

Corporate Governance, Investment and Growth The OECD Principles and Their Use*

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STRUCTURE

- ☑ The OECD Principles of Corporate Governance
 - ↪ Their development
 - ↪ The OECD Principles
 - ↪ Their Characteristics
 - ↪ Using the OECD Principles

- ☑ Corporate governance, investment and growth
 - ↪ An old issue
 - ↪ The economic rationale
 - ↪ A new context
 - ↪ Contemporary developments in the global economy

The development of the OECD Principles

✓ Preliminary work

- ↪ Collect information on Member country practices in the first half of the 1990s
- ↪ Works on specific areas (disclosure, public policy aspects...)
- ↪ Multinational business sector advisory group (1996)

✓ Development of the Principles

- ↪ Ask by member countries in 1998
- ↪ Set a special Task Force with a very inclusive approach
- ↪ A number of important non-OECD countries participated in repeated rounds of consultations and provided written comments
- ↪ Submitted to a broad public exposure to public commentary on successive drafts, including through the Internet

The OECD Principles

- ✓ The OECD Principles on Corporate Governance were adopted and issued in May 1999
- ✓ The Principles cover five main areas
- ✓ Chapter 1: The rights of Shareholders
 - ↪ “The corporate governance should protect the rights of shareholders”
- ✓ Chapter 2: The equitable treatment of shareholders
 - ↪ “The Corporate Governance Framework Should Ensure Equitable Treatment of All Shareholders. All Shareholders Should Have the Opportunity to Obtain Effective Redress for Violation of Their Rights”

The OECD Principles

- ✓ **Chapter 3: The role of stakeholders in corporate governance**
 - ↪ “The Corporate Governance Framework Should Recognise the Rights of Stakeholders as Established by law and Encourage Active Co-operation Between Corporations and Stakeholders in Creating Wealth, Jobs, and the Sustainability of Financially Sound Enterprises”

- ✓ **Chapter 4: Disclosure and transparency**
 - ↪ “The Corporate Governance Framework Should Ensure That Timely and Accurate Disclosure is Made on All Material Matters Regarding the Corporation, Including the Financial Situation, Performance, Ownership and Governance of the Company”

- ✓ **Chapter 5: The responsibilities of the Board**
 - ↪ “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”

Characteristics of the OECD Principles

- ☑ The OECD principles **focus on economic growth** as a point of departure and as a goal
- ☑ The Principles are **non binding**, they can adapt to differing national circumstances. They are not a one-size-fits-all straightjacket.
- ☑ Unique document of its kind, as the Principles represent what **governments and markets around the world agree** constitute the necessary elements for building good corporate governance
- ☑ ***The OECD Principles are genuinely global***

Using the OECD Principles

- ☑ OECD Principles have become a **truly global standard** and a *de facto* reference point,
 - ↪ they are **widely used** in both the private and public sector, in OECD and non-OECD countries
 - ↪ adopted by the Financial Stability Forum as one of its 12 **core international standards** for sound financial systems
 - ↪ individual countries have developed **corporate governance codes** modeled on the Principles, complementing them in an important way
 - ↪ **private sector** bodies model their **own corporate governance initiatives** on the OECD Principles

Using the OECD Principles

- ☑ The OECD Principles are a **process** more than a document
 - ↪ they are a tool for **policy dialogue** and for **institution building**
 - ↪ they have become an efficient tool of communication, somewhat of a **global common language** in the area of corporate governance
 - ↪ a global cooperation between the OECD and the WB, including:
 - ☞ a **Global Corporate Governance Forum (GCGF)**
 - ☞ **Regional Roundtables** which main objectives are to provide a **platform for dialogue** and to formulate **practical policy agenda**
 - ↪ The WB has started a process of **assessment** of a number of its members on the basis of the Principles, within its overall **ROSC exercise**, and on a **voluntary basis**

Using the OECD Principles

- ☑ Corporate governance has two sides or aspects
 - ↪ a **behavioral side**: corporate governance encompass the relationships and ensuing patterns of behavior of different agents in a limited liability corporation
 - ↪ a **normative side**: refers to the set of rules that frame private behavior
- ☑ A country's institutional corporate governance framework can thus be described by the following main elements
 - ↪ Statutory law and regulations
 - ↪ Voluntary standard contracts and self-regulation
 - ↪ Implicit rules, social norms and business culture.
 - ↪ Last, but not least, court practice and procedures

Using the OECD Principles

- ☑ A country's institutional corporate governance framework can be described by the following main elements:
 - ↪ **Statutory law and regulations**
 - ☞ company law
 - ☞ securities legislation
 - ☞ investment regulation
 - ☞ some others, like insolvency legislation, tax legislation...
 - ↪ **Voluntary standard contracts and self-regulation**
 - ☞ listing requirements,
 - ☞ business codes
 - ☞ Independent self-regulatory or norm setting bodies
 - ↪ **Implicit rules, social norms and business culture.**
 - ☞ their immediate and exact impact may be hard to measure
 - ☞ their importance is increasingly recognized, as technically similar legal frameworks may result in quite different outcomes
 - ↪ **Last, but not least, court practice and procedures**

Using the OECD Principles

- ☑ The responsibilities and importance assigned to different actors may however differ among countries. Some tend to **rely more heavily on self-regulation and private contracting**.
- ☑ The challenge is to make the best possible use of the **many complementary institutions** that influence corporate governance practices and arrive at an efficient division of responsibilities between them.
- ☑ ***Building good corporate governance must be a joint responsibility of governments, regulators and the private sector itself.***

An old issue

- ☑ Corporate governance is an old issue, which dates from well before the term itself became fashionable
 - ↪ in 1776, **Smith** in his famous *Wealth of Nations* warns against the issues arising from the new stock companies, namely shareholders' unwillingness and inability to control management, as well as management lack of incentive to carry out business efficiently
 - ↪ **Brandeis**, a US Supreme Court Judge in 1911, considers that ownership dispersion is a threat as it constitutes severe owner absenteeism and leads to irresponsibility
 - ↪ **Berles and Means** have launched the modern debate on corporate governance in 1931 in *The Modern Corporation and Private Property*, showing how ownership dispersion could be a threat to the very foundation of capitalism

An old issue

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 - ↪ Berles and Means idea has then been developed and made famous by **Schumpeter** in 1947, who sees in the separation of ownership from control the extinction of the *entrepreneur*, motor of capitalism development
 - ↪ The **managerial literature** in the 60's showed how managers aimed at maximizing their own welfare, instead of profit maximization, through reducing risk and maximizing growth
 - ↪ The most famous work in this stream of literature was **Galbraith** "The New Industrial State" in 1967, showing how, through this very ownership dispersion, the *technostructure* had taken the role of the *entrepreneurs*, presenting again a threat for capitalism development

An old issue

- ☑ Thus, the corporate governance issue and debate is linked to the emergence and development of the stock/public company
- ☑ History has shown how this **development of the business corporation** has been a main driving force in capitalism development
- ☑ Indeed, the business-corporation lies at the center of the investment process

The Economic Rationale

- ✓ The most solid relationship in economies and economics: **the positive link between investment and economic growth**
- ✓ But not only quantity of investment matters. How effectively the capital is **allocated** and how well is it **monitored** are also two crucial determinants of this relationship between investment and growth
- ✓ ***Growth will depend on how capital is mobilized, allocated and finally monitored***

The Economic Rationale

- ☑ Corporate governance is **how corporations are directed and controlled**.
- ☑ This is done by specifying the **distribution of rights and responsibilities** among the different participants to the corporation.
- ☑ *Corporate governance will have a crucial impact on the three stages of the investment process, namely mobilization, allocation and finally monitoring of capital*

Mobilization of capital and corporate governance

- ☑ Basic corporate governance provisions will influence our ability to **mobilize** capital
 - ↪ secure methods of ownership registration
 - ↪ effective property protection
 - ☞ credible
 - ☞ enforceable
 - ☞ effective legal redress mechanisms
 - ↪ clear and credible information

- ☑ Corporate governance is seen as a constituent element of equity risk
 - ↪ Bad corporate governance signals large asymmetries of information and high probability of expropriation of shareholder value
 - ↪ McKinsey study showing the average premium investors would be willing to pay for a well-governed companies

Allocation of capital and corporate governance

☑ The market can only make the best possible choices concerning the **allocation** of capital among alternative uses if:

↳ Transparency and disclosure

- ↳ accurate
- ↳ timely
- ↳ reliable
- ↳ comparable

Monitoring of capital and corporate governance

- ☑ Corporate governance arrangements have a crucial impact on the effective **monitoring** of capital that is handed over to companies
 - The procedures for corporate decision-making
 - The distribution of authority among company organs
 - The design of incentive schemes

Corporate governance and emerging economies

- ☑ A high priority issue for large emerging economies with large pockets of poverty
- ☑ Within the policy horizon in low-income developing or transition countries with budding but as yet not very significant capital markets
 - ⇒ the Principles in this case have an aspirational value, showing the way ahead to designers of Company Laws and providers of basic education to corporate officers

What is at stake ?

- ☑ Consequently, the importance of good corporate governance goes far beyond the interests of shareholders in an individual company
- ☑ Corporate governance arrangements will have a crucial influence on:
 - ↳ the economy's overall prospects to attract investors
 - ↳ the economy's overall prospect to build a strong private sector
- ☑ ***What is at stake is the basis framework for economic growth***

A new context

- ☑ A number of high profile cases of governance failures and misconducts, or of company declines largely or at least partially attributed to governance problems
- ☑ These cases inspired the Cadbury Report in the early 1992
- ☑ This report was followed by numerous similar initiatives, like in Canada, Australia, the Netherlands, France (*Viénot Reports*)

A new context

- ☑ The financial turmoil in the emerging economies brought the issue to the front pages at the end of the 90's
 - ⇒ revealed the bad consequences of opacity and lack of accountability on the health of financial markets
 - ⇒ countries with the lowest corporate governance standards (especially in terms of minority shareholders' protection) experienced the largest exchange rate depreciation and stock market decline

- ☑ ***Corporate governance became perceived as an issue of systemic financial stability***

A new context

- ☑ Corporate governance structures/deals are intimately linked to some of the most important contemporary developments in the global economy.
 - The growing importance of the private sector
 - Growing international interdependence
 - Changing competitive circumstances for investors and corporations

Contemporary developments in the global economy

- ☑ The growing importance of the private sector
 - ↪ Companies and investors must be governed in a way that keep them
 - ☞ focused on their objectives
 - ☞ competitive in their operations
 - ☞ accountable for their actions.
 - ↪ Good corporate governance is not only a **safeguard against waste of corporate assets**. It is also seen as a guarantee for
 - ☞ the financial transparency
 - ☞ corporate accountability
 - ☞ investor responsibility.
- ☑ *good corporate governance practices is necessary in order to preserve long term public legitimacy of market institutions, including the business corporation.*

Contemporary developments in the global economy

- ☑ The growing international interdependency
 - ↪ In their constant search for the most profitable opportunities, most investors can now **diversify on a global scale**
 - ↪ To reap the full benefits of these new opportunities, both investors and corporations **need to better understand different business cultures and corporate governance arrangements**. Both sides need to appreciate, and have confidence in the rules of the game
- ☑ *The ability to communicate and understand different corporate governance practices has therefore become an increasingly important factor for companies and countries who want to attract internationally mobile capital, be it domestic or foreign.*

Contemporary developments in the global economy

- ☑ Changing competitive circumstances for investors and corporations
 - ↪ Today's successful enterprises are often **more human capital intensive**, dependent on **intangible assets** (brand names, patents, strategic agreements and organisational know-how)
 - ↪ They operate under **more flexible contracts** with employees, business partners and other constituents. These circumstances often require their own adapted corporate governance arrangements and constitute **genuine challenges** in terms of corporate governance.
- ☑ *The ability of these companies to put the right corporate governance arrangements in place is in many cases an important part of their competitive edge.*

Recent trends

- ☑ Quite a few **legal reforms** in OECD countries concerned Company Law, but also securities legislation
 - ↪ Greater **choice and flexibility in Civil Law countries**, through
 - ☞ the introduction of new legal forms
 - ☞ deregulatory measures for existing corporate forms
 - ↪ The company law as a vehicle to **improve transparency and the protection of shareholder's rights**
 - ☞ German Act on Control and Transparency of Enterprises (1998)*
 - ☞ changes in the Japanese Commercial Code facilitating shareholder litigation and mandating the appointment of an outside auditor.
 - ↪ In Italy, 1998 reforms concerning **securities legislation**
 - ☞ increased disclosure standards and increased protection of minority shareholders
 - ☞ strengthened the regulatory powers of the securities regulator, CONSOB.

Recent trends

- ☑ Call for the creation and use of board committees (audit, nomination, remuneration) composed mainly of independent directors
- ☑ Strengthening of independence criteria for board members, following the Eron case
- ☑ Disclosure of executive remuneration.
 - ↪ 1999 the Irish and British Stock Exchanges required disclosure of individual remuneration
 - ↪ in France and Japan, an ongoing debate
- ☑ Increasing utilization of new information and communication technologies

Emerging trends

- ☑ Development of a market for corporate governance service (consulting, rating)
- ☑ Shareholder activism is increasingly taking a social dimension
 - ↪ increased involvement of trade unions
 - ↪ rise of socially responsible investment
- ☑ Global effort to harmonize reporting standards
- ☑ Incipient shift towards free-float indexes

CONCLUSIONS

- ☑ *Corporate governance framework and practices are a key determinant of investment and, consequently, of growth*
- ☑ *The OECD Principles of Corporate Governance are a useful tool in the process of improving corporate governance framework and practices*
- ☑ *The OECD Principles can be used in your specific national circumstances*
- ☑ *Such a process requires cooperation between government, regulators and the private sector*

For Further Information

www.oecd.org/daf/corporate-affairs