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Minority Shareholders

Mierta Capaul

Mierta Capaul (mcapaul@worldbank.org) is a senior corporate governance specialist in the World Bank Group's Investment Climate Diagnostics Unit. She has written a number of corporate governance assessments under the joint World Bank–International Monetary Fund ROSC (Reports on the Observance of Standards and Codes) program. Before joining the World Bank she was the regional head of a large financial institution, covering Ecuador, Guyana, Suriname, República Bolivariana de Venezuela, and the Caribbean.

What Works to Protect Shareholder Rights?

The World Bank's assessments of corporate governance practices in 25 countries across five continents have revealed a general commitment to comply with international principles. But the necessary legal changes are slow and subject to political compromise. Moreover, most countries have a poor track record in enforcing existing laws and regulations. Expropriation of minority shareholders continues to be a problem around the world.

Global debates about strengthening the protection of shareholders have moved beyond codes to oversight and compliance. How can enforcement be strengthened? What alternatives do countries have for enforcing their corporate governance laws and regulations? Should developing and transition economies rely on courts or regulators?

A lively debate is also under way about a second set of questions—whether voluntary compliance and choice can improve shareholder protection in a country. Can the incentive of attracting capital compel companies to voluntarily comply with best practice? Is using a menu of options to create choice an effective way to improve corporate governance practices? If so, under what circumstances? And can a country simply replicate approaches that have succeeded elsewhere, or does the appropriate solution depend on its level of development and other characteristics?

Reforms in the rules

The World Bank's corporate governance assessments reveal growing awareness around the world of the importance of corporate governance.[1] Almost all the countries assessed are undertaking reforms to bring their legal and regulatory frameworks into compliance with the Organization for Economic Co-operation and Development's (OECD) principles of corporate governance—a set of nonbinding standards against which countries' performance can be measured.

Consider Romania, a country that undertook mass privatization. Since the vouchers were free, the new shareholders did not see themselves as owners and the privatized companies did not treat them as investors. The result was widespread expropriation of minority shareholders. That started to change when shareholders became more vocal. Romania recently adopted regulations that significantly strengthen shareholder rights.

Still, changing laws and regulations is a slow and complex undertaking, and it requires much negotiation and compromise. Brazil's dilemma of how to treat minority shareholders in a change of control is a case in point. The corporate law originally granted all owners of voting shares "tag along" rights (equal treatment in a change of corporate control, ensuring that the control premium is equally distributed among majority and minority shareholders). In 1997, however, tag-along rights for minority shareholders were abolished to maximize state revenues from privatization. In the sale of the bank Banespa, for example, the government received a control premium of 912 percent.[2] A corporate law reform proposed in 2001 would have restored tag-along rights for all voting shares, but powerful business interests representing controlling shareholders successfully lobbied against its passage. The compromise finally reached requires that the purchaser offer at least 80 percent of the share price paid to the controlling group to all voting shareholders.

Problems in enforcement

It is not just the quality of the law that matters. An important lesson from the corporate governance assessments is that most developing and transition economies fail to enforce their laws, rules, and regulations consistently and evenly. This failure was not anticipated by the OECD principles, which implicitly assume that countries have an efficient legal and regulatory framework in place and that courts and securities regulators have the means and capabilities to enforce it. In reality, however, such practices as self-dealing and insider trading are widespread. Such offenses mostly go unpunished, even if stiff penalties apply in theory.

Auditing is another area where weaknesses are apparent. Most countries surveyed delegate the setting of accounting and auditing standards to the accounting association. Compliance by issuers is generally monitored by the securities regulator or, as in South Africa, by the stock exchange, institutions that often lack the expertise to fulfill this obligation. Meanwhile, the professional conduct of accountants and auditors is monitored by the professional accounting and auditing associations—and thus generally by the very market practitioners being supervised. Moreover, professional associations usually lack the means to impose effective sanctions. Auditors have sometimes given unqualified opinions, certifying that the accounts audited provide a true and fair picture despite the many defects noted. The penalties for such behavior are low, and enforcement generally lax. None of the countries surveyed has set the fines for such actions high enough to act as an effective deterrent.

Weak enforcement can also arise when the enforcement responsibility is divided among different institutions, allowing issuers to conduct "regulatory arbitrage." For example, while the Hong Kong Stock Exchange is the frontline regulator for listed companies, the Securities and Futures Commission supervises such aspects as takeovers, insider dealing, and disclosure of interests in securities. Since the listing rules are not statutory and carry weaker sanctions, issuers reportedly sometimes attempt to structure transactions so that they fall under the purview of the stock exchange rather than the Securities and Futures Commission. A recent example is the Boto case, where a takeover was structured as a sale of major assets governed by the listing rules. That allowed Boto's majority shareholder to avoid subjecting himself to the stringent takeover rules. While such transactions appear unfair to outside investors, they do comply formally with the law.

In some countries minority shareholders are expected to raise no questions about decisions by majority shareholders even if they have the right to do so in theory. When minority shareholders did so during a takeover in Morocco in 2000, it ignited a public controversy. The target company's minority shareholders objected to the valuation commissioned by the bidder and requested a second opinion. While this request is permitted by law, the press branded it outrageous. Through the press, the oligarchs argued that the law should not allow "just any" shareholder to bring a merger or acquisition to a standstill. Minority shareholders questioning the wisdom of management or controlling shareholders was considered unacceptable.

Alternatives for enforcement

If the courts and regulators fail to protect shareholders, there will be few shareholders. Under

the concentrated ownership that results, the controlling shareholder rather than an outside institution takes on the enforcement of shareholder rights—through the board of directors. In most developing and transition economies, regardless of their legal heritage, companies follow a parliamentarian model of board representation in which directors represent the constituency that elected them rather than all shareholders. In many countries majority shareholders exercise significant influence over boards, directly (as board members) or indirectly (through board members who report to them). Malaysia and South Africa are among the countries trying to subject such controlling shareholders to statutory requirements and hold them liable for their actions as "shadow directors."[3]

Business groups are another alternative enforcement mechanism in countries with a weak corporate governance framework. They act as intermediaries between individual entrepreneurs and the imperfect market, so that transaction costs are minimized. Business groups grow and diversify internally, constructing a web of companies through pyramid structures and cross-shareholdings that support one another. At the apex of the group is a large enterprise controlled by a family (and often not listed on the exchange) that plays a corporate finance function for smaller companies by financing suppliers and new firms and smoothing out income flows. Thus business groups ensure access to finance in an environment where external finance may be impossible to obtain. This system of internal corporate governance, while not transparent, substitutes for a weak external framework by replicating the functions provided by institutions in advanced economies.

Solutions

So, how should a country strengthen enforcement of shareholder rights?

Courts or regulators?

Should a country rely on courts or regulators for enforcement? In an ideal world both would play a part. In the countries assessed, however, courts are often underfinanced, unmotivated, unfamiliar with how the law applies to economic issues, and even corrupt (see Glaeser, Johnson, and Shleifer 2001). Judges face a broad set of tradeoffs and focus less on issues of investor protection than do specialized regulators, who tend to be more motivated and more knowledgeable about securities laws and listed firms.

There is also the question of resources. In South Africa, for example, courts are so overburdened that they simply lack the capacity to cope with commercial issues. For some countries it may be preferable to rely on regulatory agencies until the judicial system becomes more efficient. But this approach works only if the regulators can enforce sanctions without being subject to automatic and lengthy appeal.

In Poland strict enforcement of the securities law by a highly motivated regulator was associated with a rapidly developing stock market. In the Czech Republic hands-off regulation and reliance on the court system had the opposite effect.

A menu of options

Legal frameworks and their enforcement are rarely perfect. What else can help improve shareholder protection? Should regulators rely on the companies themselves? After all, attracting capital at the lowest possible cost should provide a natural incentive for companies to voluntarily comply with good corporate governance practices and even exceed the minimum requirements.

An interesting lesson from the corporate governance assessments is that giving issuers a choice of corporate governance options can facilitate reform. That has been the case in Brazil, where Bovespa, the São Paulo stock exchange, launched a new market segment known as the Novo Mercado in 2001.[4] New listing segments have traditionally been introduced to encourage small and medium-size enterprises to become listed. The listing rules for these segments are usually watered-down versions of those for the main board. Not so in Brazil. The companies listed on the Novo Mercado must adopt the one-share, one-vote principle, grant full tag-along rights to minority shareholders, abide by U.S. generally accepted accounting principles or the International Accounting Standards, and have a free float of at least 25 percent.[5] The companies also must submit to arbitration to settle shareholder disputes.

The Novo Mercado was created to give issuers a choice of complying with higher corporate governance standards than those legally required and thus differentiating themselves in the competition for capital at home and abroad. A listing on the Novo Mercado allows companies to attract quality domestic and international investors and lower their cost of capital. Brazilian pension funds, for example, are allowed to invest a larger share of their assets in companies listed on the Novo Mercado. The Novo Mercado has raised the bar, becoming the new standard that investors expect. But how successful it will be remains open to question. With only a small number of companies listed on the Novo Mercado, the jury is still out.

A "menu of options" approach based on differentiated market segments is most likely to be effective in a country with relatively sophisticated corporate and securities laws and reasonable protection of basic shareholder rights, but with weak confidence in the judicial system and a small number of investors. To be successful, the approach must include mechanisms allowing established companies to "graduate" from the main board to the corporate governance tier. Otherwise, that tier will be perceived as a small cap market with low liquidity. Countries with more mature securities markets, a strong rule of law, and effective judicial enforcement should focus on measures to improve the corporate governance standards of the market as a whole rather than establish a separate tier.

There are other ways to introduce choice. Many countries are working to improve corporate governance by developing a national code of best practice. By January 2003, 43 economies had adopted a corporate governance code, including Brazil, Croatia, the Czech Republic, Hong Kong (China), India, the Republic of Korea, Malaysia, the Philippines, Poland, Romania, the Russian Federation, and South Africa. Such codes can be tailored to each country. Some countries adopt a "comply or explain" rule requiring that companies comply with the code or explain in their annual report why they have not done so. Thailand has taken an interesting approach, allowing companies that adopt the code of best practice a discount on their listing fees.

Whatever the method, codes of best practice represent a market push to institutionalize and professionalize corporate governance. They improve the image of companies that uphold them and allow investors to sort good companies from bad.

Conclusion

The corporate governance assessments show that choice can facilitate reform. Allowing different models of corporate governance to coexist permits investors with varying risk profiles to choose the appropriate market and company to invest in and allows market forces to pick the winners. When companies have the choice of listing their shares on a stock market segment with stricter corporate governance rules or of complying with a code of best practice, they can use this option to signal to investors that they are different. While establishing a corporate governance market segment appears to be an attractive option only for middle-income countries, codes of best practice seem to be important regardless of a country's level of development.

Notes

1. For more on the World Bank's corporate governance assessments, see http://www.worldbank.org/ifa/rosc_cg.html.

2. Based on data from the Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliarios).

3. "Shadow directors" are controlling shareholders or shareholders who exert significant influence over the board even though they are not directors.

4. The transparency tier of the Bucharest stock exchange is another example of a corporate governance segment.

5. The free float is the share of capital that is not held by controlling shareholders and can be easily purchased by portfolio investors.

Reference

Glaeser, Edward, Simon Johnson, and Andrei Shleifer. 2001. "Coase versus the Coasians." *Quarterly Journal of Economics* 116: 853–99.

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Telephone:
001 202 458 7281
Fax:
001 202 522 3480
Email:
ssmith7@worldbank.org

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