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NOTE NUMBER 312
SEPTEMBER 2006
THE WORLD BANK GROUP FINANCIAL AND PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY

PUBLIC POLICY FOR THE
privatesector

Self-Dealing

Sneaking Corporate Value through the Back Door

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Self-dealing, prevalent in emerging markets, often harms minority shareholders. The related-party transaction is one common technique, especially in markets with weak law enforcement. Beyond self-dealing, other methods of expropriation, such as insider trading and dilution of share value, can also harm minorities. Countries can use several tactics to combat self-dealing, including improving disclosure, strengthening regulatory enforcement, and increasing public awareness of good governance and investor rights. While not always successful, these measures often go a long way toward protecting minority investors.

Successful entrepreneurs often expand their business with the help of outside investors. But even as outside investment grows, founders and families tend to keep a disproportionate share of control. This imbalance between ownership and control often creates opportunities for self-dealing—the practice of transferring money or assets from the company to a dominant corporate owner, manager, or director (World Bank Group 2006).

Some recent examples of self-dealing are notorious. Conrad Black, former chair and chief executive officer of publishing giant Hollinger International, was indicted in 2005 on charges of helping to skim US$51.8 million of the proceeds from the sale of the company newspapers. In the same year the U.S. Securities and Exchange Commission accused the controlling shareholder of Mexico's TV Azteca of engaging in an undisclosed debt transaction that netted him a US$109 million personal profit.

Evidence of self-dealing abounds around the world. In the Russian Federation management could divert funds so successfully that privatized assets sold at a 99 percent discount relative to Western counterparts in the late 1990s (Boyko, Shleifer, and Vishny 1998). In India firms that receive unexpectedly high earnings have been found to channel the extra cash disproportionately to the controlling family (Bertrand, Mehta, and Mullainathan 2002). Knowing that holding a controlling stake will lead to future opportunities for self-dealing, corporate owners are willing to pay a significant premium for a

controlling block of shares in a company (Dyck and Zingales 2004; Nenova 2003).

In the industrial world recent regulatory changes (such as Sarbanes-Oxley) testify to the concern about the problem. In developing countries smaller markets, weaker regulation, and the prevalence of firms with concentrated ownership mean that self-dealing is a far bigger issue. Yet some developing countries have adopted successful reforms to combat self-dealing, providing lessons in good practice. Countries adopting effective reforms will promote market integrity, attract more domestic and foreign investment, build better relationships with stakeholders, and help their economies grow. The World Bank Group, through its *Doing Business* report and Reports on the Observance of Standards and Codes, assesses corporate governance frameworks and helps guide policy reforms in private and financial sector development.

Because self-dealing is so prevalent in developing countries, it is important to know how and why it occurs. Just as important is to know how countries can try to prevent it.

The basics of self-dealing

Self-dealing occurs in many forms, from simple deals that favor owners and their friends to complex transactions hidden where the market isn't looking. The most common form is the related-party transaction—a transaction between insiders and the company they control. Examples include sales of goods or services to the company at inflated prices or purchases from it at excessively low prices, loans to or from the company on advantageous terms, and even an outright transfer of company assets to the controlling party. Under lax corporate and securities rules, these deals can be fully legal (Johnson and others 2000).

Good regulations require that related-party transactions be concluded at market prices and approved by a board committee or, for large transactions, the annual general meeting. In most developing countries, however, company disclosure is too poor to deter self-dealing, and regulators' enforcement power too weak.

Other types of minority expropriation

Self-dealing is not the only way for controlling owners to steal from minority investors. For example, majority shareholders can dilute share value by buying more shares at a discount while excluding minority investors from the deal. Preemptive rights can curb the problem, though stronger measures are sometimes needed (such as the preemptive options used in Bulgaria).[1]

Insider trading can hurt investors who trade without access to the information available to insiders. Complex regulations can help, including deal reversals, blackout periods around major corporate events, and fines up to triple the amount of lost profit. South Africa has broadened its insider trading rules to cover market manipulation and the practice of advising someone not to trade. Electronic surveillance has boosted enforcement power. Many minority shareholders in South Africa have been compensated for losses suffered through insider trading.

When company control changes hands, minorities are often excluded from sharing in the takeover premium. Equal pricing rules (such as in Poland) mandate that investors get the same price as that paid to the controlling owner. Tag-along rights extend this benefit to shares with limited or no voting rights, as in Brazil's Novo Mercado (Nenova 2005b).

Minority expropriation can also occur when companies delist. Delistings can be frequent: in Peru in 1997–2003, 179 securities were delisted. Just before delisting, the stock price is depressed, shares are illiquid, and investors are forced to sell for next to nothing. Withdrawal rights at independently determined fair value prices are a remedy used in almost all countries.

Minority expropriation mechanisms can be varied, so some countries use a catchall remedy known as appraisal rights. Such provisions establish the right of aggrieved or dissenting shareholders to sell their shares back to the corporation at a fair market price following controversial changes in company policy.

Enforcing self-dealing rules: what works?

Countries use a range of regulatory rules to combat self-dealing. But what rules can best be enforced in developing countries?

Corporate reporting and disclosure

A country's first line of defense against self-dealing is to improve corporate reporting.

Accurate, timely, and publicly available corporate information is essential. Transparency of ultimate corporate ownership is especially important, because controlling shareholders in developing countries often also are managers and dominate the board. As a result, corporate matters are controlled by insiders, and minority investors are left in the dark.

Even perfect laws cannot be enforced without adequate corporate disclosure, at least to the regulator. Enforcing the public transparency of corporate decisions can also help shareholders identify potential insider abuse and take private action with the regulator or the court. In some countries the media has used corporate disclosure to combat self-dealing through "naming and shaming."

Still, companies can get around disclosure requirements in many ways. In some countries, such as Russia, investors hold their shares in complex chains of custodians and nominees that can effectively hide the identity of the true owners. In other countries shareholders acting in concert can work together and even control a company without individually triggering thresholds for disclosing ownership shares.

Active corporate boards

Enforcement of self-dealing rules starts with a company's board of directors. In India the law requires the board to have an investor grievance committee that meets quarterly to consider shareholder rights and investor complaints. In other countries minority shareholders can nominate and elect their own directors to the board, through cumulative voting or proportional representation. If the board is composed of insiders, it probably will not actively defend minority interests.

The law often prescribes the duties of directors, one of which may be to act in the interest of all shareholders. But fiduciary duties are poorly understood by most directors. In Hong Kong (China), for example, less than 40 percent of directors understand their liability and the rest give it low priority (Ho 2003). Moreover, successful prosecutions of directors for neglecting fiduciary duties are almost nonexistent in developing countries.

An alternative regulatory solution has been to require independent directors on the board. This is easier said than done. In poorly developed markets the business community is so small that financial and personal interests often conflict. And special corporate bodies charged with oversight of conflicts of interest, such as audit committees or fiscal boards, often treat their positions as honorary appointments that require little responsibility.

Courts or securities supervisors?

The most effective means of enforcement against self-dealing in the United States is a civil shareholder suit against controlling shareholders. The court has broad enforcement powers: it can impose civil and criminal penalties, request evidence from a wide range of sources, summon witnesses, and enforce decisions. Countries such as France have set up specialized courts with magistrates that receive training in securities law. In weak legal regimes, however, this remedy has serious limitations because of slow and unspecialized courts.

Enforcement by securities supervisors, with greater securities and corporate expertise, might prove more effective. But supervisors often suffer from understaffing, inadequate powers, and lack of operational and financial independence. In Georgia, for example, enforcement efforts by the National Securities Commission are often ineffective despite strong provisions in the securities law, because of lack of clarity on the procedural rules. Countries with ineffective courts and weak regulators can instead develop alternative dispute resolution mechanisms, which can be a fast (though expensive) means of addressing corporate governance conflicts.

The choice of enforcement mechanism should fit local conditions. Brazil's securities and exchange commission actively uses its powers to resolve shareholder disputes, providing an alternative to sluggish courts. Lithuania's efficient courts make action by the securities regulator unnecessary. Colombia, where both the court and the regulator are weak, is experimenting with alternative dispute resolution.

Monitoring by creditors and large investors

Monitoring by banks may help improve minority rights, especially when creditors' interests align with those of shareholders. Bank monitor-

ing depends on the health of the banking system and regulatory environment and the availability of credit and other information. In developing countries creditors may not be effective monitors in part because most lending is backed by collateral and relatively short term.

Large institutional investors in theory have greater incentives than small individual investors to monitor management and try to influence its decisions rather than simply sell their stock when dissatisfied. But they do not always fulfill this promise, for several reasons. In Hong Kong (China), although institutional investors account for 40 percent of local market transactions, they mainly trade blue chip stocks and are not active in monitoring corporate management. In India institutional investors seldom take actions against management because they have cheaper ways to enforce their interests. As lenders as well as block holders, they have veto power over shareholder resolutions.

Another reason lies in close ties to the banking system. Institutional investors often are part of large banks that want to do business with the companies in which they invest. Finally, in many emerging markets the institutional investor sector may still be in the early stages of development.

Prodding by foreign investors, however, has led to palpable improvements in corporate governance in many countries. Shareholder activists have pushed for major corporate governance changes in Korean companies, for example.

Naming and shaming

The media can play an important part in disciplining managers and controlling owners, especially when enforcement is weak. Indeed, free media has been shown to help pressure companies into improving their corporate governance practices. In Korea many of the concerns about corporations' activities have been shared on the Internet.

Shareholder activism, voluntary codes, and investor education can go a long way toward raising awareness of corporate governance problems. In 2000 the Romanian Shareholders' Association successfully promoted an amendment to the securities law that enhanced investor protection. Reputation concerns can prompt listed firms that expect to return to the market with new stock issues to unilaterally improve their corporate governance. Similar concerns can prompt companies to voluntarily list on "model corporate governance" tiers on the stock exchange, such as the Novo Mercado in Brazil, where the 15 firms now listed fetch premiums of up to 100 percent.

Notes

This Note is based on Nenova (2005a).

1. Preemptive rights give existing shareholders a chance to purchase shares of a new issue before it is offered to others. Options on such rights prevent controlling shareholders from taking advantage of minority apathy or cash constraints.

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