005 to monitor compliance of the financial statements of publicly traded companies with legal requirements. The two-tier procedure splits responsibility for financial reporting enforcement between a private body – the German Financial Reporting Enforcement Panel (FREP) contractually acknowledged by the Federal Ministry of Justice – and the Federal Financial Supervisory Authority (BaFin). The enforcement procedure is divided into an error identification procedure and the subsequent error publication procedure.

Financial Reporting Enforcement Panel (FREP) – Tier 1

FREP can initiate an audit in the following three cases: *i)* If there are concrete indications of an infringement of financial reporting procedures (indication-based audit), *ii)* at the request of BaFin and iii) without any concrete indications as a random sampling audit. Regarding *iii)*, FREP decides which companies will be audited without any concrete indications on the basis of its Principles for Random Sampling, which were developed in agreement with the Federal Ministry of Justice and the Federal Ministry of Finance. These are a combination of a risk-aware selection and a statistical random selection and ensure that all companies subject to enforcement are audited on average at certain intervals.

Federal Financial Supervisory Authority (BaFin) – Tier 2

Enforcement in the second tier is performed by BaFin and comprises the following two steps: *a)* Identification of errors and *b)* Publication of errors. Concerning *a)*, BaFin only conducts its own financial reporting enforcement procedures if: *i)* it is notified by FREP that a company refuses to co-operate in an audit or does not agree with the results of the audit: or *ii)* there are considerable doubts about the accuracy of the results of FREP's audit or about whether FREP has conducted the audit properly. With regard to *b)*, it must normally be published by the company in case the FREP or BaFin enforcement procedure identifies an error. BaFin reserves the right to order the publication of an error; this also applies without exception to those cases in which the company agreed with FREP's findings and BaFin therefore did not conduct a Tier 2 audit.

Source: Response to the OECD peer review questionnaire.

specified time period before the shareholder meeting. A notice is previewed by the regulator (**Australia**) or by the stock exchange (**Hong Kong, China**). In **Australia**, a company must lodge the notice with the regulator 14 days before sending it to shareholders, and the securities regulator usually issues a comment letter if the materials do not comply with legal requirements.

Regarding private enforcement, almost all jurisdictions mention that directors and management have fiduciary duties to act in the best interests of the corporation, and that shareholders can sue for breach of those duties. Failure to disclose RPTs in the circumstances gives rise to a breach of fiduciary duties, but this primarily occurs in relation to transactions that are disadvantageous to the company, rather than in relation to disclosure issues. Auditors can be jointly liable toward the company for damages resulting from the violation of disclosure requirement in the materials which they have certified (**Belgium**).

The burden of evidence in the judiciary processes, which can be a major hindrance for shareholders seeking redress, varies among jurisdictions. In **Argentina**, the defendant shall prove that the transaction was carried out according to market conditions or did not cause any damage to the company, unless the transaction was approved by the board of directors with the favourable opinion of the audit committee. In **Canada**, in addition to recourses under corporate and securities legislation, in cases of negligence or fraudulent misrepresentation the plaintiff can engage in common law causes of action. A plaintiff would have to prove that: *i)* there was a duty of care owed to the plaintiff; *ii)* the duty was breached; *iii)* there was a direct connection between the plaintiff's loss and the defendant's misrepresentation; and *iv)* the plaintiff relied on the defendant's misrepresentation. Each party is entitled to an "examination for discovery" in order to clarify the claim and collect evidence.

Company groups are common and a well-established concept in most jurisdictions, and are sometimes taken into account through the definition of directors' duties. In the jurisdictions which have adopted the "German model" (**Brazil**, **Croatia**, **Czech Rep.**, **Germany**, **Hungary**, **Portugal**,[17] and **Slovenia**), the negative impact of any influence by the parent company (under the factual control group concept) must be disclosed, audited and compensated. However, it is not always clear whether enforcement under this framework is actually in place. In **Belgium** and **France**, courts have ruled that directors have a duty to the group under certain conditions, which is termed the *Rozenblum doctrine* (OECD, 2012).

Overall, many jurisdictions describe the complementarities and division of roles between public and private enforcement. Four jurisdictions (**Australia**, **Mexico**, **Sweden** and **Turkey**) considered that public supervision and enforcement plays a more important role in this area. One of the reasons is that the damage caused to any individual shareholder as a result of undisclosed RPTs is generally quite small. Three jurisdictions (**Estonia**, **Netherlands** and **Switzerland**) saw a more important role for private supervision and enforcement, due to less formal procedures than public means.

Enforcement against abusive related party transactions. Abusive related party transactions – where a party in control of a company enters into a transaction to the detriment of non-controlling shareholders – have been one of the biggest corporate governance challenges. They are addressed by the Principles from the perspective of minority protection (III.A.2) and board responsibilities (VI.D.6). According to Chapter VI.D.6 of the Principles, the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. Principle VI.D.6 specifies that the board should fulfil certain key functions including, *inter alia*, monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

Only a limited number of jurisdictions (e.g. **Brazil; Chile; Estonia; France; Hong Kong, China; Hungary; India; Portugal; Turkey;** and **United States**) have prohibited certain RPTs, especially loans to directors, while some others leave significant RPTs subject to shareholder approval (OECD, 2012). The transactions made in violation of the provision are nullified in some of these jurisdictions (e.g. **Estonia** and **Portugal**[18]).

Almost all jurisdictions lack public oversight of abusive RPTs apart from the supervision and enforcement of disclosure requirements. The exception to this is that some jurisdictions (e.g. **Brazil**) conduct an *ex ante* analysis for specific transactions such as

capital increases through private subscription, mergers and acquisitions with related parties. However, due to the complexity of the RPT and time constraints, it is not a primary option for the securities regulator to enforce by changing the main characteristic of the proposed transaction, but rather by requiring disclosure of additional information about the transaction and the procedures adopted. In **Canada** (Ontario), it is generally accepted that the regulator's mandate does not extend to intervention in transactions. The securities regulator is thus supposed to take actions in a conservative fashion. For the regulator to take action, a transaction must be demonstrated to be abusive of shareholders in particular or of the capital market in general.

In limited situations, enforcement authorities can take action based on criminal law. It is a criminal offence (fraudulent breach of trust) if a person knowingly misuses his power to administer property of a third party and thereby causes damages. Abusive transactions resulting in fraud may be punishable by criminal law.

Regarding private enforcement, almost all jurisdictions mention that directors and management have fiduciary duties to act in the best interests of the corporation, and shareholders could sue for breach of those duties. The fiduciary duty owed to the company is breached where a director uses his position to obtain benefits from the company, unless the fully informed consent of the company is obtained (**Australia**). In some jurisdictions (e.g. **Brazil**), the company law sets forth general fiduciary duties for controlling shareholders as well.

The general meeting of shareholders (possessing at least 10% of the nominal capital in the cases of **Austria** and **Estonia, or 5% in the case of Poland**) can call for a special audit if there are reasons to believe that unrighteous acts were committed in the company. In the **Czech Republic** and **Germany**, the court shall, upon motion by a shareholder, appoint special auditors to audit the business relations of the company with its controlling enterprise.

Several jurisdictions are adopting enforcement devices. In **Argentina**, the stock exchanges that list securities must have a Permanent Arbitration Tribunal. Claims arising from the companies law, including liability actions against their members or other shareholders fall within the arbitrator's jurisdiction. In **Israel**, the securities regulator is able to financially support derivative suits in addition to class actions by individuals for breaches of duty by directors and damages stemming from RPTs (Box 1.2).

One jurisdiction (**Australia**) considered that public supervision and enforcement plays a more important role in enforcement against abusive RPTs. The reason is that the detriment caused to any individual shareholder as a result of abusive RPTs is generally quite small. Two jurisdictions (**Austria** and **Estonia**) considered that private supervision and enforcement plays a more important role in this area. One of the reasons is that only a small percentage of abusive related party transactions can be qualified as criminal offences.

Takeover bids

According to Principle II.E, markets for corporate control should be allowed to function in an efficient and transparent manner:

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

The rules and procedures governing the acquisition of corporate control vary considerably between companies (and between jurisdictions), depending on company charters and by-laws, the structure of ownership and listing regulations. Some jurisdictions have take-over codes or laws specifying procedures quite closely. They usually include provisions to protect minority shareholders by requiring bidders to offer to purchase shares at a particular price (i.e. mandatory tender offer rules) and there are thresholds at which minority shareholders can require the majority to buy their shares, and/or a threshold at which the outstanding shareholders can be squeezed out (OECD, 2007).[19]

Owing to the very different situations and approaches taken by the various jurisdictions, it is perhaps not surprising that enforcement mechanisms vary as well. Jurisdictions participating in the review were asked to describe their supervision and enforcement practices in relation to takeover bids, including the main actors, the source and extent of their authority or entitlement to act, as well as the main procedures and prevailing practices. The following sections summarise the main findings.

Across the board, significant emphasis is placed on procedural fairness and guarantees that all shareholders get an equal and effective chance to participate in bids. In **Australia**, for example, these rules are contained in the "Eggleston Principles", articulated in section 602 of the Corporations Act of 2001. These principles are intended to ensure that: *i)* the acquisition of control over a relevant entity takes place in an efficient, competitive and informed market; *ii)* the holders of shares or interests, and the directors of the company or responsible entity for the scheme know the identity of the person who proposes to acquire a substantial interest, have a reasonable time to consider the proposal, and are given enough information to enable them to assess the merits of the proposal; *iii)* as far as practicable, the holders have a reasonable and equal opportunity to participate in any benefits accruing to holders under a proposal under which a person would acquire a substantial interest in the entity; and *iv)* an appropriate procedure is followed as a preliminary to compulsory acquisition.

In the **EU,** Directive 2004/25/EC on takeover bids, establishes the basic framework for takeover bids (Box 1.4).

Most jurisdictions have takeover regulations, but some address the issues in voluntary corporate governance codes rather than through hard law (**Hong Kong, China**), and others regulate voluntary bids but do not require mandatory ones (**Australia**). In the **United States**, rules do not impose a mandatory tender offer, leaving it up to the bidder to deal with shareholders, whether on an unsolicited basis without the prior approval of the target, or pursuant to a private agreement between the bidder and the target.

Supervision and enforcement of conditions set by the offeror in takeover bids. With respect to supervision and enforcement of the conditions set by the bidder of a voluntary offer, in most jurisdictions the securities regulator, a special takeover panel, or both, have legal authority over the process.[20] Often, they only control minimum information requirements aimed at properly informing the public about the offer, frequently through vetting the prospectus.

Box 1.4. **The EU Takeover Directive**

Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJL142/12 of 30 March 2004.

The objectives pursued by the Takeover Bids Directive are important to financial markets and stakeholders of listed companies. More specifically, the objectives of the Directive are:

- legal certainty on the conduct of takeover bids and community-wide clarity and transparency in respect of takeover bids;
- protection of the interests of shareholders, in particular minority shareholders, and of employees and other stakeholders through transparency and information rights, when a company is subject to a takeover bid or change of control;
- facilitation of takeover bids, through reinforcement of the freedom to deal in and vote on securities of companies and prevention of operations which could frustrate a bid;
- reinforcing the single market, by enabling free movement of capital throughout the EU.

The Takeover Bids Directive is based on general principles, which should be complied with by Member States for the purpose of transposing the Directive. The principles include:

- equal treatment of shareholders;
- protection of minority shareholders in case of change of control;
- prohibition of market manipulation or abuse; and
- shareholders must have sufficient time and information to make a properly informed decision on the bid.

Any exemptions made by member states to the rules of the Directive must still comply with these principles, as well as the other principles listed therein.

Source: European Commission (2004), Directive 2004/25/EC of the European Parliament and of the Council, 21 April, *http://ec.europa.eu/internal_market/company/official/index_en.htm*.

Many jurisdictions also devote substantial public supervision to assurances that the bidder disposes of sufficient funding to complete payment of the offer, requiring insurance, underwriting or escrow accounts. This is sometimes a condition for approval of the launching of the bid or an issue that is marked for detailed disclosure. Regulators also look into general compliance with disclosure rules applicable to the offer, sometimes conducting *ex ante* approvals or demanding corrections *ex post*. Overall, however, few jurisdictions report private enforcement of voluntary bids.

Almost all jurisdictions also mention that there is control over the fairness of corporate decisions and this is often reflected in monitoring of the offer price. Interestingly, a large number of jurisdictions do not set conditions for the price of voluntary bids (**Australia, Austria, Belgium, Brazil, Canada** (Ontario) **Chile, Czech Republic, Estonia, France, Mexico, Korea, Portugal, Switzerland, Turkey** and the **United States**), often with the argument that shareholders will likely reject it if the price is insufficient. Others include a minimum fairness requirements in the setting of the price (**Argentina;** and **Hong Kong, China**), the obligation to offer at least the same price paid in previous transactions made by the bidder (**Germany, Netherlands, Singapore, Slovenia** and **Sweden**), or set mechanisms to define a minimum price, often under the same or similar rules to those applicable to mandatory bids (**India** and **Spain**). This distinction is related to an on-going discussion about the effect that acquiring control with a voluntary bid may have on the

rules triggering a mandatory bid afterwards (in those jurisdictions where they exist). This has been addressed in a recent report by the European Commission (2012) on the implementation of the EU Takeover Directive:

> The review shows that the exemption to the mandatory bid rule included in the Takeover Bids Directive, for situations where control has been acquired following a voluntary bid for all shares of the company, has created a possibility for offerors to get round the mandatory bid rule by acquiring a stake close to the mandatory bid threshold and then launching a voluntary bid for a low price. As a consequence, the offeror would cross the mandatory bid threshold without giving minority shareholders a fair chance to exit the company and share in the control premium. This technique is clearly not in line with the objective of the Directive to protect minority shareholders in situations of change of control, although it does not appear to breach the letter of the Directive. Examples in national legislation, such as additional mandatory bid thresholds or minimum acceptance conditions to takeover offers, show that there are possibilities to prevent the use of this technique. (European Commission, 2012)

Finally, a great deal of regulatory activity in relation to voluntary bids is allocated to offering regulatory guidance and relief (**Australia** and the **United States**) or making room for exemptions (**Belgium, Canada** (Ontario)**, Spain** and **Sweden**). Sometimes these decisions are delegated to the takeover panel or other private sector bodies. The European Commission report (2012) also addressed this issue, arguing that within the range of different national derogations to the mandatory bid rule, "it is not always clear how the protection of minority shareholders is ensured", and suggesting that further work may be required.

Supervision and enforcement of mandatory takeover bids. Mandatory bids are subject to further scrutiny and to additional requirements. In many jurisdictions, the regulator or the takeover panel will have the authority to demand the launch of a mandatory bid, but in some cases that would be left for the courts, with the regulator only being able to act once a bid is launched. Several countries describe arrangements where the regulator oversees the conduct of takeovers, while the takeover panel operates as a peer-based dispute resolution mechanism, often with recourse to the courts as a last resort. **Australia** explains that this separation of powers appears to work effectively and to have widespread acceptance among corporations, their professional advisors and the public.

In general, mandatory takeovers are triggered by a 30% ownership threshold, and the calculation regularly includes all affiliated parties in the sum, making them jointly and severally liable. The concept of "acting in concert" is also used for these purposes. Once the obligation is triggered, the majority of jurisdictions establish a mechanism to determine the minimum offer price, which is often defined as the higher of: *i)* the maximum price paid during the twelve months preceding the announcement of the offer by the bidder or any person acting in concert with it for the securities concerned, and *ii)* the weighted average trading price prevailing on the market within 30 calendar days prior to the commencement of the obligation to launch a bid. Only a few jurisdictions that have mandatory bids do not set the price in a similar fashion, albeit with diverse periods (**Brazil; Canada; Hong Kong, China; Japan; Korea** and **Mexico).**

In **Switzerland,** the price offered shall be at least as high as the weighted average trading price prevailing on the market within 60 days before publication of the offer, and no lower than 25% of the highest price paid by the bidder for the shares of the target company

in the preceding 12 months. The latter criterion offered the possibility to pay a "control premium" before the publication of the offer, but this rule has been recently abolished in the revision of Federal Act on Stock Exchanges and Securities Trading. In **Chile**, the sale by the controller of his controlling stake at a premium will not trigger a mandatory bid if the price paid by the buyer is not above a threshold set annually by the regulator, and that must be between 10% and 15% above the market value.

In general, there is a marked preference among jurisdictions to delegate authority to public sector regulators to supervise and enforce takeover bids. Many jurisdictions mention that private supervision is simply not allowed, so it is uncommon to find many references to private enforcement, except for a few cases where private actors can initiate litigation or bring issues to the attention of the regulator or the takeover panel. Some jurisdictions report that private enforcement is not allowed on mandatory bids. Some offer private actors some degree of protection by depriving the shares acquired by the bidder of the right to vote (sometimes also not considering them in the quorum for voting) until the breaches to the procedure are remedied or a mandatory bid is launched. In some cases, the regulator or the courts can prevent the acquisition from taking place (Box 1.5).

Box 1.5. **Enforcement of mandatory bids in selected jurisdictions**

Canada

The enforcement of takeover bid legislation is generally conducted by provincial securities regulators. In Ontario, the Ontario Securities Commission (OSC) is primarily responsible and its responsibilities and powers are stated in the Securities Act (Ontario). The OSC may intervene to address: *i)* conduct that is inconsistent with existing securities policy statements; *ii)* novel schemes inconsistent with underlying takeover bid principles but where there is no breach of legislation or explicit policy statements; and *iii)* conduct where it is appropriate to deny certain takeover bid exemptions.

The various parties involved in a takeover bid (bidders, target corporations, target boards, shareholders) have the right to litigate certain matters before courts. Under the Securities Act (Ontario), an interested person may apply to the court for an order that a person or company has not complied with a requirement under takeover bid legislation and seek an order that the court thinks fit. Courts play a role in takeover bid regulation, including defensive tactics, in cases involving a breach of fiduciary duties or oppression, or if the remedies being sought can only be ordered by the court, which have a broader variety of remedies than those available to the OSC, including rescinding the transaction.

Estonia

If a person violates the obligation to make a mandatory takeover bid or the obligation to apply for approval of the Estonian Financial Supervision Authority (EFSA), the person may not exercise voting rights in the target issuer, and these votes shall not be included in the quorum of the general meeting of the target issuer until such time as the violation is eliminated. The EFSA also has the right to issue a mandatory precept to the registrar of the Estonian Central Register of Securities for immediate execution to prohibit, for a term of up to 20 days, the use and disposal of securities in a securities account held by a bidder or a person acting in concert with it in the event of violation of the Securities Market Act or legislation established on the basis thereof.

Box 1.5. **Enforcement of mandatory bids in selected jurisdictions** *(cont.)*

The Securities Market Act states that a target person or other person connected with the takeover bid may not demand cancellation of the takeover bid or modification of the conditions thereof after the EFSA has approved the takeover bid. However, a target person or other person connected with the takeover bid may demand compensation of damage caused by the takeover bid. The limitation period of the claim is one year as of approval of the takeover bid by the EFSA. Shareholders have the general right to apply for civil court proceedings and, in practice, minority shareholders have applied for civil court proceedings to oppose the amount of compensation determined by the majority shareholder in a squeeze-out following the takeover bid.

Germany

The Federal Financial Supervisory Authority, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) rarely has to act forcing bidders to comply with conditions for takeovers, but this is regarded as the most effective way, because compliance can be enforced in one act for all shareholders concerned. Consequently, with regard to conditions and to the price set by the bidder, shareholders' actions in court are rare. Shareholders will have a claim against the bidder or bidders only at the point in time where they have accepted the offer made by the bidder. At that point, a bidder will have complied with the requirements on the mandatory bid, although shareholders may also claim for late compliance. Non-compliant bidders are subject to the loss of rights connected to the shares according to the Takeover Act, preventing them from making use of their voting rights and entitling shareholders to bring an action to set aside any resolution passed at a shareholders' meeting with votes cast by such parties. Also, in case of intentional actions (basically knowingly and willingly), the non-compliant bidder may also be deprived of the right to dividend payments, possibly resulting in a higher dividend to be paid to the other shareholders.

Several shareholders' associations exist in Germany and their purpose is to support investors in a variety of corporate governance issues. They also provide services with regard to court action, but their entitlements are fully dependent on empowerment by shareholders. As a remedy to the collective action issue which arises in connection with certain capital markets claims, there is a special procedure in the Act on Role Model Processes in Capital Markets Disputes (Gesetz über Musterverfahren in kapitalmarktrechtlichen Streitigkeiten [KapMuG]). Concisely, that procedure allows investors to profit from the fact-finding in a role model process lead by a small number of investors relating to the same issue.

Hong Kong, China

The Securities and Futures Commission (SFC) is responsible for the daily administration of the Codes on Takeovers and Mergers and Share Repurchases (the Codes). This includes vetting takeover-related documents (such as offer announcements and offer documents) submitted by relevant parties and giving rulings under the Codes in respect of applications made by concerned parties. Although there is no official channel for private supervision and enforcement, information provided by the general public is important to the SFC in its enforcement of the Codes.

Box 1.5. **Enforcement of mandatory bids in selected jurisdictions** *(cont.)*

Where there has been a breach of the Codes, the SFC can deal with any disciplinary matter if the party to be disciplined agrees to the disciplinary action proposed to be taken by the SFC. Otherwise, the SFC may institute disciplinary proceedings before the Takeovers Panel which will hear the matter. The Takeovers Panel will give a ruling after the hearing and where appropriate impose sanctions. The Takeovers Panel hears disciplinary matters in the first instance, and reviews rulings by the SFC at the request of any party dissatisfied with such a ruling. It also considers novel, important or difficult cases referred to it by the SFC. The Takeovers Panel also reviews, from time to time upon request by the SFC, the provisions of the Codes and the Rules of Procedure for hearings under the Codes and recommends appropriate amendments to the Codes and Rules to the SFC.

Japan

The Commissioner of the Financial Services Agency (FSA) and the Securities and Exchange Surveillance Commission (SESC) are responsible and have the power for public enforcement under the Financial Instruments and Exchange Act (FIEA) and its regulations. A violation of takeover bid regulations may be subject to administrative monetary penalties, the amount of which is 25% of either the total trading value or aggregate market value of the purchased shares. At the same time, such a violation also may be subject to a criminal penalty.

Those who accepted an offer with any violation of takeover bids regulations and sold the shares to the bidder may file a lawsuit in a court for damages caused by such violation. In this case, the general principles concerning the liability for damages under the civil law are modified and provide for: *i)* absolute liability of the violator, or burden to prove that the violator paid adequate care for the discharge of the violator; *ii)* a shift of the burden to prove the causality from the plaintiff to the violator; and *iii)* a statutory provided amount of damages. Against any act in violation of takeover bid regulations under the FIEA, the Commissioner of FSA and SESC may file a petition in a court to issue an order for prohibition or suspension of such act.

Source: Responses to the OECD peer review questionnaire.

Shareholder meetings

According to Principle II.C, shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules – including voting procedures – that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.
3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

In practice, effective shareholder participation in general shareholder meetings may be hindered through various (often *ad hoc*) devices such as voting by show of hands without the right to demand a ballot, only a limited number of entry cards granted to custodians, delayed information (violation of minimum notice periods) and even the place for the meeting of shareholders being out of the way – or the date and/or location being uncertain or unknown. Furthermore, the materials sent to shareholders might not be very informative, in some cases shareholders only discovering the day of the meeting the importance of issues covered by summary descriptions (OECD, 2007).

Shareholder participation in annual shareholder meetings may also turn out to be small in companies with controlling shareholders, as the minority shareholders may have little influence.[21] This is often the case in countries with few domestic institutional investors and/or weak minority shareholder protection. Where domestic institutional investors do exist, they are often linked to the same controlling shareholders, and thus do not tend to participate in annual shareholder meetings. Foreign institutional investors, on the other hand, are often focused on country exposure and diversification, and thus rarely engage actively in such situations.[22]

Shareholder participation in general shareholder meetings has been facilitated through the possibility to attend shareholder meetings through electronic means. In Turkey, for example, all listed companies are now required to hold annual shareholder meetings both physically and electronically, through the so-called e-GEM system (see Chapter 3). Such systems may facilitate the supervision, both public and private, of compliance with corporate governance rules.

Many of the rules and procedures determining shareholder participation are only in part determined by law and regulation, and are rather often heavily influenced by the board through corporate charters and bylaws. In the latter cases, public supervision and enforcement is likely to take a less prominent role than private supervision and enforcement. The following chapters summarise the responses of survey respondents regarding supervision and enforcement in the three specific areas of *i*) convocation and distribution of information to the general shareholder meeting, *ii*) shareholders' rights to request a general shareholder meeting and *iii*) conflicts of interest at the general shareholder meeting.

Supervision and enforcement of convocation and distribution of information to the general shareholder meeting. The rules regarding convocation and distribution of information to the general shareholder meeting are typically contained in the company act, the securities act and/or in stock exchange listing requirements. Such rules may differ depending upon whether a company is listed. Minimum notification periods in some jurisdictions are longer for bearer shares than for registered shares.

For the EU, for example, minimum rules on information prior to general meetings are established through Directive 2007/36/EC on the exercise of certain rights of shareholders in listed companies ("Shareholder Rights Directive"). Article 5 of this Directive sets out, *inter alia*, minimum notification periods for shareholders (normally 21 days for general meetings), minimum content of notifications (time and place, agenda, procedures for participation and voting), and ways to access the necessary documentation.

In the majority of jurisdictions surveyed, the supervision and enforcement of convocation and distribution of information to the general shareholder meeting can take place through both public and private means. Where public enforcement seems to be the rule, it is not always clear that private enforcement is not possible, even if it is rare in practice.

In many jurisdictions, the securities regulator is charged with supervising and enforcing the rules regarding the convocation and distribution of information to the general shareholder meeting (**Argentina**, **Australia**, **Belgium**, **Brazil**, **Chile**, **Estonia**, **Germany**, **Mexico**, **Poland, Portugal** and **Turkey**), although in some of them supervision and enforcement only takes place *ex post*, and only if non-respect of the relevant rules has had an impact on decisions taken. In Brazil, for example, shareholders may ask the securities regulator to suspend the calling of a general shareholder meeting.

In other jurisdictions, the role of the securities regulator in this area is marginal (**Canada;** and **Hong Kong, China**), and/or another regulator (**Singapore**) or ministry (**India** and **Turkey**) is in charge of enforcement. In several jurisdictions, there is no public enforcement of the rules on convocation and distribution of information to the general shareholder meeting (**Austria**, **Czech Republic**, **Japan**, **Korea**, **Netherlands**, **Sweden** and **Switzerland**).[23]

Private enforcement of the rules on convocation and distribution of information to the general shareholder meeting plays a role in most of the jurisdictions surveyed, mainly through the possibility of shareholder lawsuits (**Argentina, Australia, Austria, Canada, Czech Republic, France, Germany, Hungary, Japan, Mexico, Netherlands, Poland, Portugal, Sweden, Switzerland, Turkey** and **United States**), which can lead to the nullification of decisions taken at general shareholder meetings, and/or through the supervision and enforcement of listing requirements by stock exchanges (**Brazil; Estonia; Hong Kong, China; Singapore; Sweden;** and **Switzerland**), which typically have the power to issue warnings, and, if violations are not rectified, can finally result in delisting of the company's shares.[24] In some jurisdictions, private enforcement only plays a marginal role (**Belgium** and **Chile**).

Overall, four jurisdictions (**Argentina, Belgium, Chile** and **Mexico**) considered that public supervision and enforcement plays a more important role with respect to the convocation and distribution of information to the general shareholder meeting, while eight jurisdictions (**Austria; Canada; Czech Republic; Hong Kong, China; Korea; Netherlands; Sweden;** and **Switzerland**) saw a more important role for private supervision and enforcement. Four jurisdictions (**Australia, Germany, Hungary** and **Singapore**) estimated that public and private enforcement were equally important.

Supervision and enforcement of shareholders' rights to request a general shareholder meeting

The rules regarding shareholders' rights to request a general shareholder meeting are typically contained in the company act, the securities act and/or in stock exchange listing requirements. Where such rights are not contained in laws or listing requirements, rights to request a general shareholder meeting may be granted through company statutes or by-laws.

In most jurisdictions, shareholders representing a minimum percentage of share capital may request a general shareholder meeting. Most jurisdictions set the threshold at

either 10% (**Chile, India, Mexico, Netherlands, Singapore, Sweden** and **Switzerland**) or 5% of share capital (**Argentina; Australia; Brazil; Czech Republic; France; Germany; Hong Kong, China; Poland; Portugal; Slovenia;** and **Spain**). Some jurisdictions (**Japan** and **Korea**) require no more than 3% of share capital, although in the case of **Korea** this only applies to listed companies and shareholders that have held the shares for at least six months. **Estonia** and **Turkey** set the threshold at 5% for publicly listed companies, and 10% for all other companies.[25] In **France**, shareholder associations can also request a general shareholder meeting through a court-appointed agent.

The right for shareholders to request a general shareholder meeting may be subject to additional limitations such as the type of business to be discussed (**Canada**), or requirements to cover expenses for convening the meeting. Minimum notice periods typically apply, with shorter periods sometimes foreseen in takeover cases. In some jurisdictions, notably the **United States** (Delaware), shareholders only have a right to request a general shareholder meeting, if such a right is foreseen in the company's statutes.[26]

In the majority of jurisdictions surveyed the supervision and enforcement of shareholders' rights to request a general shareholder meeting takes place primarily through private means.

In some jurisdictions, the securities regulator is charged with supervising and enforcing the rules regarding shareholders' rights to request a general shareholder meeting (**Argentina, Australia, Brazil, Chile, Estonia** and **Mexico**).[27] In other jurisdictions, the role of the securities regulator in this area is marginal (**Canada; Hong Kong, China;** and **Portugal**), or another regulator (**Singapore**) or ministry (**India** and **Turkey**) is in charge of enforcement.[28] In many jurisdictions, there is no public enforcement of the rules on shareholders' rights to request a general shareholder meeting (**Austria, Czech Republic, France, Germany, Japan, Korea, Netherlands, Slovenia, Sweden, Switzerland** and **United States**).[29]

Private enforcement of the rules on shareholders' rights to request a general shareholder meeting plays a role in most of the jurisdictions surveyed, mainly through the possibility of shareholder lawsuits (**Argentina; Australia; Austria; Belgium; Canada; Czech Republic; France; Germany; Hong Kong, China; Hungary; Japan; Korea; Netherlands; Poland; Portugal; Singapore; Slovenia; Sweden; Switzerland;** and **United States**), which can lead to the nullification of decisions taken at general shareholder meetings, and/or through the supervision and enforcement of listing requirements by stock exchanges, which in some cases have the power to issue warnings, and, if violations are not rectified, can finally result in delisting of the company's shares. In some jurisdictions, private enforcement only plays a marginal role (**Chile** and **Mexico**).[30]

Overall, seven jurisdictions (**Argentina, Australia, Brazil, Chile, Estonia, India** and **Mexico**) considered that public supervision and enforcement plays a more important role with respect to shareholders' rights to request a general shareholder meeting, while 15 jurisdictions (**Austria; Belgium; Canada; Czech Republic; France; Germany; Hong Kong, China; Japan; Korea; Netherlands; Portugal; Slovenia; Sweden; Switzerland;** and **United States**) saw a more important role for private supervision and enforcement. Two jurisdictions (**Hungary** and **Singapore**) estimated that public and private enforcement were equally important.

Supervision and enforcement of conflicts of interest at the general shareholder meeting. The rules regarding conflicts of interest at the general shareholder meeting are typically contained in the company act, the securities act and/or in stock exchange listing requirements. Where such rights are not contained in laws or listing requirements, rules regarding conflicts of interest at the general shareholder meeting may be contained in company statutes or by-laws.

In most jurisdictions, shareholders that have a conflict of interest are required to abstain from voting at a general shareholders meeting (**Argentina; Austria; Brazil; Czech Republic; Estonia; France; Germany; Hong Kong, China; Korea; Portugal; Singapore;** and **Sweden**). In seven jurisdictions, on the other hand, there are no rules that foresee voting abstentions by shareholders with conflicts of interest (**Belgium, Chile, India, Japan, Netherlands, Switzerland** and **United States**). At the same time, some conflicts of interest may be covered by rules that prescribe a general duty of loyalty to the company for company directors.

In some jurisdictions, shareholders with conflicts of interests only have to abstain from voting on specific issues, such as discharge of or claims against directors (**Austria, Germany, Poland, Slovenia, Sweden** and **Turkey**), acquisitions of the company's own shares from the shareholders concerned (**Australia** and **Japan**), buybacks (**India** and **Turkey**), related party transactions and remuneration (**Australia**). These restrictions also typically apply to proxy voting.

In about half the jurisdictions surveyed the supervision and enforcement of rules on conflicts of interest at the general shareholder meeting takes place through public authorities, and in the other half through private means.

In some jurisdictions, the securities regulator is charged with supervising and enforcing the rules regarding conflicts of interest at the general shareholder meeting (**Argentina, Australia, Brazil, Estonia, India, Mexico** and **Turkey**). In other jurisdictions, the role of the securities regulator in this area is marginal (**Czech Republic;** and **Hong Kong, China**), or another regulator (**Singapore**) local agency (**Germany**), and/or ministry (**Turkey**) is in charge of enforcement. In a significant number of jurisdictions, there is no public enforcement of rules on conflicts of interest at the general shareholder meeting (**Belgium, Chile, France, Japan, Netherlands, Portugal, Singapore, Sweden** and **Switzerland**).

Private enforcement of the rules on conflicts of interest at the general shareholder meeting plays a role in many of the jurisdictions surveyed, mainly through the possibility of shareholder lawsuits (**Argentina, Austria, Australia, Brazil, Czech Republic, Estonia, France, Germany, Hungary, Japan, Poland, Portugal** and **Sweden**), which can lead to the nullification of decisions taken at general shareholder meetings, and/or through the supervision and enforcement of listing requirements by stock exchanges (**Hong Kong, China** and **Singapore**). In some jurisdictions, private enforcement only plays a marginal role (**Mexico**) or is not relevant or non-existent (**Belgium, Chile, India, Netherlands, Slovenia, Switzerland** and **United States**).

Overall, three jurisdictions (**Argentina, Brazil** and **Mexico**) considered that public supervision and enforcement plays a more important role with respect to conflicts of interest at the general shareholder meeting, while seven jurisdictions (**Austria; Czech Republic; France; Hong Kong, China; Japan; Portugal;** and **Sweden**) saw a more important role for private supervision and enforcement. Five jurisdictions (**Australia, Estonia, Germany, Hungary** and **Singapore**) estimated that public and private enforcement were equally important.

Notes

1. Whistleblowers could also be included in the category of private supervisors.
2. For the US, Jennings et al. (2011) find that SEC enforcement actions, as well as securities class action litigation are associated with significant deterrence, and that repeated and sustained enforcement in an industry, as opposed to isolated investigations, provides more effective deterrence.
3. The securities regulators in all three jurisdictions that participated in the in-depth review (Brazil, Turkey and the US) have faced significant constraints in this respect (see Chapters 2-4).
4. The FSAP assessments are based upon IOSCO Principle 12, which states that the regulatory system "should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance programme". In its reviews of regulators from member jurisdictions, IOSCO assesses, among other things, *i)* the resources dedicated to an enforcement programme; *ii)* the level of fines imposed per annum; *iii)* the cost of capital in the jurisdiction as a proxy for investor confidence in the enforcement programme; *iv)* the number of cases filed per annum; and *v)* number and type of investigations conducted per year.
5. It can of course also be an incentive to lower the standards themselves.
6. Another reason may be that if the names of the companies targeted by these informal measures are not published, the authorities will worry less about reputational damage to "their" companies and markets.
7. As emphasised by Armour et al. (2009), "informal or reputational sanctions imposed by private parties, which might take the form of lower share prices, a decline in social standing, or a personal sense of shame" are also forms of private enforcement.
8. As with public supervision and enforcement bodies, these private sector bodies often have wider responsibilities. An exception may be specialised bodies such as Takeover Panels.
9. On the other hand, some argue that large potential fee awards for lawyers are necessary as an incentive to pursue private litigation.
10. See e.g. Jackson and Roe (2009), who also argue that ownership dispersion can weaken private enforcement, in the sense that it "creates collective action problems that dilute shareholders' capacity to litigate effectively, to vote efficiently, or to take other remedial actions to control insider misbehaviour".
11. This is the case for example in both Brazil and Turkey, who are reviewed in more detail in Chapters 2 and 3.
12. The study cites evidence suggesting that, in the United Kingdom, over the 1990-2006 period, there were only three reported judgements in which a shareholder action was brought to court in relation to misfeasance by directors of a listed company.
13. Whereas Brazil's BM&FBovespa exchange has had a positive experience with the establishment of the higher standard "Novo Mercado", other countries (e.g. Turkey, UK, US) have lowered their requirements, notably in respect to mimimum free float, in order to increase the attractiveness of IPOs in their markets (see Chapters 2-4).
14. See e.g. Millstein et al. (2005), notably the article "Corporate Governance and Enforcement" by Berglöf and Claessens.
15. See e.g. Angelides (2013).
16. In that context, some fear that the relaxation of relevant disclosure obligations, e.g. as part of the JOBS Act in the US, may complicate the identification of potentially abusive related party transactions (see Chapter 4).
17. In Portugal, where the Companies Law allows three different governance models (including the German model), disclosure of the negative impact of any influence by the parent company is required by all companies regardless of their governance model.
18. In Portugal, furthermore, every RPT must be authorised by the board of directors following a favourable recommendation by the supervisory board or the audit committee, depending on the governance model which has been adopted (see Note 17).

19. In the many jurisdictions where control rights are concentrated, hostile takeovers are rare but transfers of control nevertheless do occur through private sales. The concern is that controlling shareholders will act in their own self-interest to the detriment of other shareholders thus breaking the principle of equal treatment within the same class of shares (OECD, 2007).
20. Brazil is the latest example of a country setting up a Takeover Panel, the so-called Mergers and Acquisitions Committee (see Chapter 2).
21. Shareholder participation may of course also be low in cases where ownership is widely dispersed among retail investors, and each individual shareholder thus has only a limited influence.
22. The examples of Turkey, and to a large degree Brazil, illustrate such an environment of controlling owners (see Chapter 3).
23. In some countries, inspectors of the securities supervisor or relevant ministry participate in the general shareholder meetings, as a rule (Argentina) or on a case-by-case basis (Chile, Turkey) to ensure that the applicable rules are respected.
24. In a recent example from Sweden, Nasdaq OMX issued several "criticisms" against a company during 2011 for not having published a notice of an annual general meeting in a timely manner.
25. The Czech Republic lowers the threshold to 3% for smaller companies. Portugal requires 2% for publicly listed companies.
26. Some US states (e.g. California) do, however, provide for rights to request general shareholder meetings.
27. In some countries (e.g. Estonia), no relevant cases have occurred in practice.
28. In case of failure to call a meeting in accordance with the applicable rules, some jurisdictions provide that individual shareholders (Netherlands) or the external/internal auditors (Switzerland/Portugal) can call a general shareholder meeting.
29. In some jurisdictions, the financial regulator also has a right to request the board to call an extraordinary shareholder meeting of a credit institution or companies such as CCPs or stock exchanges.
30. In Sweden, the rights are enforced through county administrative boards.

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Chapter 2

Brazil: The corporate governance framework and practices relating to supervision and enforcement

This chapter, part of the fifth peer review based on the OECD Principles of Corporate Governance, summarises public and private supervision and enforcement practices in Brazil, in particular in the areas of related party transactions (RPTs), takeover bids and shareholder meetings. The chapter, prepared by Maria Helena Santana, former Chair of Brazil's Securities Commission, the CVM, acting as a consultant to the OECD, highlights the key characteristics, strengths and limitations of the Brazilian framework for corporate governance-related enforcement, including a strong reliance on the supervision of its Securities Commission (CVM); close co-operation between CVM and Brazil's Stock Exchange (BM&FBovespa), on enforcement of listing requirements; and greater use of market arbitration mechanisms than court processes to settle corporate governance-related disputes. It concludes with some recommendations on further improvements in the supervision and enforcement framework.

2.1. Introduction

This chapter highlights the key characteristics, strengths and limitations of the Brazilian framework for corporate governance-related enforcement, including a strong reliance on the supervision of its Securities Commission, CVM; close co-operation between CVM and Brazil's Stock Exchange, BM&FBOVESPA, on enforcement of listing requirements; and greater use of market arbitration mechanisms than court processes to settle corporate governance-related disputes, due to the slow pace of the court system.

The following OECD Principles of corporate governance were used as a reference for this review:

- I.B: The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable;
- I.C: The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served; and
- I.D: Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

The Committee decided to review supervision and enforcement to a deeper extent by relating these to the following three corporate governance issues:

- disclosure and monitoring of related party transactions (Principles V.A.5 and VI.D.6);
- the market for corporate control (Principles II.E.1 and 2); and
- effective shareholder participation in the general shareholder meeting (Principle II.C).

This report uses information gathered in the project's first phase, which encompassed a detailed questionnaire answered by Brazilian representatives in the Committee from CVM, as well as interviews with several Brazilian market players (i.e. the Association of Capital Market Investors (AMEC), BM&FBOVESPA, CVM, the Brazilian Institute of Corporate Governance (IBGC), the Market Arbitration Chamber, investors, lawyers and a specialised court judge). All references used are listed at the end of this report.

In addition to this Introduction (2.1.), the report contains five sections. The first section (2.2.) contains a brief description of the legal and regulatory frameworks for the Brazilian capital markets as well as the market's key characteristics and recent progress. The second section (2.3.) covers public supervision and enforcement procedures to identify the leading players in charge of said procedures and to describe how they are organised, the main features of the system as a whole and its actual effectiveness. This section also looks at the key features of the regulatory system as applicable to each of the three selected corporate governance sub-topics. The third section (2.4.) presents the same analytical approach, but with a focus on private supervision and enforcement. The fourth section (2.5.) reviews the interaction between public regulatory and stock exchange enforcement. The fifth section (2.6.) draws conclusions on the issues canvassed in the report. Relevant examples and cases for this report are presented and reviewed in specific boxes.

2.2. Basic framework and market characteristics

Brazilian law is affiliated with the system of civil law. In addition to the civil code, there are several special laws (corporation law, bankruptcy law, consumer protection law etc.), which regulate economic activity. Moreover, Brazilian law is characterised by an extensive federal constitution, which establishes rules, including rules for private economic activity. Thus a Brazilian judge works firstly within the framework of written rules in the Constitution and laws when resolving a conflict between private parties. Only at a second level does the judge decide on a case based on judicial precedents. Throughout history, Brazilian laws for companies have been influenced by law as applied in countries in continental Europe, such as Italy, France and Portugal. Nevertheless, there is considerable North American influence in Acts No. 6404 and 6385, which currently regulate corporations and the securities market.

Brazilian Corporate Law is federal. Act No. 6404 of 1976 established the rules related to all relevant corporate governance issues, such as shareholder rights, disclosure, accounting standards, shareholders' meetings and fiduciary duties of directors and controlling shareholders. The responsibility for the enforcement of this law was given to the Securities and Exchange Commission – CVM, in Act No. 6385/76. CVM was also given the power to regulate certain aspects of corporate law, which is done through Instructions.

In 2000, the Brazilian stock exchange BM&FBOVESPA established rules related to corporate governance by means of the *Novo Mercado* and Levels 1 and 2 of Corporate Governance. These are special listing tiers which companies can join by signing a contract of adhesion, committing themselves to adopting the tiers' corporate governance rules, more rigorous than those legally required. Adherence to the tiers is voluntary, but after signing the contract, its rules become binding. Therefore, it is not a mechanism based on *comply* or *explain*.

Lastly, it is worth mentioning that the Brazilian Institute of Corporate Governance (IBGC) has developed and frequently updated a Code of Best Practice for Corporate Governance (a set of principles and recommendations that have constituted important benchmarks for the evolution of corporate governance in Brazil) since the late 1990s. However, it is not required that public companies apply such guidelines, nor must they explain themselves if they choose not to adopt them.

The Brazilian stock market has evolved greatly over the past ten years, having received a number of new companies: 132 IPOs between 2002 and 2012.[1] In marked contrast to the previous decade, they were able to attract capital from foreign and domestic investors by listing only in the Brazilian market. This has paved the way for a number of medium-sized companies that would not have had access to the market otherwise.

The main cause for this change was the creation of the *Novo Mercado* and the improvement that the aforementioned rules brought to the perception of investors. In other words, the improvement in corporate governance was at the centre of the turnaround of the Brazilian market. It is not by chance that the vast majority of new companies were listed on the *Novo Mercado* or Level 2 (88%). Market capitalisation has multiplied 10-fold (from USD 121 billion in 2002 to USD 1 215 billion in 2012), not only because of the improvement in the country's economic scenario, but also because of the entry of new companies which were better priced by investors. The average daily trading value in the stock market rose from USD 167 million in 2002 to USD 3 220 million in 2012. The investment options in the Brazilian market diversified, with the entry of companies from more dynamic sectors which had not yet been represented in its listing. At the end of

2012, the companies of the *Novo Mercado* represented 31.3% of market capitalisation and 42.5% of the trading value on the stock exchange.

In addition to the creation of the *Novo Mercado*, a set of revisions in corporate law and in Act No. 6385 (Securities Market Act), completed in 2002, followed by significant improvements in the CVM regulations, have contributed to the improvement and modernisation of the Brazilian regulatory framework in the last decade.[2]

Nevertheless, Brazil still has a very small number of listed companies (364 in late 2012), especially considering the size and dynamics of its economy. The reason for this seems to stem fundamentally from cultural tradition, such as the unwillingness of entrepreneurs to share power with partners and to reveal information to the public. This scenario is changing, but it is a rather slow process. At present, there are initiatives to increase the number of companies that use the market by creating measures to tackle the main obstacles identified.

Brazilian companies are mostly owned by families or economic groups, while dispersed ownership of listed companies is a very recent phenomenon and include a limited number of cases. The recent emergence of a number of widely held companies is fundamentally related to the creation of the *Novo Mercado*. The most symbolic among its rules is the one-share-one-vote rule. Since controlling shareholders in those companies are no longer able to maintain control by issuing non-voting shares to the market, relatively dispersed ownership characterises a growing number of *Novo Mercado* companies. At the end of February 2013, 56 out of 127 *Novo Mercado* companies reported more than 50% of the voting shares as free float. That said, it is important to observe that most of those companies have shareholders who own relevant blocks of shares and are, in some cases, even formally characterised as controlling shareholders.

Foreign and domestic institutional investors, in this case mainly investment funds, are the main holders of traded shares.

2.3. Public supervision and enforcement

Public supervision and enforcement of corporate governance-related rules and statutory provisions fall under the remit of the CVM. Moreover, the Federal Prosecutor's Office has the power to pursue cases involving corporate governance issues provided that they are deemed to represent an offense to public interest (or diffuse interests of society in general). They have the power to file criminal and civil charges. Act No. 6385 established the CVM and its mandates, which are focused on investor protection, securities market integrity and promotion of capital formation of Brazilian enterprises. CVM is a federal agency linked to the Ministry of Finance under special status, endowed with administrative autonomy and whose general operating policies are approved by the National Monetary Council.[3]

CVM was given the power, by means of Acts No. 6385/76 and 6404/76, to issue detailed rules on several aspects covered by those acts.

CVM has broad investigative powers, which include the authority to conduct on-site inspections as well as to request physical and electronic documents from, among others, public companies, auditors, investment managers and securities analysts. The Commission also has enforcement powers, such as to impose monetary penalties and to suspend or cancel authorisations given to market participants. In terms of disclosure by public companies, besides issuing the rules that establish those obligations, CVM's powers include ordering the disclosure of specific facts or asking for further clarifications of information already disclosed.

CVM's powers do not, however, include the possibility of issuing stop orders or determining, as precautionary measures, what public companies or their managers should do. There are articles in Act No. 6385 that give the Commission such power (especially arts. 9, § 1 and 20), but which only grant CVM the right to act in order to ensure market integrity, by canceling trades or suspending offerings or trading when justified, by determining the disclosure of information or the immediate suspension of operations in the market by people who are not duly authorised by the Commission.

Act No. 6385, also established the institutional setting for CVM, largely inspired by the U.S. SEC. In 2001 the legislation was reformed with the objective of strengthening the Commission and furthering its independence. CVM is governed by a board of four commissioners and a chairman, all of them appointed by Brazil's President, approved by the Senate, and chosen for their expertise in securities market issues. They serve a five-year term, with only one board member being replaced per year, and cannot be removed unless wrongdoing is proven. This arrangement aims at protecting CVM from political interference and ensuring the stability of its governing body. The board members are subject to the "Code of Conduct of the High Federal Administration", which establishes clear rules and principles, including a prohibition on their acceptance of gifts worth more than USD 50. As for CVM's staff, it is mainly comprised of civil servants admitted through a public sector entrance exam, which tests a candidate's technical expertise.

Throughout history, Commissioners and Chairs of CVM have mostly come from regulated industries, while staff members, although some may have worked in the market place before joining the Commission, rarely leave it to go back to private practice due to lifetime employment stability provided by the legal regime applicable to civil service. Even though this hiring procedure is in principle able to ensure the independence of CVM's employees, it poses important challenges to the Commission, such as how to qualify its personnel to deal with the extremely sophisticated issues they must regulate, supervise and enforce. The challenge is even greater if one considers that, at the other side of the table, there sits the best legal and financial advisors money can buy.

CVM is respected in Brazil and among international investors for its technical approach to capital market matters and for its seriousness. It is generally perceived as an entity with a good level of independence from the industry and from political interests. Nevertheless, frustration among investors is sometimes expressed regarding CVM's handling of specific cases involving state-owned companies that are listed publicly. In such cases, the perception seems to be that it is difficult for the Commission to be as tough as it would have been if the subject were a privately owned company.

CVM is funded by fees charged to the market participants it supervises (brokers, public companies, auditors, fund managers, investment funds, etc.), as well as by registration fees of public offerings of securities. Such fees are provided for by Act No. 7940 of 1989. Although CVM obviously depends on funds raised by the regulated market, it stays clear from pressures that could affect its independence, as it receives funds from about 52 000 entities under its jurisdiction (CVM, 2012). Furthermore, registered participants cannot opt out of paying such fees established by law, and CVM employees do not receive any compensation based on its revenues.

Although Act No. 6385 provides CVM with "financial and budgetary autonomy", the collected fees and fines are paid to a separate account under its name, but which is in fact controlled by the National Treasury. CVM's budget must be approved by the Ministry of

Finance, by the Ministry of Planning and by Congress and may be subject to a process that can involve various levels of negotiation and persuasion. CVM's access to the needed resources is bound to the fiscal policy in place for the entire Brazilian public sector. Even if it makes a surplus in a specific year, its budget can suffer cuts if fiscal tightening is deemed necessary.

Moreover, the budget process is, apart from being influenced by priorities outside CVM's legal mandate, slow and heavily regulated, which in itself can cause difficulties when seeking to use available resources. One example is resource allocation between activities. It is not possible to alter the budget after Congress establishes it, even if faced with material changes in market risks and market scenarios throughout the year. Relocation of people between different sectors of the Commission is a bit more discretionary, even though the process for hiring new staff is extremely time consuming and is subject to approval by the Ministries of Finance, Planning and Congress itself.

CVM has full autonomy in terms of setting its own priorities directed towards enforcement, but is not in control of overall resource levels and lacks discretion for certain items such as decisions on international travel and to redirect funds if priorities change.

CVM is subject to inspection of its operations by external control agencies. Firstly, the Commission's own internal auditing is regarded by law as an arm of the national external control which all federal government agencies are subject to, the Comptroller General of the Union (CGU). The nomination of its head and its annual audit plan is also subject to the same body's approval. Each year, CGU audits the CVM report, which contains all the performance indicators as well as information about its activities in general. Inspection is also carried out by independent control of the federal legislature, the Federal Audit Court (TCU). CVM's annual management report is divulged to the public. The annual plan of internal audit and inspections to which CVM is subject cover supervisory and enforcement activities, and include, for example, the duration of enforcement cases.

As of 2008, the Commission officially adopted a policy of Risk Based Supervision (SBR), which has been expanding its scope to include new segments to its activity. In 2013, such a policy already includes supervision of public companies, investment funds, exchanges and OTC markets, brokerage firms and other intermediaries that operate in these markets or in the distribution of securities, as well as independent auditors. The SBR is based on a two-year plan, which begins by classifying agents and events according to two guidelines: the potential risk they bring to the market and the impact they would cause if the potential risks were to be materialised. Thereafter, activities and quantitative targets are established to cope with the risks identified relative to the various participants.

This activity is reported biannually to the board of CVM and the National Monetary Council,[4] the body that approved the adoption of this policy by CVM. These biannual activity reports are disclosed on the Commission's website, leaving out the names and individual qualifications of the regulated agents. Although there has been a growing positive influence of the SBR on the results of CVM's work in carrying out its legal mandates, the policy is focused on preventive supervision. The enforcement activity, on the other hand, is not organised according to formal planning. It occurs mainly in response to problems identified during the preventive supervision or because of complaints by third parties. CVM enforcement was strongly boosted when in 2008 an administrative restructuring initiative established a department especially dedicated to conducting investigations and presenting charges. This new department does not take part in preventive or on-site inspections.

There are two ways in which CVM can impose sanctions. In the case of objective breaches of the rules, such as noncompliance with the deadline for submission of information, the directors of the divisions hold clout to establish penalties based on the evidence and respecting the due process. For all other breaches of law or regulations, the CVM board decides the cases, after analysing the evidence and the defense presented. Such trials are conducted in sessions open to the public and to the media, with justified votes which are then published on CVM's website.

The process of imposing appropriate sanctions in each case is based on the parameters established by Act No. 6385,[5] in jurisprudence, as well as on the assessment of the CVM board of the characteristics of the case which would justify mitigation or aggravation of penalties. Their assessment takes into account the current state of the market, with an aim to ensure lessons learned and the prevention of further irregularities. In several cases, the votes contain a clear explanation for why specific penalties were established. The penalties imposed by the CVM board are not subject to any prior control mechanism except for limitations established by law (see Note 35). However, their decisions in these cases are subject to frequent appeals to the National Financial System Appeals Council (CRSFN), a joint administrative body composed of representatives from both the public and private sector, as well as appeal to the judiciary (see Table 2.1).

Table 2.1. **Brazil – CVM enforcement. Cases per year (2008 to 2012)**

Year	Cases opened	Cases closed through settlements	Cases judged by CVM's board	Total closed (settled + judged)
2008	77	36	42	78
2009	80	24	60	84
2010	74	24	53	77
2011	82	22	34	56
2012	68	21	36	57
Total	381	127	225	352

Source: CVM response to the OECD peer review questionnaire.

The following table presents data on the number of enforcement cases conducted by CVM, between 2008 and 2012, where charges were presented and the cases have been closed, either through settlements (or consent decrees) or after trial by the CVM's board.

On a different basis, the next table shows data on the number of persons that were judged by the CVM's board and found guilty of the charges, followed by the number of appeals to the CRSFN, the number of decisions actually taken by that appeals council and, lastly, the number of CVM decisions on penalties that were maintained by the Council. It is easy to see that the CRSFN, although serving the public interest for providing defendants with the opportunity to appeal at the administrative level, is in fact watering down the enforcement performed by CVM, due to the extremely slow pace of its decisions. It is even difficult to analyse the figures on the number of CVM decisions that have not been confirmed, due to the very low absolute number of CRSFN decisions. That also helps to explain the extremely high proportion of appeals, since in practice this enables the appellant to defer the penalty for several years.

Table 2.2. **Brazil – Persons subject to enforcement per year (2008-2012)**

Year of CVM's decision	Number of defendants found guilty	Number of appeals to the CRSFN	Number of CRSFN decisions	Number of CVM penalties maintained
2008	269	248	9	5
2009	202	174	15	12
2010	550	501	1	1
2011	95	84	0	0
2012	292	205	0	0
Total	1 408	1 212	25	18

Source: CVM response to the OECD peer review questionnaire.

Basic regulatory framework for the disclosure and monitoring of related party transactions (OECD, 2012b)

Among the three topics that are the focus of this report, cases of related party transactions (RPTs) are the most common and most relevant to the Brazilian market, and by far the one that has required the most intervention by CVM or the courts. Some key developments and cases in this regard are highlighted in Box 2.1.

Box 2.1. **Brazil – Related party transactions: Key developments and cases**

Guideline 35

The most emblematic and significant transaction between related parties is usually the one that involves a combination of companies under the control of a single shareholder, as it may lead to the potential dilution of the subsidiary's minority interest. In the Brazilian regulatory framework, mergers of controlled and parent companies and other variations of this type of operation must be approved at a general meeting of shareholders. However, corporate law allows the controlling shareholder to participate in the deliberation and vote at the meeting of the controlled company to approve the proposed exchange ratio. Despite being a clear case of conflicting interests, it is widely recognised by interpreters of the law and by CVM that this vote is excluded from the rules applicable to other cases of conflict of interest with the company in corporate law, allowing for the controlling shareholder to participate in the vote.

Given this limitation imposed by the legal system, and driven by the need to address the high incidence of operations that were detrimental to minority shareholders, CVM issued Guideline 35 in 2008, to provide guidance as to how directors can fulfill their fiduciary duties in cases of mergers involving parent companies and their subsidiaries, or companies under common control.

In essence, under Guideline 35 CVM will consider that the legal obligations of directors under the corporation law have been met if: *i)* the RPT was approved by a majority of non-controlling shareholders of the subsidiary (including holders of non-voting and restricted-voting shares; majority of minority rule); or *ii)* negotiation of the RPT was conducted on behalf of the subsidiary by a special independent committee and such committee recommended the transaction to the board. Guideline 35's provision for direct negotiation of the transaction by independent parties (as opposed to ratification by some sort of outside expert or the audit committee, or a committee of independent directors) is unique among Latin American countries surveyed by the Task Force on Related Party Transactions of the Latin American Roundtable on Corporate Governance. In CVM's view, good faith approval by the subsidiary's board of the terms of an RPT that were directly negotiated by independents on behalf of the company satisfies the board's fiduciary duties.

Box 2.1. **Brazil – Related party transactions: Key developments and cases** *(cont.)*

After issuing Guideline 35, CVM began to analyse all mergers of subsidiaries as soon as they were disclosed in notices of shareholder meetings, asking for clarification and disclosure of additional information, while also informing companies about the staff's interpretation of the correct use of Guideline 35 in each case. Such enforcement of Guideline 35 is evolving, and with time has become less formal (box ticking) and more substantive, thus generating better results. The effective independence of the special committee members has been the aspect in which CVM has tended to focus its intervention.

Not only has CVM learned from experience, but also companies and the banks that advise them have evolved in their understanding and adoption of the recommendations of the given Guidelines. One can say that the Guideline 35 has, overall, improved the quality of the mergers of subsidiaries which can be measured by a lower number of conflicts and complaints related to this issue after its edition. In several cases, the negotiations conducted by independent committees caused a change in the exchange ratio initially proposed by the administration of the parent company allowing for a more favorable result for the shareholders of the controlled company. In other cases, the controller opted to abstain from voting, leaving the approval of the transaction to the minority, either after being questioned by CVM, or even before that, by their own initiative.

Investors surveyed for this report also stated that, in general, they noted a clear improvement in merger transactions of subsidiaries. One respondent even mentioned a change in the behavior of banks that produce the required appraisal reports. In his opinion, assessors seem to be more cautious and unwilling to produce "less stringent" appraisals out of concern for distressing cases in the past and because of the negative impact they caused to their reputation.

Case MMX-PortX

The company MMX Mineracao and Metalicos S.A. ("MMX"), listed on the Novo Mercado, decided to merge its subsidiary PortX S.A. Operacoes Portuarias (PortX), also listed in the same segment. A board meeting was held on 3 February 2012, in which "the installation of a special independent committee, as recommended by the Guideline 35" was approved to negotiate the conditions of the transaction. Three months later the company reported the exchange ratio (the number of shares of the parent company that would be granted to the minority shareholders of the subsidiary) that it would propose at the PortX shareholders' meeting. After analysing the transaction, CVM staff found that two members of the special "independent" committee of MMX were also members of the board of directors of PortX, and questioned the company about the independence of the committee and of the negotiating process. Furthermore, the company was required to provide evidence that such negotiations had actually occurred. One day before the shareholders' meeting that would decide on the merger, MMX announced it had chosen to abstain from voting. In the shareholders' meeting, the minority shareholders proposed a new, more favorable, exchange ratio, which was then approved in a new meeting.

As for other types of related party transactions, the preventive supervision of CVM designated this kind of transaction, in 2009, as one of the potential risks related to public companies. Thus it established criteria and targets for the analysis of its SBR (risk-based supervision) biennial plans. In 2012, the Commission worked, for example, on the information provided in the explanatory notes to the financial statements, as required by the IFRS, in force in Brazil since 2010, and on the Form of Reference. It decided to focus on those companies that reported having signed contracts for the use of brands, royalties, technology transfer and intellectual services with related parties, but also examined other types of contracts. Its analyses resulted in requests for clarification or disclosure of additional information and, in a

Box 2.1. **Brazil – Related party transactions: Key developments and cases** *(cont.)*

few cases, in allegations of abuse (defendants were charged in 7 out of 17 investigated transaction cases). In several cases, the Commission's staff recommended companies to adopt a policy for related party transactions, defining formal processes of evaluation and approval. Even if the quality of information provided by companies is still regarded as poor, it is important to point out that prior to 2010 (when IFRS was adopted and the Reference Form was required), it would have been impossible to carry out a comprehensive supervision effort related to RPTs in Brazil, given the lack of disclosed information.

The Tractebel case

A key CVM board interpretation was issued in 2010 in response to an appeal against the decision of the Commission's staff, who had decided against the controlling shareholder voting in the case of an asset acquisition by a controlled company. The controlled company was Tractebel Energia S.A. (Tractebel), listed on the Novo Mercado.

On 21 December 2009, Tractebel announced the approval by its board of directors of the acquisition of all Suez Energia Renovável S.A. (SER) common shares held by GDF Suez Energy Latin America Participações Ltda. (GDF), the latter being Tractebel's parent company. The announcement also said that the proposal would be subject to ratification by the general meeting of shareholders, in compliance with Article 256 of Act No. 6404. By answering CVM staff's interrogation about whether GDF intended to vote in the aforementioned meeting, the company confirmed that the parent company would vote in the deliberation of the transaction of which it was also the seller of the asset. Given this fact, the CVM staff stated that they understood that the controller was not allowed to vote because of § 1° of Article 115 of the corporate law, which prohibits the vote of the shareholder who has a conflict of interest with the company. After analysing the appeal, the CVM board confirmed the opinion against the vote of the controlling shareholder, reversing the interpretation of the law that had been in effect at the CVM since 2002, in CVM case no. TA/RJ2002/1153. CVM understood that the ban existed even considering that Tractebel had set up a special independent committee to negotiate the terms of transaction with the parent company.

This interpretation has not been challenged so far, neither by a controlling shareholder ignoring it and voting, nor by taking it to the courts. This decision has contributed to the improvement in the quality of the transactions with related parties, as it gives a strong incentive to proposals being presented to the shareholders' meetings on fairer terms. However, as not all RPTs are necessarily subject to voting in the shareholders' meeting, the impact of the decision is rather limited in practical terms.

The CCR airports case

The experience of the Companhia de Concessoes Rodoviarias S.A. (CCR), also listed on the Novo Mercado, provides a good example of best practice, in which an acquisition of assets held by the controller was carried out on absolutely fair and transparent terms. This case combines measures recommended by CVM in its Guideline 35 (though this was not necessary in this case) and respect for the decision in the Tractebel case.

Box 2.1. **Brazil – Related party transactions: Key developments and cases** *(cont.)*

The company, whose main business activity was highway concession, wished to operate other types of public service concessions. The controllers, on the other hand, had shareholdings in the international airports of San Jose, Costa Rica, in Curacao, in Quito, Ecuador and a greenfield project to build a new international airport in Sao Paulo, Brazil. A special committee was formed for the valuation of the assets, coordinated by one independent board member of the CCR and composed of three other independent members (two external and one board member linked to a participant of the shareholders' agreement, but not in conflict in that case). The very composition of the committee was decided by the independent board member, without the intervention of the company board, dominated by controllers. The committee had the freedom to select its legal counsel, financial and technical experts, and received significant support from the company's legal department to do their job.

In the end, the committee presented its recommendation to the company board, with price ranges for each asset, and disclosed to the market the documentation on which its decision was based. The board decided to submit the independent committee's recommendation to the shareholders' meeting. The controlling shareholders, accepting CVM's view on the Tractebel case, abstained from voting for the proposal, which was approved by a representative group of local and foreign minority shareholders, with 99.88% of the ones present at the meeting voting in favor. This acquisition of assets of related parties occurred without any complaint being filed with CVM before or after its completion.

The legal framework for oversight of RPTs mainly addresses disclosure. Brazil implemented International Financial Reporting Standards beginning in 2010. In addition to the *ex post* reporting of RPTs required by IAS 24, CVM issued Instruction 480/09 in 2009 requiring all Brazilian public companies to keep a "Reference Form" on file electronically and periodically update it, including Section 16 specifically related to RPT disclosure. The Reference Form must include a description of the company's policies and practices for engaging in RPTs, its policies with respect to conflicts of interest, the evidence required to ensure the fairness of the terms of RPTs, and the main features of each relevant[6] related party transaction concluded by the company during the last three years. CVM Instruction 481/09 also requires the disclosure of information, as prescribed in detail by the Rule, on any transaction subject to shareholder approval in a general shareholders meeting. Furthermore, the law provides standards for the immediate disclosure of any transactions, including RPTs, that qualify as material events, which must include identification of all related parties and their interests in the transaction and the counterparties.

Brazil's corporation law does not establish special approval procedures for RPTs. An RPT only needs to be approved in a general shareholder meeting if the operation to which it relates depends on shareholders approval, such as those that change the company's capital structure (mergers, spin offs, etc.) or change any shareholder rights. Most RPTs therefore are treated as part of the normal course of business by the law and, unless there is a requirement for board or shareholder approval in the company's bylaws, are decided by the management.

Act No. 6404 provides for general directors' duties of loyalty and care. The law requires that any transactions with officers and directors, controllers and affiliates must be

conducted on terms equitable to the company and minority shareholders. As previously mentioned, the law does not set out specific procedures to be followed in negotiating and approving such RPTs. However, in 2008, the CVM issued guidelines (*Parecer de Orientação* 35; hereinafter referred to as Guideline 35) to provide guidance on how directors can fulfil their fiduciary duties in cases of mergers and acquisitions involving parent companies and their subsidiaries, or companies under common control, as shown in a specific box later in this chapter. Brazil's legal regime provides some entry points for shareholder intervention. Most corporate reorganisations must ultimately be submitted for shareholder approval. The corporation law requires that mergers between parent and subsidiary companies, or between companies under common control, be approved by the shareholders of each company. In addition, the purchase by one company of any company whose value is more than 10% of the purchaser's equity, or any purchase at a substantial premium to its value based on certain metrics,[7] must also be approved by the purchaser's shareholders. Brazil's corporation law generally prohibits a shareholder from voting on a resolution in which such shareholder has a "particular" interest or on which the shareholder and the company have conflicting interests. However, CVM cannot mandate a majority of the minority vote in the particular case of an acquisition of a controlled company by its parent, since Brazilian company law is explicit in providing that the parent company may in such circumstances participate in the vote of the shareholders of the subsidiary. In such cases the managers and directors of the subsidiary remain subject to the duties of loyalty and care. Act No. 6404 prohibits loans to managers without previous authorisation by the board or the general meeting of shareholders.

Basic regulatory framework for takeover bids

Brazilian laws provide no rules on mandatory bids due to the acquisition of control of public companies. Legal provisions only grant tag along rights in the case of sale of such companies' control, applying to ordinary shares only (i.e. shares that give their owners the right to vote). Takeover bids are regulated as voluntary tender offers where key requirements call for a guarantee of settlement by a financial institution, disclosing information prior to and during the offer, and prohibition of certain conduct that could be regarded as market abuse.

CVM rules for takeover bids underwent major changes in 2010 due to the growing number of dispersed ownership public companies. Furthermore, a takeover operation in 2009 yielded some lessons, and changes in the rules were then regarded as utterly necessary. The main changes are described in the Box 2.2, describing the GVT S.A. takeover case.

Box 2.2. **Brazil – The takeover of GVT**

As previously mentioned, the vast majority of Brazilian public companies are controlled by a shareholder or a defined group. Only after the emergence of the Novo Mercado, which requires that a company issues only voting shares, some companies started to have the majority of their voting stock traded in the market. Such was the case with GVT S.A., a Novo Mercado company in the telecommunications industry whose controlling block held around 30% of its capital. The control of this company was acquired through a takeover bid that had been negotiated with this block of shareholders from the beginning.

Box 2.2. **Brazil – The takeover of GVT** *(cont.)*

At the time of the acquisition in 2009, Brazilian legislation was not yet fully prepared to deal with this kind of situation as the existing legislation and CVM's regulation were focused on the reality of companies with a controlling shareholder. The unfolding of this case and some gaps that became evident triggered a review of CVM Instruction 361/02, altered on 25 November 2010. Moreover, this episode was characterised by the fact that both the buyer and a foreign investor breached Brazilian law. Both parties signed consent decrees with CVM to end the disciplinary procedures against them and to pay compensatory damages for a total value of around USD 80 million.

On 8 September 2009, GVT announced that its controlling shareholders had signed an agreement with Vivendi to launch a tender offer in order to acquire a 100% stake in GVT, for BRL 42.00. On 7 October 2009, Telefonica S.A.'s board of directors approved the launch of a voluntary competing offer to acquire 100% of GVT shares at a price of BRL 48.00 per share, as was then launched and published on 8 October 2009. On 4 November 2009, Telefonica S.A. increased the competing offer price to BRL 50.50 per share. On 13 November 2009, GVT disclosed that its controlling shareholders had reported the acquisition, by Vivendi, of shares and stock options that totaled 57.5% of its share capital, thus indicating the acquisition of controlling interest, at a price of BRL 56.00. This disclosure frustrated the competing takeover bidder, whose auction was scheduled for 19 November 2009. From that moment on, Vivendi continued buying GVT shares, before later on launching the offer to acquire all outstanding shares.

After analysing the disclosed information and questioning those involved, CVM concluded that a relevant portion (9.7% stake in GVT) of the total of 57.5% Vivendi announced to possess on 13 November 2009 was in the form of total return swaps, entitled exclusively to financial settlement. Therefore, CVM concluded that the information Vivendi disclosed to the market on that date, and that sealed the fate of the operation, was misleading, since Vivendi did not have the right to acquire more than 50% of GVT's capital at that time. Moreover, CVM found that Vivendi deliberately made a fraudulent statement, as obtained evidence showed that the company was well aware of the characteristics of the attained contracts. Yet another market investor was found by CVM to have played a role in this fraud. Both parties were accused of fraud and market abuse and eventually made settlements with the Commission to close the case as described above.

It is noteworthy that, as reported by interviewees, there are currently some arbitral cases pending at the Market Arbitration Chamber (CAM) for disputes related to this case. GVT was listed on the Novo Mercado (NM) and therefore its controlling shareholders and new controllers are required to solve minority shareholders claims (including related to NM rules) through arbitration.

In 2010, CVM set forth a revision of Instruction 361/02 to make some changes on takeover bidding rules, as a result of this case and in view of the Brazilian stock market evolution to date. Among the main changes are: measures to prevent a takeover bid from being coercive to the company's shareholders; restrictive measures to offeror on trading and buying derivatives based on the target company's stock during the offer; information to be disclosed to the market by the target company, as soon as an offer for its shares is disclosed, on trading, shareholdings, derivatives and any other contracts based on the company's shares in the previous three months; information to be disclosed on a daily basis, throughout the offer process, by offeror and by the target company and its management and controlling shareholders, if any, about positions and trades with the company's shares and any other contracts that may have them as underlying assets; and better regulation of offer procedures in the event of a competing offer.

Without specific legal provisions concerning mandatory bids for gaining control (or any relevant participation that implied control), many companies, particularly those listing on the *Novo Mercado,* set forth their own statutory provisions containing this requirement. Most of these companies determined such levels as 20-30% of their capital stock to trigger purchasers' obligation to bidding for the remaining shares. CVM enforces these rules because they are statutory rules.

As regards *Novo Mercado* and Level 2 contracts, the only rules related to takeovers are as follows: *i)* the board of directors should issue an opinion on any offer made to gain control of a company; and *ii)* a statutory provision will be rendered as null and void if it prevents shareholders' right to vote for removing a statutory rule (as has been seen in Brazil, where mandatory bidding provisions in some cases could not be dropped and eventually had practical effects similar to those of poison pills). In 2010 BM&FBOVESPA proposed to *Novo Mercado* listed companies to include in the contracts a rule to require a mandatory bid after a 30% share acquisition. This proposal was nevertheless rejected because most companies took up a contrary position to this matter.[8]

Basic regulatory framework for shareholder participation in general shareholder meetings

The Brazilian Corporation Law provides, since 1976, for majority voting by shareholders in director elections and majority voting on executive remuneration – say on pay – among other voting rights, but essential conditions for the participation of shareholders were missing. The CVM Instruction 481/09 looked to address some major obstacles preventing shareholders from effectively exercising their voting rights in general meetings: the lack of information on matters included in the agendas, the costs to attend general meetings and the costs to mobilise other shareholders.

First, the rule seeks to ensure adequate information to shareholders prior to general meetings, by defining the minimum information to be disclosed, at the moment of the meeting notice, for the most common subjects (directors nomination, approval of financial statements, capital increases, executive remuneration, etc.).

Second, it regulates public requests for proxy contests, aiming to stimulate shareholders participation. For that, the rule says that shareholders holding at least 0.5% of the company's capital stock can have access to the list of shareholders' addresses and can include proposals in the company's or controlling shareholders' proxy statement. And it also provides for the reimbursement of certain expenses incurred by shareholders promoting a proxy contest:all expenses, if the proposal is approved and partial, if the proposal is defeated at the general meeting. But if the company provides a service on a website to host proxy requests, it has no obligation to reimburse expenses.

Although this was a great advance in the regulation of general meetings, the new rule seems to need some improvement as shown by a few shareholders' practical experiences after it was implemented. Some companies have, apparently, exploited small loopholes in highly contentious situations, to the detriment of shareholders being able to actually exercise their rights. Moreover, CVM must also provide detailed rules for a new provision included in Act No. 6404 in late 2011, whereby shareholders are empowered to remotely vote and take part in public company meetings.

In view of that, CVM has held discussions with investors and their representative bodies as well as lawyers and foreign proxy consulting companies. CVM is about to issue

new regulations on this new legal provision, and intends to take the opportunity to enhance its own rules in order to resolve all remaining practical issues.

General shareholder meetings and takeover bids are issues that only recently have become of real interest to companies' shareholders, after the listing of a growing number of companies in the *Novo Mercado* (as mentioned in Section 2.2). Previously, there were practically only non-voting shares outstanding, which made general meetings of shareholders a non-event, a formal act where decisions were already made by the controlling blockholders when the proposals were presented through the meeting notice. And, of course, since only non-voting shares were outstanding, the control of listed companies was not in the market and as a result, a market where one could bid for corporate control never developed.

That said, although most minority shareholders had non-voting shares, some of the rights granted to minority shareholders by the Brazilian corporate law provided relevance to the general meetings, including the right to request the adoption of cumulative voting for board election, for those bearing at least 10% of the voting capital. Furthermore, minority shareholders that represent at least 15% of the voting shares are allowed to elect one board member on a separate vote. The same right is granted to holders of non-voting shares, provided they represent at least 10% of the company's total capital. Minority shareholders also have the right to elect at least one representative to the Fiscal Council,[9] on a separate vote. CVM has had a number of cases related to enforcement of minority shareholder rights to elect board members, including a recent case involving a Petrobras board election discussed in greater detail in Box 2.3.

It is noteworthy that since there is no public market for control, control sales have basically been private transactions as ruled and regulated by Companies Law Article 254 and CVM Instruction No. 361/02. These transactions have raised strong concern and conflict throughout Brazilian stock market history because they usually result in high premiums to controlling shareholders given that in general no tag-along-rights are granted. Specifically, the Brazilian law prescribes that only ordinary shareholders (i.e. with voting rights) are entitled to a tender offer at 80% of the price paid for the controlling shareholder's sold shares. Preferred stock holders (i.e. with no right to vote), in turn, are not thus protected and are not required to receive any offer for their shares. This explains why one of the most important *Novo Mercado* (and also Level 2) rules to investors is the right to tag along for ordinary (and preferred) stock at the same price as paid to the controlling shareholder.[10]

Thus, despite not being the most relevant topics among the three covered in this review, takeover bids and shareholder meetings have been the subject of attention and measures involving CVM regulations and changes in corporate law by the national Congress, besides the Commission's supervision and enforcement activities.

Among the administrative sanction procedures carried out by CVM in the last five years, 34 focused on the governance issues that are the subject of this peer review. Procedures may still take too long to be performed (over four years on average). However, this figure reflects the fact that more old pending cases have been closed as compared to newly filed ones, which have been closed within two years on average. More specifically on RPT cases, the Commission reports having conducted 20 cases between 2000 and 2011.

Between 2009 and 2012, with the implementation of risk-based supervision, CVM analysed in depth 318 board proposals' (the Brazilian equivalent to proxy statements) to general shareholders meetings and 56 RPTs. This work particularly benefited from the 2010 implementation of the new disclosure regime.

Box 2.3. **Brazil – Shareholder participation: The Petrobras 2012 shareholders' meeting**

In this case, only one private shareholder with quite a small position filed a claim in court to request that the calling of the meeting be halted on the grounds of improper procedures of minority representative election. The specialised court rejected the claim, apparently because they understood that such a strong measure could not be claimed by a minimally representative shareholder. No other Petrobras shareholder took any further action or filed any claim at CVM.

In 2012, Petrobras, the Brazilian state-controlled company with a huge base of minority shareholders among local and foreign investors, held a meeting to elect its board of directors. Making use of their rights under corporate law, minority shareholders joined forces to elect representatives for the board of directors and for the company's fiscal board, in separate voties. They claimed their goal was thwarted by the votes of institutions linked to the State, controlling shareholder of Petrobras, acting as minority shareholders but supporting other candidates. Among them, for example was the pension fund sponsored by the company and BNDES, a state-owned development bank.

As of May, 2013, CVM was still investigating this case and therefore had not yet taken a stance. Still, it is worth reporting what the Commission's consolidated jurisprudence, established in similar cases, has concluded in the past. In short, CVM has decided that the impediment to controller voting to fill board positions destined for election by minority shareholders extends to pension funds sponsored by the company since, after analysing its governance, it was concluded that they do not have political independence in relation to the sponsor. This seems to be exactly the case of the shareholders that voted as if they were minority shareholders in the Petrobras meeting.

On 28 February, prior to the company board calling of the 2013 Petrobras' GSM, CVM's staff issued a Staff Letter to all the public companies reflecting CVM's understanding in previous cases as described above. This helped to elevate the profile of the issue for boards and management of state-owned listed companies in Brazil. Negotiations between minority shareholders, Petrobras' management and its board resulted in the inclusion of a minority representative in the board's list of candidates, finally elected on April 29. Also, the same process resulted in the appointment of a minority shareholder representative to the Fiscal Board of Petrobras. The case provides a good illustration of how CVM has apparent impact on the market through issuance of opinions, even when not ruling directly on a specific case.

2.4. Private enforcement

In Brazil, shareholders can resort to certain instruments whenever they consider themselves harmed by acts or decisions made by managers or controlling shareholders.

What comes closest to a class action in the Brazilian legal framework is a public civil lawsuit (collective lawsuit) of liability for damages (Act No. 7347 of 1985), which can be filed by the Prosecutor's Office and other state bodies, such as the CVM or even by associations for the defense of collective interests.

The Federal Prosecutor's Office (MPF) can also file suits, whether at the request of CVM or not, for damages to the securities market, according to Act No. 7913 of 1989, aimed mainly at cases of market abuse. In this case, only the MPF, CVM and investor associations, but not shareholders directly, can file public civil lawsuits. In these lawsuits, plaintiffs are not required to deposit the total cost of the legal expenses in advance. Furthermore, if the

lawsuit does not succeed, the plaintiffs cannot be ordered to pay attorney fees or legal expenses, unless it can be proven they acted in bad faith.

Also in existence, is the liability lawsuit that the company can file with the judiciary against its directors or managers for any losses they caused, as long as it is approved in the shareholders' meeting. If the company does not take action within three months after the approval, any shareholder may take on the case in his/her own name but in legal defense of the rights of the company. The requirement of approval by a majority of shareholders is usually an obstacle, since most companies have a controlling shareholder. However, if the shareholders' meeting does not approve the filing of the lawsuit, any shareholder who holds at least 5% of capital may do so. In this case and in that of the filing by any shareholder as mentioned above, there exists the right to reimbursement of incurred expenses (Article 159 of Act No. 6404) (such lawsuits are Brazilian versions of American derivative suits). The legal provisions just described do not preclude shareholders from taking direct legal action against managers, the controlling shareholder or the company itself for damage caused directly to them.

Furthermore, under Article 246 of the same law, it is possible to file a lawsuit against the controlling shareholder for damage to the company, which can be done by shareholders representing at least 5% of the capital. If found guilty, the controlling shareholder must repair the damage and bear the costs of the lawsuit, pay attorney fees of 20% and a compensation of 5% to the plaintiff.

Aiming to prevent harm to shareholders, injunctions can be obtained in all aforementioned lawsuits.

In the investigation procedure of investors' demands with the courts it is possible to use all the information from enforcement cases already judged by CVM, as the records and decisions, as well as their own trial sessions, are public. Moreover, Art. 31 of Act No. 6385 provides for the invitation of CVM as *amicus curiae* to speak, if it deems convenient, in court cases in which the subject relates with its legal mandate.

Alternatively, it is possible to discuss matters through arbitration, which in the case of companies listed on the *Novo Mercado* and Level 2 is a shareholder right provided by the bylaws. The regulations of those listing tiers foresee the obligation to discuss disputes through the Market Arbitration Chamber (CAM), which specialises in matters of corporate law and corporate governance, and whose administration, concerned with costs, seeks to establish the fees of the arbitrators at below market levels. Generally speaking, arbitration has been widely used in discussions about corporate law in Brazil in the recent years, even among non-listed companies, and nowadays it is recognised and has been successfully tested in courts. This growing importance stems directly from the flaws of the judicial system, which will be discussed below.

Finally, it is worth mentioning the existence since 2001 of seven courts specialised in corporate law in the state of Rio de Janeiro. As reported by an interviewee, there has been a significant decrease in the number of corporate law cases brought to these courts since 2004, which is attributed to an increase in the use of arbitration by companies in business contracts and in bylaws. Reportedly, the specialised courts have been mostly sought for precautionary measures (to obtain injunctions) that, in many cases, are for preparation of arbitrations. In the state of Sao Paulo, two chambers that specialise in business law were established at the Court of Justice (*Tribunal de Justica*), an appeals court, in 2012. As they are very recent, there are no reports regarding their effective use.

Although all mechanisms described above are available, shareholders of public companies rarely appeal to the courts. There are a few good reasons for this. Firstly, there are the shortcomings of the judicial system, starting with the incredibly slow pace in conducting the proceedings, which in many cases may even take a decade. This makes the costs of a legal lawsuit unpredictable and usually very high. Even among the very few cases brought to court, the overwhelming majority close with an agreement. As a result, given the small number of decisions regarding the lawsuits, there exists little jurisprudence on such corporate matters, which leads to insecurity about the success of potential disputes. Moreover, the judiciary does not have, as a general rule, good knowledge of corporate law issues, a problem which is exacerbated by the virtual absence of this kind of cases in most courts.

A second reason that was cited to explain the limited use of the judiciary is the "competition" of CVM itself, which in addition to conducting supervision and enforcement, still has the legal duty to respond to queries. Accordingly, through its decisions on specific cases or opinions and due to its high specialisation in the field, it has established case law on corporate matters in Brazil. Claims by shareholders to CVM have replaced, to some extent, appeals to the courts, and can be considered the most widely used mechanism for private enforcement. CVM cannot, however, determine reimbursement or compensation for those affected, as it only has the power to impose penalties in administrative proceedings.[11]

By filing a complaint with CVM, shareholders can count on a free mechanism, which is more efficient and faster than the court system, and that necessarily results in an analysis by the Commission's staff. CVM must investigate every complaint put forward.

Therefore, the widespread perception is that there is some distortion in roles that are effectively performed by CVM and the judiciary in the enforcement of corporate issues, with CVM being overwhelmed by demands and, above all, by expectations that it can fill the gap left by the lack of private enforcement through the courts.

A positive development is that the Market Arbitration Chamber, which until recently had not been used by investors to resolve disputes, seems to have begun to attract some disputes, including cases directly instigated by minority shareholders. Apparently, some recent changes in its rules and a greater communication effort explain CAM's increased importance. Although CAM was established in 2001, it was not until 2010 that it received its first 4 cases. In 2011 it already had 7 cases filed and another 16 in 2012, revealing strong growth. Despite the undoubted expertise of its body of arbitrators, only 27% of the filed cases focus on issues of corporate law. Of the other cases, 37% deal with other issues of the capital market and another 37% with business law (BM&FBOVESPA, Secretary to the Market Arbitration Chamber – CAM).

It has been widely believed that the lack of disputes involving *Novo Mercado* and Level 2 companies does not indicate an inadequacy of arbitration or of CAM, but rather its power to discourage breaches of listing regulations and Brazilian law. As arbitration is faster and more effective, it would have the power to work much better as a deterrent than would the judiciary. In fact, only three out of all the procedures that have been initiated in CAM involved companies from those listing segments.

Although arbitration is much faster and more specialised than the courts, one must admit that its disadvantage is that decisions are not made public due to the confidential nature of arbitration proceedings. Therefore, it does not encourage case law that could guide behaviour and even support other legal decisions. From another perspective, while

seen as expensive, it is not necessarily a more expensive mechanism than the judiciary, given the long duration of the court proceedings and unpredictability of judicial decisions.

The biggest obstacle in the use of arbitration, however, is the fact that most listed companies are not obliged to deal with this mechanism. Only companies that have joined the *Novo Mercado* or Level 2 are obliged to use arbitration, as is stated in their bylaws. Arbitration could be much more important as an enforcement mechanism in Brazil if more traditional companies allowed their shareholders to use this form of dispute resolution.

Finally, CVM has a tool which can have the effect of a precautionary measure. Article 124 of Act No. 6404 was revised in 2001 in order to give CVM the power to take a position regarding companies' general meetings. Thus shareholders may ask CVM to suspend the calling of shareholder meetings for up to 15 days in order to assess the legality of the proposals on the agenda, or to extend the meeting notice period for up to 30 days if the complexity of the issue justifies such measure. In practice, CVM has used this power with extreme caution and has rarely decided to interrupt the calling period of a shareholders' meeting (in 8 out of 49 requests between 2002 and 2012). CVM has expressed its opinion on the legality, or lack thereof, of proposals to be submitted to the shareholders' meeting, but only in cases where the discussion involved purely legal issues or very simple claims, never acting when the claims involved lengthy review of evidence, given the limitation of the deadline of 15 days as prescribed by law. Even so, it can be said that this legal provision has created a tool of pre-evaluation of the legality of proposals which has contributed to greater clarity and security in the market, by requiring CVM to disclose its understanding in advance to a shareholders deliberation, whenever possible. CVM's opinions, although not binding, are generally highly respected and taken into consideration, given the high probability of prevalence when challenged in the courts.

As for possible ways to facilitate the use of the judiciary by minority shareholders, creating incentives in Brazil for further demands to be presented, the majority view suggests that there are already reasonable mechanisms and even incentives, such as the case of a reward for the shareholder who filed a lawsuit against the controller. And that hardly any extra incentive would be sufficient to counter the flaws of the system previously mentioned, in a scenario where even public civil lawsuits on issues of consumer rights very rarely lead to someone receiving compensation.

Nevertheless, several possibilities have been suggested, including:

- the creation of an association of minority shareholders, provided that its own good governance is ensured, for the sole purpose of promoting public civil damages lawsuits;
- efforts with the Federal Prosecutor's Office to convince that body to take a more active stance on the issues of corporate law; and
- CVM's more active direct involvement in promoting those lawsuits on issues related to governance and shareholders' rights.

One idea mentioned would be for CVM to contribute to the funding of the new association by allocating some of the funds it receives through settlements of enforcement cases, considering the public interest that would be served by that entity. Dissemination of behaviour in compliance with the rules by managers and controlling shareholders of companies could be encouraged if there was effective accountability by means of compensation for damage, and not merely punishment on an administrative level, by CVM.

However, CVM has questioned the justification for such an association as well as its funding by CVM. They ask whether there would be enough cases to justify the establishment of an association solely for this purpose, and note some overlap in the role that would be played by this new institution and those of the existing shareholder association AMEC as well as the governance institute IBGC. In addition, they suggested that funding such an institution could present difficulties both in terms of funding availability as well as justifying the funding for a particular association over others that also work to promote effective functioning of Brazilian capital markets.

In Brazil, investors show a very low level of activism in seeking their rights or compensation for losses, even if the complaints that reach CVM are considered. Given the importance of asset managers and pension funds as shareholders of listed companies in Brazil, one would expect them to be much more present in shareholders' meetings and active in advocacy. Some interviewees have pointed out that this stance would, to a large extent, be caused by the existence of conflicts of interests, since the biggest local asset managers are those related to financial conglomerates, which have other business interests when dealing with companies. Another reason would be the very slow process, especially in the judiciary, but also in the sanctioning process conducted by CVM. For mutual funds managers, this delay in decision-making would be especially harmful as their shareholder basis can change greatly during the time during which a lawsuit lasts, generating hidden assets and potential transfer of wealth among funds' shareholders.

Moreover, some among the most active investors say they feel abandoned, not only because of the slow pace of the legal processes in the judiciary, but also at CVM and importantly, at the National Financial System Appeals Council (CRSFN), where appeals against decisions of CVM are tried, and suggested that this seems to indicate that their demands do not receive due attention from these entities. They consider themselves to be at a further disadvantage to effectively defend their rights because companies and controllers have more resources to spend on lawyers and legal opinions, hiring the best law firms, which often impedes them from accepting mandates from investors in specific cases.

Aiming at a greater participation and involvement of asset managers in the companies they invest in, another suggestion was that CVM could provide a strong incentive in this direction by reviewing its interpretation regarding fiduciary duties of these professionals. While CVM regulation mandates that private equity funds have an effective influence on the governance of the companies in which they invest, for other types of funds, the requirements are more limited to a mandate to disclose voting policies. The suggestion was that CVM could give the concept of fiduciary duty more breadth, by considering that active participation in shareholders' meetings and defense of the rights of shareholders of the managed funds are an essential part of those duties. However, some fund managers oppose such requirements on the basis of the cost involved, particularly for short- or medium-term financial projects.

As regards the efforts to educate judges and prosecutors in securities markets matters, for a few years CVM has been promoting initiatives in co-operation with associations and schools of justice and the Federal Prosecutor's Office itself to deal with professional training, in which it has had the support of market players' associations and the Exchange. These initiatives include a few training courses and, in the case of the Federal Prosecutor's Office (MPF), the formation of a permanent group to discuss themes related to the capital markets, and whose aim is to contribute to professional training and to coordinate the

actions of the two bodies – CVM and MPF – in cases of enforcement. Such initiatives have yielded some results, but are still rather limited to change the overall picture in terms of judges' and prosecutors' lack of familiarity with corporate and capital market affairs.

Regarding the three themes discussed in this report, in the context of private enforcement, the greatest number of conflicts and demands stem from related party transactions. In the case of a very active asset manager, as reported in an interview, basically all his claims to CVM and lawsuits were related to abusive transactions with related parties, particularly the acquisition of controlled companies.

CVM reports that, in 2012, 11 claims about shareholders' meetings and 11 claims about company restructuring were filed. Among these, 6 claims featured related parties. And that among the 22 claims filed about abuse of controlling shareholder in the same year, 11 mentioned conflicts of interests in RPTs.

To deal with company control sales/acquisitions and controlled companies mergers, the private sector is taking the most recent steps towards setting up the Mergers and Acquisitions Committee (CAF). This committee will review not only the transactions submitted but also claims and offense reports about the companies who formally commit to comply with its Code. This is one more self-regulatory initiative in Brazil, as it is performed and sponsored by AMEC (the Association of Capital Markets Investors), ANBIMA (Brazilian Association of Investment Banks and Other Intermediaries), BM&FBOVESPA and IBGC. CAF's main goal is to play a similar role to UK's Takeover Panel and, as such, take prompt, unbiased, expert action to defend its Code's principles and rules, which all depart from the principle of equitable treatment of shareholders. In a coordinated action between public and private sectors, CVM supported this initiative by providing "regulatory encouragement" to apply the new rules, by assigning legal status to all transactions submitted to CAF Code, thus in principle waiving these transactions from further reviews.

2.5. Interaction between CVM and stock exchange enforcement

When discussing the available mechanisms for private enforcement in the previous section, we already addressed the dynamics in Brazil between appeal to the judiciary and the claims to CVM, its possible distortions, and the "solutions" that market participants have encountered, exploiting weaknesses of one and virtues of the other.

In this section, it is worth mentioning that there is a dimension of coordination between the public enforcement, conducted by CVM, and the private sphere of supervision and enforcement, which is one of the striking characteristics of the Brazilian market: the co-operation between the regulator and the stock exchange, BM&FBovespa, as a self-regulatory organisation.

BM&FBovespa must monitor and ensure the integrity of its markets and, accordingly, has powers and duties as a self-regulator for intermediaries operating in its trading systems. This condition is established by Act No. 6385. In addition to this legal requirement, the Brazilian exchange oversees listed companies in two dimensions. It checks and works to ensure that all required information is delivered by listed companies and that it is available for investors. And it also created the *Novo Mercado* and Levels 1 and 2, regulated by contracts in which registered companies commit to complying with its terms. In this case, the stock exchange ensures compliance with the rules and respect for rights established in contracts.

Thus, regarding listed companies, the self-regulatory activity is basically voluntary and can be seen as a mechanism of private enforcement. The stock exchange has structured itself in recent years to have a better performance in this role, having begun by elevating the position of the Issuer Regulation Department in its structure, which now reports directly to the board of directors of the company. Reportedly other measures have been and are being taken to ensure greater effectiveness when conducting enforcement.

One of them was the establishment of an agreement with CVM, in which the exchange formally agreed to act as the regulator's first line of defense, supervising the disclosure of information by listed companies. Such supervision covers, among others, the general meetings notices and information and documents required by CVM's regulation on the agenda items. If the exchange requests additional information and the company does not respond to the request, CVM is committed by covenant to also issue an order, reinforcing the exchange's. This same arrangement regarding companies' disclosures had already been practiced by CVM and the stock exchange for many years. The decision to make a formal agreement was aimed at reinforcing the role of the exchange and ensuring a stable commitment to continuity. The scope of joint action has been extended, since it now includes the support by CVM to the requirements made by the exchange in the evaluation of documents for the initial registration of companies.

Therefore, according to those involved, the work of the exchange and of CVM complement each other and there is close co-ordination, which has occurred even in cases not foreseen in the agreement, as a result of the existing trust and partnership.

2.6. Conclusions

This section seeks to draw conclusions regarding the supervision and enforcement related to corporate governance issues in Brazil in line with OECD's relevant Principles,[12] and to bring forward some suggestions for improvement.

Regarding the first principle, it can be affirmed that the legal and regulatory framework is consistent with the rule of law and is generally well known and understood by market participants. Due to its characteristics, it is enforceable by public and private agents, at least in theory.

In practice, private enforcement is very weak, creating an imbalance that concentrates the burden of ensuring compliance with the legal and regulatory requirements only on the agents in charge of public enforcement: CVM and the Federal Prosecutors Office (MPF). The main reason for that is perceived to be the shortcomings of the judicial system, starting with the incredibly slow pace in conducting the proceedings, which can make the costs of a legal lawsuit unpredictable and usually very high. Even among the few cases brought to court, the overwhelming majority close with agreements, resulting in very few decisions and little jurisprudence on corporate matters. Moreover, the judiciary does not have, as a general rule, good knowledge of corporate law issues, a problem that is exacerbated by the virtual absence of these kinds of cases in most courts.

Claims by shareholders to CVM have replaced, to some extent, appeals to the courts and can be considered the most widely used mechanism for private enforcement. CVM cannot, however, determine reimbursement or compensation for those affected, as it only has the power to impose penalties in administrative proceedings. Therefore, the widespread perception is that there is some distortion in roles that are effectively performed by CVM and the judiciary in the enforcement of corporate issues, with CVM

being overwhelmed by demands and, above all, by expectations that it can fill the gap left by the lack of private enforcement through the courts.

As for possible ways to facilitate the use of the judiciary by minority shareholders, creating incentives in Brazil for further demands to be brought to the courts, most consider that there are already reasonable mechanisms and even incentives, and that hardly any extra incentive would be sufficient to counter the flaws of the system. Arbitration has been growing in importance for corporate disputes but could be much more used as an enforcement mechanism if more of the traditional companies – those that are not listed on the *Novo Mercado* or Level 2 – committed to use this form of dispute resolution.

In Brazil, investors show a very low level of activism in seeking their rights or compensation for losses, even if the complaints that reach CVM are considered. Suggestions to counter that situation include the creation of an association of minority shareholders for the sole purpose of promoting public civil damages lawsuits (although CVM, as noted earlier, has raised questions about this proposal). And also, aiming at a greater involvement of institutional investors in the companies they invest in, it was suggested that CVM could provide a strong incentive in this direction by reviewing its interpretation regarding fiduciary duties of these professionals. While CVM currently requires private equity funds to participate in the effective governance of the companies in which they invest, and also requires other funds to disclose their voting policies, the suggestion was that CVM could give the concept more breadth, by considering that active participation in shareholders' meetings and defense of the rights of shareholders of managed funds are an essential part of those duties.

Regarding Principle I.C, the duties of each agent in the public enforcement system, specifically CVM and the Federal Prosecutor's Office, are clear and there are no major relationship problems or a lack of co-ordination. However, what both organs are lacking is probably a more active stance in promoting cases dealing with corporate governance matters by the judiciary, using the available tools in the legislation to seek accountability of wrongdoers and compensation for companies or shareholders for the damage sustained.

Regarding the third principle, it can be stated that CVM has sufficient authority and power to carry out its mission in this field and that its performance is generally seen as technical and transparent. Nevertheless, it suffers criticism for excessive length of its disciplinary proceedings and for a certain lack of focus on the truly relevant enforcement cases. And although CVM is probably the most independent and respected among the Brazilian regulators, due to its respectable track record, frustration among investors is sometimes expressed regarding CVM's handling of specific cases involving state-owned companies that are listed publicly. In such cases, the perception seems to be that it is difficult for the Commission to be as tough as it would have been if the subject were a privately owned company.

In terms of the resources to perform its mission, as the Principle recommends, it is widely perceived that CVM does not have sufficient human and material resources to fulfill its mission in the best possible way. The Commission collects a more than sufficient amount for its maintenance, but does not have access to these resources, suffering cuts in its proposed budget, which depends on the approval of two ministries and the legislature itself. It would be necessary to see the legal provisions that give CVM "financial and budgetary autonomy" truly respected, allowing it to keep the fees it collects, being of course accountable for their good use and transparent to external control bodies, to

Congress and to the public. Perhaps measures to give CVM stronger budgetary independence could even counter perceptions by some investors that CVM is limited in how aggressively it can act on enforcement when the case involves state-owned enterprises.

With regard to human resources, there is also the challenge of qualifying its personnel to deal with the extremely sophisticated issues CVM must regulate, supervise and enforce. Besides the resources to invest in capacity building, CVM could also benefit from a more flexible hiring process, which would allow it to select candidates in the marketplace, at least in part, based on their experience and expertise.

But even considering the difficulties faced by CVM in speeding up the enforcement procedures, the main obstacle that exists at the administrative level is the workings of the National Financial System Appeals Council (CRSFN), as seen by the figures in Table 2.2. (Section 2.3). It seems necessary to evaluate its structure and composition and, moreover, to provide it with enough resources to permit faster conclusions to the appeals of CVM's decisions. Pending a more comprehensive review of the structure and functioning of the CRSFN, a possible first step that could already reduce the backlog of cases would be to waive a current requirement that all enforcement decisions in which CVM finds the defendants not guilty must automatically be appealed to the CRSFN.

In spite of the problems presented and some necessary adjustments, Brazil not only has improved regulation and self-regulation on issues of governance, but also the effectiveness of supervisory and enforcement activities. There is a widely held perception that the enforcement by CVM has been improving steadily in the last decade, having changed behaviours of market participants and resulting in a market environment which is more investor-friendly without becoming excessively hostile to businesses.

Notes

1. All the figures in this paragraph were provided by CVM and BM&FBOVESPA.
2. There has also been some improvement as far as corporate governance practices are concerned, attributable not only to new companies that have listed on the Novo Mercado and Level 2 corporate governance tiers, but also for previously listed firms, including to their board structures, board procedures, shareholder rights and disclosure. For further information, see Black et al. (2012).
3. The National Monetary Council (CMN) is presently composed of the Minister of Finance, the Minister of Planning and Budget, and the Governor of the Brazilian Central Bank. The composition of the Council has varied during its existence. CVM's chairman, among other officers at the federal level, sits at the CMN as observer, with no vote. CMN is empowered by Act 6385 (Securities Market Act) to define the policies to be observed in the organisation and functioning of the securities market, as well as to fix the general orientation to be observed by CVM (Article 3rd of Act 6385). This legal provision was important in the establishment and in the first years of CVM, since it had only been created by the same law. In practical terms however, regarding CVM's activities, the CMN has progressively concentrated only in matters that require coordination between the Commission and the Central Bank, such as the regulation of foreign portfolio investment, for its communication with the foreign exchange market.
4. In 2006, CVM proposed to the National Monetary Council a draft CMN Resolution, through the Ministry of Finance, allowing it to adopt as a policy risk based supervision. The reason for that was, in fact, the need to give comfort to CVM's staff in officially and publicly adopting a policy that would imply choosing to supervise certain areas of the market more intensely than others, something that brings a lot more responsibility and accountability. The Resolution 3427 was enacted on 21 December 2006.This Resolution established CVM's obligation to present to the Council each SBR two-year plan, after its approval by CVM's board, and to give account of the activities in implementing the plan biannually. CVM's risk-based supervision activities according to the plan are also subject to audits by the external control bodies, as mentioned in this Section 2.

5. The parameters for the penalties that CVM can impose, established by Act No. 6385 in its Article 11, are: "I – reprimand; II – monetary fine; III – suspension from duties of director [...]; IV – temporary disqualification, up to a maximum period of 20 years, from occupying the posts mentioned in the previous item; V – suspension of the authorisation or registration for the execution of the activities covered by this law; VI – cancelation of the registration or of the authorisation to carry out the activities covered by this law; VII – temporary prohibition, up to a maximum period of 20 years, [...]; VIII – temporary prohibition, for a maximum period of 10 years, of trading, directly or indirectly, in one or more types of transactions in the securities market."
6. Relevant RPTs for this purpose are the ones that are to be informed on the explanatory note to the financial statements, as required by IAS 24. Instruction 480/09 does not provide any more specific guidance about what thresholds should be considered for determining relevance beyond the general guidance offered by IAS 24.
7. Article 256 of Act No. 6404 fixes as parameter of a premium paid that requires shareholders approval if the acquisition price per share is more than 1.5 times the largest among three indicators: a) average market quotation of the acquired company's shares in the 90 days preceding the deal; b) equity value per share, being the company's equity in this case calculated based on the assets' market prices (art. 183, § 1º), or c) net profit per share.
8. Novo Mercado and Level 2 contracts rules cannot be changed if one third of the listed companies disagree. In other words, these companies have the power to veto any change proposed by the exchange.
9. A Fiscal council must be established, with its members being elected at a GSM, if requested by shareholders or by company's initiative. Its mission is to supervise the board and the management according to certain limits, to give its opinion on the financial statements to be published by the company and on certain other proposals to be submitted to the shareholders. Some corporations in Brazil, mainly among those that are also registered with the SEC, have fiscal councils rather than a board audit committee, which the SEC admits for compliance with the Sarbannes Oxley Act by foreign issuers. Fiscal councils performing audit committee functions are generally comprised of a majority of outside experts.
10. Preferred (non-voting) shares are only admitted for companies listed on the Level 2 Corporate Governance listing tier. This is the only relevant difference between *Novo Mercado* and Level 2 rules.
11. The only case in which CVM can decide to determine compensation is through consent decrees, which are settlements to close enforcement cases. In cases in which it is possible to identify those affected by unlawful conduct, CVM can only sign a settlement if such losses are compensated. However, this is not the case in most sanctioning procedures related to governance issues, in which losses are diffuse.
12. I.B: The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable;

    I.C: The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served; and

    I.D: Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

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Chapter 3

Turkey: The corporate governance framework and practices relating to supervision and enforcement

This chapter, part of the fifth peer review based on the OECD Principles of Corporate Governance, summarises public and private supervision and enforcement practices in Turkey, in particular in the areas of related party transactions (RPTs), takeover bids and shareholder meetings. The chapter, prepared by the OECD Secretariat (Akira Nozaki and Winfrid Blaschke), highlights the key characteristics, strengths and limitations of the Turkish framework for corporate governance-related enforcement, including a strong reliance on the supervision of its Securities Commission (CMB).

3.1. Introduction

An importnant characteristic of the Turkish economy is the strong presence of family controlled company groups. Related party transactions and shareholder meetings are therefore two areas of particular interest when reviewing supervision and enforcement in this country that will be looked at in depth. The review will also cover the related issue of the appointment of independent directors, and will follow up on some of the recommendations from the OECD Pilot Study of Corporate Governance in Turkey (OECD, 2006).

Another overarching characteristic of Turkey is the limited record of private enforcement. This is reflected in the review, which will primarily focus on the scope and quality of public supervision and enforcement.

3.2. Overview of the corporate governance landscape

While Turkey's economic growth rate is higher than in any other OECD country, capital markets are still considered to be underdeveloped. This includes the equity market, where market capitalisation as percentage of GDP remains relatively low. In response to this, the Turkish government has in recent years taken a number of measures to make capital markets more attractive to both domestic and foreign investors and companies.

Most recently, the parliament passed a comprehensive modernisation of the Turkish Commercial Code (new TCC) and the Capital Market Law (new CML). The implementation of these new regulatory frameworks will be made gradually and finalised during 2013. While the content of these reforms will be presented and discussed, the review will not be able to assess the impact of the reform package.

Overview of the capital market

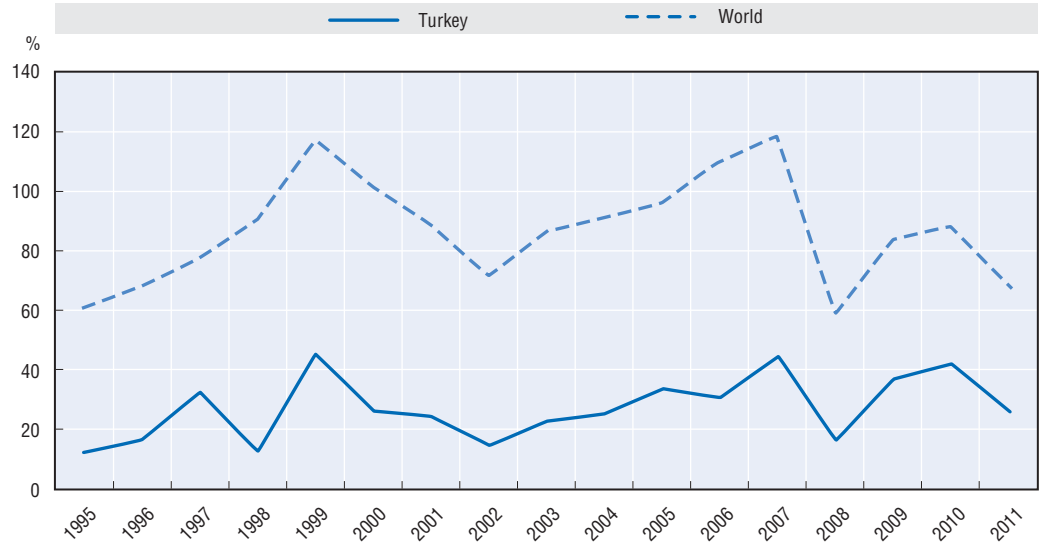
Turkey has a low savings rate and serious constraints on capital formation.[1] Turkish companies have been reluctant to access funding through the public equity market, and only 12% of the thousand largest Turkish companies are listed.[2] Total market capitalisation of companies listed on the Istanbul Stock Exchange (ISE) represented 26% of GDP at the end of 2011, and reached USD 307 billion at the end of 2012.[3]

The Capital Markets Board (CMB), ISE and other institutions jointly initiated a new campaign in 2008 to encourage companies to gain funding through IPOs, which was followed by a Prime Minister's initiative.[4] At the end of 2012, there were 600 companies registered with the CMB[5] (including 404 ISE-listed companies) and the ISE had become the second best performing stock exchange in the world.

The structure of ownership and control

Turkish listed companies are characterised by concentrated ownership, often in the form of family-controlled groups. The corporate conglomerates dominating the Turkish economy are typically controlled through pyramidal structures, and have often been operated by family members for several generations.[6] Controlling shareholders often use

Figure 3.1. **Turkey – Market capitalisation as percentage of GDP**



Source: The World Bank (n.d.), World Bank data on market capitalization of listed companies, *http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS*.

control-enhancing mechanisms such as multiple voting rights that, for example, allow them to nominate and elect directors single-handedly.[7] These characteristics have remained dominant despite recent developments in capital markets.

The average free float ratio among ISE-listed companies peaked at 33% in 2006, and was at 28% at the end of 2012. For the purpose of boosting IPOs, the CMB published a Communiqué in April 2010 to abolish the requirement for a minimum free float ratio under certain conditions.[8] Issuers were granted the right to determine their free float ratios, which ranged from 5.3% to 35.8% in 2012. 16% of companies have a free float ratio of above 50%. Among the 20 largest companies in terms of market capitalisation, however, none had a free float ratio above 50% (Table 3.1).

Table 3.1. **Turkey – Free float ratios (end-2012)**

Free float ratio (by range)	Number of companies		Share of total free float capital
50.0-100%	62	(17%)	16%
40.0-49.9%	41	(11%)	**30%**
30.0-39.9%	59	(16%)	17%
20.0-29.9%	**82**	**(22%)**	25%
10.0-19.9%	71	(19%)	12%
0-9.9%	54	(15%)	1%
Total	369	(100%)	100%

ISE-listed firms by market capitalisation (share of total capital)		Free-float ratio (weighted average)	Number of companies with free-float ratio	
			Above 50%	*Below 20%*
Top 20	**(57%)**	28%	**0**	**5**
Top 50	(76%)	27%	3	19
Top 100	(88%)	28%	11	38
All	(100%)	28%	62	125

Source: OECD calculations on the basis of data from the Turkish Central Registry Agency (TUYID and MKK (2013), "ISE Trend Report – Volume 3: January – December 2012", January 2013, *www.tuyid.org/files/ISE_Trends_Report_III.pdf*.

The other aspect of the Turkish ownership structure is the significant presence of foreign (mostly institutional) investors.[9] At the end of 2012, foreign investors owned two thirds of the free float. This is a considerable increase compared to 2003 when they held only 52%. The average holding period of foreign investors is 389 days, while domestic

investors on average hold their shares for 46 days (TUYID and MKK, 2013). Recently, the government introduced a private pension incentive scheme in order to promote private savings and encourage an increase in domestic institutional equity investment in Turkey.[10]

Corporate governance framework

The legal tradition in Turkey is characterised by civil law, and the corporate governance framework rests primarily upon codified legislation and its enforcement. The Capital Markets Board (CMB) plays a leading role in setting corporate governance standards for publicly held companies.

In dealing with corporate governance issues, Turkey uses a combination of various instruments including the Turkish Commercial Code (TCC), the Turkish Capital Markets Law (CML), as well as subordinate instruments published under the CML, generally in the form of CMB Communiqués. The CMB adopted the Corporate Governance Principles in 2003, and revised them in 2005. Starting from the 2004 financial year, the CMB required publicly held companies to publish a report of compliance with the CMB Principles as part of their annual report, which became a regular requirement in the CMB Communiqué in 2009. Turkey recently went through extensive legislative reforms (including the adoption of the new TCC and CML – see Box 3.1.) that have significant effects on corporate governance standards.

Box 3.1. **Turkey – Key milestones in the update of corporate governance standards**

October 2011: The CMB is explicitly empowered to regulate corporate governance of listed companies.

- By an amendment to the Capital Markets Law, the CMB is explicitly empowered to regulate corporate governance rules for listed companies. For breach of mandatory rules, the CMB is empowered to *i)* determine the breach, ask courts for precautionary legal measures, or file a lawsuit for execution of the relevant corporate governance rules, or *ii)* impose administrative pecuniary fines.

October 2011: Mandatory compliance of CMB Principles for ISE-30 companies.

- Communiqué IV-54 set mandated the ISE-30 companies (excluding banks) to comply with some of the provisions recommended by CMB Principles. Through this Communiqué the CMB moved from 'comply or explain' in the direction of a mandatory approach.

December 2011: Compliance with the Principles to cover *all* listed companies.

- Communiqué IV-56 replaced Communiqué IV-54, to expand the scope of its application from the ISE-30 companies to all ISE-listed companies (excluding companies on the Watch List and Emerging Companies markets).
- This Communiqué classifies ISE-listed companies into three categories depending on their market value and free float. The provisions are compulsory for Category I companies and applicable with certain exemptions for Category II and Category III companies. Communiqué IV-57 (February 2012) revised some of the provisions of Communiqué IV-56 regarding the requirements of major transactions and independent directors.

Box 3.1. **Turkey – Key milestones in the update of corporate governance standards** *(cont.)*

	Category I	Category II	Category III
	Market value ≥ TL 3 000 M free float ≥ TL 750 M	Market value ≥ TL 1 000 M free float ≥ TL 250 M	Others
Minimum ratio (number) of independent directors (IDs) on the board	1/3	1/3	2
CMB screening of candidates for IDs	Required	Not required	Not required
Establishment of board-level committees on audit, nomination, remuneration, corporate governance, and risk management.	Required	Required	Required
Major transactions and all RPTs to be approved by a *i)* majority of independent directors or *ii)* general shareholder meetings.	Required	Required	Required
Additional disclosure requirement for general shareholder meetings	Required	Required	Required
Number of companies (January 2013)	24	24	343

July 2012: First overhaul of the Turkish Commercial Code in 55 years addresses a number of corporate governance provisions ("new TCC").

- The key provisions relevant to this peer review include: *a)* special requirements for company groups; *b)* squeeze-out rights for shareholders holding at least 90% of the equity in case of a merger; *c)* representation of shareholders in general shareholder meetings (e.g. institutional representative); *d)* electronic voting and online general shareholder meetings; and *e)* broadening the scope of application of the compulsory independent auditing requirement to all limited liability companies (excluding small and medium sized ones).
- The new TCC clearly stipulates that the CMB is authorised to determine the corporate governance roles, prepare and publish corporate governance statements and corporate governance ratings for public companies.
- One day before the effective date of the new TCC, a Law Decree (30 June 2012) was enacted to narrow the scope of the compulsory independent audit requirement from all limited liability companies to large companies only (possibly 1% of all limited liability companies).

December 2012: Upgrading of the governance of the CMB and transformation of the stock exchange into a joint stock company ("new CML").

This fundamental revision of the CML addresses a number of issues concerning: *a)* the governance and authority of the CMB; *b)* the formation of the stock exchange; *c)* independent directors; *d)* related party transactions; *e)* material transactions; and *f)* mandatory takeover bids.

3.3. Public supervision and enforcement

The judicial system in Turkey is not very experienced in handling investor complaints, and compliance with the corporate governance framework rests primarily on public supervision and enforcement. This situation gives particular importance to the key features of the CMB, including its governance, funding, resources, and accountability, in line with the OECD Principle I.D. ("Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner"), and the relevant annotations ("Regulatory responsibilities should be vested with bodies that can pursue their functions without conflicts of interest").

Institutions in charge of public supervision and enforcement

The CMB is the sole national authority to regulate and supervise the capital markets. The CMB has exclusive standard-setting powers and extensive supervisory powers regarding the corporate governance of publicly-held companies and other capital market institutions. The Ministry of Customs and Trade (MCT) administers the TCC and reviews and approves certain fundamental changes in company affairs. The presence of a representative of the MCT is required for the validity of general shareholder meetings under certain conditions. The Banking Regulation and Supervision Authority (BRSA) is the principal competent authority for banks. The BRSA is in charge of implementing the regulations in the CML to listed banks, in co-ordination with the CMB where relevant.

The Public Oversight, Accounting and Auditing Standards Authority (KGK), established in 2011, is the body in charge of authorising and monitoring statutory auditors and audit firms.[11] The Istanbul Stock Exchange (ISE) remains a public institution (although the new CML provides a roadmap to change this) and a separate legal entity, but it has no specific responsibility for monitoring listed companies for compliance with corporate governance standards.

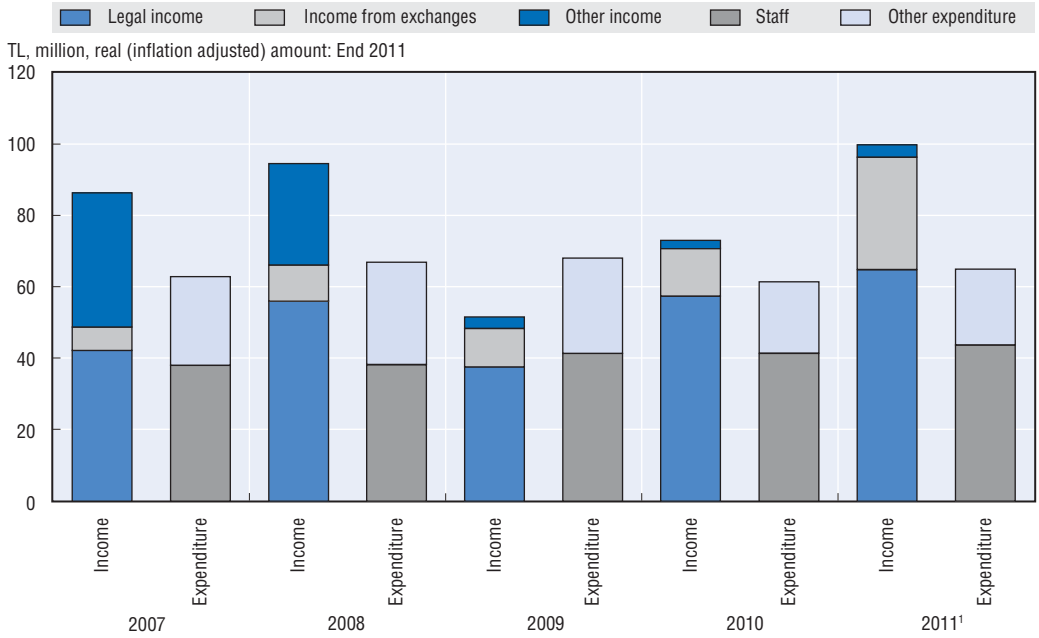
The Capital Markets Board (CMB)

Governing body: The Executive Board, consisting of seven members, is the highest decision making body of the CMB. The new CML revised the governance of the CMB Board. Under the new framework, the terms of office of the board members is shortened from six to five years, while remaining longer than the (four year) political cycle. The staggered system where every two years two members (one third of Board members excluding the chair), randomly selected, are required to be replaced by new members, has been repealed.[12] The allocation of Board seats to specific authorities was replaced by qualification requirements (e.g. ten years of experience in the area of financial market or related topics, at private sector capital market institutions, or at the CMB).[13] As part of the new CML, a new CMB Board was also appointed.[14] The changes were introduced by an amendment to the new CML, agreed by Parliament.

Funding: Accountability and autonomy in funding arrangements are essential to ensure integrity. The CMB was established as a self-funding statutory public entity with administrative and financial autonomy empowered by the CML. All the expenditures accrued are paid by a special fund. Issuers pay a fee to this fund corresponding to 0.05-2 per thousand of the volume of the securities registered with the CMB.[15] The new CML broadens the CMB's financial base. In addition to the income from the stock exchange, a certain ratio (maximum of 10%) of the revenues of the other institutions regulated by the CMB (e.g. the central registry agency, central clearing houses, and central securities depositories) may be collected as revenue. The budget of the CMB is audited by the Turkish Court of Public Accounts.

The new CML requires the CMB to notify the level of fees (maximum 10% of the revenues) levied to the regulated institutions at least thirty days before payment in light of the future cash position of the CMB. It is worth considering that the CMB increase its accountability to the public by explaining its standard method for determining the level of fees. In order for the CMB to ensure its financial autonomy, the OECD (2006) recommended that the Ministry of Finance reconsider its decision requiring the CMB to turn over, on a quarterly basis, a significant proportion of its budget surplus. While no measure has yet

Figure 3.2. **Turkey – Income and expenditure of the CMB**



1. In 2011 a special budget (TL 54 million in Income and TL 88 million in Expenditure) was allocated for the Istanbul Financial Center Project, these amounts have therefore been deducted from 2011 Income and Expenditure.

Source: Capital Markets Board of Turkey (n.d.), Annual Reports, *www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=3&pid=1&submenuheader=-1.*

been taken in this regard, the CMB considers that this framework leaves room for flexibility, where it can retain its surplus in case the future funding needs are justified to the Ministry of Finance.

Resources: Resource constraints at supervisory authorities have been identified as hampering progress toward improving the intensity and effectiveness of supervision around the world. In the case of Turkey, the CMB has discretion in allocating budget and human resources, and keeps recruiting top-ranked candidates. Entry-level professionals hired by the CMB must be top-ranked university graduates and obtain high marks in a general civil service exam and a special CMB exam. In-house training is also satisfactory, and all staff are required to take a qualification examination after three years of work experience at the CMB.

There are, however, some concerns in the area of enhancement of human resources. The Law Decree adopted in 2011, which is applicable to all government agencies, reduced salaries for new staff, regardless of their qualifications and specialities.[16] This may create a disincentive for junior professionals, and impair the ability to attract staff on competitive terms in the future. Moreover, CMB staff rarely have the chance to obtain extensive, hands-on experience in company operations. The OECD (2006) had recommended that the CMB ensure recruitment, retention, and training of staff with extensive private sector experience.

As described above, Turkey has gone through extensive legislative reforms, notably the amendment of the TCC and CML for the first time in decades. As the government does not envisage substantial increases in resources for implementing these rules, swift and efficient implementation of the new framework may represent a challenge for the CMB,

even if the resource constraints will be mitigated in the mid and long term as the financial base is broadened by the new CML.

Accountability: Market participants that were interviewed for this review are typically satisfied with the CMB's practices with regard to transparency and accountability. The CMB publishes weekly bulletins (in Turkish) that contain summaries of information on market conditions, main legislative amendments, and enforcement actions. The bulletins are communicated via email, so that market participants are regularly provided with updated information. The new CML requires that at least once a year the CMB shall report its activities to the Plan and Budget Commission in Parliament, where its performance against pre-set objectives is formally reviewed. This review process is open to the public.

The CMB publishes annual reports, which mainly include quantitative information such as statistical data on supervision and enforcement actions, but these could be improved. The CMB discloses in its weekly bulletins information on individual cases of violations with a description of enforcement actions, but the annual reports do not comment on common characteristics of violations or identified weaknesses. The CMB regularly reviews companies' corporate governance reports as part of the annual report without, however, regularly publishing a summary of its findings.[17]

In order for the CMB's practices to be better communicated to market participants, it is worth considering that the CMB publishes: *i)* manuals or guideline for supervision and enforcement, to increase transparency and predictability of the CMB's actions; and *ii)* an annual plan or strategy to highlight the focus areas of the CMB's supervision and enforcement practices. These measures are important, particularly since the enforcement powers of the CMB have increased in the new CML.

The regulators have a responsibility to help underpin Principle I.B, which calls for a transparent and predictable legal and regulatory framework. As the CMB has exclusive standard-setting powers on corporate governance, particular emphasis should be placed on ensuring accountability in the process of drafting and implementing the regulations. The CMB has been proactive in bolstering corporate governance regulations, but some examples may argue for reconsideration of its drafting and implementing practices. For example, Communiqué IV-54 (October 2011) introduced the obligation for ISE-30 companies to comply with some of the corporate governance principles. In less than two months, the new Communiqué IV-56 (December 2011) was published, broadening the scope of application to include other companies traded on the ISE. This in turn was amended by Communiqué IV-57 (February 2012) within two months. While the reforms were consistent and went in the right direction, it may have been preferable to present a comprehensive set of regulations at the same time, and to broaden their scope of application gradually, in accordance with a pre-announced timetable.

Dual mandate? In jurisdictions where the corporate governance framework relies to a great extent upon a public enforcement model, the authorities will always face the difficult task of balancing the need to pro-actively use their supervisory powers to prevent harm, against the need to pull back and facilitate the development of market discipline.

Boosting the IPO market has been a high-priority issue in Turkish capital markets. In 2008, the CMB, ISE and other organisations signed a protocol to encourage public offerings, and in October 2009 the Prime Minister published a Strategy and Action Plan for an "Istanbul International Financial Center". One of the plan's stated priorities was to

encourage companies to go public and increase public shareholding ratios.[18] As part of this initiative, the CMB published a Communiqué (effective as of April 2010) repealing the minimum free float requirement.

These initiatives illustrate the issue of dual mandates, not only in Turkey but in many other jurisdictions. For example, the UK FSA .recently published a consultation paper that discusses free float as follows: "We are keenly aware of the potential role that the amount of shares in public hands plays in giving shareholders sufficient power to counterbalance a dominant shareholder. But we also believe that free float would be a blunt tool even if used explicitly to ensure effective governance in a company. In addition we are aware of the concerns held by the sell-side that any increase in free float would risk damaging London's attractiveness as a market for IPOs" (FSA, 2012).

In the case of Turkey, the CMB recognised the possible effects of lower free float on minority shareholder protection, especially in situations where there is a controlling shareholder, as well as concerns from the sell side that the requirement for a high free float may damage the attractiveness of IPOs.[19] At the same time, the CMB considered that low free float may not necessarily create disadvantages for minority shareholders, if there is sufficient liquidity and other rules are implemented to protect the rights of minority shareholders.[20]

Public supervision and enforcement practices

The subjects and focus of supervision activities are determined by a yearly programme, taking into consideration investor complaints, other feedback, and notices from others. Following the supervision, examination and auditing activities made in accordance with the CML, the CMB is authorised to take sanctions that range from legal warnings to legal prosecution (Table 3.2). The main sanction tools have been legal prosecutions and trading prohibitions, where the CMB applied to the Public Prosecutor's Office to initiate the legal prosecution process, sometimes in combination with prohibiting persons from trading on stock exchanges. Recently, the number of cases brought for legal prosecution has decreased (see Table 3.4 and the discussion for this below), and legal warnings have become the dominant tool in CMB enforcement. In relation to the CMB Principles ("comply or explain"), the CMB communicates with companies regarding insufficient explanations of non-compliance, and has sometimes imposed administrative pecuniary fines in cases where the disclosure about non-compliance is misleading.[21]

Table 3.2. **Turkey – CMB sanctions (2005-11)**

	2005	2006	2007	2008	2009	2010	2011
Legal warnings	61	115	**171**	133	107	**260**	**181**
Legal prosecutions and trading prohibitions	**137**	**153**	164	**190**	**183**	230	59
Administrative pecuniary fines	30	48	89	82	109	57	69
Total number of sanctions	228	316	424	405	399	547	309

Source: Capital Markets Board of Turkey (n.d.), Annual Reports, *www.cmb.gov.tr/indexcont.aspx?action=showpage &menuid=3&pid=1&submenuheader=-1.*

For the breach of mandatory rules, the CMB is empowered to determine the breach, ask courts for precautionary legal measures, and file a lawsuit for execution of the related corporate governance principles. The CMB does not directly intervene on behalf of shareholders in corporate disputes, but it may take some measures to protect the rights of the shareholders.[22]

The CMB at one time faced a significant number of lawsuits against its enforcement actions, requesting annulment or full remedy actions. Only 40% of the cases brought to the administrative court were adjudicated within a three year period, the others remain unsolved including some prominent cases (e.g. the lawsuit No. 1 and 2 in Box 3.6). In some cases they were adjudicated against the CMB either definitely or indefinitely (Table 3.3). Along with the implementation of the regulations, however, the number of administrative cases against the CMB has rapidly decreased, showing that the CMB's supervision and enforcement actions have gained a certain level of confidence from the participants in capital markets.

Table 3.3. **Turkey – Civil and administrative cases against the CMB (2004-11)**

	Civil cases	Administrative cases						
			Adjudicated cases within 3 year period					
				Against CMB		In favour of CMB		Lack of competence
2004	29	12 271	3 807	977	(26%)	2 805	(74%)	25
2005	16	3 026	1 723	455	(26%)	1 231	(71%)	37
2006	3	1 003	809	28	(3%)	766	(95%)	15
2007	9	391	350	4	(1%)	326	(93%)	20
2008	7	245	233	21	(9%)	186	(80%)	26
2009	2	184	129	14	(11%)	108	(84%)	7
2010	5	80	48	2	–	41	–	5
2011	8	38	6	0	–	6	–	0
2004-09	66	17 120	7 051	1 499	(21%)	5 422	(77%)	130

Source: Capital Markets Board of Turkey (n.d.), Annual Reports, *www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=3&pid=1&submenuheader=-1.*

Following the completion of investigations, the CMB may initiate the legal prosecution process by submitting a written application to the Public Prosecutor's Office. It appears, however, that this process is not always efficient. Only 30% of the cases initiated by the CMB between 2004 and 2009 were put to the court and adjudicated within a three-year period after the CMB's application. Out of 126 adjudicated cases, 52 cases (41%) resulted in punishment (e.g. condemnation or prepayment), while in 21 cases (17%) the prosecution was dismissed, and in 47 cases (37%) the CMB appealed acquittal decisions to the Supreme Court. The process is time-consuming, as only 4% of the cases initiated between 2004 and 2009 were adjudicated within a year, and the average period from the CMB application to the initial adjudication is around two years. The public prosecutor did not react to more than half of the applications submitted by the CMB (Table 3.4).

While it was argued that the level of administrative fines had been relatively low (OECD, 2006), the new CML introduced a new deterrent capability, prescribing that, in cases where a benefit has been gained due to violation of the obligation, the amount of the administrative fine to be imposed cannot be less than double this benefit. The average amount of administrative pecuniary punishments was TL 41 000 in 2010 and TL 101 000 in 2011. The new CML increases the range of CMB enforcement powers and increases sanctions for non-compliance with the regulations. For example, in cases of abusive related party transactions and disguised profit transfer of public companies, the CMB is entitled to file a lawsuit for determination of the breach, cancellation of the transaction, and for the return of an amount determined by the CMB within a certain period of time. The CMB is also empowered to dismiss board members of capital market institutions who by court decision are found liable for the violation of obligations regulated in Law.

Table 3.4. **Turkey – Applications by the CMB to the Public Prosecutor**

	Application by CMB to public prosecutor	Situation at the period of time after the application by the CMB to public prosecutor									Adjudicated cases within 3 year period/CMB's application (%)	Average period from application to adjudication (years)
		1st year			*2nd year*			*3rd year*				
		Prosecutor's investigation	Pending	Adjudicated	Prosecutor's investigation	Pending	Adjudicated	Prosecutor's investigation	Pending	Adjudicated		
2004	127	78	49	0	24	97	6	8	104	15	12	2.1
2005	65	40	23	2	14	44	7	6	35	24	37	2.1
2006	63	29	30	4	3	43	17	0	28	35	56	1.9
2007	42	15	25	2	1	31	10	0	26	16	38	1.8
2008	72	17	50	5	7	54	11	7	49	16	22	1.5
2009	56	17	36	2	8	38	10	0	36	20	36	1.9
2010	69	42	25	2	8	48	13	–	–	–	–	–
2011	21	15	6	0	–	–	–	–	–	–	–	–
2004-09	**425**	**196**	**213**	**15**	**57**	**307**	**61**	**21**	**278**	**126**	**30**	**1.9**

Source: OECD calculations on the basis of data from Capital Markets Board of Turkey (n.d.), Annual Reports, *www.cmb.gov.tr/indexcont.aspx?action=showpage&menuid=3&pid=1&submenuheader=-1.*

In order to illustrate public supervision and enforcement practices in Turkey, the following sections focus on the specific areas of: *i)* appointment of independent directors, *ii)* related party transactions (RPTs), *iii)* takeover bids and *iv)* general shareholder meetings. The CMB plays an essential role in all of these areas.

Appointment of independent directors

Through the adoption of Communiqué IV-56 in December 2011, Turkey became one of the few countries where (outside the banking sector) public authorities are involved in the appointment process for independent directors. How independent directors are appointed is also important in view of their new role in the analysis and approval of RPTs under the Communiqué (see the discussion for this below).

In 2011, the CMB mandated listed companies, except those traded on the Watch List and Emerging Companies markets, to appoint independent directors. Some observers have expressed concerns that requiring a minimum of one third of independent directors could be a disincentive for companies to launch IPOs, notably where they intend to float only a small part of the shares.

Independent directors must meet the requirements for qualification and independence. For companies with large market cap and free float value (Category I in the table), the board of directors, based on a report of the nomination committee, prepares a list of candidates to be sent to the CMB before the general shareholder meeting. If the CMB has a negative opinion about any of the candidates, those candidates cannot be nominated as independent directors.[23] Moreover, in cases where a candidate is appointed as independent director and shareholders with at least 1% of the share capital vote against that candidate during the general shareholder meeting, the CMB shall conduct a separate assessment and make a decision regarding the independence of the appointed director.

The Turkish approach may be seen as a way to ensure the quality of independent directors, without compromising the principle of electing the board through majority decision.

Under the new compulsory independent director mechanism, the CMB is authorised to conduct a substantive screening of candidates, as the requirements include qualitative criteria (other than the mere formality of independence) such as having *i)* the necessary educational background, information and experience for fulfilling independent director duties, and *ii)* the ethical standards, reputation and experience enabling the independent director to contribute to company activities, protect his impartiality with regard to conflict of interest that may arise among shareholders, and make independent decisions by taking into account the rights of stakeholders. In addition, the CMB has obtained the right to nominate a person as an independent director.[24]

Against this background, it is not a straightforward task for both companies and the CMB to nominate and assess independent directors as prescribed in the regulation. One open issue in Turkey is the sufficiency of the pool of persons qualified to serve as independent directors. Perhaps more importantly, the market for board members will always be imperfect in an environment where personal contacts are important (OECD, 2012b). In the controlled and family companies common in Turkey, it is the controlling shareholder that effectively nominates directors including the independent ones.[25]

The difficulties in the appointment of independent directors, especially in a situation with conflicting shareholders, are illustrated in the recent case of Turkcell (Box 3.2).

Box 3.2. **Turkey – The Turkcell case**

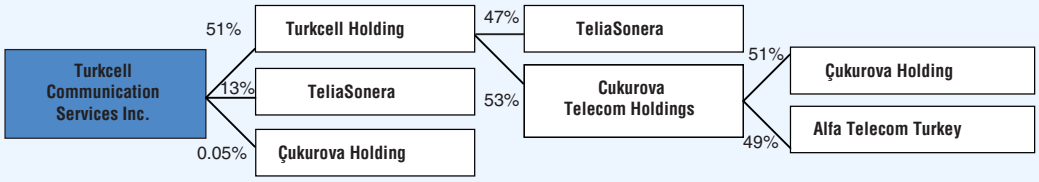
Turkcell Communication Services Inc., Turkey's largest mobile phone operator, has not convened a general shareholder meeting since April 2010, and shareholders have not received dividend payment for more than two years.

The general shareholder meeting scheduled for June 2012 was cancelled one day before the planned date. Behind the cancellation was a dispute over board composition among the principal shareholders:

- Çukurova Group (14%, Turkish capital, one of Turkey's largest conglomerates);
- TeliaSonera (37%, Swedish capital); and
- Alfa Telecom Turkey (13%, Russian capital)

Broad sketch of the ownership structure (as of end 2012)

Excluding intermediate companies with 100% ownership



Box 3.2. **Turkey – The Turkcell case** *(cont.)*

Because of this, the board of Turkcell (seven members) failed to reach a resolution regarding the list of candidates for independent directors, the appointment of whom became mandatory in 2011.

Turkcell submitted to the CMB the list of candidates. Due to the absence of a resolution by Turkcell's board, the CMB expressed a negative opinion on the list without evaluating individual candidates. Following this decision, Turkcell Holding (51% shareholding) decided not to be present at the general shareholder meeting, resulting in the cancellation of the meeting.

The board of Turkcell was expected to submit a new list with its resolution, but it was not able to break the deadlock. The CML authorises the CMB to nominate independent directors, but no action was taken until June 2012.

Minority shareholders had called for government intervention, following a similar statement from a cabinet minister. On 27 June 2012, the Turkish Transport and Communications Minister signalled that the government may intervene in the Turkcell conflict if the shareholder dispute continues.

On 11 March 2013, the CMB announced that it had appointed three independent board members to the board of Turkcell, replacing three incumbent members representing each of the major shareholders. Two of the nominees are former ministers who served under the incumbent Prime Minister.*

TeliaSonera and Çukurova Holding supported the CMB's initiative as "a step towards fair corporate governance and efficient management" (TeliaSonera). Alfa Telecom Turkey, meanwhile, expressed disappointment that the impasse with the Çukurova Group preventing the implementation of corporate governance rules had forced the CMB to appoint three independent board members.

* The CML amendment of 2 August 2013 authorises the CMB to appoint a board member for the purpose of convening a general shareholders meeting to elect a new board member. This applies under the condition that a seat has become vacant and the quorum requirement for the board meeting has not been met. Following the CML amendment, the CMB appointed, on 15 August 2013, two additional independent board members to resolve the impasse paralysing Turkcell. The new board members are expected to serve until replaced either by a shareholder meeting or by the CMB.

Source: CMB (n.d.), *Weekly Bulletins*, *www.cmb.gov.tr*; *The Economist* (2012), "The battle for Turkcell", 21 April, *www.economist.com/node/21553054*; Turkcell's annual reports and press releases (Turkcell n.d., *www.turkcell.com.tr/site/en/turkcellhakkinda/yatirimciiliskileri/Sayfalar/genel.aspx*), and announcements by TeliaSonera (TeliaSonera n.d., *www.teliasonera.com/en/investors*), Çukorova Holding (Çukorova Holding n.d., *www.cukurova.com.tr/eng/indexen.asp*) and Alfa Telecom Turkey (Alfa Telecom Turkey n.d., *www.alfa-telekom.com.tr*).

Related party transactions

One of the typical approaches to the *ex ante* enforcement of RPTs relies on market mechanisms and shareholder activism, both of which are underpinned by disclosure requirements. Considering, however, that the monitoring function of shareholder activism is relatively weak under controlled and family ownership, it is debatable whether or not disclosure is a powerful tool for influencing corporate behaviour. As a consequence, public supervision by the CMB plays a dominant role in this area.

The key legal and regulatory requirements for listed companies concerning disclosure of RPTs are as follows:

- ***IAS/IFRS:*** Turkey adopted International Financial Reporting Standards (IFRS), and listed companies are required to disclose in their financial statements RPTs in accordance with International Accounting Standard (IAS).[26]

- ***Material information disclosure:*** In addition to the financial statements, publicly held companies are required to disclose material events that may affect investment decisions and prices of capital market instruments.
- ***Independent fairness report:*** Listed companies are required to obtain an independent report[27] verifying the fairness of the terms and conditions for RPTs above a certain threshold (5% of total assets or total revenues),[28] and to disclose the result of the independent report and informative brief on the general shareholder meetings.[29]
- ***Special report of company groups*** *(as of July 2012):* Pursuant to the new TCC, the board of the controlled company shall prepare a report on the relations with controlling and controlled companies (related companies). If the company has incurred a loss, the report must explain whether such losses have been compensated.
- ***Information regarding disapproval by independent directors*** *(as of December 2011):* Pursuant to Communiqué IV-56 and the new CML, major significant transactions, and all RPTs, can be directly executed by the board of directors if the majority of independent directors provide their consent. If, however, the majority of independent directors do not approve the transactions, the approval of the general shareholder meeting (excluding the votes of related parties) is required for execution. In such a case, the reasons behind the dissenting votes of independent directors shall be disclosed to the public, notified to the CMB, and presented at the general shareholder meeting.

While the adoption of IFRS (and therefore IAS 24 for RPTs) has introduced an important standard for transparency, it is not alone sufficient, as noted in OECD (2012a). Turkey has introduced a requirement for ongoing disclosure of material events, but the definition of materiality in terms of RPTs is not clearly stipulated, calling into question how effectively this can function as a monitoring mechanism. The requirement of an independent fairness report above a certain qualitative threshold can serve as a safeguard, but to avoid circumvention, continuous monitoring by the regulator is essential, particularly in the absence of private oversight through shareholder activism.

Turkey has recently taken further steps to increase transparency and enhance oversight regarding RPTs, thereby assisting investors and regulators in monitoring such transactions. Special disclosure rules covering intra-group transactions were introduced, in view of the dominance of company groups in RPTs. Giving independent directors a central role in *ex ante* assessment might increase the level of oversight, under the condition that their qualification and independence is ensured and their assessment supported by independent experts (OECD, 2009).

The CMB supervises companies' financial statements using a risk-based approach. This approach consists of two phases: risk analysis and detailed review.

- ***Risk analysis:*** The CMB selects the companies for detailed review by scoring the risk of each company before the financial statement is disclosed. The CMB scores the risk by taking into consideration key factors including: capital market information; financial environment; organisational structure and corporate governance; and compliance with other laws and regulations. If the company is part of a group with a complex structure, or the level of RPTs is significant, the company gets a higher score, increasing the likelihood of a detailed review.[30]
- ***Detailed review:*** Several dozen companies are reviewed every year. Their financial statements are reviewed through a web-based checklist programme. The CMB staff do not investigate individual case in this process, but if concerns are raised in relation to

individual transactions, these will be communicated to the CMB Enforcement Department for further investigation.

The disclosure of material information is also under on-going supervision by the CMB. A Public Disclosure Platform[31] has been developed to provide timely and relevant information with investors. Complaints and proposals from investors that amounted to 7 897 in 2012 might be a useful resource for the CMB to identify an issue for further investigation. Whistle-blowing by insiders is also one of the origins of information.

Despite all the on-going monitoring practices regarding disclosure documents, it remains difficult for the CMB to detect misstatement or non-disclosure in financial statements with regard to RPTs, particularly in cases where they are intentionally disguised. In practice, almost all of the CMB's investigations about related party transactions have been initiated by investor complaints or insider information from the company. The new CML empowers the CMB to require a public company to get an *ex ante* shareholders' approval for RPTs above a certain threshold, but whether this will be effective in preventing abusive RPTs is yet to be seen.

Avoiding "abusive" RPTs is a central issue. The key legal and regulatory requirements for listed companies concerning abusive RPTs are as follows:

- ***Prohibition of deceitful RPTs:*** Publicly held companies shall not impair their profits and/or assets by engaging in deceitful RPTs such as by applying a price, fee or value clearly inconsistent with similar transactions with unrelated third parties.[32]
- ***Sanction against abuse of trust:*** Any person who illegally holds possession of a property entrusted to him for certain purposes, or converts this property to his own or others' use beyond the objective of seeking transfer of possession, or denies this transfer event, is punished with imprisonment and fines.[33]
- ***Prohibition and compensation of abuse of control (as of July 2012):*** Pursuant to the new TCC, a controlling company shall not exercise its control in a manner to cause a loss to controlled companies, and if a loss is incurred, such loss shall be compensated.

The CMB has taken action against abusive RPTs. The typical approach is to launch a legal prosecution according to the provision prohibiting deceitful RPTs (Case 1 and 2 in Box 3.3). Before submitting an application to the Public Prosecutor's Office, the CMB issues a legal warning that includes a brief description of the identified case and the possible penalties to be imposed if the losses or profits are not compensated or disgorged within a certain period of time (e.g. one month) fixed by the CMB. The provision prohibiting deceitful RPTs requires evidence about the price of similar transactions with unrelated third parties. In cases where it is not possible to determine a price clearly consistent with similar transactions with unrelated parties, the CMB prepares an indictment according to the provision on abuse of trust in the Turkish Criminal Code. By the end of 2012, the CMB had initiated 28 cases, 5 of which resulted in the conviction of the defendant. In 4 cases, the court decided in favour of the defendants, and 12 cases were abandoned due to the statue of limitation.

Abusive RPTs are usually linked to tax avoidance or evasion (e.g. Case 1 in Box 3.3.), and co-ordination between the Ministry of Finance and the CMB is sometimes an issue of discussion. In the face of weak enforcement by the authorities and courts, many companies are tempted to engage in unregistered transactions for the purpose of tax avoidance (Ararat and Orbay, 2006).

Box 3.3. **Turkey – CMB enforcement actions against abusive RPTs**

Case 1: Doğan Group

On 16 October 2008, the CMB announced that it was recommending court action against Aydin Doğan and three executives of Hurriyet Gazetecilik and Doğan Gazetecilik for having caused losses to the shareholders through the purchase of overpriced paper and publishing supplies from off-shore companies owned by the Doğan family.

On 25 September 2009, an indictment was filed by the CMB to the Public Prosecutor' Office against these four executives for intentionally causing losses by purchasing paper and publishing supplies from offshore companies in the 1999-2007 periods. This action followed the Finance Ministry's fine of TL 3.76 billion (USD 2.53 billion) on Doğan Yayın Holding for evading tax regarding its accounts for the time period 2005-07.

Case 2: ABC Holding

ABC Holding decreased the reported profits and/or assets of the publicly held company, by applying a higher price instead of the value applied in similar transactions with unrelated third parties.

The CMB's investigation was initiated by insider information provided by a former employee of ABC Holding. Following the investigation, the CMB launched a legal prosecution against ABC Holding due to its deceitful transaction. The Turkish Court of Appellate confirmed that these transactions were deceitful and decreased the profits/assets of the publicly held company, concluding that the authorised persons of this company should be punished.

Source: CMB (n.d.), *Weekly Bulletins*, *www.cmb.gov.tr*.

The role of gatekeepers such as external auditors and valuation experts is essential in an effective regime to ensure the accuracy of disclosure and to manage RPTs. In light of principles-based definitions of RPTs in IFRS, a premium is placed on auditors to make the right judgements. However, as with fraud, it is difficult for auditors to identify all related parties and to detect individual transactions that might be abusive. Nevertheless there still needs to be a fall back regulatory position including detailed audit guidance. The CMB has already implemented a regulatory framework on audit firms in accordance with the International Standards of Auditing (ISA), and a newly established organisation (KGK) is in the process of drafting updated audit standards equivalent to the ISA.

Takeover bids

Given the prevalence of concentrated and family ownership structures, acquisitions of controlling interests by takeover bid are not common in Turkey. There are no contested (or unsolicited) takeovers, since it is not possible to obtain a significant interest in most companies except from a controlling shareholder or shareholder group.

A bid is made public by the announcement of the offeror to the market of his decision to launch a takeover bid. The offeror is required to apply to the CMB with the intention of either making a takeover bid or obtaining approval for an exemption from the mandatory takeover bid rule.

Based on the authorisation by the CML, the CMB adopted Communiqué IV-44 (September 2009, effective as of April 2010) on takeover bids for publicly held companies. The key requirements relevant to this review are the following:

- ***Triggering events:*** The mandatory takeover bid rule can be triggered by an acquisition of shares that results in an offeror controlling the management of the target company (e.g. holding of shares carrying 50% or more of the voting rights or share capital, obtaining the right to appoint the majority of the board members). This does not apply if a voluntary bid to all shareholders of the target company follows the acquisition.
- ***Bid price:*** All shares of the target company of the same class must be afforded equivalent treatment. Key requirements regarding the bid price include that it shall not be lower than the highest of: *i)* the price determined by a valuation report prepared by an agency selected by the CMB; *ii)* the highest price paid by the offeror for the same class of shares of the company within the six-month period; and *iii)* the daily weighted average market price within the six-month period.
- ***Exemption from mandatory takeover bid rule:*** The CMB may grant an exemption from the mandatory takeover bid rule if the acquisition of shares: *i)* is necessary for reinforcing the financial structure of the company; *ii)* would not cause any change in the control of management due to the capital distribution of the company; *iii)* is realised as a result of a privatisation process. In most cases *ii)* is claimed as a basis for the exemption.

Before the adoption of the new Communiqué, many of the cases brought to the CMB were applications for the exemption (Table 3.5).

Table 3.5. **Turkey – Takeover bids (2007-11)**

Applications to the CMB	2007	2008	2009	2010	2011
Mandatory bids	13	12	1	11	15
Exemption from the mandatory bid rule	36	18	12	2	5
Total	49	30	13	13	20

Source: CMB response to the OECD peer review questionnaire.

The bid price once became an issue of a judicial dispute in Turkey (Case 1 of Box 1.4). The CMB's decision regarding the exemption from the mandatory takeover bid rule requires substantive judgement and has sometimes been brought to the court (Case 2 of Box 3.4.). With regard to the breach of the provisions laid down in the Communiqué, the CMB is authorised to impose administrative fines. This sanction has, however, never been taken except for the case of Tram A.Ş., where the CMB imposed an administrative fine on the company that failed to launch a takeover bid according to the mandatory takeover bid rule. As is noted in OECD (2006), the penalties for breaching Communiqués are very low and there is no risk of imprisonment. Therefore, some companies and individuals find that the benefits of non-compliance outweigh the costs of such fines.

To strengthen the legal and regulatory framework and the enforcement powers of the CMB with respect to takeovers, the new CML clarifies the concept of "control of management", and defines takeover bids in a more stringent fashion.

- ***Control of management:*** The new CML requires a mandatory takeover bid in cases where control of management of a company is acquired. Control of management means owning directly/indirectly more than 50% of the voting rights or having the privileged

Box 3.4. **Turkey – Prominent cases of takeover bids**

Case 1: Takeover bid price

In April 2006, Finansbank announced that National Bank of Greece (NBG) had signed an agreement to purchase a 46% stake of Finansbank from Fiba Holding and its group companies.

The CMB approved, with its decision dated 6 December 2006, the mandatory takeover bid price proposed by NBG, which had been calculated based on a weighted average of the subsidiary's stock price during the three months preceding the change of control over the target. However, this price was lower than the actual trading price on the date of the CMB's approval.

East Capital Asset Management, one of the shareholders of Finansbank, challenged the decision of the CMB, claiming that the offer price should not be less than the trading price of the shares on the date of the CMB's approval.

The Administrative Court reviewing the matter ruled in favour of the claimant shareholders, cancelling the CMB decision approving the tender offer with immediate effect (16 May 2008). The CMB initially appealed the ruling of the Administrative Court and adopted a second decision requiring the purchaser, National Bank of Greece, to apply to the CMB for a second tender offer and provide with this application the calculation regarding the shares of the listed subsidiary. The National Bank of Greece provided the valuation for the shares, but challenged the CMB decision requiring a second tender offer to be launched, by filing an administrative lawsuit on the grounds, among others, that the tender offer was already completed.

Case 2: Exemption from the mandatory takeover bid rule

The CMB has the authority to grant an exemption from the mandatory takeover bid rule. In this case, the non-controlled shareholders in a corporation may file a lawsuit against the CMB's decision regarding the exemption from the mandatory takeover bid rule.

In the case of X Bank, the shareholders of the corporation to which the CMB granted an exemption had filed a lawsuit against the CMB's decision. The court decided that the corporation had acquired shares in an amount enabling a change of control. Therefore it ordered a takeover bid for the purchase of the shares of other shareholders as well. Hence the court had annulled the CMB's decision.

Source: CMB (n.d.), *Weekly Bulletins*, *www.cmb.gov.tr*.

shares to elect or nominate the majority of board members. This upgrade of the regulatory basis of mandatory takeover bids from subordinate legislation (i.e. CMB Communiqué) to the law empowers the CMB to impose higher amounts of administrative fines as well as criminal charges.

- ***Freezing voting rights:*** The voting rights of persons and persons acting in concert are frozen unless they fulfil the requirement for mandatory takeover bids during the time period fixed by the CMB. The intention is to prevent the infringement of minority shareholders' right in the process of changing the control of management.
- ***Squeeze-out:*** The new TCC and CML introduces the squeeze-out procedure into Turkish law by entitling the controlling block to forcibly acquire shares held by a minority block.[34]

Shareholder meetings

In Turkey, minority shareholder participation in general shareholder meetings is low, and shareholders rarely use their right to request information from companies. Foreign institutional investors own a majority of free float shares, while domestic institutional investors are largely absent and investor activism is not noticeable. Considering the procedures and the rights given to shareholders, the low presence of institutional investors can hardly be attributed to the legal and regulatory framework in terms of corporate governance. Rather, the regulatory explanation should probably be sought in portfolio restrictions for mutual and pension funds and other legal restrictions.

The TCC sets out comprehensive provisions regarding general shareholder meetings. The key requirements are as follows:

- ***Convocation and distribution of information:*** The TCC prescribes that board shall make an announcement regarding the general shareholder meeting (in which the agenda must also be disclosed) 15 days in advance of the meeting. CMB Communiqué IV-56 and the new CML require all listed companies to disclose the convocation on the company website and trade registry gazette three weeks in advance of the meeting. For ordinary annual meetings, audited financial statements, the independent audit report, the annual report of the board, suggestions of the board regarding the method of distribution of dividends and the report of the statutory auditors are made available to shareholders at least 15 days in advance of the meeting.
- ***Shareholder's right to request a meeting:*** Shareholders holding 5% of the share capital of public companies may request the board to call a general shareholder meeting.

The new TCC introduced distinctive mechanisms to incentivise both domestic and foreign institutional investors to participate in the shareholder meetings:

- ***Electronic general shareholder meetings:*** The new TCC established the legal basis that electronic participation and voting have the same legal consequences as physical participation and voting for all joint stock companies, while making electronic general shareholder meetings compulsory for listed companies (see Box 3.5).
- ***Institutional representative:*** The new TCC introduced the concept of an institutional representative, allowing the pooling of individual shareholders' voting rights, and their collective exercise.

One distinctive characteristic in Turkey regarding the supervision of the general shareholder meetings is the direct involvement and attendance by representatives of the Ministry of Customs and Trade (MCT) and the CMB.

- ***MCT:*** In the previous TCC, the presence of a representative of the MCA was required for the validity of all general shareholder meetings. The new TCC repealed this requirement and requires MCA's presence only in limited cases including when the agenda of the meeting includes incorporation or amendment of the articles of association, which is subject to the MCA's approval.
- ***CMB:*** The CMB has been authorised in the CML to send a representative to general shareholder meetings of public companies to identify potential problems and wrongful acts.[35] In 2011, CMB experts attended 16 annual shareholder meetings of listed companies. The presence of a CMB representative provides assurance (or pressure) that rights under the CML will be respected at the meeting.

Box 3.5. **Turkey – The electronic general meeting system (e-GEM)**

The electronic general meeting system (e-GEM) enables hybrid general meetings covering both physical and electronic attendance. The Central Registry Agency (MKK) portal facilitates real-time electronic participation in general assembly meetings, including submission of proposals, comments and voting, simultaneously with the physical meeting. Electronic-only GEMs are not allowed. Existing and prospective beneficial shareholders can register their votes in advance of the meeting by proxy, but still have the opportunity to change their votes during the GEM if they register and attend electronically.

The process starts with issuers publishing their call for a GEM at least 21 days in advance on e-GEM portal and uploading all the proxy materials. The GEM is broadcasted via streaming video by MKK. Investors and their local custodians can enter the system via their computers or mobile devices using the electronic signatures regulated by e-Signature Law. The system allows concurrent attendance to multiple GEMs by the same user. Meeting information and voting reports are instantly communicated to all participants via e-GEM and vote confirmations are available no later than 15 days to any requesting party.

e-GEM also serves as a forum for existing and prospective shareholders to communicate with each other such as in the case of proxy solicitation as well as with the issuer. Meeting documents, audio-visual records and voting results are electronically archived by MKK. The system has also been integrated into the existing Public Disclosure Platform.

Issuers	Shareholders
Make convocation	Receive convocation
Publish proxy materials	Download proxy materials
Prepare list of attendees	Watch the meeting on-line
System will automaticall send list of attendees and minutes to Trade Registry	Send opinions and questions to the chairman of the meeting (within 600 words)
Use the archive	Register the votings before the meeting

Source: Ararat, M. and M. Eroğlu (2012), "Istanbul Stock Exchange Moves First on Mandatory Electronic Voting at General Meetings of Shareholders", SSRN: *http://dx.doi.org/10.2139/ssrn.2172964* and MKK – Central Registry Agency (2013), *www.mkk.com.tr/wps/portal/MKKEN*.

It is possible that representatives from both the MCT and CMB are present in the same general shareholder meeting, where the MCT and CMB take their responsibilities from the TCC and CML perspectives, respectively. However, with corporate governance standards spread among various instruments, including the TCC and CML, this division of responsibilities might create gaps. In the new TCC, it is clearly stipulated that the CMB is authorised to determine the corporate governance rules for public companies, narrowing the gaps in oversight.

In spite of the close on-site monitoring by national authorities, companies sometimes fail to comply with the compulsory two-week deadline for sending relevant materials to shareholders. The new TCC has vested the MCT with enforcement powers and additional resources. It remains to be seen how it will use these powers in practice. The CMB has been taking enforcement actions if necessary, as in one case where the CMB filed a lawsuit

against the decisions taken in the general shareholder meeting on the grounds that the convocation of the general shareholder meeting had been made contrary to law and the agenda had not been announced in the form indicated in the articles of association. The primary court accepted the lawsuit and annulled this general shareholder meeting.

Supervision practices in Turkey will change significantly with the implementation of the system of mandatory electronic general shareholder meetings. Regulators are authorised to monitor the meetings, and all the materials and communications concerning the meetings will be electronically archived by the MKK. They are accessible to regulators as well as shareholders. The new framework is expected to provide a high level of assurance (or pressure) that rights under the TCC and CML are respected.

3.4. Private supervision and enforcement

Private enforcement is rarely used in Turkey, due to a time-consuming judicial mechanism and weak shareholder activism. Non-controlling shareholders have little power to influence the policies of companies, in an environment where family-controlled structures predominate and the culture of share ownership remains underdeveloped.

Institutions of private supervision and enforcement

Key actors of private supervision and enforcement include investors, private sector organisations such as associations of industries and shareholder associations.

- ***Institutional investors:*** Domestic institutional investors such as mutual and pension funds, many of which are basically controlled by Turkey's largest financial institutions, have limited presence in the capital market. In the absence of pressures from domestic investors, foreign institutional investors,[36] who own a majority of the free float shares, are not able to exercise much influence. A study noted that the average value of shares held in a single company by foreign institutional investors is generally too small to justify the cost of monitoring (Ararat and Eroğlu, 2012). To help institutional investors gain power, the new TCC introduced the concept of an "institutional representative", who allows pools of individual shareholders to exercise voting rights collectively. However, challenges remain as mutual funds are not required to develop and disclose voting policies or policies to deal with conflicts that might affect their decisions regarding the exercise of key ownership rights.
- ***Individual investors:*** Individual investors hold the majority of the locally-held shares, while domestic corporate investors only hold 16% of market capitalisation. The stock exchange is seen as a platform for domestic investors to make short-term profits (the average holding period is 46 days). Some attribute the lack of shareholder culture "to the fact that the state has historically had a predominant role in every aspect of economic and social activities of Turkey, and the citizens have always expected the government to set market mechanisms rather than being actively involved by themselves" (Gonencer, 2008).
- ***Private sector organisations:*** Against this background, private sector organisations have become more active in promoting corporate governance reforms. The Turkish Industrialists and Businessmen's Association (TUSIAD) and Corporate Governance Association of Turkey play a leading role in co-ordinating and presenting the views of publicly held companies in Turkey, including corporate governance matters. The Turkish Shareholders' Association (BORYAD) holds a share in all ISE-listed companies and acts as

the voice of shareholders, notably in the recent high-profile cases such as Turkcell (Box 3.2) and Doğan (Case 1 in Box 3.3).

Stock exchanges can assume a key role in implementing corporate governance standards, as is the case in many OECD countries. Whereas the CMB Principles do not form part of the listing requirements, the ISE has promoted the Corporate Governance Index, as discussed in the following section. The new CML has paved the way for the ISE to become a joint-stock company, after its planned merge with the Istanbul Gold Exchange by September 2013. The Treasury will own the majority of ISE shares for three years. During this time period, a public offer of the ISE shares can be made upon determination by the Council of Ministers.[37] The expectation is that, after the transition period, the ISE will be able to play a more active part in international competition among stock exchanges. At the same time, a transformation to a profit maximising exchange may reduce the emphasis on corporate governance aspects in order reduce cost and promote trading.[38]

Private enforcement in the area of corporate governance can only be effective in an environment of a well-functioning legal system, including an efficient judicial court system, complemented, where appropriate, by alternative dispute resolution systems.

- ***Judicial system:*** Investors in the Turkish capital markets have recourse to the court system for complaints. Civil disputes are heard initially by the Civil Court of First Instance, which has specialised branches for dealing with commercial, labour and other types of claims. Specialist administrative courts deal with matters of public law involving an administrative institution. Appeals go to the Court of Appeals and the High Court of Appeal. A lack of capacity and efficiency in the judicial system has long been an issue in Turkey, notably large backlogs of cases and the slow speed of proceedings (European Bank, 2012). Whereas specialised courts have only dealt with a limited range of cases (e.g. insider trading), the plan to establish Istanbul as an international financial center includes a recommendation to broaden the case of specialised courts.[39]
- ***Alternative dispute resolution systems:*** Commercial Arbitration exists in Turkey, and arbitral awards are binding and final. Regarding disputes arising from stock exchange transactions, the ISE may be appointed as an arbitrator for disputes between exchange members and their clients. Arbitral awards are subject to appeal before the CMB, whose decisions are binding and final. They are, however, subject to appeal before the administrative court for procedural deficiencies. Regarding disputes arising from other than stock exchange transactions, the Association of Capital Market Intermediary Institutions of Turkey (TSPAKB) assists parties in the mediation process, but TSPAKB's mediation decisions are not binding. The Law on Mediation for Civil Law Conflicts, which implements the legal framework for an alternative dispute resolution mechanism, will be effective as of June 2013.

Private supervision and enforcement practices

The chief private enforcement device in the area of investor protection is the shareholder lawsuit for monetary damages, brought against directors, issuing companies, and audit firms (Kraakman et al., 2009). While Turkish laws do not recognise class actions or derivative actions, in practice several disputes on the same issue can be combined (Ararat and Orbay, 2006).

The board of directors can incur two types of liability, civil and criminal. The TCC requires board members to act prudently and diligently when carrying out their duties and

the business of the company. Board members may only be held liable for acts arising from their negligence or fault. The new TCC has six categories of civil liability, including failure to fulfil obligations originating from the company's articles of association.[40] While this categorisation provides for a clearer definition of board liability, it may also create gaps. The board, in terms of responsibility, is not clearly defined as a collegial body, as the law does not state that every member will be vicariously liable for another director's acts or culpable inaction (Bicak Law, 2012). In terms of burden of proof, the presumption in the TCC is that losses incurred by the company are a result of the acts of the board members. This means that unless the board members prove that the losses have not resulted from their negligence or fault, they can be held liable.

With regard to the three areas covered by the survey, there is an exceptional case that private enforcement by an institutional investor has a significant impact on both companies and the CMB's decision (Box 3.6).

The new legislative regime may have some impact on the development of private supervision and enforcement practices, either formally or informally:

- ***RPTs:*** Private enforcement mechanisms against abusive RPTs are enhanced in the new TCC. Transactions that may result in financial loss to the controlled company are prohibited without compensation. In the case of transactions that are regarded as abuse of control, those who expressed dissent against the resolution in the general shareholder meeting or board meeting may request a court to order the controlling company to compensate their loss.
- ***Takeover bids:*** One method of private enforcement in this area is the filing of a lawsuit for "specific performance under civil law against the party in default". For instance, in the case of Tram A.Ş. (see page 85), the shareholders filed a lawsuit against the company following administrative sanction by the CMB. In that case, the Court of Appeals decided that if natural or legal persons and those acting in concert do not comply with the mandatory bid requirement, the minority shareholders have the right to sell their shares against equitable compensation. This decision was codified in the new TCC.
- ***Shareholder meetings:*** The mandatory e-GEM system introduced in the new TCC (Box 3.1) is expected to increase the transparency of ISE-listed companies, and to empower both domestic and foreign investors to embrace a more activist approach. One concern has been that problems encountered in maintaining voting integrity, and in the use of shareholder rights, through the e-GEM system may increase the possibility of annulment of meetings by courts, putting companies at risk of being unable to function effectively. Whether such concerns are justified, remains to be seen.

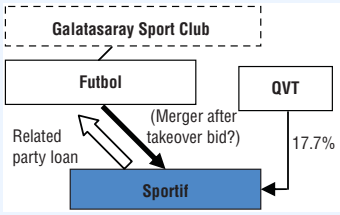
The implementation practice of the corporate governance code (backed by a mandatory "comply or explain" rule) provides an example of informal private supervision. To promote the implementation of the Principles, the ISE in August 2007 launched a Corporate Governance Index (CGI). Listed companies with a corporate governance rating of 7-10 are entitled to a 50% discount in annual listing fees for the first two years[41] and to inclusion in the CGI. The corporate governance rating is determined by rating firms authorised by the CMB, whose methodologies are based on the CMB Principles.[42] This mechanism has attracted some listed companies, but the incremental benefit of obtaining a rating is small or non-existent for most of the companies. At the end of 2011, 41 out of 373 ISE-listed companies were included in the CGI. Investors, however, rarely use corporate

Box 3.6. **Turkey – The Sportif and Futbol case**

RPTs: "Sportif" (Galatasaray Sportif Sinai ve Ticari Yatirimlar A.S.) made loans to its majority shareholder "Futbol" (Galatasaray Spor ve Futbol ISletmeciligi Ticaret A.S.) that amounted to TL 343 million. Pursuant to the CMB decision, those loans were due on 28 March 2010.

Takeover bid *(9 March 2010):* The CMB authorised a voluntary takeover bid by Futbol with the intention of a merger with Sportif. The bid price for the Sportif shares was TL 155.77 (almost 8% less than the ISE market price). The bid period was from 9 to 24 March (15 days).

Snapshot of the situation before the takeover bid



15 March 2010: **Lawsuit No.1** (Ankara Administrative Court)	The largest minority shareholder "QVT" (QVT Financial LP, UK capital) filed a lawsuit against the CMB in relation to its decision (dated on 9 March) authorising the takeover bid. The lawsuit alleged that the CMB failed to apply the proper criterion for determining the minimum takeover bid price and violated its duties to protect the interests of minority shareholders. It argued that, in determining an appropriate minimum price (TL 155.77), the CMB failed to take into account *i)* the ISE market price; *ii)* the loans owed to Sportif by Futbol (TL 343 million, amount to TL 169 per share); and *iii)* the unpaid dividends or future expected cash flows of Sportif from valuable licensing agreements. The bid price was more than 75% below the fair value of the shares calculated by a valuation firm engaged by QVT.
15 March 2010: **Lawsuit No. 2** (Ankara Administrative Court)	QVT separately filed a lawsuit against the CMB requesting the suspension or extension of the takeover bid in order to give time to address issues raised by QVT, including: *i)* the under-valuation of Sportif; *ii)* the failure of Futbol to comply with the CMB's mandate regarding the repayment of loans due on 28 March; *iii)* the failure by Sportif to distribute dividends; and *iv)* the improper use of Sportif's assets as financing for the loans arranged to funds the takeover bid.
18 March 2010: **Lawsuit No. 3** (Istanbul Commercial Courts of First Instance)	QVT filed petitions against Sportif and the members of the Sportif board (six of seven members are also directors of Futbol), requiring the appointment of an independent trustee to supervise Sportif and prevent the board of directors from completing the merger with Futbol.
19 March 2010: **The letter issued by the CMB**	The CMB directed Sportif to explain what actions were planned to comply with the CMB's requirement for repayment of the related party loans due on 28 March.
24 March 2010: **Update of Lawsuit No. 2**	The Court granted the CMB five days to respond to GVT's request.
25 March 2010: **QVT's partial tender**	QVT announced that it had "reluctantly" tendered approximately 60% of its shareholdings (its share decreased from 17.7% to 7.2%).
28 April 2010: **QVT's request for information and placement of items on the agenda**	QVT requested a copy of the loan agreement, and the placement of items on the agenda of the general shareholder meeting (scheduled on 3 May).

Source: PR Newswire (2010), "QVT Financial Files Lawsuits Against Galatasaray Sportif and Its Board of Directors to Prevent Coercive Tender by Galatasaray Futbol and Subsequent Merger", 18 March, QVT Financial LP, *www.prnewswire.com/news-releases/qvt-financial-files-lawsuits-against-galatasaray-sportif-and-its-board-of-directors-to-prevent-coercive-tender-by-galatasaray-futbol-and-subsequent-merger-88344367.html*, PR Newswire (2010), "QVT Tenders Approximately 60 Percent of Its Galatasaray Sportif Holding Into Coercive Tender Offer by Galatasaray Futbol", 25 March, QVT Financial LP, *www.prnewswire.com/news-releases/qvt-tenders-approximately-60-percent-of-its-galatasaray-sportif-holding-into-coercive-tender-offer-by-galatasaray-futbol-89096912.html*, PR Newswire (2010), "Galatasaray Sportif's Board Blocks QVT Initiative for Enhanced Disclosure, Corporate Governance Reform and Recovery of Inappropriate Loans", 4 May, QVT Financial LP, *www.prnewswire.com/news-releases/galatasaray-sportifs-board-blocks-qvt-initiative-for-enhanced-disclosure-corporate-governance-reform-and-recovery-of-inappropriate-loans-92740149.html*.

governance ratings as criteria for investment decisions. A recent study shows that companies that are part of the CGI have no difference in performance compared to their peers listed in the ISE-50 index (Sengur, 2011).

3.5. Relation between public and private supervision and enforcement

Extensive public supervision and enforcement is essential for ensuring the implementation of corporate governance standards in Turkey. This is not only because private enforcement practices are not well developed in Turkey, but also because central elements of private enforcement generally depend on public supervision and enforcement. The scope of private supervision and enforcement includes share pricing and voting, as well as shareholder lawsuits, all of which typically depend on the reliability of publicly enforced, mandated disclosure (Jackson and Roe, 2009).

In Turkey, where damages caused by corporate misconduct and the cost of private remedies cannot easily be compensated through private enforcement, the primary and rational option for investors is to submit complaints to the CMB. The number of complaints submitted to the CMB has in fact increased significantly (2 238 in 2010 and 5 801 in 2011). The number of such complaints does not appear to be directly reflected in the number of enforcement actions by the CMB, although they may be taken into account in the CMB's supervision and enforcement practices.

In addition to relying on public disclosures, investors typically depend on the information collected by the CMB as a basis for private enforcement. Pursuant to the Law on Information Requests, the CMB is required to respond to information requests from investors within 15 business days, by providing copies of relevant materials. The number of information requests has also increased recently (848 in 2010 and 2 025 in 2011). In case of civil lawsuits against public companies or their board members, the CMB usually provides information and relevant materials upon request of the courts. Furthermore, the CMB sometimes provides guidance to investors regarding available legal tools. Despite the indirect support by the CMB, private enforcement is rarely considered a promising option for investors and shareholders.

3.6. Conclusions

In an environment of largely family/owner-controlled companies with low free float, an absence of independent domestic institutional investors, and a judicial system not well prepared to handle corporate law cases, the supervision and enforcement of corporate governance standards falls largely upon the securities regulator, the Capital Markets Board of Turkey (CMB). While plans for an Istanbul International Financial Centre foresee the creation of specialised courts, up to now private supervision and enforcement has only played a minor role in Turkey.

Due to the reliance on public supervision and enforcement, the governance and effectiveness of the relevant public authorities, notably the CMB, is of high importance. The CMB has been strengthened over the years, and is now regarded as one of the most professional and competent authorities in Turkey. The CMB believes that its future independence will not be affected by the recent replacement of its board (as part of an amendment to the new Capital Market Law agreed by the parliament). The CMB has paid increasing attention to the supervision and enforcement of related-party transactions (RPTs) and the appointment of independent directors, the two most common problem areas in the Turkish context.

The powers of the CMB were significantly strengthened in the context of the recent modernisation of the Turkish Company Code (TCC) and the Capital Markets Law (CML). The new framework incorporates distinctive features, such as *i)* the CMB's involvement in the

appointment of independent directors, *ii)* the introduction of the company group concept and independent directors' duties in the RPT regulation; and *iii)* mandatory electronic general shareholder meetings. These are designed to address the specific features of the Turkish capital markets environment. However, since these reforms are very recent, it will be some time before the overall impact of the reform package can be assessed.

Notes

1. Total domestic saving as percentage of GDP in Turkey has declined since 1988, reaching 12.7% in 2010, the lowest saving rate since 1980. The World Bank (2011) discussed "With domestic saving low, Turkish investments have increasingly been financed by foreign capital, which has raised concerns about external sustainability as the current account deficit has widened. (…) As a result, increasing domestic saving is critical for promoting sustainability of growth in Turkey".
2. According to the Chairman/CEO of the Istanbul Stock Exchange (ISE), "only 12% of the one thousand largest companies are listed on ISE whereas SMEs are virtually unaware of the perks of being listed" (Erkan, 2012). The Oxford Business Group 2009 Report noted that "just 130 of Turkey's 1 000 largest companies are now listed".
3. Market capitalisation of the ISE reached USD 307 billion at end-2012, up by 45% on TL basis and 54% on USD basis. According to the survey by the World Bank (2011), market capitalisation as percentage of GDP in Turkey was 26%, far below the world average (69%) and OECD average (75%) at the end of 2011.
4. An "Initial Public Offering Campaign" was initiated in 2008 by the CMB, ISE, the Union of Chambers and Commodity Exchanges of Turkey, and the Association of Capital Market Intermediary Institutions of Turkey (TSPAKB). The target of this campaign is to have 1 000 ISE-listed companies in 2023. On 2 October 2009, the Prime Minister signed and published a "Strategy and Action Plan for Istanbul International Financial Center", which was prepared under the coordination of State Planning Organization and approved by the Resolution of the High Planning Council on 29 September 2009. This plan set out 21 priorities, one of which addresses the fund raising in capital markets: "Going public of non-public companies and spreading capital funding to the public base shall be encouraged" (Priority No. 11).
5. According to the CML, capital market instruments to be issued or to be offered to the public are required to be registered with the CMB. Companies with more than 500 shareholders are also required to be registered with the CMB.
6. For example, Demirag and Serter (2003) analysed the 100 largest Turkish traded companies (ISE 100) and showed that "the majority of these firms are ultimately owned and controlled by families who organise a large number of companies under a pyramid ownership structure or through a complicated web of inter-corporate shareholdings". At the end of 2012, the largest listed companies groups are owned by family groups: Koç Holding (Koç family 69%), Sabancı Holding (Sabancı family and group companies 58%), and Doğan Holding (Doğan family and group companies 67%).
7. According to a CMB survey in 2004, 42% of public companies have share classes with the privilege of nominating board members, which is the most commonly used privilege (CMB, 2005). For example, Koç Holding issues two groups of shares (A-group 27% and B-group 73%). A-group shareholders have two voting rights for each share owned (except for resolutions to change the articles of association).
8. In April 2006 the CMB abolished minimum free float requirements and granted the issuers the opportunity to determine the number of shares to be sold. Unlike the previous framework requiring at least 5%, 15% or 25% free float depending on the size of the issuer's share capital, this Communiqué provides issuers the flexibility to determine the number of shares to be sold and thus the free float rate. However, due to ISE listing requirements, this freedom is applicable only for certain issuers (i.e. issuers listed on the ISE National Market with a market capitalisation of publicly offered shares exceeding TL45 million and issuers listed on the ISE National Second Tier Market or New Economy Market).
9. According to the ISE Trends Report by TUYID and MKK (2013), foreign investors with US residence hold 33% of the foreign investment at the ISE, followed by UK investors holding 18% at the end of 2012.

10. In June 2012, Turkey's parliament passed a draft law allowing the government to give 25% of contributions to private pension plans. The government's contributions will be withdrawn if a client cancels membership within three years. The law also exempts 15% of taxes on financial gains from all pension contributors (Meric, 2012).
11. The CMB may place additional conditions for the authorisation of audit firms (Article 62 of the new CML).
12. According to Article 19 of the previous CML, one-third of the members other than the Chairman shall be elected every two years.
13. The previous CML had also stipulated qualification requirements such as: *i)* a bachelor's degree in law, economy, finance, etc.; and *ii)* 12 years experience in the area of financial markets, economy, finance, etc.
14. The replacement of the CMB Board, in the context of the CML revision, raised some questions in the financial press, as several members of the CMB Board (including the Chair) had not yet served out their full term.
15. In case the income from this fund is insufficient to meet the expenditures, the deficit should be financed by the budget of the Treasury, although no deficit has been reported since 1992. This ratio may be reduced by Council of Ministers if deemed appropriate.
16. Pursuant to Statutory Decree (November 2011 and December 2012), professional staff who join the CMB after January 2012 are subject to salary limitations not exceeding those of the Prime Ministry staff.
17. The CMB conducted a survey on the compliance with the CMB Principles for all listed companies in 2004 (CMB, 2005) and for ISE-100 companies in 2007 (CMB, 2007). Since 2007, the CMB has not published any survey reports on corporate governance compliance.
18. See supra Note 4.
19. Investors have the right to sell out shares in case the free float falls below 5%. In practice, the free float ratio increases through the sales by shareholders following the IPO.
20. The CMB adopted a number of rules designed to strengthen the rights fo minority shareholders (e.g. CMB Communiqué IV-56 in Box 3.1).
21. On 7 September 2012, the CMB imposed an administrative pecuniary fine (TL 18 492) on a listed company (Kardemir) for breach of the disclosure requirement regarding non-compliance with the CMB Principles.
22. For example, the CMB may request the cancellation of the board decisions regarding the increase of share capital adopted within the scope of the registered capital system (CML Article 46).
23. There are some instances in which the CMB gave a negative opinion on independent member candidates. In the case of Koç Holding A.Ş., the CMB concluded that the candidates proposed by the company failed to satisfy all the qualifications. In the case of Turkcell, CMB did not evaluate individual candidates, as the list of the candidates had failed to gain the board of directors (see Box 3.2).
24. According to Article 17 of the new CML, the procedures and the principles regarding (…) the independent memberships of board of directors shall be determined by the CMB.
25. One observer noted, "If they are independent, they won't be nominated".
26. The Turkish Accounting Standards Board (TMSK) adopted IFRS in 2005. Pursuant to CMB Communiqué XI-29, public companies shall apply IAS and IFRS, and shall indicate in the footnotes that the financial statements were prepared according to IAS/IFRS as they are endorsed by the European Union (Article 5). Turkey adopted IAS 24 to define RPTs and related parties for the purposes of financial reporting. In addition to IAS 24, the adoption of IFRS also involves a number of other highly relevant standards. In particular, IAS 27, IAS 28 and IAS 31 require both a list and a description of significant investments in subsidiaries, associates and entities under joint control.
27. This report is required to be prepared by the valuation companies accepted by CMB.
28. CMB Communiqué IV-41. In the amendment of July 2011, the threshold of RPTs requiring an independent fairness report was decreased from 10% to 5% (of total assets or total revenues). Furthermore, listed companies are no longer required to obtain an independent fairness report for RPTs of a continuous and prevalent nature.
29. The following information shall be disclosed: the nature of the transaction and relation of parties; the summary of the independent fairness report; and (if the actual transaction price does not coincide with the report's result) the reasoning of the difference by the management. The

independent fairness reports shall be available for shareholder examination 15 days before the annual meeting.

30. The selection of the companies for detailed review can occasionally be based on special risk factors (e.g. becoming a publicly held company through a recent IPO).

31. The Public Disclosure Platform (*www.kap.gov.tr*) is an electronic disclosure system using Internet and electronic signature technologies. Starting from June 2009, all notifications of listed companies shall be announced on this platform. The system is operated and managed by the ISE. The information regarding an independent fairness report (ibid.) shall be disclosed on this platform.

32. Article 15/6 of the previous CML. In the new CML, Article 21(1) forbids publicly-held companies to transfer income to related parties by decreasing their profits or their assets, or by preventing the increase of their profits or their assets via performing transactions such as contracts or commercial practices containing different prices, fees, amounts or conditions or producing a trading volume in violation of the conformity with market practices and comparability to similar transactions, prudence and honesty principles of commercial life.

33. Article 155 of the Turkish Criminal Code.

34. Article 208 of the New TCC provides for granting the squeeze-out right to the shareholder who controls, directly or indirectly, at least 90% of the share capital and having at least 90% of the voting rights (i.e., the parent company) in a joint stock corporation.

35. The CMB may appoint its staff as observer at general shareholder meetings: *a)* at the company's request; *b)* at the shareholders' request; *c)* to determine whether CMB requirements are fulfilled; or *d)* to determine how a conflict of interest among the shareholders is handled.

36. In contrast to the case of domestic investors, the beneficial ownership of the foreign investors is not always disclosed.

37. The shares of the ISE will be owned by the Treasury (51%) and the ISE (49%), and a part of the latter shall be transferred to other parties (e.g. the Association of Capital Markets). After three years, the remaining shares in the ISE shall devolve to the Treasury. A public offering of the ISE's shares can be made upon the determination by the Council of Ministers (Article 139 of the new CML).

38. See e.g. Caglio and Pescatori (2013).

39. One of the priorities listed in the "Strategy and Action Plan for Istanbul International Financial Center" addresses an improvement of the judicial system to ensure expeditious and effective resolution of disputes (Priority No. 1). As a part of this measure, it is stated that "one of the existing courts shall be mandated to become the specialised court because such action would be easier and more economic than establishing a new, separate specialized court".

40. The new TCC defines six categories of civil liability: *i)* liability arising from non-compliance of documents and declarations; *ii)* false declarations regarding capital and knowledge as to insolvency; *iii)* liability originating from valuation; *iv)* liability originating from collection of money from the public; *v)* failure to fulfil obligations originating in the law articles of a company; *vi)* liability arising from breach of confidentiality.

41. Companies included in the ISE Corporate Governance Index are entitled to a 50% discount in annual listing fees for the first two years, a 25% discount for the following two years, and a 10% discount thereafter.

42. A rating between 1 and 10 shall be determined based on the compliance assessment with all CMB Principles as a whole. This is determined by calculating the weighted average of the ratings of four sections of the Principles: Shareholders (25%); Public disclosure and transparency (35%); Stakeholders (15%); and Board of directors (25%).

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Chapter 4

The United States: The corporate governance framework and practices relating to supervision and enforcement

This chapter, part of the fifth peer review based on the OECD Principles of Corporate Governance, summarises public and private supervision and enforcement practices in the United States, in particular in the areas of related party transactions (RPTs), takeover bids and shareholder meetings. The chapter, prepared largely by Laurence Hamermesh, Professor, Widener University School of Law, acting as a consultant to the OECD, highlights the key characteristics, strengths and limitations of the US framework for corporate governance-related enforcement, including a strong reliance on private supervision through shareholder lawsuits. It also examines the interaction of private supervision and enforcement with public enforcement, of governance rules applicable to related-party transactions (RPTs) and takeovers.

4.1. Introduction

This report is part of a more comprehensive review of supervision and enforcement of corporate governance rules in various jurisdictions. Focusing in particular on the United States, this report examines private supervision and enforcement, in interaction with public enforcement, of governance rules applicable to related-party transactions (RPTs) and takeovers.

For purposes of this report, RPTs are defined as transactions between *i)* the issuer or one or more of its unrelated shareholders and *ii)* a related party (that is, a person exercising substantial control over the conduct of the issuer's business, by reason of share ownership or status as a director or executive officer of the issuer). Consistent with the approach taken in the OECD's 2012 report on the subject, however, this report does not address executive compensation (remuneration). This report also addresses only operating businesses, and excludes coverage of investment companies, which in the United States are subject to specialised regulation of governance and RPTs.[1]

In general, governance rules (as distinguished from disclosure requirements) relating to RPTs and takeovers in the US are enforced through private litigation. That private enforcement system relies on an active complement of plaintiffs' class and derivative suit attorneys and the availability of substantial fee awards for successful litigation. That system offers a robust level of protection for investors from misappropriation of shareholder value due to RPTs, and is also effective in addressing a limited range of fiduciary conduct in connection with corporate takeovers not involving RPTs. The efficacy of that enforcement system, however, which is largely based upon the law of individual states rather than national (federal) law, depends significantly on the continuation of strong disclosure requirements in relation to RPTs and takeovers, requirements that are prescribed by the federal government and enforced by both the Securities and Exchange Commission (SEC) and private litigation. To the extent that recent securities legislation eliminates those disclosure requirements across a significant group of issuers with widely traded equity securities, the efficacy of the private enforcement system could therefore be impaired. Likewise, recent litigation trends toward parallel litigation in multiple forums and toward favouring privately imposed arbitration requirements might also affect the efficacy of the current private enforcement system.

4.2. The market context and the governing legal structure

Market context

In the United States, investment in publicly traded enterprises tends to be widely dispersed; public equity investors most commonly invest in firms with no controlling or dominant shareholder or shareholders. For such broadly owned enterprises, the listing requirements of national securities exchanges require that the governing body – the board of directors – have a majority of directors who are independent of management.[2] As a result, significant RPTs typically involve approval by a board consisting of a disinterested,

independent majority of directors, and are thus not implemented unilaterally by the controlling shareholder and its nominees on the board of directors. Perhaps for this reason, problems for public investors arising from RPTs tend to be concentrated in the United States in the minority of publicly traded enterprises that have a controlling shareholder, as was the case with the *Southern Peru* litigation described in the section on state law/fiduciary duty of loyalty.

Federal/State/SRO allocation of authority

In the United States, the regulation of RPTs and corporate takeovers in the interest of investor protection is a responsibility shared by multiple layers of governmental and self-regulatory organisations. As discussed below, the primary role of the central/federal government in the US arises under the federal securities laws.[3] Those laws establish a system of continual information reporting for issuers whose equity securities are either traded on a national securities exchange or held by a specified minimum number of shareholders identified as such on the issuer's stock records.[4] Other aspects of the federal securities laws require issuers offering securities to the public to disclose to potential investors information regarding RPTs during specified periods leading up to the offering.[5]

Complementing that federal disclosure-oriented regulatory system are the laws of the individual states (notably Delaware[6]) that define the powers and duties of corporate directors and the rights of stockholders to seek judicial relief for violations of those duties.[7] As discussed below, those duties – particularly the judicially defined fiduciary duty of loyalty – significantly constrain the ability to engage in RPTs, and private litigation is the primary tool by which shareholders are able to enforce these obligations.

The US system of regulation of RPTs and takeovers also includes rules established by securities exchanges that require shareholder approval for certain actions, including issuance of common stock to a director, officer or substantial security holder, and issuance of stock that would either result in a change of control of the issuer or the issuance of stock having voting power in excess of 20% of the voting power of the shares previously issued and outstanding.[8] Because the ultimate enforcement sanction for violating these rules is delisting from the exchange, however, rather than fines or penalties or damages in civil litigation,[9] this report does not address these rules any further.

Roles of public and private enforcement

Because of the allocation of regulatory responsibility described above, understanding the roles of public and private enforcement in regard to RPTs and takeovers requires examination of multiple regulatory schemes. The federal (primarily disclosure-oriented) regulatory scheme is enforced both publicly and privately. The Securities and Exchange Commission ("SEC") is the agency charged with enforcing the federal securities laws, and federal legislation confers upon it a variety of enforcement powers (to impose administrative fines and penalties, initiate litigation seeking injunctive relief, bar individuals from serving as officers or directors of public companies, and to enter cease and desist orders[10]).

Despite its extensive enforcement powers, the SEC views private enforcement mechanisms as an important supplement in achieving compliance with the federal securities laws. A current Commissioner of the SEC has expressed the belief that "both the public and private aspects of securities enforcement are critical, that they complement each other, and that they are interrelated" (Walter, 2011).[11] It thus appears to be commonly

accepted that over the long term, public and private enforcement measures complement one another. Those mechanisms include the private class action, as discussed in the secton on private class actions. In addition to those private enforcement mechanisms, the SEC is now empowered, by the Dodd-Frank Act of 2010, to grant monetary awards to persons (identified as "whistleblowers") who provide information to the SEC leading to recoveries of USD 1 million or more in public enforcement proceedings.[12]

Enforcement of the fiduciary duties imposed by state law, in contrast, is almost exclusively a matter for private litigation. The laws of judicial process in the state and federal courts in the US provide two important and distinct mechanisms for private litigation to enforce fiduciary duties: class actions, brought on behalf of a large number of similarly situated investors (such as minority stockholders affected or potentially affected by a merger with a controlling person in which their shares are converted into the right to receive cash); and derivative suits, brought by a stockholder to pursue the corporation's claim for relief on account of harm to the corporation itself (arising from, for example, misappropriation of corporate assets by a related party).[13] In both forms of litigation, the primary and critical incentive to pursue the litigation is the prospect that the court will award counsel for the plaintiff stockholder(s) a fee based on any monetary recovery or other benefit obtained through a judgment or settlement in the litigation.[14] The standard justification for such an award is that the person who creates a benefit (plaintiff's attorney) for others (members of the stockholder class, or the corporation and, indirectly, its stockholders) is equitably entitled to a share of that benefit.[15]

4.3. Enforcement relating to related party transactions

Disclosure requirements

Federal law (public companies)

The federal securities laws include a variety of requirements designed to assure that investors in publicly traded companies have access to material information concerning RPTs.[16] As previously noted, the '34 Act requires registered companies to disclose, on at least an annual basis, the material information concerning any transaction by the issuer involving over USD 120 000 with any director, executive officer, or holder of over 5% of any class of the issuer's securities.[17] If the issuer seeks a vote of stockholders to approve an RPT, the issuer's proxy statement submitted to stockholders must describe "any substantial interest, direct or indirect," in the matter to be voted on.[18] Finally, when affiliates of an issuer (including controlling stockholders) purchase the issuer's shares or engage in a transaction (such as a going-private merger) so as to result in deregistration under the '34 Act (and resulting termination of periodic reporting requirements) or delisting from a securities exchange, SEC Exchange Act Rule 13e-3 requires that the issuer disseminate to investors extensive information about the transaction, including its purpose, alternatives considered, whether the transaction is believed to be fair or unfair to unaffiliated stockholders, and the factors relied upon in forming that belief.[19]

The SEC is the primary enforcer of these federal disclosure requirements, and it accomplishes this by a variety of techniques. The SEC's Division of Corporation Finance:

> [S]electively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with the applicable disclosure and accounting requirements. In its filing reviews, the Division concentrates its resources on critical disclosures that appear to conflict with

Commission rules or the applicable accounting standards and on disclosure that appears to be materially deficient in explanation or clarity (SEC, 2012).

Where an issuer consistently fails to prepare and file the disclosure documents required under the '34 Act, the SEC is empowered to – and regularly does – revoke the registration (and hence trading privileges) of the issuer's equity securities (e.g. SEC, 2013). The SEC's enforcement powers also include imposition of administrative fines and penalties, seeking injunctive relief, and reference to the Department of Justice for criminal prosecution, and those powers may be exercised with respect to materially inadequate disclosures, as well as outright failures to make required filings.[20]

The SEC's enforcement powers are supplemented by the ability of investors to bring civil class actions to recover damages due to materially false or misleading disclosures in connection with RPTs. In most cases, the efficacy of these private class actions is limited by the requirement that the investor sufficiently allege and prove that the issuer and one or more of its senior officers acted with fraudulent intent, as opposed to ordinary negligence, in making the materially false or misleading statement(s) about the RPT.[21]

State law/fiduciary disclosure duties

Under state common law, directors, officers and controlling shareholders have long been held to have a duty to disclose to shareholders all material information concerning RPTs for which shareholder approval or response (by tendering shares or voting to ratify, for example) is requested.[22] Investors' claims that this duty of disclosure has been violated are commonly brought as class actions in state (often Delaware) courts, seeking to enjoin the RPT until curative disclosure is made, or seeking monetary damages, or both.[23] Indeed, one of the landmark opinions in this area sustained a claim for damages on behalf of a class of minority shareholders whose shares had been purchased in a tender offer by a controlling shareholder based on material omissions in the offering documents.[24] State law claims of breach of fiduciary disclosure duty in connection with RPTs, unlike parallel claims under the federal securities laws, do not require pleading or proof of fraudulent intent on the part of the directors, officers or controlling shareholder.[25]

Substantive requirements

The discussion up to this point has addressed obligations of disclosure relating to RPTs. Those disclosure obligations, and their enforcement, are critical to the regulation of RPTs, in at least two respects: first, they result in the provision of information necessary to the success of efforts to enforce substantive limitations on RPTs; and second, the obligation to disclose the existence and substance of RPTs may itself constrain the ability and motivation of related persons to take unfair advantage of the corporation and its public shareholders through RPTs.

State law/fiduciary duty of loyalty

In the United States, state corporate law supplies the primary legal constraint on RPTs, through enforcement of the fiduciary duty of loyalty. RPTs necessarily implicate that duty, because they inherently involve the possibility that the terms of a transaction between a director, executive officer or controlling shareholder, on one hand, and the issuer or minority or public shareholders, on the other hand, will be influenced in a manner adverse to the issuer or its minority or public shareholders due to the conflicting financial interest and influence of the related party. Thus, for instance, the duty of loyalty of a director,

officer or controlling shareholder is implicated when the corporation sells assets to or purchases assets from such a related party, issues shares to or acquires shares from such a party, and merges with an entity affiliated with such a party, where the shares held by minority or public shareholders are acquired for cash (a "squeeze-out merger").

The rules governing judicial review of RPTs in private litigation include presumptions and burdens of proof that significantly strengthen such litigation as an enforcement tool. Most notably, and as expounded primarily by the Delaware courts, in response to litigation the proponents of an RPT are required to carry the burden of proving the "entire fairness" of an RPT, in the absence of protective measures (discussed below) to validate the transaction. "Entire fairness", in turn, has been said to require inquiry into "two basic aspects: fair dealing and fair price".[26] "Fair dealing" "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained".[27] "Fair price" "relates to the economic and financial considerations" of the transaction.[28]

If the proponents fail to establish the "entire fairness" of the RPT, the court may rescind the transaction or award monetary damages that would place the affected parties in a position as nearly equivalent to rescission as possible. In the absence of one or more mechanisms requiring evaluation, negotiation and approval by disinterested, independent directors or minority or public shareholders, the related party bears the burden of proving the entire fairness of the RPT.[29] And if the related party in an RPT is a controlling shareholder, the court must still engage in a substantive evaluation of the fairness of the RPT, even if such approval is obtained, rather than extend essentially conclusive deference (under the so-called "business judgment rule") to the transaction.[30]

In RPTs with a related party other than a controlling shareholder, proponents of the RPT can implement certain protective measures to avoid the burden of proving entire fairness. Thus, by conditioning completion of the transaction on approval by informed, disinterested and independent directors or minority or public shareholders, the proponents of the transaction may be able to establish that it is as fair to the corporation "as though each of the contending parties had in fact exerted its bargaining power at arm's length".[31]

For that reason, related parties commonly structure the RPT based on evaluation by and negotiation with a special committee of disinterested directors who are sufficiently independent of the related party. Approval of the RPT by such directors in such a process will restore application of the deferential "business judgment rule" standard of judicial review, but only if the proponents of the RPT demonstrate that the special committee was *i)* comprised of truly disinterested directors who are independent of the related party, and *ii)* fully informed by the related party of all facts material to their evaluation and negotiation of the transaction.[32] Alternatively, or in addition to approval by a special committee of independent directors, proponents of an RPT may condition effectuation of the transaction on approval by the holders of a majority (or higher level) of the shares held by minority or public shareholders. As with special committee approval, this "majority of the minority" approval is effective to restore "business judgment rule" deference only if *i)* the shareholders are themselves disinterested and independent of the related party, and *ii)* they are fully advised of all facts material to their evaluation of the RPT.

Thus, the doctrinal content of state law governing RPTs encourages related parties to structure such transactions to include requirements of informed approval by disinterested,

independent directors or shareholders, or both, or risk judicial invalidation of the transaction. The following inset describes a notable recent example of private enforcement of the duty of loyalty in the context of an RPT involving a public company.

Cases like *Southern Peru* (Box 4.1) – where duty of loyalty claims are the subject of a full trial, court opinion, and appellate opinion – are rare, because in shareholder litigation (and civil litigation in general) cases that proceed beyond initial efforts to dismiss the case as legally insufficient on the face of the pleadings most frequently result in negotiated settlements. Although such settlements in shareholder representative litigation require judicial approval before consummation, they rarely involve precise judicial evaluation of the claims presented. Despite their rarity, however, cases like *Southern Peru* are important because they provide guidance to and influence the behaviour of related parties when they consider and structure RPTs.

Box 4.1. **USA – The Southern Peru litigation**

In 2004, Grupo Mexico, S.A.B. de C.V., the controlling shareholder of Southern Peru Copper Corp., proposed that Southern Peru issue shares of its stock in exchange for Grupo Mexico's 99.15% interest in Minera Mexico, S.A. de C.V. A Southern Peru shareholder brought a derivative suit challenging the transaction. In 2011, finding that the Southern Peru shares issued in the deal had a value of USD 1.263 billion in excess of the value of the interest in Minera Mexico acquired by Southern Peru, the Court of Chancery entered judgment against Grupo Mexico in that amount, plus interest, payable via return of Southern Peru shares. Despite the fact that a special committee of independent directors (a minority of the board) approved the transaction, the Court placed upon the defendants the burden to establish the entire fairness of the transaction. That imposition resulted in part from the limited role of the committee (evaluating a proposal, rather than negotiating or seeking alternatives) and its strained efforts to adopt a valuation approach that would permit it to approve the deal, rather than rejecting the proposal. The Court awarded attorney's fees of over USD 300 million, payable out of the award returning shares to Southern Peru.

Procedural rules governing private enforcement (including fee awards)

Private class actions

The substantive fiduciary obligations described in the section on state law/fiduciary duty of loyalty are frequently invoked by stockholders asserting that directors or controlling shareholders have established terms of a merger or other transaction by which the publicly held shares are converted into cash or other shares on a basis that benefits the controlling shareholder or other related party to the detriment of the public shareholders. The primary mechanism by which to assert those claims of breach of fiduciary duty is the class action.[33] The class action is privately initiated, by one or more public or minority shareholders, seeking recovery of damages or other judicial relief not only on their own behalf but on behalf of the class of similarly situated shareholders. This private litigation mechanism is critical to enforcement of fiduciary duties of directors and controlling shareholders, because in an environment in which publicly traded shares are widely dispersed, and in which the costs of litigation are substantial, it is not economically viable for any one or even a few individual shareholders to bring the necessary litigation; the potential recovery for those few individuals would typically not nearly cover the cost of the

proceedings. Where the claims may be pursued in a class action on behalf of a large number of similarly situated shareholders, however, meritorious litigation becomes economically viable: an attorney representing the shareholder plaintiffs in such a class action can be induced to make the necessary investment of time and out of pocket expenses (for expert witnesses, for example) by the potential for recovering significant fees (and reasonable expenses as well) if a recovery is obtained for the class through either judicial award or settlement. The United States has an active and extensive set of plaintiffs' attorneys who are capable of and interested in pursuing private class actions in which there is a realistic prospect of success, and indeed, such plaintiffs often compete with one another for the right to engage in an active role in such litigation (Strine et al., 2013). The viability of such representative litigation is also enhanced by the prevailing rule that defendants in such litigation may not recover their own fees and expenses from the stockholder plaintiff except in cases of extreme misconduct and bad faith in bringing class and derivative litigation.[34]

Derivative actions. Where an RPT (such as a corporation's purchase of an asset from a related party at an improperly inflated price) results in harm to the corporation itself, rather than to stockholders through conversion of their shares in a merger or similar transaction, prevailing law in the United States deems that the claim of breach of fiduciary belongs to and must be brought by or in the name of the corporation.[35] When such proceedings are brought by shareholders derivatively – that is, on behalf and in the right of the corporation – they are described briefly as "derivative actions". And like class actions, derivative actions are critical to the enforcement of fiduciary duties in relation to RPTs: the same potential for recovery of attorney's fees and expenses out of the proceeds of a judgment or settlement in favor of the corporation (and against a related party) provides the incentive for private plaintiffs' counsel to initiate and prosecute the proceeding. As with class actions, there is an active and extensive set of plaintiffs' lawyers who are capable of and interested in pursuing derivative actions in which there is a realistic prospect of success.

Where the alleged harm to the corporation arises from a transaction approved by a disinterested and independent board of directors, however, applicable rules ordinarily preclude a shareholder from pursuing a claim of breach of fiduciary duty, on the theory that the corporation's claim is an asset of the corporation that should ordinarily be managed by or under the supervision of the board of directors.[36] Where the transaction is an RPT, and is not approved by disinterested directors constituting a majority of the board of directors, those rules are relaxed to permit shareholders to proceed on the corporation's behalf, on the theory that the board of directors cannot appropriately determine whether to pursue the corporation's claim.[37]

4.4. Enforcement relating to takeovers

Disclosure duties

Corporate takeovers (i.e., changes in corporate control effected through acquisition of stock) are effected in the US primarily through either tender offers for a company's stock, or a merger with the target company, or a combination of both mechanisms. In addition to the state law fiduciary disclosure duty described in the section on State law/fiduciary disclosure duties above, federal law prescribes significant disclosure requirements in connection with both tender offers and mergers. Because of this paper's focus on

enforcement of governance rules, however, the following description of those disclosure requirements is limited to the requirements applicable to target companies and their managements.

Within ten business days after commencement of a tender offer for a company's shares, the target company is required under federal securities laws to publish a statement disclosing whether it recommends acceptance or rejection of the offer,[38] and that statement must be accompanied by the filing with the SEC of a schedule including the reasons for the target's recommendation, conflicts of interest involving the directors and officers and the tender offeror, and transactions entered into by the target company in response to the tender offer.[39] Where a corporate takeover is accomplished by means of a merger, the shareholders of the target company are required under state law to vote to approve the transaction.[40] As a result, federal rules governing the solicitation of proxy voting authority prescribe extensive disclosures about the transaction to shareholders in connection with that vote.[41]

As with the periodic disclosure requirements reviewed in the section on federal law (public companies), supervision and enforcement of federal disclosure requirements in regard to mergers and acquisitions are conducted both by private litigants, who typically are permitted to seek injunctive relief to enforce the requirements, and by administrative regulatory authorities (the SEC's Division of Corporation Finance reviews compliance with the rules governing mergers and acquisitions and other disclosure requirements).

State law/fiduciary duty limitations on takeover defenses

Where directors of a target company actively pursue the sale of the company, the state law doctrines of fiduciary duty described in the section on state law/fiduciary duty limitations on company sales govern the directors' handling of the sale process. The target directors have considerable authority under applicable state law, however, to decline to accept a takeover bid and recommend that stockholders reject it;[42] and they also have authority to take unilateral actions that interpose obstacles to the consummation of an unsolicited tender offer to stockholders.[43] The directors' authority in this regard, however, is not limitless, and has been the subject of substantial attention in private litigation, primarily in Delaware, challenging the use of that authority.

Takeover defenses generally

As developed by the Delaware courts, the framework for judicial review of anti-takeover measures adopted by directors is highly contextual: in general, the judicial inquiry into the validity of such measures examines whether the measure is "coercive" to stockholders or "preclusive" in rendering the success of takeover bids essentially unattainable; if not, the courts examine whether the measure falls within a "range of reasonableness", and approval by a disinterested, independent majority of the board of directors promotes a finding of such reasonableness.[44]

As a practical matter, the most important antitakeover device used in the US is the so-called poison pill, or shareholder rights plan. The validity and efficacy of the poison pill, however, at least as a matter of Delaware law, depends on the possibility that stockholders can elect a new board of directors with authority to eliminate the poison pill if they determine that a takeover bid should go forward.[45] That principle of ultimate stockholder control of the poison pill through the electoral process was established in private litigation initiated by both the bidder and by a stockholder plaintiff in a class action.[46]

Electoral manipulation

Because of the importance of shareholder electoral rights, including in the context just described in the section on takeover defenses generally, it is important to examine the extent to and manner in which those rights are enforced. As in the other contexts reviewed above, such enforcement in the US is based on state law doctrines of fiduciary duty, applied in the setting of private litigation by shareholders. That law does not invalidate all actions by the board of directors that indirectly or even directly make it marginally more difficult for shareholders to remove incumbent directors and elect a competing slate of candidates. But within the limitations of the US system of proxy solicitation – ordinarily, shareholders seeking to nominate and elect a competing slate of directors must expend substantial resources to campaign against incumbent candidates whose campaign is funded by the corporation itself – state fiduciary duties prohibit directors from taking actions that substantially impair the ability of stockholders to mount a successful campaign to replace incumbent directors.[47] Such actions are not accorded the same judicial deference accorded to ordinary or even extraordinary decisions involving business judgment; rather, even where directors believe in good faith that electing a competing slate would be contrary to the interests of the corporation and its shareholders, their fiduciary duties prohibit them from manipulating the electoral process to prevent such an election, unless they can establish at a minimum a compelling justification for such manipulation.[48]

State law/fiduciary duty limitations on company sales

As discussed above in the section on state law/fiduciary duty of loyalty, transactions in which a related party acquires the corporation's publicly held shares (typically by means of a merger or tender offer) are governed by fairly stringent doctrines associated with the fiduciary duty of loyalty. In the absence of the conflicts of interest associated with RPTs, however, fiduciary duty doctrine prescribes much greater judicial deference (through a formulation often described as the "business judgment rule"[49]). The Delaware courts, however, have developed and applied an interim, somewhat more demanding level of judicial review in the case of takeovers, even by unrelated third parties. This doctrinal approach emerged in 1986 in the Delaware Supreme Court's influential *Revlon* opinion and has been refined extensively in subsequent case law.[50]

The *Revlon* doctrine has been applied primarily to limit the ability of the board of directors to enter into agreements with a friendly bidder that have the effect of unduly deterring competing bids. Thus, for example, granting an option to a management-friendly bidder to acquire major lines of business at severely discounted prices could effectively deter any other bidder from presenting a superior bid, and would thereby deprive stockholders of the ability to reject the management-sponsored bid with the view to receiving a higher competing bid. On the other hand, bidders' willingness to bid may be enhanced by the availability of termination fees or similar rewards that compensate for the fact that the target's shareholders must approve the deal and that the target may retain the flexibility to entertain superior bids, while the bidder remains contractually and financially committed. Delaware courts have resolved this tension by validating common bidding deterrents (such as termination fees of 3% of deal value or less, and agreements ("no-shop" clauses) to refrain from actively soliciting competing bids), while invalidating more intrusive deterrents such as the "lockup" options described earlier.[51]

Courts applying fiduciary duties of directors in relation to the conduct of management in structuring corporate takeovers have also actively questioned the role of participants in

the sale process who suffer from motivations that compete with the interests of investors in securing the highest price in the sale of the company. In some instances, for example, the courts have questioned the role of financial advisors who, while assisting the board of directors in evaluating a bid, have an undisclosed interest in financing the bid.[52] Similarly, the courts have questioned the role of senior executive officers who, while purporting to negotiate the sale in the interests of investors, engage in undisclosed discussions with the bidder concerning the possibility of the officer's acquiring a significant division of the company following its sale.[53] In both situations, the courts have ordered that the company sales not go forward without full disclosure of the potentially competing motivations of the deal participants.

Class action procedures for private enforcement

Like the fiduciary obligations applicable to RPTs, the fiduciary obligations associated with the directors' handling of corporate takeovers are typically enforced by shareholders through the class action mechanism discussed in the section on private class actions. In addition, and as in Revlon itself, competing bidders frequently initiate and prosecute fiduciary duty litigation individually rather than on behalf of a class. Although they typically litigate their cases concurrently with shareholders, their financial motivation for litigating is the success of their bid rather than the potential for an award of attorney's fees.

4.5. Longer-term trends regarding private enforcement

In general, the private enforcement system in the United States, with its active complement of plaintiffs' class and derivative suit attorneys and the availability of substantial fee awards for successful litigation, offers a robust level of protection for investors from misappropriation of shareholder value due to RPTs. That system is also effective in addressing a limited range of fiduciary misconduct in connection with corporate takeovers not involving RPTs. The three recent developments described below, however, merit attention because of their potential to diminish the efficacy of the existing private enforcement system.

Multi-forum litigation

Recent studies have observed that within the last decade, class action litigation is now filed with respect to nearly every merger and acquisition of a public company; in nearly half of these cases, class actions targeting the same transaction were filed in multiple US jurisdictions; and only about 5% of these situations resulted in any additional payment to investors (yet 84% of them resulted in payments of attorneys' fees to plaintiffs' counsel, principally attributable to additional disclosures (as opposed to enhanced payments to investors) made by the corporation).[54] These statistics have engendered concern that existing private enforcement mechanisms may, in the context of representative shareholder litigation, be disserving investors and enriching plaintiffs' counsel and, in some instances, enabling the termination of legitimate claims of breach of fiduciary duty. In a number of ways, the existence and continuation of the practice of filing of lawsuits nearly simultaneously in multiple jurisdictions may be contributing to those effects.[55]

A variety of approaches to address the problem of multi-forum litigation has been proposed and to some extent tried. Under one approach, defendants ask the various courts involved to consider and, if necessary, confer with one another to reach consensus on which court should handle all litigation relating to a particular transaction. Another

approach advocates that the courts in the jurisdiction that supplies the governing law (most commonly Delaware) should ordinarily be the center of litigation involving claims arising under that jurisdiction's corporation law. Finally, another approach would rely on private ordering, by advocating the adoption of provisions in the corporation's governing documents (the articles or certificate of incorporation, or the bylaws) requiring that litigation involving the internal affairs of the corporation (notably, cases invoking the fiduciary duties of directors) proceed in the courts of the state of incorporation.[56]

Each of these three approaches has potential shortcomings. The first approach (judicial conference and consensus) presupposes that judges in multiple forums will inevitably agree on which forum should proceed with litigation, but that presupposition may not always be correct. The second approach may be somewhat more promising, because a revised and more generally accepted doctrinal structure may provide an inducement or protection that would enable judges to implement a consensus approach to the choice of forum.[57] The third approach is also promising, but only to the extent that courts and other legal institutions outside the jurisdiction of incorporation are willing to enforce a forum choice reflected in the corporation's governing documents. Not all jurisdictions are clearly willing to do so,[58] however, and litigation has contested the validity and enforceability of a forum selection provision in a corporation's bylaws (Pileggi, 2012).

Arbitration provisions affecting private enforcement

Private enforcement in the US of the fiduciary duties of directors and controlling shareholders has been centered in state (and to a lesser extent federal) courts. Recent decisions of the United States Supreme Court, however, have strongly favored private agreements to submit disputes and claims for relief to arbitration in lieu of court proceedings, and have invalidated state legislation prohibiting arbitration agreements that exclude the possibility of pursuing claims on behalf of a class of similarly situated claimants.[59] To this point there has been little effort to include provisions in governing corporate documents that would require arbitration of shareholder claims of breach of fiduciary duty. The SEC appears to take the position that the effectiveness of a registration statement for a public offering should not be accelerated where the issuer's governing documents purport to require arbitration, rather than litigation, of investor claims (Roos, 2012). It is unclear, moreover, whether a corporate charter or bylaw provision requiring arbitration of claims of breach of fiduciary duty in relation to RPTs would be enforceable against a shareholder who did not specifically consent to such a requirement. Nor is it clear, on the other hand, that even if such a requirement were deemed valid the investor's recourse in arbitration would be less effective than in a court proceeding. It is possible, however, that issuers may in the future seek by private ordering to channel investor claims (including those relating to RPTs) into arbitration rather than court proceedings, and that such a change of forum could adversely affect the efficacy of private enforcement of such claims.

The JOBS Act of 2012

As explained earlier, the viability of the private enforcement system in constraining behaviour adversely affecting investors in connection with RPTs depends significantly on public disclosure of information concerning those transactions. That flow of information, as also explained earlier, depends significantly on the application of federal disclosure requirements. To the extent, however, that recent legislation (the JOBS Act[60]) reduces the

scope of application of those requirements, the investor's ability to make effective use of state law remedies based on fiduciary duties may be reduced due to absence or insufficiency of information about RPTs. Experience under the new federal legislation is still limited, however, and it is difficult to predict at this point whether there will be an increase in the extent of public investment in and active trading of securities of issuers that are not (but before 2012 would have been) subject to the periodic public reporting requirements of the '34 Act.

4.6. Conclusions

In the United States, corporate governance rules relating to related-party transactions and takeovers are primarily enforced through private litigation, typically alleging violation of fiduciary duties under state law. The private enforcement system in the US is supported by a high degree of legal certainty, an active complement of plaintiffs' class and derivative suit attorneys, and the availability of substantial fee awards for successful litigation.

The efficacy of this enforcement system depends significantly on strong disclosure requirements in relation to related-party transactions and takeovers, requirements that in the US are prescribed by the federal government and enforced by both the Securities and Exchange Commission (SEC) and private litigation. Recent private enforcement actions involving going-private transactions often resulted in additional disclosures.

Private and public enforcement have shown themselves as largely complementary in the US, not only with regard to disclosure. Whereas the SEC is the primary enforcer of US federal securities laws, private parties sometimes initiate an action before the SEC brings its own enforcement action. At the same time, the significant influence of private enforcement remains rather unique to the US, as its strong "private enforcement infrastructure" is not easily transferable to other jurisdictions.

Notes

1. Specifically, this report excludes those entities governed by the Investment Company Act of 1940 (15 U.S.C. §§ 80a-1 et seq.) and the Investment Advisers Act of 1940 (15 U.S.C. §§ 80b-1 et seq.).
2. See NYSE (n.d.), ¶303A.01 and NASDAQ Stock Market (n.d.) Rule 5605(b)(1). Those standards exempt companies with a 50+% shareholder from compliance with the requirement of having a majority of independent directors. NYSE (n.d.), ¶303A.00 and NASDAQ Stock Market (n.d.) Rule 5615(c)(2).
3. The principal body of federal regulation relevant to RPTs and takeovers derives from the Securities Exchange Act of 1934, 15 U.S.C. §78a et seq. (the "'34 Act").
4. Section 12(g) of the '34 Act, and the rules adopted by the SEC to implement that statute, have long defined the number of record shareholders that triggers the periodic reporting requirements and other regulatory aspects of the '34 Act. That statute was amended in 2012, by the Jumpstart our Business Startups Act ("JOBS Act"), to increase the triggering threshold from i) 500 shareholders of record to ii) 2 000 shareholders of record or 500 non-accredited investors, as currently defined in SEC Rule 501(a).
5. The Securities Act of 1933, 15 U.S.C. §77a et seq. (the "'33 Act") governs the registration of public offerings of securities. Initial public offerings are generally governed by the disclosure requirements specified in Form S-1, which (in Item 11(n)) provides for disclosures of the information specified in Regulation S-K Item 404, 17 CFR §229.404. Those disclosures include information concerning transactions in the previous year with related persons involving over USD 120 000, and similar information regarding transactions with promoters during the previous five years.
6. Over half of issuers with equity securities registered under §12 of the '34 Act are incorporated under the law of the state of Delaware (Bullock, 2011).

7. In general, those powers, duties, and rights are defined by a body of statutory law, such as the Delaware General Corporation Law (8 Del. C. §101 et seq.) or other states' statutes patterned after the Model Business Corporation Act (MBCA) promulgated by the Corporate Laws Committee of the American Bar Association's Business Law Section. Those powers, rights, and duties are supplemented by rules of common law reflected in extensively developed bodies of judicial precedent.
8. See NYSE (n.d.), ¶312.03 and and NASDAQ Stock Market (n.d.) Rule 5635(a).
9. Courts have consistently rejected claims that violations of securities exchange rules create liability in private civil litigation. E.g., In re VeriFone Securities Litigation, 11 F.3d 865, 870 (9th Cir. 1993); Daniel Boone Area Sch. Dist. v. Lehman Bros., 187 F. Supp. 2d 400, 408 (W.D. Pa. 2002). Delisting of securities is not uncommon (see, e.g., NYSE & Euronext [n.d.], such suspensions and delistings appear overwhelmingly to be attributable to either bankruptcy or an insufficient level of share price or market capitalisation, and not to failure to comply with a corporate governance standard.
10. '34 Act §§ 21-21C.
11. This report further describes Commissioner Walter's stated views below in discussing longer-term trends relating to private enforcement of the federal securities laws.
12. Id. §922.
13. The rules governing class and derivative actions are described in somewhat greater detail in the section on procedural rules governing private enforcement (including fee awards).
14. Boeing Co. v. Van Gemert, 444 U.S. 472, 478 (1980) ("a litigant or a lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole."). The most striking, but very unusual, recent example of such an award is the USD 304 million fee granted by the Delaware Court of Chancery to plaintiff's counsel in litigation successfully challenging the corporation's purchase of a business from its controlling stockholder. Americas Mining Corp. v. Theriault, 51 A.3d 1213 (Del. 2012).
15. Id.
16. As noted above, discussion of these laws is limited to transactions other than executive compensation, a matter that is separately and extensively regulated in terms of required disclosure to investors.
17. Form 10-K, Item 13, requiring disclosure of the information specified in Item 404 of Regulation S-K, including: *a)* Transactions with related persons. Describe any transaction, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, in which the registrant was or is to be a participant and the amount involved exceeds USD 120 000, and in which any related person had or will have a direct or indirect material interest. Disclose the following information regarding the transaction: *i)* The name of the related person and the basis on which the person is a related person; *ii)* The related person's interest in the transaction with the registrant, including the related person's position(s) or relationship(s) with, or ownership in, a firm, corporation, or other entity that is a party to, or has an interest in, the transaction; *iii)* The approximate dollar value of the amount involved in the transaction; *iv)* The approximate dollar value of the amount of the related person's interest in the transaction, which shall be computed without regard to the amount of profit or loss; *v)* In the case of indebtedness, disclosure of the amount involved in the transaction shall include the largest aggregate amount of principal outstanding during the period for which disclosure is provided, the amount thereof outstanding as of the latest practicable date, the amount of principal paid during the periods for which disclosure is provided, the amount of interest paid during the period for which disclosure is provided, and the rate or amount of interest payable on the indebtedness; *vi)* Any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.
18. Schedule 14A, Item 5.
19. 17 CFR §240.13d-101, Schedule 13E-3, Items 7-8.
20. See, e.g., '34 Act Sections 21, 21B, and 21C, 15 U.S.C. §§78u, 78u-2, and 78u-3.
21. E.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007), citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 & n. 12 (1976) (applying '34 Act §21D(b)(2), requiring that a complaint seeking damages for securities fraud "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," which in such cases is "the defendant's intention to deceive, manipulate, or defraud").

22. Malone v. Brincat, 722 A.2d 5, 12 (Del. 1998) ("Directors are required to provide shareholders with all information that is material to the action being requested and to provide a balanced, truthful account of all matters disclosed in the communications with shareholders").
23. E.g., In re Atheros Communs., Inc. S'holder Litig., 2011 Del. Ch. LEXIS 36 (Del. Ch. 4 March 2011); and see generally Drexler et al. (2012).
24. Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981).
25. Compare In re John Q. Hammons Hotels Inc. S'holder Litig., 2009 Del. Ch. LEXIS 174, *50 n. 49 (Del. Ch. 2 October 2009), and In re Transkaryotic Therapies, Inc., 954 A.2d 346, 362-363 (Del. Ch. 2008), with Tellabs, see Note 108.
26. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).
27. Id.
28. Id.
29. Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110, 1115 (Del. 1994).
30. Id. at 1116.
31. Weinberger v. UOP, Inc., 457 A.2d at 709-710 n.7.
32. Krasner v. Moffett, 826 A.2d 277, 284-285 (Del. 2003) (in a suit challenging a merger structured by related companies, defendants were required to establish that the members of a special committee charged with negotiating the transaction acted "independently, with real bargaining power to negotiate the terms of the merger").
33. E.g., BVF Partners L.P. v. New Orleans Emples. Ret. Sys., _ A.3d _, 2012 Del. LEXIS 658, *24 (27 December 2012) (noting that it is "commonplace" for courts to permit litigation to proceed on behalf of a class of investors who hold shares as of the date on which a squeeze-out merger is approved).
34. Alaska Elec. Pension, Fund v. Brown, 988 A.2d 412, 417 (Del. 2010) ("Delaware generally follows the American Rule, under which litigants are responsible for their own attorneys' fees, regardless of the outcome of the lawsuit."); Kaung v. Cole Nat'l Corp., 884 A.2d 500, 506 (Del. 2005) ("One well-recognized exception to the American Rule is where the "losing party has 'acted in bad faith, vexatiously, [[wantonly, or for oppressive reasons.'"]]")
35. Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031 (Del. 2004).
36. See Kamen v. Kemper Fin. Servs., 500 U.S. 90, 101 (1991).
37. E.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004).
38. SEC Rule 14e-2(a), 17 CFR §240.14e-2(a).
39. SEC Rules 14d-9, 14d-101, 17 CFR §§240.14d-9, 240.14d-101, and Regulation M-A Items 1005(d), 1006(d), and 1012(b), 17 CFR§§229.1005(b), 1006(d), 1012(b).
40. E.g., Delaware General Corporation Law §251(c), 8 Del. C. §251(c).
41. SEC Regulation 14A, Item 14, 17 CFR §240.14a-101, Item 14.
42. TW Services, Inc. Shareholders Litig., 1989 Del. Ch. LEXIS 19, *37-*38 (Del. Ch. Mar. 2, 1989).
43. In re Unitrin Inc. Shareholders Litig., 651 A.2d 1361 (Del. 1995).
44. Id.
45. Quickturn Design Systems, Inc. v. Mentor Graphics Corp., 721 A.2d 1281 (Del. 1998).
46. Id.
47. MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).
48. The classic opinion establishing this application of fiduciary doctrine is Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988).
49. Gantler v. Stephens, 965 A.2d 695, 706 (Del. 2009).
50. Revlon, Inc. v. MacAndrews and Forbes, Inc., 507 A.2d 163 (Del. 1986). By judicial decision or statute, some jurisdictions in the United States have rejected the application of the enhanced level of scrutiny contemplated by Delaware's Revlon doctrine. E.g., Dynamics Corp. of America v. WHX Corp., 967 F. Supp. 59, 64-65 (S.D.N.Y. 1997) (denying preliminary injunction to competing bidder, holding that under New York law, there is no heightened scrutiny for an independent target board's

antitakeover actions); Minzer v. Keegan, CV-97-4077 (CPS), 1997 U.S. Dist. LEXIS 16445, *32 (E.D.N.Y. Sept. 22, 1997) (business judgment rule applies to merger decision absent "fraud, illegality or self-dealing" under New York law), aff'd, 218 F.3d 144 (2d Cir. 2000), cert. denied, 531 U.S. 1192 (2001); Ind. Code Ann. §23-1-35-1(f); Md. Code Corps & Assns §2-405.1(f);15 Pa. Cons. Stats. §171.

51. Paramount Communications v. QVC Network, 637 A.2d 34, 42 (Del. 1994); In re Answers Corp. S'holders Litig., 2011 Del. Ch. LEXIS 57, *19 n.52 (Del. Ch. 11 April 2011).

52. In re Del Monte Foods Co. S'holders Litig., 25 A.3d 813 (Del. Ch. 2011).

53. In re El Paso Corp. S'holder Litig., 41 A.3d 432 (Del. Ch. 2012).

54. Putting Stockholders First, Note 37 above.

55. Id. at 17-24.

56. Id. at 52 n.144.

57. Id. at 26.

58. See, e.g., Idaho Code § 29-110 ("[E]very stipulation or condition in a contract, by which any party is restricted from enforcing his rights under the contract by the usual proceedings in the ordinary tribunals. . . is void".); Galaviz v. Berg, 763 F. Supp. 2d 1170 (N.D. Cal. 2011). The Delaware Court of Chancery recently upheld the validity of bylaw provisions, adopted by boards of directors without shareholder approval, that purport to require that breach of fiduciary duty claims and other matters of internal corporate governance be litigated exclusively in the Delaware courts, Boilermakers Local 154 Retirement Fund v. Chevron Corp., Del. Ch. C.A. No. 7220-CS, and ICLub Inv. Partnership v. Fedex Corp., Del. Ch. C.A. No. 7238-CS. See also, e.g., Stephen Bainbridge (2012).

59. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011); Rent-A-Center, W., Inc. v. Jackson, 130 S. Ct. 2772 (2010); Stolt-Nielsen S. A. v. AnimalFeeds Int'l Corp., 130 S. Ct. 1758 (2010).

60. See Note 91.

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