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Focus

*Enforcement
and Corporate
Governance:
Three Views*

Ira M. Millstein

Shri G. N. Bajpai

Erik Berglöf and Stijn Claessens

Global
Corporate
Governance
Forum

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FOREWORD

by Harvey J. Goldschmid¹

It is a great pleasure to write an introduction to this work as it tackles a subject dear to my heart, which is enforcement's role in improving markets. Over my years of experience with the U.S. Securities and Exchange Commission (SEC), first as General Counsel, then as Special Advisor, and now as a Commissioner, I have seen the critically important role effective enforcement – both public and private – plays in increasing market confidence, which in turn attracts and protects investment.

In the first piece of this collection, **Ira M. Millstein**, a long-time close friend and legal colleague, provides an overview of some practical approaches that the private sector can take to strengthen corporate governance in countries where enforcement of laws may be lax. **G.N. Bajpai**, who has just finished his term as the Chairman of the Securities and Exchange Board of India (SEBI), talks not just about what is happening in his country but also dwells on the importance of ethics in business, a most important topic that is often overlooked in discussions of corporate governance. Leading academics, **Erik Berglöf and Stijn Claessens** go deeper on the importance of enforcement in developing countries, again stressing the spectrum of activity from private to public actions. Finally, **Tatiana Nenova**, in her work at the World Bank Group has roughed out a matrix of the enforcement spectrum, which highlights relevant parties who might get involved.

To add to these views, let me give you a feel for how important effective public enforcement has become in the United States. After disclosure of the corporate scandals of the 1990's and early 2000's, Congress recognized the need for effective enforcement in the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley gave the SEC enhanced powers with respect to civil penalties, disgorgement, officer and director bars, and equitable remedies. In addition, more powerful substantive criminal provisions and sanctions were provided to the Department of Justice. What Congress recognized in Sarbanes-Oxley is that if our securities regulatory system is to work, corporations and other entities, the individuals who comprise them, and the various "gatekeepers" in

¹ The views expressed here are Commissioner Goldschmid's and do not necessarily represent the views of the Commission, his fellow Commissioners, or the Commission Staff.

our system, must know that they are likely to be held accountable for wrongdoing. Effective deterrence requires a strong, credible threat. It is that “threat” that creates powerful incentives to avoid wrongful acts and to bring about the cultural, procedural, and process changes necessary to restore integrity and protect investors. Accountability and deterrence are the key words in the Commission’s enforcement approach today.

And let me provide a quantitative sense of the rigor and seriousness of the Commission’s current enforcement efforts. When I went back to Columbia Law School after having served as the SEC’s General Counsel in 1998-1999, I would indicate to a class that the SEC could bring roughly 350 to 450 cases a year. These covered a broad landscape, including cases involving broker-dealers, investment advisers, insider traders, and disclosure failures. In fiscal year (FY) 2001 (the government’s fiscal year ends on September 30), the SEC had already become more active. The number of enforcement cases that year had risen to 484. In FY 2003, the SEC brought 679 cases. In general, these cases were more important, larger, and more complex than those brought in earlier years. With respect to financial fraud, in FY 2001, which was a big year, the SEC brought 112 cases. In FY 2003, the number was 199.

Officer and director bars are a powerful deterrence tool. Such a bar precludes individual from serving as an officer or director in a public corporation again, or for a specified time frame. In FY 2001, there were 51 of these bars. In FY 2003, the number had reached 170.

In terms of civil money penalties and disgorgements, the numbers are off the page. In FY 2002, the SEC exacted its first \$10 million civil money penalty from a public corporation. There were twenty penalties of \$10 million or higher in FY 2003, and the number will be even higher in 2004. In terms of the dollars involved: in FY 2003, the SEC collected more in civil penalties than during the prior fifteen years combined. Also, in terms of deterrence and accountability values, SEC policy now prevents civil money penalties from being insured, indemnified, or used for a tax deduction. If you – an individual or an entity – are a serious wrongdoer, you will be hit personally, – in your own pocket, and will be unable to pass the penalty on.

The criminal laws should be used carefully, but there is no more powerful deterrent than the criminal laws when appropriately used. Throughout most of the last century – and, indeed, until early in the 21st century – very few U.S. Attorneys were willing to bring criminal securities cases, even in the most willful, hard-core areas. In a dramatic change in FY 2003, there were 246 defendants indicted for SEC-related criminal activity. But the fascinating figure for me is that there were forty-eight different criminal authorities bringing those cases.

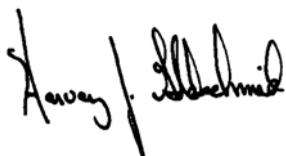
The large number of criminal authorities willing to prosecute hard-core wrongdoers, and the high profile of the cases today, brings something very important to mind. There is a basic need for care, so that we make sure that the criminal law is used only for willful, venal activity. The SEC works with U.S. Attorneys (who carry out the work of the Department of Justice) to help ensure appropriate balance in the use of the criminal laws.

And I hasten to add that fairness, proportionality, and concern about culpability continue to be essential elements of the SEC's enforcement process. The U.S. economic system will not work unless good people continue to serve our public corporations. We must not unfairly frighten officers, directors, and others away from serving.

I must also emphasize that nobody at the SEC wants to diminish or interfere with risk-taking, corporate entrepreneurial activity, or appropriate corporate autonomy. From corporate risk-taking can come new products, innovation, efficiency, and healthy change. No recent case to my knowledge (and I think I know of each and every one) has been brought that second-guesses honest business decisions of directors or officers. A fair number of business decisions to develop new plants or products – or otherwise innovate – are not going to work out. No one is second-guessing those decisions. The message from the SEC is: if a business decision goes well, report it accurately in your financials; normally, that is easy to get people to do. If it goes badly, report that accurately as well. In general, the SEC fully recognizes the critical importance of not inhibiting – indeed, of encouraging – prudent risk-taking, innovation and change.

Over the past two years serious SEC rulemakings enforcement efforts have occurred in area after area. Officers and directors, accountants, lawyers, and

others in the financial community have been dealt with sensibly and with balance. In general, the scandals of the 1990's and early 2000's have forced us to face serious systemic imperfections, but they have also made it possible for us to bring about healing and reform. My view is that what has been done will allow the U.S. to maintain its status as one of the world's leaders in corporate accountability, disclosure, and financial integrity. But in closing I must emphasize that there is no issue so integral to market confidence as effective enforcement. I have found the pieces included in this publication richly rewarding and hope that others will learn from them too.

A handwritten signature in black ink, reading "Harvey J. Goldschmid". The signature is written in a cursive, flowing style.

Harvey J. Goldschmid
Commissioner
U.S. Securities and Exchange Commission

Edited extracts of the speech delivered by Ira M. Millstein, Senior Partner, Weil, Gotshal & Manges LLP, and Chair of the IFC/World Bank's Private Sector Advisory Group, at the 2003 Lex Mundi North America Regional Conference (on a panel jointly organized by Lex Mundi and the Global Corporate Governance Forum).

NON-TRADITIONAL MODES OF ENFORCEMENT

by Ira M. Millstein

Abstract

My thesis today is straightforward: Attracting investment requires protecting investors. Investor protection requires both law and the effective enforcement of law. However, in many developing countries, neither the quality of the law nor its enforcement are adequate. As to law, few developing countries have, for example, an enforceable concept of the fiduciary duties that controlling shareholders, directors and managers owe to investors – particularly to minority shareholders. As to enforcement, few developing countries have adequate courts, judges and public enforcement agencies, and the means for shareholders to institute legal actions on their own. To join the global capital market, developing countries will need to attend to these deficiencies. In the meantime, there are some second best options.

Introduction

Private capital is necessary for economic development, but capital does not flow to dangerous neighborhoods. Investors, whether purchasers of equity or lenders, will not invest in a market or a company they view as unstable, corrupt, or utterly lacking basic protections for their investment and contractual rights.

Thus, countries seeking to create a capital market – and private and state owned enterprises seeking to attract local or global capital – must develop a framework that assures public investors that the assets they provide will be protected. Strong securities and company law is necessary, but it is not sufficient.

Katherina Pistor and Chenggang Xu in “Incomplete Law – A Conceptual and Analytic Framework . . .”¹ define law as incomplete when “law makers are unable to foresee all future contingencies.” They note that law is incomplete when all potential harmful actions cannot be unambiguously specified. Law may be incomplete due to gaps where the law simply fails to address the potentially harmful act, or it may be incomplete by intentionally leaving open some areas for judicial interpretation. Whether these gaps are intentional or due to an inability to foresee all future contingencies, a mechanism must be devised to ensure that law is complied with.

Law and regulation may cover some specific events that are identified beforehand, but law and regulation cannot foresee all future contingencies. The minds of men and women are simply too inventive and ingenious in devising schemes to harm investors.

Securities law and investor protection present a fine example of the incomplete law problem. It is not possible for company and securities law to unambiguously define every actionable lack of due care on the part of directors and managers, every pyramid scheme, every funneling technique, or every method a manager or controlling shareholder might use to misappropriate or misuse company assets. Potential harm comes to investors in an infinite variety of forms.

Law and regulation may cover some specific events that are identified beforehand, but law and regulation cannot foresee all future contingencies. The minds of men and women are simply too inventive and ingenious in devising

schemes to harm investors. Just witness this last round of corporate malfeasance. In some cases so-called black letter law was violated, and in other cases the behavior fell within the gaps in open-ended common law. Fraud is an example of the former and the lack of due care and loyalty are examples of the latter. In most common law jurisdictions, fraud is statutory; due care and loyalty are, for the most part, judicially created. Neither can be sufficiently defined in advance to cover the myriad of fact-driven situations which brought harm to investors.

¹ Katharina Pistor and Chenggang Xu, *Incomplete Law – A Conceptual and Analytical Framework – And its Application to the Evolution of Financial Market Regulation* (Apr. 2003) <http://ssrn.com/abstract_id=310588>.

I think of civil law as an effort to provide black letter rules and common law as intentionally leaving many questions open ended. Under both traditions, however, a mechanism must exist whereby the law is applied to the facts of the case. I'll call that mechanism "enforcement." By enforcement, I mean the basis for determining whether a violation of investor rights has occurred or might occur (whether or not expressly or explicitly covered by law or regulation), and an apparatus to translate these violations into regulatory sanctions or recovery for those harmed.

Effective enforcement is thus required not just to address clear cut violations of law, but to fill in the ambiguities and gaps that law always leaves open. Ambiguities and gaps need to be filled in by judgment, on a case by case basis. This is true in developed countries as well as in developing countries, in civil law jurisdictions as well as common law jurisdictions.

Recent academic research underscores the importance of enforcement. As La Porta, Lopez de Silanes, Shieffer, and others have found, jurisdictions that better enforce legal rights tend to have more developed financial markets regardless of the content of their laws. These findings make intuitive sense as well. Why would any sensible investor invest if investor rights either didn't exist, or could not be enforced?

Articulating Fiduciary Duties: Creating a Basis for Filling the Gaps

For me, an important key to addressing the ambiguity or gap problem begins with whether a country's law has an established "fiduciary duty" concept as applicable to directors and managers.

Let's start with Corporations 101. Investors provide the capital, but directors and managers control the enterprise. Thus whatever directors and managers do – or don't do – affects the dollars and cents value of the enterprise to the investor. If they use good business judgment overall, this value should go up. If they use bad business judgment overall, this value should go down. And as recent events so rudely demonstrated, if directors and managers misrepresent, lie, steal or cheat, the value of the enterprise to investors can fall to zero.

How can law attempt to deal with these realities? Just what constitutes good or bad judgment? What is misrepresenting or cheating? These questions must be addressed somehow if investors are to be protected.

How can law attempt to deal with these realities? Just what constitutes good or bad judgment? What is misrepresenting or cheating? These questions must be addressed somehow if investors are to be protected. The answer lies in recognizing the “fiduciary” relationship between managers and directors on the one hand, and investors on the other.

According to Black’s Law Dictionary, a fiduciary relationship is defined as “a relationship in which one person is under a duty to act for the benefit of the others.” In the corporate context, directors and

managers have a fiduciary relationship to the shareholders; they are under a duty to act for the benefit of the shareholders. If not explicitly stated in a statute or regulation, this duty is implicit – directors and managers are using other people’s money; not for their own benefit – but for the benefit of the investors. This fits the classic definition of a “fiduciary duty.”

These fiduciary duties are sometimes articulated by laws and regulations that explicitly condemn or prohibit certain actions by directors and managers. In common law systems like the U.S. and the U.K., whenever necessary, courts interpret the applicable laws and regulations (to the extent they exist) and apply the fiduciary standard as well, to fill in the gaps that legislation and regulation do not explicitly reach. As a result, after many years and many cases, an entire body of law developed that defines the fiduciary duties of directors and managers to the corporation and its investors. Through this process, in jurisdictions like the U.S., law is made less incomplete.

To quote from a seminal opinion of the New York Court of Appeals:

Because the power to manage the affairs of a corporation is vested in the directors and majority shareholders, they are cast in the fiduciary role of “guardians of the corporate welfare.” In this position of trust, they have an obligation to all shareholders to adhere to fiduciary standards of conduct and to exercise their responsibilities in good faith when undertaking any corporate action. Actions that may accord with statutory requirements are still subject to

the limitation that such conduct may not be for the aggrandizement or undue advantage of the fiduciary to the exclusion or detriment of the stockholders.

The fiduciary must treat all shareholders, majority and minority, fairly. Moreover, all corporate responsibilities must be discharged in good faith and with “conscientious fairness, morality and honesty in purpose.” Also imposed are the obligations of candor and of good and prudent management of the corporation. When a breach of fiduciary duty occurs, that action will be considered unlawful and the aggrieved shareholder may be entitled to equitable relief.

*Alpert v. 28 Williams St. (1984)*²

In short, the articulation of a “fiduciary” duty – whether developed case by case under common law concepts or by legislation and regulation in civil law countries – is necessary for investors to be secure that their rights will be protected.

In common law countries, then, the contours of these “fiduciary” duties – the duties of care, loyalty, good faith and candor – are refined by judges on a fact driven, case by case, basis. They evolve, incrementally, and the gaps narrow.

In civil law countries, statutory law may attempt to mandate or prohibit specified actions, in a legislative effort to create a system from the bottom up – brick by brick. This structure may attempt to define the responsibility of corporate directors and management to investors, but may not explicitly create a “fiduciary” principle that can be applied to fill remaining gaps. There inevitably will be gaps even in what the statute is intended to cover, much less what the statute doesn’t purport to reach.

In short, the articulation of a “fiduciary” duty – whether developed case by case under common law concepts or by legislation and regulation in civil law countries – is necessary for investors to be secure that their rights will be protected. In both common and civil law countries, some form of case-by-case judicial analysis of actual controversies is required, simply because each fact pattern is unique.

² *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 568-69 (1984) (citations omitted).

In my view, the “fiduciary” duty concept is a critical tool for courts, or whoever adjudicates matters relating to investor protection.

Any country seeking to assure investors that their rights will be protected, must, and I use “must” advisedly, have some form of “fiduciary duty” embodied in its enforcement system. The fiduciary duty is the foundation stone by which to adjudicate manager and director actions that impact investors – actions that often fall within the gaps and ambiguities of incomplete law. If a country’s legal and regulatory system doesn’t yet articulate that duty, either explicitly or implicitly, it should do so, or its system is truly incomplete.

Fiduciary duties embody the notion of how and in whose interest officers and directors are supposed to act, set the standard by which director and officer actions are to be judged, and, therefore, provide a basis for the enforcement of investor rights under any system of law.

It would seem to me a fruitful area of research to determine whether countries do or do not embody in their system the fiduciary concept, and if not, how best they may do so.

Research on investor complaints, such as self-dealing; conflicts of interests; interested or related party transactions; share dilution; fraudulent disclosures; and, pyramid schemes is essential to helping us understand the extent to which different jurisdictions address these issues. It helps us identify the scope of the problem and aids us as we try to design and implement a system to enforce investor rights.

But further, fiduciary duties only gain meaning when shareholders can hold directors and managers who breach these duties responsible. And holding directors and managers responsible requires that there be a forum in which investors can enforce those rights. Beyond looking for fiduciary duties and the rights of shareholders that spring from these duties, sophisticated investors also consider what redress they may have should these duties, or black letter law, be breached. And now, we’ve come to enforcement.

In many developing countries, effective institutions for the enforcement of shareholder rights don’t exist. If those countries seek global capital, they require effective legal institutions capable of enforcing investor rights, wherever they do not exist. But these institutions will not spring up overnight.

No regulatory body can possibly reach all directors and managers who improperly impinge on shareholder rights – regulators don't have the resources to do so.

Given the immediate need for capital in developing economies, what can be done in the meantime? How can companies in developing countries assure investors that their rights will be protected, especially where law, regulators, and related institutions are absent or weak? Unfortunately, there is no easy answer, and there is no one magic bullet solution.

So for the meantime, let's explore ways in which countries and companies can fill the gaps in their enforcement of investor rights. How can disputes between investors, managers, and directors be addressed? As more developing markets seek capital, and academic and international attention continues to focus on these issues, we will begin to learn more about what works and what doesn't. For now, I will concentrate on a few options and make a few observations about what we have seen so far.

Obviously there is, or should be, some official governmental body to enforce, on a system-wide basis, the laws and regulations that impact shareholder rights. I will not focus here on public enforcement by regulators. That is a critically important element for investors and a major area for reform, but beyond the scope of this paper. No regulatory body can possibly reach all directors and managers who improperly impinge on shareholder rights – regulators don't have the resources to do so. And further, in the U.S. breaches of fiduciary duties – care, loyalty, candor and good faith – all are matters which are generally enforced through derivative and class action law suits by investors who have been harmed. Thus, not only securities and company law, but the enforcement of that law – whether by regulators, courts or otherwise – is often incomplete.

Options

Enforcement by Contract

One option is for investors to encourage companies to adopt good governance practices through contractual arrangements with investors. Presumably if a company has "good governance," its directors and managers are more likely to observe fiduciary duties. Indeed the checks and balances created by good

governance are designed to assure the discharge of fiduciary duties, even if these duties are not explicit in a particular jurisdiction.

Securities purchase agreements, shareholder agreements, credit agreements, indentures and other loan agreements between investors and companies are often crafted specifically to include provisions designed to improve corporate governance and protect investors' rights. Such provisions may relate to:

- Board representation;
- Board committee requirements (composition & duties);
- Anti-dilution provisions;
- Access to information;
- Disclosure requirements;
- Change of control rights; and/or
- Procedures for approving related party transactions.

But once a company commits to providing contractual protections to investors, these investors must turn to the courts or a specified forum to enforce their contractual rights. This can be a costly and time consuming undertaking. Often, an ineffective judiciary may be a significant part of the enforcement problem to begin with. Thus, robust contractual provisions do not provide an adequate solution unless there is an effective forum in which to seek enforcement of contractual rights.

Even where such contractual provisions are effective – whether because a venue for enforcement exists or because of the company's continuing need for capital requires that it stay on good behavior – contracts typically protect only those with considerable economic power. They are only available to those investors with the leverage to extract important rights from the companies in which they invest. They are of little help to the widely dispersed body of small shareholders.

Tools to Get to Court

In the United States, shareholders, large and small, have a number of procedural devices that enable them to bring suits seeking redress for breach of their rights as investors, including through derivative suits, which allow shareholders to sue on behalf of the corporation, and class action suits, which lower the burdens on individual plaintiffs and make access to the courts easier. In both derivative and class action lawsuits, plaintiff-shareholders are also supported by attorneys who

will accept contingency fees (often one-third of a damage award if the plaintiff wins) instead of requiring hourly rates.

In many parts of the world these devices – particularly contingency fee arrangements – are viewed skeptically, as inappropriately incentivizing people to bring unwarranted suits. Nevertheless, much as they are derided, these devices deter “bad” behavior on the part of directors and managers. Other countries are taking heed, and are devising some means of allowing private actions.

NPOs

A possible alternative to class action contingency litigation by individual shareholders is the use of non-profit shareholder organizations (NPOs) for collective action. In his excellent article, *Non-Profit Organizations and Investor Protection: Economic Theory and Evidence From East Asia*,³ Professor Curtis Milhaupt defines NPOs as private, self-governing, non-profit distributing, voluntary organizations that often hold a portfolio of representative stocks to enable them to act as shareholders and protect the rights of their members, who are also shareholders. In other words, NPOs provide an organization of shareholders with a means of going to court and enforcing shareholder rights. And because they are not-for-profit, they are perceived to have little financial incentive to bring frivolous lawsuits.

These organizations, which don't exist in the United States, have developed in a number of Asian markets. In Taiwan, the Securities and Future Institute, has brought suits on behalf of minority investors in a number of securities and fraud cases. In Korea, the People's Solidarity for Participatory Democracy (PSPD), has engaged in a number of shareholder advocacy efforts, including a shareholder derivative suit against the controlling shareholder and directors of Samsung Electronics. In Japan, the Shareholder Ombudsman, which has 150 members and portfolio of 300 stocks, has used shareholder derivative suits to bring cases against directors of many of Japan's major companies.

³ Curtis J. Milhaupt, *Nonprofit Organizations as Investor Protection: Economic Theory, and Evidence from East Asia* (Mar. 10, 2003) (unpublished manuscript on file with the author).

NPOs also use the threat of a legal action to cause many corporations to agree to adopt a variety of investor protections. Settlements often consist not only of cash, but also of commitments from the defendant company to adopt procedures designed to prevent the challenged conduct from reoccurring.

The emergence of NPOs as a tool to enforce shareholder rights is particularly valuable where as Professor Millhaupt explains the “infrastructure for private law enforcement is inadequate and the government is unable or unwilling to meet the increased demand for investor protection . . .”⁴

Dispute Resolution Forums

Contractual arrangements, derivative suits, class actions, contingency fee arrangements, and NPOs make it easier for shareholders to enforce their rights in a public forum. Unfortunately, however, many developing countries do not have effective (and uncorrupted) courts with judges experienced in investor protection issues. Building an effective judiciary, with a cadre of trained and impartial judges, should be a priority, but often is not. A fundamental change in political culture may be required.

Where courts are unreliable or impractical, arbitration provisions can be used in contracts to bind the parties to alternative dispute resolution.

In recognition of these difficulties, some investors may have the leverage to negotiate the inclusion of a choice of venue clause in their investment agreement to ensure access to a court they trust. Yet, requiring companies to submit to courts in the investor’s jurisdiction to resolve disputes is costly for small or start up companies in less developed countries.

Are there alternatives to court enforcement? Trial by combat is one option. In the age of reality television, perhaps it is only a matter of time before we read about “Corporate Death Match.” However, for those who would rather not risk physical injury in their quest to protect their rights, there are other options.

⁴ *Id.*

Where courts are unreliable or impractical, arbitration provisions can be used in contracts to bind the parties to alternative dispute resolution. When developed appropriately, with trained arbitrators and established rules of procedure, arbitration can lead to predictable outcomes and is often less costly than a court proceeding.

For the most part, arbitration historically has been used mostly in bilateral agreements – where only the parties actually executing the agreement have the right to arbitrate. Recently, however, the Novo Mercado in Brazil has incorporated into its listing agreements arbitration provisions that provide enforcement rights to all shareholders of listed corporations.

The Novo Mercado is a separate segment of the Bovespa Stock Exchange that requires companies to comply with more rigorous corporate governance standards relating to shareholder rights and transparency. Under the Novo Mercado rules, shareholders may submit any disputes relating to the listing rules to binding arbitration in Brazil. Because many of the Novo Mercado's governance standards address matters traditionally the subject of corporate or company law, these provisions give shareholders of Novo Mercado companies a forum – entirely separate from the Brazilian judicial system – to seek redress for violations of their rights as shareholders.

A fundamental problem for developing countries seeking to institutionalize an arbitration-based solution is the lack of arbitrators with specialized experience and knowledge – especially where the legal culture, generally, has little experience with investor rights issues. Therefore, it is important that arbitrators (as well as traditional judges) be trained in issues relating to investor rights.

Governance training programs have proliferated throughout the U.S. and abroad, and certainly the capacity exists to create specially designed programs for arbitrators and judges on investor protection issues. Given the wide array of governance programs available on-line or through teleconferencing it might be possible to provide judges, arbitrators, and attorneys with the needed expertise without requiring significant travel. The Novo Mercado attempts to mitigate the risk of inexperienced arbitrators by requiring that disputes be submitted to the Market Arbitration Panel, which consists of at least 30 arbitrators elected by the Board of Directors of Bovespa. To be elected to the Market Arbitration Panel, an arbitrator is required to possess good knowledge of the capital markets. This is a start.

As this discussion suggests, crafting an arbitration based solution also raises a number of questions. One must decide:

- Who arbitrates?
- What level expertise is required for the arbitrators?
- Are their decisions binding?
- How are they enforced?
- Are the decisions appealable?
- If so, where?
- What are the arbitrators' powers over discovery?
- Should arbitration decisions be published?

The answers to these questions may depend on a number of factors. But ultimately, the effectiveness of arbitration as a solution will depend on how arbitration is imposed in a particular company. In the Novo Mercado example, an exchange requires that companies submit to arbitration as a condition to listing. Thus, companies that refuse to submit to arbitration – and abide by the judgments of arbitrators – risk being de-listed. But if not imposed by an exchange or another party with similar leverage over the company, arbitration may become simply another contractual provision in need of enforcement.

Role of Stock Exchanges: Local & Foreign

The Novo Mercado model also shows how local stock exchanges can be an effective means to enforce corporate governance standards in developing countries, even where legal and judicial institutions are less efficient. As an enforcement model, the Novo Mercado is exemplary because it provides a right of action to aggrieved shareholders outside the traditional judiciary. But local stock exchanges can be effective as agents of reform even where the right to arbitrate is not granted to all shareholders.

First, reforming exchange listing rules is often easier than reforming general securities or company statutes. But, more importantly, the threat of delisting provides exchanges with a unique ability to compel compliance with the rules they set. Stock exchanges enjoy special self-enforcement abilities.

The efficacy of stock exchanges as enforcers is demonstrated by the adoption by the London Stock Exchange (and others) of listing rules which require companies to comply with certain governance requirements or explain publicly why they have not

done so.⁵ In many respects this “comply or explain” approach has proved to be an effective mechanism for enforcing corporate governance because companies are reluctant to disclose their failure to adhere to code standards.

Through foreign listings, stock exchanges in developed countries also facilitate the development of governance standards in the developing world. When a company from a less developed jurisdiction lists in London or New York, it effectively binds itself to heightened standards and enforcement powers. Even though the technical corporate governance listing rules often do not apply, foreign issuers are subject to increased disclosure requirements and the general oversight of the listing exchange. These alone can provide potential investors with needed assurances that their rights are more likely to be protected.

However, listing abroad can have adverse effects. When all the “blue chips” of a given jurisdiction go off and list in London or New York, it becomes more difficult for their home jurisdictions to develop and maintain a vibrant capital market.⁶

Lending Institutions

Banks can also effectively enforce corporate governance standards in developing economies. After family and friends, local banks are often the primary source of capital for businesses in developing countries. As a result, lending institutions have self-enforcement capabilities much like stock exchanges.

Banks that make loans in developing countries – whether local banks or foreign banks – could offer better interest rates for “well governed” companies. Banks can also refuse to extend additional credit to companies that do not sufficiently improve their governance practices after the initial loan has been made. The lure of better interest rates and additional credit give banks the ability to compel compliance with governance standards. In fact, BNDES, the Brazilian national development bank, is considering a plan to offer better financial terms to borrowers meeting specified governance criteria. This is a development that bears watching. Hopefully it will be imitated.

⁵ Weil, Gotshal & Manges LLP, *Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States – Final Report & Annexes* (January 2002), 16, 19.

⁶ See Stijn Claessens, Daniela Klingebiel, & Sergio L. Schmukler, *Explaining the Migration of Stocks from Exchanges in Emerging Economies to International Centers* (2003).

Additionally, focusing banking institutions on the importance of good governance for their borrowers could help spur governance reform of the banking institutions themselves.

Softer Enforcement

Beyond courts, arbitration panels, stock exchanges and lending institutions, other institutions – such as rating agencies, institutional investors and the media – can also play an important role in improving corporate governance practices in developing countries. I think of these as the softer enforcers of good corporate governance.

Ratings Agencies. Rating agencies that include governance issues in their rating criteria provide clear incentives for good governance. Organizations such as Transparency International rate countries and corporations on, among other things, the state of their governance and shareholder protections. How a company or jurisdiction scores on these issues is factored into its overall score. If no enforcement mechanisms are in place, the rating decreases significantly. Another organization, the Russell 20-20, conducts investor surveys and analyses regarding how investors perceive the investment climate in a variety of countries. Originally a non-profit group made up of 20 major pension funds and 20 major money management organizations, the Russell 20-20 produces reports that provide insight on how investors perceive the investment environment of selected emerging markets. Given the influence of these reports, companies and countries have a great incentive to adopt governance best practice standards and ensure that these standards are enforced. Quite simply, low ratings deter investment.

Other Forms of Investor Activism. Institutional shareholder organizations have also emerged to provide guidance and give a voice to shareholders concerns.⁷

One such organization is the Pensions & Investment Research Consultants Ltd. (PIRC), which was set up by public sector pension funds in the mid-1980s. The PIRC examines a corporation's compliance with its own set of governance principles, and then invites management to discuss its conclusions. After completing this diligence process, the PIRC publishes a recommendation to

⁷ Jonathan Charkham & Anne Simpson, *Fair Shares: The Future of Shareholder Power and Responsibility* (Oxford University Press 1999).

shareholders with respect to the company as an investment. The influence of the PIRC is demonstrated by the fact that many companies have “quietly modified” their plans after a discussion with PIRC, rather than risk a negative recommendation.

The PIRC is not the only active investor organization. Other investor-related entities, such as the Danish Shareholder Association, TIAA-CREF, or CalPERS, create their own codes of best practice, publish governance criteria for investment selection, and/or make recommendations for shareholder votes. No matter what approach an investor organization takes, it is clear that groups of investors, once organized, will have a greater voice in influencing critical governance issues. Their capital and influence make investor organizations another institution capable of enforcing investor rights.

The Media. Finally, the impact of the media cannot be underestimated. Consider the power of public scrutiny – who would want to invest in a company which makes headlines because its majority shareholders sacrifice the interests of the minority shareholders for their own private gain? By bringing these stories to light, the financial media in developing countries can play an important role in facilitating the enforcement and recognition of investor rights.

How to effectively define and enforce shareholder rights is an issue that all developing markets must face. Indeed, even developed economies also should examine their own enforcement policies and mechanisms to see how they can be improved.

There many hard questions:

- How to establish the fiduciary duty standard?
- How effective are public enforcement institutions?
- What is the role of the private sector?
- How can judges or arbitrators gain the necessary expertise to deal with such issues?
- Where should contractual arrangements be enforced?

These questions are only the beginning, but developing countries do not have to find the answers alone.

Edited extracts of the speech delivered by Shri G. N. Bajpai, Chairman, Securities and Exchange Board of India at the 2003 Lex Mundi North America Regional Conference (on a panel jointly organized by Lex Mundi and the Global Corporate Governance Forum).

INDIA AT THE CUTTING EDGE OF CORPORATE GOVERNANCE

by Shri G. N. Bajpai

I would thank you for bestowing on me this great opportunity to share with you my thoughts and experience relating to corporate governance, particularly in the Indian context.

It gives me a special happiness because the subject is very close to my heart, as it holds the key to wealth creation, wealth management and wealth sharing in any society and to investors' confidence in the securities market. The onus of maintaining/improving corporate governance

standards squarely falls on the management team consisting of minority shareholders and/or professionals, who are entrusted with the valued resources of the silent majority and are expected to enhance the interests of all the stakeholders in compliance with ethical principles. In case they do not do so on their own, the regulator for the securities market, who has a vicarious responsibility to ensure non-manipulated demand for and supply of securities in the market, should not hesitate to enforce such standards on them.

I passionately nurture and propagate the belief that improved corporate governance is the key objective of the regulatory framework in the securities market.

I passionately nurture and propagate the belief that improved corporate governance is the key objective of the regulatory framework in the securities market. I propose to discuss, first, the developments in India on the subject, then the role regulators can play to improve corporate governance practices and the legislative initiatives on the anvil to strengthen the corporate governance framework further.

Insulation from Scandals

Recent corporate scandals, such as Enron and WorldCom have rocked the global financial markets and shaken the confidence of investors. The authorities and the regulators all over the World are burning midnight oil to prevent the recurrence of such scandals. Fortunately, we in India are having peaceful sleep as we are to a large extent insulated from corporate scandals. No major scandal involving corporate governance has taken place in India so far. It did not contract any contagion effect of overseas, in particular across the Atlantic, corporate governance scandals, even though the Indian economy is substantially integrated with the global markets; a number of trans-national corporations are operating in India and quite a few large Indian firms are listed on various overseas stock exchanges, including the New York Stock Exchange, the Nasdaq and the London Stock Exchange. This is largely due to the robust corporate governance standards put in place by the regulators to prevent corporate scandals. However these global, well-publicized corporate debacles have provoked an engaging debate across the Indian jurisdictions on strengthening corporate governance standards further.

Securities Market

The securities market reflects and regulates corporate governance standards. Many jurisdictions use securities markets as a tool to improve corporate governance. Let me, therefore, first share with you how the Indian securities market has been undergoing a cleansing over the last decade or so and building resilience to corporate scandals. With the objectives of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package of reforms consisting of measures to liberalise, regulate and develop the securities market was introduced in the 1990s. The practice of allocating resources among different competing entities by a central authority was discontinued. The issuers –complying with the eligibility criteria— now have the freedom to issue securities at market determined rates. The secondary market overcame the geographical barriers by moving to screen based trading, which made trading system accessible to everybody anywhere in the Indian sub-continent. Trades enjoy counter-party guarantees. The trading cycle was shortened to a day and trades are settled within two working days, while all deferral products are banned. Physical security certificates have almost disappeared. A variety of derivatives are available. In fact, some reforms such as

straight-through processing in securities, T+2 rolling settlement, the clearing corporation as the central counter-party to all the trades on the exchanges, real-time monitoring of brokers' positions and margins, and automatic disabling of brokers' terminals are singular to the Indian securities market. Indian disclosure and accounting standards are as modern, updated, potent and versatile as those of any other market. Today, the Indian securities market stands shoulder to shoulder with most developed markets in North America, Western Europe and East Asia.

SEBI's Role

As the regulator for the securities market, the Securities and Exchange Board of India (SEBI) has been focussing on the following areas to improve corporate governance:

- a. Ensuring timely disclosure of relevant information,
- b. Providing an efficient and effective market system,
- c. Demonstrating reliable and effective enforcement, and
- d. Enabling the highest standards of governance.

Disclosure standards in
the Indian Regulatory
jurisdiction are on par
with the best in the world...

A. DISCLOSURE STANDARDS

Disclosure standards in the Indian Regulatory jurisdiction are on par with the best in the world, according to feedback from several global organisations, as well as both regulatory and market participants. Similar views have been expressed by various academicians and researchers. Key research grants India 100% marks on disclosures.

A company is required to make specified disclosures at the time of issue and make continuous disclosures as long as its securities are listed on exchanges. The standards for these disclosures, including the content, medium and time of disclosure, have been specified in the Companies Act, Disclosure and Investor Protection Guidelines, Listing Agreement, regulations relating to insider trading and takeovers, etc. These disclosures are made through various documents such as prospectuses, quarterly statements, annual reports, etc. and are disseminated through media, websites of the company and the exchanges, and through EDIFAR (Electronic Data Information Filing and Retrieval) System, which is maintained by the regulator. These disclosures relate to financial performance, shareholding pattern, insider trading, substantial acquisitions, related party transactions, audit

qualifications, buyback details, corporate governance, actions taken against the company, risk management, utilization of issue proceeds, remuneration of directors, and much more. All listed companies and organisations associated with securities markets, including the intermediaries, asset management companies, Trustees of mutual funds, SROs, stock exchanges, clearing house/corporations, public financial institutions, professional firms such as auditors, accountancy firms, law firms, analysts, consultants, etc., assisting or advising listed companies are required to abide by the Code of Corporate Disclosure Practices specified in SEBI's Insider Trading Regulations.

B. EFFICIENT AND EFFECTIVE MARKET SYSTEM

(In India)... there are 23 stock exchanges, about 10,000 brokers, 15,000 sub-brokers, 10,000 listed companies, 500 foreign institutional investors, 400 depository participants, 150 merchant bankers, 40 mutual funds offering over 450 schemes, and 20 million investors

Indian securities market has to have a large infrastructure to meet the demands of the sub-continental market. There are 23 stock exchanges, about 10,000 brokers, 15,000 sub-brokers, 10,000 listed companies, 500 foreign institutional investors, 400 depository participants, 150 merchant bankers, 40 mutual funds offering over 450 schemes, and 20 million investors. [Karin, for this quote, please start "(In India)... there are 23 stock exchanges....] Yes, there is only one regulator. Not only are the numbers gigantic, but the systems and infrastructure are equally massive and sophisticated. All stock exchanges in India offer on-line, fully automated, nation-wide, anonymous, order-driven, screen-based trading systems. The clearing corporation performs full novation and settles the transactions on T +2 rolling settlement. (Never, ever has the clearing

corporation's exposure as a percentage of the net worth been more than 5% in the past two years). It has a comprehensive risk management system, including Value at Risk (VaR) based margining system, which is monitored on a real-time basis with a built-in mechanism automatically disabling the terminals of the trading/clearing members. The depositories' legislation ensures free transferability of securities with speed, accuracy and security. The securities are transferred

electronically in dematerialised form. Further, Indian accounting standards follow International Accounting Standards (principle based) and are by and large aligned. In addition to creating an efficient trading platform and clearing and settlement mechanism, our focus is substantially directed towards:

- a. Provision of timely availability of high quality price sensitive information to the market participants to enable them to take informed decision and ensure efficient price discovery,
- b. Maintenance of high quality of services and fair conduct for market participants. The regulations specify high standards for those seeking to become market intermediaries and require them to abide by a code of conduct.
- c. Ensuring that the market is fair, transparent and safe so that issuers and investors are at ease when carrying out transactions.

Every market participant, irrespective of his size and influence in the market or in the polity, is held accountable for his misdeeds very expeditiously.

C. RELIABLE AND EFFECTIVE ENFORCEMENT

The regulator aims to ensure that no misconduct goes unnoticed or unpunished. It keeps an eagle eye on the happenings in the market and identifies anything unusual or undesirable, which may adversely affect the efficacy of the market. Every market participant, irrespective of his size and influence in the market or in the polity, is held accountable for his misdeeds very

expeditiously. The proactive and aggressive approach of the regulator in enforcement can be gauged from the fact that during the financial year 2002-2003, SEBI passed 561 orders, out of which over 350 were punitive.

D. HIGHEST STANDARDS OF GOVERNANCE

If the Indian securities market is a model for others, it is natural that it leads in the area of corporate governance as well. The Kumar Mangalam Birla Committee of the Indian jurisdiction outlined a Code of Good Corporate Governance, which compared very well with the recommendations of the Cadbury Committee and the OECD Principles of Corporate Governance. The code was operationalised by inserting a new clause (Clause 49) to the Listing Agreement, and applied to all the listed companies in India in a phased manner. Following the implementation of the

Birla Committee recommendations, substantial developments took place in the corporate world and securities market that required revisiting the issue. The Narayan Murthy Committee has refined the corporate governance norms which will be implemented through modification of the listing agreement. Government also appointed a few committees to look into specific governance related issues. Based on their recommendations, the Government is trying to provide statutory back-up to corporate governance standards.

The initiatives for improvement in corporate governance are coming mainly from three sources: the market, the regulator, and the legislature.

While the legislative initiative is directed towards bringing about amendments to the basic law – India's Companies Act – in order to include certain fundamental provisions related to corporate governance, dynamic aspects of corporate governance such as disclosures, accounting standards, etc. are being pursued through regulatory initiatives by bringing about amendments to the Listing Agreement. Such an approach is better for us because amending legislation is a comparatively complicated and protracted process in a truly democratic society like India. The most important initiative comes from market forces and the mechanisms which encourage and proscribe management's improvements on the quality of corporate governance. The Indian market has formalised such forces in the form of a rating called the

'Corporate Governance and Value Creation Rating', which is quite unique in the World and is sought after voluntarily by the companies. Let me discuss these three initiatives in the reverse order.

I believe that while a lot has been done in the field of corporate governance, we need to advance the issue to the centre stage of corporate operations.

i. Market Initiative - Governance and Value Creation Rating

I believe that while a lot has been done in the field of corporate governance, we need to advance the issue to the centre stage of corporate operations. Otherwise, it would remain as an ineffective side agenda, which will get a lot of lip-service but would never be used as the important tool in improving corporate behaviour. In order to bring it

to centre stage, we must have an unambiguous yardstick which can be used to measure and monitor progress on the path of corporate governance.

The Indian market has developed such a yardstick in the form of 'Governance and Value Creation Rating (GVC)' architected by CRISIL, a leading credit rating agency in India and one of the four largest agencies in the world. This is significantly different from the 'Traditional Corporate Governance Rating (TCG)', which is available in several regulatory jurisdictions. The GVC approach stems from the belief that good governance, over and beyond its process aspects, is fundamentally a sustainability issue - good governance should result in the creation and fair distribution of tangible benefits. It is based on the following premises:

- The strength of stakeholder relationships can add to/impede future wealth creation by the corporation.
- Governance processes must be such that wealth created is evenly distributed across all classes of stakeholders.
- Management quality must be such that it is able to adapt the above two to match the dynamics of the business environment.
- All these impact stability of future wealth creation.

While corporate governance is expected to enhance the interests and fulfill the aspirations of all stakeholders, it does not necessarily always happen. While the ultimate purpose of all corporations is to create wealth for shareholders, it is important to recognise that shareholders are indeed the residual stakeholders. The obligations towards the contractual stakeholders such as customers, employees, vendors, creditors and the society get precedence over the interests of the shareholders. The contribution of other stakeholders to the success of the corporation is not less important than that of the shareholders. Unless the company blends a harmonious relationship among all the stakeholders, it may jeopardise its ability to create wealth on a sustained basis. The GVC rating seeks to capture this sentiment.

Before I go about describing the process, let me briefly indicate the distinction between TCG and GVC ratings. While the TCG rating primarily focuses on internal processes, the GVC rating seeks to balance process assessment with an assessment of the benefits of good governance; TCG rating focuses on the treatment and rights of shareholders, while GVC rating aims at a balanced assessment for all stakeholders; and TCG rating is either qualitative or purely historical in orientation, while GVC rating focuses also on sustainability of practices.

Under the GVC assessment, the shareholders have a residual entitlement, while all other stakeholders have contractual entitlement to the value created by the company. The customers benefit from using the company's products and services. The suppliers benefit from steady and profitable sales to the company. The society benefits from receipt of taxes, generation of employment, and social commitment displayed as well as public projects undertaken by the company. Lenders benefit from safety of interest and principal, and they also gain from enhancement of their portfolio quality through improvement in the quality of their lending/investment portfolios. Employees benefit from salaries and benefits, and through stability of employment. The residual belongs to shareholders – majority and minority – and are shared appropriately.

The board and management are expected to create value for all the stakeholders. Hence, governance processes must be such that wealth created is distributed across all classes of stakeholders in proportion to their contribution, and in keeping with market and business practices. It is in this perspective that the quality of management should be enhanced so that it is able to adapt to match the dynamics of the business environment. Eventually, all these decisions of companies impact the stability of their future wealth creation.

The GVC assessment process of CRISIL is quite detailed, and I would not like to bore you with the technical details. It comprises assessments of:

- **Governance processes:** The factors assessed include treatment of shareholders, safeguarding ownership rights/interests of shareholders, transparency and disclosure, composition and functions of the board, etc. The assessment evaluates how the governance processes are conducive to these factors and the true spirits at work.
- **Wealth Creation:** This is assessed in detail for each kind of the stakeholder. The finances of the company are assessed with a view to understanding the level of wealth creation (inputs minus outputs), particularly with reference to macro-economic and micro-industry environment, and if the wealth has been created in a manner beneficial to all stakeholders. A methodology similar to Economic Value Addition (EVA) is used for this.
- **Wealth Management:** This is assessed across the stakeholders. The wealth generated from management of inputs and the functioning of the organisation has to be managed well. The wealth must at all times remain on a multiplier

matrix so that it grows optimally. Even if the wealth is being utilised for purposes other than the core businesses and activities of the company, it should be for the ultimate good of all the stakeholders in the medium and long-term.

- **Wealth Sharing:** Similarly, GVC assesses if the wealth is being shared proportionately, i.e. if those who are entitled to contractual sharing get their dues and in time. Further, residual is shared amongst various classes of shareholders proportionately and equitably. There is no disproportionate sharing in particular through instruments like ESOP, Sweat Equity, disproportionate compensation, etc.

GVC ratings are a globally unique initiative, and are gradually gaining acceptance in the Indian market. Efforts are also under way to propagate this initiative in other markets, both on account of its intrinsic merits as a comprehensive and forward-looking measure of governance, and also to create a common language for understanding corporate processes and their effectiveness.

ii. Regulatory Initiative – Listing Agreement

The regulator has been endeavouring to inculcate a culture of corporate governance among the market participants and the listed companies. The Listing Agreement has been amended with a view to ensure, inter alia, the following:

- a. Not less than 50% of the board of directors shall comprise of non-executive directors.
- b. In case of a non-executive chairman, at least one-third of the board shall comprise independent directors and in case of an executive chairman, at least half of the board shall comprise independent directors.
- c. Compensation paid to non-executive directors shall be approved by the shareholders and also disclosed.
- d. Independent directors shall periodically review legal compliance reports as well as the boards' disclosures on risk management.
- e. Company shall lay down a code of conduct for all board members and senior management.
- f. The audit committee shall consist of qualified and independent directors. While all the members of the audit committee have to be financially literate, the chairman must be a person, who is well versed in accounting and management. This committee shall exercise oversight of the company's financial reporting process. It is empowered to recommend the appointment and removal of external auditors. It is responsible for reviewing the adequacy of

internal control systems with the management, and external/internal auditors and also reviewing the company's financial and risk management policies.

iii. Legislative Initiatives – The Companies (Amendment) Act

The Companies Act is the basic law to facilitate incorporation and management of companies. A bill proposing amendments to the Companies Act of 1956 is expected to be considered by Parliament to provide for statutory backing to corporate governance standards. The amendment would possibly focus on reforming the audit process and the board of directors.

In order to reform the audit process, the bill is expected to make the provisions for:

- i) Laying down the process of appointment and qualification of auditors,
- ii) Prohibiting non-audit services by the auditors,
- iii) Prescribing compulsory rotation, at least of the audit partner,
- iv) Requiring certification of annual audited accounts by both CEO and CFO, and
- v) Providing an expeditious disciplinary mechanism for the auditors.

In order to reform the boards, following major initiatives are being proposed:

- i) The expression 'Independent Director' would be defined. Among other requirements, an independent director should not have substantial pecuniary interest or hold more than 2% of the company's shares.
- ii) Remuneration of non-executive directors can be fixed only by shareholders and must be disclosed. A limit on the amount which can be paid would also be laid down. It is also envisaged that the directors should be imparted with suitable training.

You may thus note that there is a concerted effort - the market, the regulator and the government are working in tandem to improve corporate governance in India. Like the securities market, I have no doubt in my mind that India will soon be a model for others in the area of corporate governance.

Erik Berglöf is the Director of SITE, Stockholm School of Economics and Stijn Claessens is Professor of International Finance Policy, University of Amsterdam, respectively. Both are Centre for Economic Policy Research Fellows. This paper was prepared for the Global Corporate Governance Forum, but the views are the authors and do not necessarily represent those of the Forum or its donors. The authors owe Katharina Pistor many thanks for her extensive comments. They would like to thank the participants in a workshop on June 19, 2003 on Enforcement in Corporate Governance at the World Bank and participants in the workshop Enforcement during the GCGF High Level Working Meeting and Consultation on the OECD Corporate Governance Principles, November 2-4, 2003, Paris for useful suggestions.

CORPORATE GOVERNANCE AND ENFORCEMENT

by Erik Berglöf and Stijn Claessens

Abstract

Enforcement more than regulations, laws-on-the-books or voluntary codes is key to effective corporate governance, at least in transition and developing countries. Corporate governance and enforcement mechanisms are intimately linked as they affect firms' ability to commit towards their stakeholders, in particular towards external investors. We provide a framework for understanding these linkages and how they are shaped by countries' institutional contexts. When the general enforcement environment is weak and specific enforcement mechanisms function poorly, as in many developing and transition countries, few of the traditional corporate governance mechanisms are effective. The principal consequence in these countries is a large blockholder, but there are important potential costs to this mechanism. A range of private and public enforcement "tools" can help reduce these costs and reinforce other supplementary corporate governance mechanisms. The limited empirical evidence suggests that private tools are more effective than public forms of enforcement in the typical environment of most developing and transition countries. However, public enforcement is necessary regardless, and private enforcement mechanisms often require public laws to function. Furthermore, in some countries at least, bottom-up, private-led tools preceded and even shaped public laws. Political economy constraints, resulting from the intermingling of business and politics, however, often prevent improvements in the general enforcement environment, and adoption and implementation of public laws in these countries.

1. INTRODUCTION

Much effort in recent years has been devoted to the formulation of ever more elaborate and complete rules of corporate governance. Many countries have adopted their existing or established sophisticated and extensive new legal texts and regulations, often imported from developed market economies. In addition to laws and regulations, more informal codes of conduct have been adopted. Besides international efforts, such as the corporate governance principle of organizations like OECD, recent surveys have identified well over hundred national corporate governance codes adopted by various organizations (Gregory, 2000 and 2001). And one can add to this the seemingly endless corporate governance pronouncements by individual companies. These sets of rules, whether international, national, or company-specific, are all remarkably similar. Yet corporate governance practices differ substantially across countries and companies (see, for example, OECD, 2003). And there are still many concerns regarding the effectiveness of corporate governance rules in transition and developed countries, as well as many developed countries. In other words, the written rules are not adhered to and pronouncements of firms are not being followed up by actions. In great part this is because rules and regulations are not enforced and increasingly policymakers have come to realize that enforcement more than regulations and laws-on-the-books is the key problem, at least in transition and developing countries.

The problem of enforcing agreements obviously extends far beyond corporate governance. The Nobel Laureate Douglass North (1991) argued that "how effectively agreements are enforced is the single most important determinant of economic performance". Recent research supports this assertion, suggesting that enforcement of the rule of law is a, perhaps *the*, central functional difference between developed market economies and developing economies. Indeed, according to some analysis, the development of countries as well as their vulnerability to external shocks can be explained by the degree to which private property rights are being respected (Acemoglu, Johnson and Robinson, 2002). Comparisons between developed market economies and transition economies in Central and Eastern Europe also show much larger differences in enforcement (law effectiveness) than in laws-on-the-book (law extensiveness) (Pistor, Raiser and Gelfer, 2001).

While enforcement is a general problem of development, it particularly affects firms seeking external financing. Financial contracts after all involve the commitment of the firm to adhere to certain obligations, in particular pay an appropriate rates of return to

the providers of external financing. A weak enforcement environment makes it harder for firms to commit to honor financial contracts and attract external financing. Again, it is not only the laws, but also their enforcement that affects the ability of firms to attract external financing and, consequently, the degree of general financial development. Empirical evidence, for example, shows that it is not the presence of insider trading laws but rather actions taking against insider trading that help explain the development of securities markets (Bhattacharya and Durnev, 2001).¹ A large international study finds that the level of enforcement is much more important than quality of laws-on-the-book in explaining the turnover of CEOs (Defond and Hung, 2003).

Through its effect on commitment a weak contracting environment also influences ownership and control patterns, and ultimately the functioning of the different

Many, if not most, corporate governance systems in developing and transition countries are heavily tilted in favor of controlling owners, thereby potentially perpetuating any social costs.

corporate governance mechanisms. If commitment instruments are missing or weak, the typical corporate governance response is high ownership concentration. While ownership concentration can be the best individual response, and may indeed improve corporate governance, it also has many potential costs. At firm level these costs include entrenchment of the manager and owner, poor performance of firms, limited risk diversification and liquidity costs as the owner cannot sell its stake easily and minority rights expropriation. At the country level, these potential costs risk undermining development of capital markets, with overall costs in lower growth, etc. High ownership concentration can also affect the development of corporate governance rules. Many, if not most,

corporate governance systems in developing and transition countries are heavily tilted in favor of controlling owners, thereby potentially perpetuating any social costs.

¹ This is not to say that laws are not important, but rather that more than laws is needed. Lopez-de-Silanes (2003), for example, surveys the evidence on securities laws and enforcement and concludes that: "the development of capital markets depends crucially on laws that facilitate enforcement and the improvement of court procedures that allow for a more efficient dispute resolution."

The concentrated ownership structures also affect the effectiveness of other corporate governance mechanisms, which weaknesses cannot be rectified by laws and regulations (only). Discouraging, for example, investors from taking controlling positions by adopting governance standards from developed market economies may lead to worse outcomes when other corporate governance are missing. Moreover, standards that are transplanted without sufficient domestic debate and adaptation are less likely to be adhered to or enforced. In the near term, corporate governance mechanisms in developing and transition countries have to function and reform has to be implemented in an environment where courts and other enforcing institutions are missing or very weak. The challenge is not to undermine perhaps the most potent corporate governance mechanism in less developed economies, concentrated ownership, while at the same time mitigating the potential costs which come along with these ownership structures. The solutions more likely to be effective will have to be mechanisms that rely less on public enforcement. These mechanisms and their effectiveness should be evaluated against the key corporate governance issue in emerging markets, finding the appropriate level of protection of (enforced) minority rights. Again, solutions should not (just) be laws on the books but rather solutions that encourage practices that matter most for corporate governance in these countries.

In this paper, we develop a framework to help understand when which corporate governance rules are (not) enforced and what can be done to improve corporate governance mechanisms in a weak enforcement environment. The analysis of various options should help understand which reforms, including corporate governance rules, are best pursued to improve corporate governance practices and mitigate social costs. The paper comes with its caveats. The literature on how to improve poorly functioning enforcement environments is large, in one sense it coincides with the literature on development. To summarize this disparate body of work in a short paper would be an insurmountable task. The paper instead focuses on enforcement issues as they relate to corporate governance.

We start by characterizing the general corporate governance problem and the functioning of the various corporate governance mechanisms in weak contracting environments. We then provide a typology of different forms by which each of these governance mechanisms can be strengthened. We consider several classifications. One distinction is between private and public mechanisms. Private initiatives can be outside of the legal system and can be unilateral, bilateral and multilateral. Separate from such private ordering among agents is private law

enforcement, such as litigation by individuals. Laws can also be enforced through public means, when the government also acts as the prosecutor. And the government can have full control over all activities, in which case there are no property rights of contracts to enforce, and the laws are immaterial. We analyze the various enforcement mechanisms along this continuum. In the end, the most interesting question is why improvements in enforcement in corporate governance are so hard to implement. Why do firms and countries, given the supposed benefits in terms of share prices and financing conditions, not adopt and adhere to the best possible governance standards? Even more puzzling, if there are such enormous returns to better enforcement, why do governments not invest more in enforcing? We provide some of these fundamentally political economy questions, but acknowledge that we have limited answers to date.

2. THE CORPORATE GOVERNANCE PROBLEM IN DEVELOPING AND TRANSITION COUNTRIES

The corporate governance problem in developing and transition countries is quite distinct from that of developed market economies.² In this section we briefly define the problem with a focus on how a weak general enforcement environment influences the basic corporate governance mechanisms. To understand corporate governance and the role of enforcement it is useful to start with a simple conceptual model of the firm and how it can be financed by outside sources. We then discuss how various mechanisms may be used to deal with the principal agent problems that arise because of the external financing (for more extensive overviews of the corporate governance literature, see Shleifer and Vishny 1997 and Becht, Bolton and Roell 2003).

An entrepreneur or manager approaching outside markets for finance faces a serious commitment problem: how can investors be assured that he will choose the right projects, exert sufficient effort, adequately disclose relevant information, and ultimately repay investors? In the complete absence of credible commitment, outside investors will assume the worst-case scenario, i.e., that the entrepreneur/

² For simplicity, we do not distinguish between developing and transition countries, even though the problems are often different in nature; for a discussion of the different corporate challenges facing developing and transition countries, see Berglof and von Thadden (2001). More recently, there has been some convergence, for example, in terms of ownership concentration (Berglof and Pajuste 2003).

manager will use all opportunities to defraud investors or in other ways not live up to his promises. The worse is the entrepreneur/manager's commitment power, the costlier will its outside financing be (and the more difficult it is to recruit good personnel and establish long-term supplier/customer relationships).

Corporate governance is in great part about mitigating this commitment problem.³ This is actually the definition of corporate governance advanced by Shleifer and Vishny in their 1997 review: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (1997, p. 737). Investors can reduce the likelihood of being defrauded or deceived by monitoring and potentially punishing management. Firms can try to employ a variety of commitment mechanisms to overcome investors' concerns.

Problems arise for two reasons: an individual investor may not have proper incentives to pay the costs involved in ensuring that the entrepreneur lives up to his promises and may attempt to free-ride on monitoring and enforcement by other investors; and the mechanisms to commit and punish may be missing or incomplete, possibly due to poor enforcement of property rights in the country. Typically the two problems will go together. When the costs of collecting information and enforcing contracts are high, as in many developing and transition countries, investors will find it more difficult to monitor and will thus be less likely to do so when there are many investors; and firms cannot commit credibly as institutions are missing or mechanisms are too costly to make seeking external financing attractive. These problems involve costs, in a narrow sense of some transaction costs and in a broad sense of lost firm and economic growth when some investment opportunities are not being financed.

³ We consider here definitions of corporate governance that concern with the normative framework, that is, the rules under which firms are operating—with the rules coming from such sources as the legal system, the judicial system, financial markets, and factor (labor) markets. vary widely. We do not define corporate governance as a set of behavioral patterns, that is, the actual behavior of corporations, in terms of such measures as performance, efficiency, growth, financial structure, and treatment of shareholders and other stakeholders. The second provides of course input for analysis of corporate governance, and for studies of single countries or firms within a country, this definition is the most logical choice, but for comparative studies, the first definition is the more logical one. It investigates how differences in the normative framework affect the behavioral patterns of firms, investors, and others.

Corporate governance is thus also structures in place that can help resolve the conflicts of interest among multiple stakeholders.

Corporate governance is not only about mitigating the commitment problem, but often also about balancing the rights and interests of multiple stakeholders (i.e., management, the corporation, shareholders, creditors, employees and other stakeholders). Corporate governance is thus also structures in place that can help resolve the conflicts of interest among multiple stakeholders. Much of this resolution is ex-post, as when contracts were incomplete and did not foresee certain events. This resolution of conflicts

of interest is different from the enforcement of property rights and contracts. It can actually involve the violation of ex-ante contracts or property rights. Bankruptcy is such an example, where absolute priority rules are sometimes violated in the interests of stakeholders. But these forms of corporate governance involve enforcement as well since the mechanisms that help resolve conflicts among certain stakeholders ex-post need to be enforced.

Bankruptcy also illustrates that conflicts within classes of stakeholders also are important for commitment. Bankruptcy law is primarily concerned with conflicts among creditors. While the interests of shareholders are generally viewed as being more aligned, through profit maximization, there are also important potential conflicts among shareholders in particular between large blockholders and dispersed, small shareholders. Corporate governance must also resolve these conflicts.

The two forms of ‘enforcement’—enforcement needed to mitigate the commitment problem (“property rights”) and enforcement of resolution mechanisms—while conceptually different, are closely related in several ways. Weak property rights—because of unclear legal definitions of creditor and equity rights or poor and unpredictable enforcement—can imply that the scope for ex-post conflicts of interest problems is larger than otherwise. Poorly defined and enforced property rights can also mean that the mechanisms typically used to resolve conflicts of interest among multiple stakeholders are missing or weak as well. In turn, the large scope for ex-post conflicts of interest and the limits on the ex-post resolution mechanisms can complicate the ex-ante commitment problem. More generally, weak property rights enforcement and poor mechanisms for ex-post conflicts of interest resolution will often go together.

This combination need not be the case, however. Many countries may have weak ex-ante rules or poor property rights, but may have developed good ex-post resolution mechanisms. There have been studies, for example, showing that the probability of a CEO being forced out following bad corporate performance is equally high for countries with very different corporate governance regimes (Kaplan, 1994, Kaplan and Shivdasani, 1995, and Gibbons, 2003). What is clear is that a combination of poor enforcement of property rights and weak resolution mechanisms gives rise to “corporate governance” problems, in terms of lower capital markets development, less external financing, lower firms valuation and higher cost of capital, etc. (see survey by Claessens, 2003). We do not want to address the general issues of property rights definition and contract enforcement. For this, we refer to the general literature on enforcement (for a recent review, see Polinsky and Shavell, 2000). We try to address the second “enforcement” problem, defined as the resolution of conflicts of interest among multiple stakeholders using various mechanisms. Figure 1 provides an overview of these mechanisms that can be used (see Becht et al., 2003 for a general review).

The Corporate Governance Mechanisms in Developing and Transition Countries

Corporate governance mechanism	Relative importance in developing and transition countries	Scope for policy intervention
Large blockholders	Likely to be the most important governance mechanism	Strengthen rules protecting minority investors without removing incentives to hold controlling blocks
Market for corporate control	Unlikely to be important when ownership is strongly concentrated; can still take place through debt contracts, but requires bankruptcy system	Remove some managerial defenses; disclosure of ownership and control; develop banking system
Proxy fights	Unlikely to be effective when ownership is strongly concentrated	Technology improvements for communicating with and among shareholders; disclosure of ownership and control
Board activity	Unlikely to be influential when controlling owner can hire and fire board members	Introduce elements of independence of directors; training of directors; disclosure of voting; cumulative voting possibly
Executive compensation	Less important when controlling owner can hire and fire and has private benefits	Disclosure of compensation schemes, conflicts of interest rules

The Corporate Governance Mechanisms in Developing and Transition Countries

Corporate governance mechanism	Relative importance in developing and transition countries	Scope for policy intervention
Bank monitoring	Important, but depends on health of banking system and the regulatory environment	Strengthen banking regulation and institutions; encourage accumulation of information on credit histories; develop supporting credit bureaus and other information intermediaries;
Shareholder activism	Potentially important, particularly in large firms with dispersed shareholders	Encourage interaction among shareholders. Strengthen minority protection. Enhance governance of institutional investors
Employee monitoring	Potentially very important, particularly in smaller companies with high-skilled human capital where threat of leaving is high	Disclosure of information to employees; possibly require board representation; assure flexible labor markets
Litigation	Depends critically on quality of general enforcement environment, but can sometimes work	Facilitate communication among shareholders; encourage class-action suits with safeguards against excessive litigation
Media and social control	Potentially important, but depends on competition among and independence of media	Encourage competition in and diverse control of media; active public campaigns can empower public
Reputation and self-enforcement	Important when general enforcement is weak, but stronger when environment is stronger	Depend on growth opportunities and scope for rent seeking. Encourage competition in factor markets
Bilateral private enforcement mechanisms	Important, as they can be more specific, but do not benefit outsiders and can have downsides	Requiring functioning civil/commercial courts
Arbitration, auditors, other multilateral mechanisms	Potentially important, often the origin of public law; but the enforcement problem often remains; audits sometimes abused; watch conflicts of interest	Facilitate the formation of private third party mechanisms (sometimes avoid forming public alternatives); deal with conflicts of interest; ensure competition
Competition	Determines scope for potential mistreatment of factors of production, including financing	Open up all factor markets to competition, including from abroad

The preferred mechanisms will depend importantly on the institutional development of the country, especially its contracting environment. It is therefore very difficult to generalize. Moreover, a potentially important corporate governance mechanism may be hard to influence through policy, or vice versa, a mechanism susceptible to policy intervention may not be very important. Ultimate policy recommendation should take both into account. A potentially important mechanism is the market for corporate control and the threat of a hostile takeover. An outside owner can take over the firm to correct management failure not disciplined by existing owners, and the mere prospect of such a hostile takeover could influence management even if it never happened. When hostile bids are not possible, e.g., new shareholders do not have sufficient resources to accumulate a large enough stake, they can hope that the company's board will become active, possibly even replacing incumbent management. If the board does not intervene or is ineffective, shareholders can pursue their interests in court, assuming of course that a court decision would affect what happens inside the firm. Small shareholders could also come together through the accumulation of votes or proxy fights. A shareholder can rely on holders of other claims, primarily creditors but potentially also labor when human capital is a critical asset to monitor and enforce contracts. Since holders of other claims may face collective action problems, they often delegate the tasks to one large actor, typically the bank, or sometimes the labor union can be effective.

These corporate governance mechanisms all depend nevertheless to varying degrees on the general contracting and enforcement environment in the country. Obviously, litigation is less likely to be effective when enforcing institutions are weak, but also other mechanisms are affected. Proxy fights require well-functioning shareholder registries, and markets for corporate control are hard to establish when shares are illiquid and the rights of outside investors uncertain. Bank lending is less likely to flourish when credit contracts are not enforced and collateral cannot be collected, or when banks are saddled with large stocks of non-performing loans or subject to a weak regulatory and supervisory framework. Still, as the enforcement environment improves, external finance becomes possible, typically in the form of bank and trade credit.

When the general enforcement environment of courts and other institutions is very weak, firms can choose to rely solely on internal funds or contributions from closely related investors. The literature normally does not talk about corporate governance in such closely held firms (as interests are supposed to be aligned).

But if functioning corporate governance arrangements are not feasible, firms cannot even if they wanted, obtain outside finance and their growth will be constrained. Empirical evidence supports the negative impact of a weak contracting environment especially on the growth of SMEs and new firms (Beck, Demirguc-Kunt, and Maksimovic, 2003). Poor contracting environment also inflict large costs on owners, including limited risk diversification and poor liquidity for the inside investor.

The most common response to the free-rider and poor contracting problems is to give one shareholder a sufficiently large stake in the firm so as to provide him or her with incentives to monitor and intervene when necessary.

The most common response to the free-rider and poor contracting problems is to give one shareholder a sufficiently large stake in the firm so as to provide him or her with incentives to monitor and intervene when necessary. In fact, the overwhelming majority of companies in developing and transition countries have highly concentrated shareholdings. Also in developed countries, however, many firms are closely held. Some controlling shareholdings have their origins in (individual or family-owned) firms growing large and accessing public markets while maintaining close control. But investors also respond to weak contracting environments by building up controlling stakes sufficiently large to provide proper incentives to monitor management. In countries in Central and Eastern Europe, for example, where initially shareholdings were

widely dispersed deliberately, shareholdings have consolidated over the last five years to concentration levels exceeding those in Western Europe and comparable to those in many developing countries (Berglof and Pajuste, 2003). Concentrated shareholdings are often further reinforced as ownership is separated from control, primarily through pyramiding but in some countries also through cross-ownership and dual class shares.

Large blockholders is a solution to some corporate governance problems. This large ownership does reduce the pre-commitment problem in one dimension since the demand of external financing is correspondingly less. Combined with control and a direct role in management, it also overcomes some of the principal agent and ex-post resolution problems. At the same time, there are important costs in various ways of ownership concentration, as documented extensively (Morck and

Yeung, 2003 review). Needless to say, such delegation of authority gives rise to the problem of monitoring the large shareholder. The large shareholder may be entrenched and optimize private benefits rather than shareholder value, and engage in expropriation of minority shareholders through tunneling and other mechanisms.⁴

Corporate governance
policy in weak contracting
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In weak contracting environments, nevertheless, controlling shareholders are most often the inevitable outcomes. Unlike many developed countries, notably the United States and United Kingdom, where the over-riding corporate governance conflicts are between powerful managers and widely dispersed investors, the main corporate governance conflict in developing and transition countries thus pits controlling shareholders against minority shareholders. Corporate governance policy in weak contracting environments has to strike a balance between the benefits of the controlling shareholders and the protection of minority investors. While many if not most corporate governance systems in developing and transition countries are heavily tilted in favor of controlling owners, wholesale transfer of governance standards from developed market

economies may discourage investors from taking controlling positions and thus undermine perhaps the most potent corporate governance mechanism in less developed economies.

The presence of large blockholders while inevitable in weak contracting environments will undermine the other corporate governance mechanisms. Both takeover bids and proxy fights against the desire of the controlling shareholder are

⁴ While empire-building and excessive self-confidence of managers and controlling owners are likely to be the main sources of corporate governance failures in developed market economies, in weak enforcement environments preventing fraud becomes of paramount importance. Both developing and transition countries have seen systematic asset stripping, and tax evasion, by managers or controlling shareholders in large numbers of companies listed on exchanges. From an ex-ante point of view, the mere prospect of fraud has made it very difficult for companies to list on exchanges and raise outside funds, suggesting that actual costs of corporate fraud are much greater than suggested by the actual cases.

less likely to succeed when shareholdings are concentrated. The market for corporate control will never materialize, as insiders cannot be challenged. Similarly, board activism is less likely to be successful in challenging the dominant owner, given that board members are appointed on his or her mandate. Executive compensation schemes are also less important as governance mechanisms, when controlling investors easily can intervene more directly and oust management. The middle column of Figure 1 summarizes the above discussion of the effectiveness of these corporate governance mechanisms.

The basic insight of this analysis is that the priorities for corporate governance reform must take into account both the relative importance of a particular mechanism in a particular environment and the scope for impact of policy intervention in this environment. For example, in some environments where the court system functions satisfactorily, formal protection of minority shareholders enforced through private litigation is an option for improving the functioning of the key mechanisms of large shareholder monitoring. However, in weaker enforcement environments policy may have to focus on promoting private mechanisms and empowering shareholders through information dissemination. But ultimately the effectiveness of these other mechanisms will hinge on the general and specific enforcement environment. In developed countries, many firms are also closely held, yet minority investors do have some means to challenge the insiders, assure a reasonable rate of return on their investment, and thus are consequently willing to provide external financing. The last column of Figure 1 provides some suggestions for reform for each corporate governance mechanism. In the next section, we will discuss the connection between the general enforcement environment and the specific enforcement mechanisms.

3. ENFORCEMENT: SPECIFIC MECHANISMS

Even though enforcement is generally agreed to be critically important to economic performance, and there is a vast literature on the subject, no simple framework for thinking about enforcement exists. We can consider several ways of classifying the issues related to enforcement. One distinction is between private and public mechanisms. Private initiatives to enforce contracts are critical to the functioning of any economy and can be outside of the legal system. These initiatives can be unilateral, bilateral and multilateral. Such private ordering among agents is different from private law enforcement. Law serves to standardize contracts and clarify liability. Laws can be enforced through private means, such

as litigation by individuals, or by public enforcement. Under private law enforcement, private agents avail themselves of the framework defined by law or regulations to punish violations from contracts, using the courts to adjudicate and the state to enforce the final judgment. With public enforcement, the government not only provides the final enforcement system, but also acts as the prosecutor. In the extreme case, the government has full control over all activities, there are no property rights of contracts to enforce, and the laws are immaterial.

An enforcement system thus consists of a continuum of overlapping mechanisms ranging from private ordering via private law enforcement laws and government-enforced regulation to full government control (Djankov et al., 2003). All mechanisms have their costs and benefits and tradeoffs exist. Private and public initiatives are often complements, rather than substitutes. The effectiveness of private enforcement mechanisms often depends on the effectiveness of public enforcement mechanisms. Public enforcement brings down the costs of private enforcement. But while more public intervention may mitigate market failure, it is more vulnerable to government failure, and may not be the most efficient when private agents have better information, resources and incentives. Private agents are particularly important when the general institutional environment is weak. A system of social control of business is necessary in areas where both markets and government fail or cannot be expected to operate, and more generally is necessary to support the functioning of markets.

Another way to consider the issues is the degree and nature of the written laws (and regulations), which can be more or less extensive. Many laws are unwritten, so the question arises what needs to be codified in the first place, how codification varies preferably by the level of development and social and economic features of the country, and how codification interacts with the various enforcement mechanisms. Presumably, very homogenous and close societies may still be able to rely on social means to enforce norms of behavior. But more development may mean more market-based economies and requiring more formality and codification. Second, the extensiveness of the law can affect the nature of the enforcement problem. Each law and regulation has its own optimal balance between the different mechanisms, blurring the distinction between written rules and their enforcement. With imprecise laws, private ordering and private enforcement may be costly or uncertain, and the benefits for parties to deviate may be too big. At the same time, broader laws allow for more evolution.

Private Ordering

Transactions can take place without the existence of courts and other public enforcing institutions. Actually, this private ordering has been the norm rather than the exception common historically and in many parts of the world. Greif (1992, 1993) provides historical examples of enforcement traders in the Mediterranean, and Ostrom (1990) gives illustrations from management of common resources in less developed societies. Ellickson (1991) discusses the protection property rights among cattle farmers in California. McMillan and Woodruff (2000) find evidence of private enforcement in the transition economy of Vietnam. Besley (1995) analyzes the protection of property rights for farmers in Ghana. Gambetta (1993) documents the role of the Sicilian mafia as a private enforcement arrangement. For a general review, see Dixit (forthcoming). We discuss the different forms of private enforcement mechanisms as they relate to corporate governance and the scope for public policy in supporting these mechanisms. We distinguish as the literature generally does between unilateral, bilateral, and multilateral forms (e.g., Rubin, 1994).

Unilateral enforcement mechanisms involve efforts of individual firms to potentially improve their commitment power. A firm can through its own actions create valuable assets, which would be lost in case of violations of earlier agreements or standards. The most common unilateral mechanism is reputation, built for example through costly advertising. In the absence of a well-functioning general enforcement environment, unilateral actions can be important. For example, the Russian oil company Yukos was generously rewarded by the stock market when it unilaterally reformed its management and corporate governance. The actions presumably were credible because if the company, which before the campaign had a poor governance record, were to violate its professed principles, much of the investment would be lost (of course, it did not protect the company and its valuation from actions by the government as happened last year). Other unilateral forms include certain investment strategies, which only pay off if the firm continues to have access to external financing. A natural resources extraction firm may, for example, undertake a large investment with long gestation time and much sunk costs to signal its commitment to honoring current financial contracts.

The obvious problem with self-enforcement through reputation is that it relies on future interactions, e.g., that Yukos will have to come back to the stock market for more funding. Moreover, since the costs of building reputation are sunk, they may not deter future violations if the gains are sufficiently large. An additional problem

of the reputation mechanism is that memory, particularly in stock markets, may be short. With losses to investors from previous violations already incurred and new investors coming into the market, considerations of new investments may not be affected by previous actions, thus weakening the commitment power of reputation in financial markets.

In terms of bilateral mechanisms, two firms can strengthen their commitment ability in their interactions. Reputation of one party can play an important role in sustaining such bilateral enforcement arrangements. Yukos, for example, used the (expensive) consulting company McKinsey to reform, where McKinsey presumably would not have agreed to associate itself with the company had it not been convinced that Yukos was committed. Another means is through creating vertical or horizontal dependence by which one party can give up or share control over important decisions. A firm may also delegate some aspects of the business to a third party. Examples are plenty here, as in the separation of production and distribution in many industries which creates dependences and incentives not to deviate from commitments. Or, in order to avoid conflicts of interests credit allocation and risk management functions may be separated in a bank, which can enhance the overall quality of the lending process as each agent has less incentive to deviate from its assigned tasks and responsibilities.

Another form of bilateral mechanism is through investments. Control-oriented investment with one shareholder taking a large stake in a firm is one form of bilateral enforcement.⁵ Such structures are common in many business transactions. Many joint ventures, for example, are based on 50/50 control stakes. This may appear to be an ambiguous control structure, with much scope for conflicts among shareholders, especially when used in weak contracting environments. Yet the specific assets each partner brings in allows for optimal, bilateral private contracting and commitment (see Hauswald and Hege, 2003, for analysis of joint ventures).

The parties could also exchange "hostages", i.e., leave with each other assets that are valuable to the provider but not to the party holding the hostage asset (in

⁵ This form of commitment relates to the boundary of the firm; in the presence of transactions costs, potentially due to a weak contracting environment, firms will more likely internalize transactions or create "conglomerates". Conglomerates or business groups can be thus be more common in weak contracting environments, although this raises its own set of corporate governance issues.

medieval times princes were supposedly used assuming that they were primarily valuable in the country where the father was a king). It is harder to find specific examples of hostage exchanges that improve the corporate governance of firms towards outside, third-party investors. Hostage exchanges are difficult to arrange since the specific assets needed are in short supply and of less value for the outside investors. Some private shareholder agreements include covenants that are of a hostage nature, by for example, requiring some assets to be held offshore. Compensating cash balances and prepayments are sometimes mentioned as examples, but they are both highly symmetric in value and typically require some third party, like a bank or a court, determining whether the party can draw on the cash balance. Moreover, timing is critical, since the exchange preferably should be simultaneous. Bilateral mechanisms in general require some duration and reputation, and both parties should earn above market returns to sustain the mechanism.

For corporate governance
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multilateral arrangements.

For corporate governance by far the most important class of mechanisms is multilateral arrangements. Customs among multiple parties are established over time in repeated interactions or through learning across industries and jurisdictions, such as in gilts or other associations. Private parties can take the next step and establish institutions for collecting and conveying information about the adherence to these customs and erect credible punishments for deviations. Intermediaries may emerge exploiting economies of scale and profit opportunities, and preventing free-riding in enforcement.

Examples of such mechanisms abound. Trade associations adopt their own codes of conduct, and eventually also their own institutions for conflict resolution. In the financial sector, self-regulatory organizations are many: brokers associations providing licenses and overseeing conduct of brokers; investment banks establishing standards for underwriting; clearing houses and payments systems organizing settlement and payment services; and associations of banks and other financial institutions developing rules for conflicts of interest, exchange of information, etc. Intermediaries like business organizations sell information and thereby develop rules and standards, while rating agencies and other organizations for quality monitoring collect data, establish standards and disseminate information.

Stock exchanges in turn develop listing requirements. These organizations develop norms for interactions among members, with mechanisms for punishments. Clearing houses, for example, need to be able to expel members to function properly. Commercial and investment banks can certify and monitor firms in the context of lending and underwriting activities. Since they engage in multiple relationships, they can act as a multilateral enforcement mechanism. Private arbitration is another form of multilateral mechanism where parties sign up to a mechanism that has some commitment power as it is involved in repeated interactions. Ultimately though, some form of public intervention enforcement may be necessary to enforce private arbitration.

Private enforcement mechanisms, multilateral arrangements in particular, face a number of challenges. Actors should generally be expected to behave opportunistically whenever it pays. The more parties are involved the harder it is to sustain such collaboration, unless it is supported by some form of public actions. At the same time, a small number of actors can lead to entrenchment and weaker (corporate governance and others) standards. This is particularly so in small markets where self-regulatory associations and organizations have often not been successful as they maintained low standards and engaged in rent-seeking behavior. Some degree of competition can help limit opportunistic behavior, although this is not guaranteed (as recent events in competitive financial markets in developed countries have shown). Reputation is also important in sustaining bilateral and multilateral arrangements, but often difficult to establish as multiple equilibria can arise. When reputation is low in general, as in many developing and transition countries, few transactions can be sustained. Thus there are fewer opportunities to build reputation. Moreover, the uncertainty so pervasive of developing and transition economies reduces the value of future rewards for good behavior today. As consequence, moving out of a low-reputation equilibrium is hard.

How effective are private mechanisms - unilateral, bilateral or multilateral - in bringing about change in enforcement of good governance practices? Black (2001) provides some suggestive data from Russia indicating that individual firms, even in a poorly functioning environment, can increase their value substantially by improving their corporate governance unilaterally. Similar evidence exists for Korea (Black, Jang and Kim, 2003), but as with the Russian study serious causality and other methodological problems weaken the power of these tests. The entry of foreign firms normally adhering to higher governance standards can also help. Cross-border mergers and acquisitions have been found to originate from

countries with higher corporate governance standards and to be aimed at countries with lower standards, thereby potentially improving corporate governance (Rossi and Volpin 2003). There is also a tendency, however, for foreign investors to adjust to or even misuse the local corporate governance environment, as shown by some corporate governance scandals involving foreign investors from developed countries taking over firms in developing and transition countries. Even if incentives are weak for individual firms, foreign (and domestic) entry and competition may nevertheless help put pressure on local firms to improve their corporate governance.

The effectiveness of all of these private enforcement mechanisms in the area of corporate governance does, however, depend on the general institutional environment. Private arbitration, for example, is more likely to be effective when courts and enforcing agencies work well. In work on Korea, Black, Jang and Kim (2003) show that private mechanisms often are not sufficient, but need the support of government intervention. Evidence from Durnev and Kim (2003) and Klapper and Love (2003) show that by improving their own corporate governance individual firms cannot compensate fully for deficiencies in local governance practices.

Given efficiency and incentive considerations, private enforcement mechanisms will nevertheless need to be the main corporate governance mechanisms in most markets. This will be even more so in countries with severe weaknesses in public law and public enforcement. Furthermore, in one view, public law emerges out of private ordering, at least in common law systems; courts “find” well-functioning contractual arrangements among parties and elevate them to law (Cooter, X). A related view applied to securities law in the United States suggests that private parties adopt rules, which later are adopted by individual market places and eventually become laws or regulations (Coffee, 2001).

Private Law Enforcement

In most societies, it is largely private initiatives that help enforce existing laws and regulations. The government creates the rules governing private conduct but leaves the initiation of enforcement to private parties. When a party feels cheated, he or she could initiate a private suit and take it to the court or other agency. Private enforcement is more likely to work and cheaper if the law has mandated a certain standard. It may then be easier to initiate and prove a case than if courts have to rely on general principles. The burden on the courts and the plaintiff of

proving liability or lack of liability is reduced if statutes specify what facts need to be established. Well-defined statutes may also reduce the discretion of judges and undermine attempts to subvert the law. Private law enforcement may be particularly efficient in situations with weak or ill-experienced courts (Black and Kraakman (1996) and Hay, Shleifer, and Vishny (1996)).

In the area of securities regulation, private law enforcement seems highly effective for capital markets development, while public enforcement seems less important (La Porta et al., 2003). As many elements of securities regulation involve issues related to corporate governance, this may apply to enforcement of corporate governance more generally (Lopez-de-Silanes, 2003 reviews). For private enforcement to be effective, however, agents must have incentives. For many of the corporate governance issues related to securities markets, stock exchanges have appropriate incentives, to check for example, whether firms adhere to listing standards (although there are concerns about a race to the bottom and there needs to be competition among stock exchanges or at least for the services stock exchanges provide). For many other corporate governance issues, this will not be the case. Individual shareholders will have fewer incentives to litigate due to the free-riding problems, although class-action suites can overcome this (with the caveat that it can lead to frivolous law suits).

Needless to say, the society needs institutions that can impose sanctions for private law enforcement to work. This can be a court and a judge, but also other institutions. Governments, for example, often “delegate” enforcement to lower levels of government or self-regulatory agencies or authorities (SROs). Much of the implementation of rules for say obtaining a business license and accompanying appeals is delegated to semi-government agencies. Licensing for many professions, such as medical doctors or lawyers, are delegated to respective own associations. In financial markets, many SROs derive their status and ability to regulate financial markets transactions from public law. A stock exchange, for example, may be granted a natural monopoly and thereby have the explicit and implicit powers to regulate securities markets activities, although it may not be a government agency itself (and typically would not be so).

These forms of delegated enforcement may work better if the subsidiary body has more specific information, better resources and a broader range of sanctions. Local agencies may for example, be better able to judge the quality of the application for a business license. SROs may, for example, have greater insights in

what constitutes market manipulation and have more information system to detect such behavior. SROs may also be able de-license, issue a reprimand (name and shame), as well as impose financial sanctions, action which may be more difficult for a government agency. Nevertheless, these agencies will need some backing up from higher levels of government or from the judicial system.

Public Enforcement

The literature on how to improve public enforcement is large. This section focuses on a three issues in this literature, as they relate to corporate governance: the interrelationship between the extensiveness and effectiveness of law; the positive theory of enforcement and the efficiency and effectiveness of enforcing institutions; and the relationships between laws, corruption and enforcement.

In the simplest possible characterization the written law has no independent function, the only thing that matters is what part of laws and regulations are actually enforced. Others argue that this dichotomy is too simple: the written law can be more or less extensive, and enforcement more or less effective. Some laws are also more easily enforced than others, suggesting that the enforcement environment may shape what laws are desirable and that how the law is written may in turn influence the scope for enforcement. In this view we have a two-by-two matrix with rudimentary vs. extensive corporate governance rules and weak vs. strong enforcement. A related view distinguishes between low and high legal standards, where the distinction more relates to the threshold set for violating the law.

A large literature has documented differences between the extensiveness of law, i.e., the scope and detail of the law, and effectiveness, i.e., the extent to which the law is actually enforced. Pistor and Xu (2003) apply this concept empirically and found that it helps predict choices between regulatory and legal approaches to financial markets regulation. A closely related body of work discusses the choice between very detailed, highly nuanced rules, and simple, easily understood and interpreted, rules (co-called bright-line rules) (Glaeser and Shleifer, 2002).

There is the general economic literature on enforcement, inspired by Gary Becker's (1968) provocative article suggesting that maximizing punishment would ensure optimal enforcement. Later contributions have emphasized the constraints imposed on fines by the liquid assets available to those punished. Others have pointed to the (exogenous) limits to enforcement technology. These analyses have

provided some insights on the factors affecting enforcement technology and the choice among enforcement technologies.

The efficiency and effectiveness of technologies and enforcing institutions such as courts, stock exchanges, SROs and the like, are, however, hard to study empirically. Efficiency normally refers to outputs relative to inputs, but both outputs and inputs are difficult to measure. In evaluating the efficiency of courts, we are normally concerned not only with timeliness, i.e., how fast cases are processed, but also with access to the court (e.g., for the poor), fairness, and predictability. Effectiveness may in some cases be the overriding objective, e.g., in some cases very large sums are justified to ensure that the outcome is just or right. The Microsoft anti-trust case has cost millions of dollars, but it may have been worth it given its large implications. It also matters how cases are managed, i.e., what input is entered when. Input efficiency involves assessing the type of funding and incentives provided. Ultimately, court output must take into account overall “customer satisfaction”, i.e., do citizens trust the legal system. Furthermore, an analysis of court efficiency needs to extend beyond the courts themselves to understand their role in the larger legal system. So far, few empirical analyses exist.

There is a specific literature on the importance for enforcement of regulators and supervisors that are independent, have adequate powers, are well-staffed and have operational and financial functional independence. This has been found for central banks and other agencies, such as competition policy agencies and regulatory agencies. The financial and operational independence can be particularly important. In many countries, securities exchange regulators have their own sources of income (by collecting fees from new issues or trading), yet they have to transfer some part to the general budget or otherwise have to get their budget approved by the parliament or other government agencies, thus reducing their de-facto independence. At the same time, there can be limits to the benefits from stronger regulators and supervisors in weak institutional environments such as in many developing countries. Perverse effects may arise from more legal powers in environments with relatively low pay for regulators and supervisors, and weak checks-and-balances (as highlighted by Barth, Caprio and Levine, 2000). In such environments, more powers may simply invite more corruption.

4. THE CHOICE OF ENFORCEMENT TECHNOLOGIES AND THE GENERAL ENVIRONMENT

The Choice of Enforcement Technologies

The preferred mix of enforcement technologies will vary by type of activities and by country characteristic (next section). In some areas, social norms will serve as the first enforcement technology with the more formal system as a second resort. Media can play a potentially important role in “enforcement,” both nationally and locally, although they may not use any legal tools. Threats of revolts by store-costumers against a large pay-package for the new manager of the Dutch grocery chain Albert Heijn led the pay-package to be reduced and the chairman of the board of directors of the group (Ahold) to resign. In many ways, these social pressures will be the most important corporate governance mechanisms. They do in turn require a relatively free media and access to newspapers. Here technology can help, as in Korea where much of the concerns on corporations’ activities have been shared through the internet.

The role various formal enforcement technologies will play in a particular sector or activity will in part depend on the relative costs and benefits of the technologies. The existence of cheaper outside options, for example, will affect the use of courts versus other enforcement technologies. The use will also depend on the extent to which one enforcement technology requires the backing of another technology to make it credible and assure finality of decision. Activist movements, like shareholder lobbying group, do require some legal backing (Milhaupt, 2003). Regulatory intervention in the corporate governance area will typically not fully resolve the basic commitment problem and will require some backing of the court system for appeals and enforcement (say insider trading pursued by the stock exchange requires the backing of the sanctions of an SEC). An important corporate governance mechanism is monitoring by banks, but the development of bank lending and monitoring obviously relies on the effectiveness of the regulatory framework and supervision, in addition to the other institutions for public enforcement allowing collateral to be collected.

To a certain extent, cost-benefit considerations can explain the choices among enforcement technologies. Path dependence is, however, also important: an enforcement technology may be introduced and then remain used for a long time, even though other more efficient technologies have become available. For

example, collateral and its registration is a form of contract enforcement. These days, it can more easily be registered and consequently perfected using electronic, dematerialized registries than using expensive courts or notary-based systems, but the transition often takes time and institutional reluctance may have to be overcome. Technological progress can change this, but typically only slowly. Securitization, the sale of many assets bundled together, for example, became possible because of information technology progress, which allowed secondary asset sales while assuring that the underlying contracts remain identifiable and could be enforced.

Public enforcement can only play a limited role in weak institutional environments, as powerful controlling owners and managers will most likely find their way around the system.

Most importantly, each country will choose a different mix of technologies. Clearly, for many developing countries the optimal mix of technologies will differ from what we observe in developed countries today. Public enforcement can only play a limited role in weak institutional environments, as powerful controlling owners and managers will most likely find their way around the system. Private enforcement of public laws and the power of litigation and court intervention vary greatly across countries depending on the functioning of the public enforcement institutions. Russian investors, for example, almost never go to courts, because when they do so, the likelihood of success is miniscule and even if they win a judgment in their favor is often not enforced (Zhuravskaya and Zamulin, 2003).

With weaknesses in courts, other enforcement mechanisms maybe used more in trying to enforce good corporate governance. Policies promoting bank lending and financial development may, for example, then help to enforce corporate governance. Yet, even here relative costs are important. In China, investors became increasingly active in taking their grievances to court although court decisions were not always predictable or necessarily enforced (Pistor and Xu, 2003; and Xu and Pistor, 2003).⁶ The reason is that other mechanisms are even more costly or absent; the banking system, for example, is little reformed.

⁶ After the onslaught of litigation, the Chinese Supreme Court basically froze the process by stating that it did not have the competence to adjudicate these cases. Recently, litigation activity has again surged.

The General Enforcement Environment

Much of the choices between the various technologies will depend on the overall environment. A number of interrelated factors are likely to influence the general enforcement environment of courts and other enforcing institutions (Slinko, Yakovlev and Zhuravskaya, 2002): the incentives of national and local authorities, political competition at various levels of government, and the strength of civil society. These aspects will not only vary across countries, but also across regions and municipalities within a country. In Russia, Brazil and Mexico, for example, large differences exist in enforcement among states or provinces (Broadman, 2000, Pinheiro Castelar, 2001; Laeven and Woodruff, 2003). Furthermore, where markets function poorly, the legal system is generally weak. Conversely, competition in product markets, by affecting the scope for capture, and the size of the small-and-medium-sized-enterprise sector can affect the functioning of courts.

Only a combination of strong investor rights and an efficient judicial system leads to a well-developed financial markets.

Endowments and distribution of natural resources and technology also matter for the institutional development of countries, including the degree of public enforcement. Relationships have been found between institutional features and countries' more permanent characteristics, including culture, history, and physical endowments. Institutional characteristics such as the risk of expropriation of private property can be long-lasting and relate to a country's physical endowments (Acemoglu, Johnson and Robinson 2003 show this for a cross-section of countries). The historical origin of the legal and general institutional system, whether English, French, German, or Scandinavian, and the corresponding basic legal mechanism, whether common law or civil law, seem to matter for enforcement (LaPorta et al., 1997, and 1998). While the differences in the functioning of legal systems have decreased over time, the various systems still differ in terms of the balance between private and public rules and still correlate with the degree of general enforcement. Similarly, wholesale transplants are largely ineffective in the diffusion of governance practices (Berkovitz, Pistor and Richard, 2003).

The quality of the general enforcement environment affects the functioning of legal mechanisms specific to investor and creditor protection. Only a combination of

strong investor rights and an efficient judicial system leads to a well-developed financial markets. More recent research shows that both a country's initial endowments and the origin of its legal systems are important determinants of the degree of private property rights protection (Beck, Demirgüç-Kunt, and Levine 2003).

The general enforcement environment is not only the product of many different market, endowment and legal factors, but also of social and cultural factors. Enforcement will depend on basic social norms and trust (Djankov et al. (2003) denote this "civic capital"). When societies are socially and culturally heterogeneous, the base for natural forms of enforcement is typically weaker. This is clearly true at the micro level. The ability to have well-functioning rotating saving schemes, for example, greatly depends on the presence of close relationships and homogenous groups. But it also seems true at the country level. The roles of culture and openness have been found to be important for financial sector development, including for corporate governance (Stulz and Williamson, 2003). As societies develop, and undergo both economic and social transformation, the nature and forms of enforcement are likely to change towards more formal modes of enforcement.

Political institutions are part of the general enforcement environment.⁷ Political institutions may not function well and can be dominated, for example, by an absolute ruler or captured by special interests. In both cases, serious enforcement problems can result. Countries with absolute rulers will have many public governance issues, including the protection of property rights against interference by the dictator. These countries may have fewer corporate governance issues, however, as there will be few genuine "market" transactions. The other set of countries are those like many emerging markets where business and politics tend to merge. When large controlling owners become politicians, an important countervailing force to government is lost, and the interests of minority shareholders are less likely to be protected. When the rich influences the path of justice, litigation does not work (Glaeser, Sheinkman, and Shleifer, 2003). When enforcing institutions are corrupt, the level of enforcement may be endogenous

⁷ Political institutions can be evaluated based on several criteria: how well represented the views of the electorate are in the institution, the extent to which politicians and bureaucrats are accountable to their constituencies and to each other (vertical and horizontal accountability, respectively), whether certain positions are appointed (from above) or elected (from below) (bureaucratic vs. democratic accountability), and, closely related, their independence from each other (Persson and Tabellini, 200X; and Berglof et al., 2003).

(Acemoglu and Verdier, 2000). Corruption lowers enforcement effectiveness by increasing the costs of motivating and monitoring bureaucrats.

As noted already, legal standards and the level of enforcement can interact. In the general enforcement context, corruption may affect how laws are written (Immordino and Pagano, 2003). Governments may respond to weak enforcement by formalizing through codes to reduce discretion and opportunities for subversion of law, but this can have its own costs. Stricter laws and regulations offer more incentives to evade, and thus are more costly to enforce than others. In the model of Immordino and Pagano, a benevolent government trades off the benefits of stricter legal standards with the costs of their enforcement. With a benevolent government, standards should be set lower, because the costs of enforcing them are higher. In other words, legal standards and enforcement are complements, and as countries develop both can increase. In practice, this tradeoff between strictness of the laws and incentives to evade has been used in the debate on accounting principles, where the choice has been between International Accounting Standards, which are more principle-based, and US FASB-norms, which are more detailed, rule-based.

Laws and regulations could not only be adopted to correct market failures, reduce transactions costs and achieve social objectives, but also to extract bribes. Djankov et al. (2002) find some support for this so-called tollbooth view, especially in less developed countries, suggesting to err on the side of less strict laws in weaker environments. The work of Barth, Caprio and Levine (2003) supports this for bank regulation and supervision as more powers to bank supervisors lead to less efficient and more unstable financial systems in environments with limited checks and balances. Immordino and Pagano (2003) provide evidence that even governments in developing countries actually rationally adopt lower standards, as the costs of enforcement are higher.

5. CORPORATE GOVERNANCE AND ENFORCEMENT

Private ordering, private law enforcement and public enforcement all have a role in influencing the overall effectiveness of the corporate governance system. While we have discussed the different sets of mechanisms separately, they do overlap and can both substitute for and reinforce each other. To evaluate how the various options interact, we need to go back to the main corporate governance problem in developing and transition countries as summarized in Figure 1. As noted, the overriding corporate governance problem in emerging markets is about balancing

incentives for controlling shareholders and protecting minority rights against actions by insider shareholders. Different mechanisms can be used to address these and each needs different enforcement tools.

Figure 2 shows how different forms of enforcement can help reinforce the basic corporate governance mechanisms identified in Section 2. We note that the figure does not attempt to be comprehensive, rather it aims to illustrate by use of example the specific enforcement technologies that can be used to enhance their effectiveness.

Large shareholders. When the general enforcement environment is weak, external finance is costly, resulting in ownership concentration. Controlling shareholders are thus a feature of weak environments, and any attempt to improve corporate governance will have to take this into account. Large shareholders will act in their own interests and can pursue private benefits, rather than increasing overall firm value or minority shareholders' rates of return. State-ownership or golden shares can in some circumstances be a means to deal with the social costs of weak enforcement settings.

The market for corporate control will be correspondingly less active, making hostile takeovers less effective and proxy fights more difficult to win. Hostile takeovers are not completely impossible, however. In Russia, for example, investors have found ways to exploit financial distress and using bankruptcy rules to topple incumbent owner-managers (Guriev et al., 2003). Whether this is leading to efficient outcomes is still to be seen, but it shows that some elements of a market for control are working.

Since **the owners appoint boards**, little independent corporate governance should be expected from the board in a firm with a controlling owner. Requiring independent directors will have limited direct effect, as the controlling shareholder will not allow for any real influence on a firm's board. Nevertheless, requiring some degree of independence from some directors could still be important. For example, independent directors can play an important role in transferring knowledge at the level of the individual firm and building constituencies for corporate governance reform at the country level.

Executive compensation schemes will not play the same role in decision-making as it does in firms with more dispersed ownership structures given that the controlling owner can hire and fire managers at his own discretion. Furthermore,

Corporate Governance Mechanisms and Enforcement

Corporate governance mechanism	Private ordering	Private law enforcement	Public enforcement	State control
Large blockholders	Natural consequence of weak enforcement	(Minority) shareholder suits	Governance codes evolving into corporate and securities law	State ownership or golden share to mitigate social costs
Market for corporate control			Corporate law: defenses, procedural rules; transparency of ownership and control	
Proxy fights			Improve communication technology; Allow vote by mail	
Board activity	Facilitate interaction among board members, training of independent directors			
Executive compensation	Transparency rules of stock exchanges		Transparency rules	
Bank monitoring	Credit bureaus, registries, reputation		Protection of collateral; bankruptcy reform	
Shareholder Activism	No ownership limits		Require disclosure of the voting and positions of institutional investors	Encourage public pension funds to be more active
Employee monitoring	Encourage labor flexibility			
Litigation		The key mechanism for private enforcement	Governance codes adopted by exchanges and others which have a "charter" provided by law	
Media and social control	Deregulate media to allow freer competition			Provide more information through public media
Reputation and self enforcement	Depends on growth opportunities and degree of rents			
Bilateral private enforcement mechanisms	Hostage and shareholders agreements. Require firm-specific assets	Establish specific control rights under contract law		
Arbitration, auditors, other multilateral mechanisms	Arbitration to resolve conflicts. Other third parties (auditors, rating agencies, stock exchange listing requirements, foreign listings; formation of trade organizations; corporate governance codes) for reputation, signaling, standardization of norms			
Competition	Greater competition in all factor markets			

the controlling shareholder will typically have many other means to “reward” himself. Disclosure of executive compensation schemes is nevertheless a good thing, even when they are not the key motivating force in managerial decision-making, as general public pressure may help restrain some forms of dilution. More generally, transparency promotes an informed discussion of corporate governance both at the firm and country level.

Banks as lenders and monitors. Lending and monitoring by banks, typically the most important source of external finance, is of particular interest. As lenders, banks will have a direct stake in the governance of corporations, requiring firm behavior that assures that their loans can be repaid. As monitors, banks can compensate for some weaknesses in the general enforcement environment as they have repeated dealings, have reputation to maintain in lending, and can economize on monitoring and enforcement technology. The development of bank lending itself obviously relies on the effectiveness of the regulatory framework and supervision, in addition to other institutions allowing collateral to be collected. As such, public enforcement is still a necessity.

Shareholder activism groups can be important. These have been in existence in US, UK, Korea, Japan, and many other countries. As shown by Milhaupt (2003) in an analysis of shareholders groups organized as non-for-profit organizations in Korea, Japan and Taiwan, the effectiveness of such groups can vary depending on issues such as their funding structures, the non-distribution of awards and whether they seek to use and improve existing local enforcement institutions or abandon those.

Employee monitoring can be an effective mechanism to enhance corporate governance as its interests are largely aligned with good firm performance and fair treatment of all stakeholders. For this mechanism to be powerful, employees must be mobile, however, in order to credibly threaten to leave the firm. More generally, effective competition in all factor markets will help improve firm’s corporate governance. Increased competition in output markets not only puts more pressure on the firm to enhance its performance, but also increases the premium to better corporate governance to be able to attract the necessary financing to invest and survive.

Litigation can neither be expected to be a good governance mechanism in weak contracting environments. Litigation is, however, still less dependent on government actions than public enforcement is, as it is a private enforcement of

public laws. As shown by La Porta, Lopez-de-Silanes and Shleifer (2003), private enforcement works relative better in securities markets than public enforcement does, especially in less developed countries. And litigation can help develop the standards against which corporations know they will be judged and which may eventually evolve into law.

Media and social control often play an important role in disciplining managers and controlling owners (Dyck and Zingales, 2003). In a narrow sense, in improving the access to information and reducing the costs of monitoring, and in a broader sense in making corporate governance an issue of public debate. In countries like Korea, corporate governance became a household word thanks in part to wide media coverage of corporate sector abuses. In turn, regulation and other efforts promoting plurality in media could have a strong impact on the enforcement of good corporate governance.

Reputation. When ownership and control in individual firms are concentrated because of weak enforcement, reputation mechanisms can still be of value for large shareholders as they need to raise outside funds, but minority shareholders should not expect too much from formal governance mechanisms.

Bilateral private enforcement mechanism. Most private agreements are bilateral. In order not to be renegotiated ex post when there is no enforcement, they require firm-specific assets and in any case they need not benefit other shareholders. Nevertheless, bilateral agreements may be valuable (to blockholders) even in the absence of firm-specific assets. While they also suffer from the weaknesses in the general contracting environment, agreements between blockholders and the controlling shareholder, that may cover board representation, access to information, permission for changes in control rights, and procedures for approving related party transactions, can add value. Because they include more specific covenants, they may overcome some incompleteness in the existing legal system and can be more easily judged by inexperienced courts. Also, the general court system dealing with civil cases may be better than the specific court dealing with capital markets transactions. In many developing and transition countries, for example, civil courts function relatively well, but courts to deal with capital markets transactions are not well equipped. In case of such “arbitrage” opportunities, shareholders’ agreements can add value to blockholders. They are of little value, however, for small shareholders.

Multilateral private orderings. For joint ventures or international investments, *arbitration* can help in enforcement as it can rely on tools such as the New York Convention that makes international arbitration binding in the local context (although it still requires some degree of local enforcement). Arbitration is of less value domestically when the general enforcement environment is weak as backup and appeal procedures are missing. Only in markets with repeated dealings and a small number of participants might arbitration still work well.

Stock exchanges' listing requirements are another multilateral tool. Examples of stock exchanges' efforts to raise corporate governance are the Novo Mercado in Brazil where higher corporate governance standards in a new market are combined with an arbitration system. Provision of such voluntary standards that corporations can adhere to can be useful, although they do require some enforcement. Their effectiveness depends on the "franchise value" of the exchange: if the exchange is a (local) monopoly, it may have more enforcement power. (At the same time, the stock exchange may be less interested in corporate governance reform.) In other markets, listing rules from stock exchanges are forcing corporations to reform or risk delisting and seeing their access to public markets' financing disappear. Still, the effort needs to improve over other options for firms to signal higher corporate governance standards, such as using international markets. Foreign listings can be a bonding device, as they involve some costs to adhere to higher standards. Licht (2002) and Seigel (2003) note, however, that the SECs of host countries often do not take actions against minority rights violations committed at home. As with the general findings for securities markets, listing abroad may help more through private enforcement of exchange listing requirements, particularly disclosure, and only for some aspects of public laws.

Other third parties can help by bonding. *Accountants* and *auditors* can signal the quality of a corporation and some its corporate governance aspects if they have some reputation to lose. The scope for improvement through the role of accounting and auditors will, among others, depend on the local standards used in accounting and auditing, and the legal liabilities for misrepresentation. Furthermore, these firms can suffer from conflicts of interest if they have other, say consulting business with the same firm. *Investment banks* can signal quality of firms in the process of underwriting public offerings, although they too can suffer from conflicts of interest lowering the value of the signal. *Rating agencies* assess firms in general for bond and loan ratings, which includes some assessment of

firms' corporate governance. More recently, specific corporate governance ratings of firms have been produced, by the traditional rating agencies and others. These ratings can coordinate information collection, establish standards, and be a source of bonding when rating agencies have reputation to protect. The ratings are new and they have yet to show their value, but they could be particularly useful for institutional investors that cannot incur the costs of assessing the corporate governance of individual firms.

Corporate governance codes and other standards. As with corporate governance ratings, codes can coordinate information collection and establish standards. Stock exchanges can use them as part of their listing requirements ("comply or explain"), thus given some enforcement power to the codes. Codes can also have an indirect value if they lead to the codification of laws. Yet, they are no enforcement by themselves and need to be used by investors and others to lead to changes in the behavior of corporations.

6. THE POLITICAL ECONOMY OF ENFORCEMENT

Ultimately, the effectiveness of many enforcement mechanisms hinges on the commitment from the political sphere to enforce existing laws and regulations. Given the enormous potential gains from improvements in public enforcement building support for reforming these institutions should be easy. In particular, enforcement institutions should be easier to reform than changes in basic investor rights where there often are clear winners and losers. But many attempts to reform investor rights have failed because of powerful opposition. In Brazil attempts to revoke the right to issue and maintain non-voting shares were unsuccessful, as they would have reduced value for the voting, controlling shareholders. In Thailand senators blocked bankruptcy reform, as they were also major owners of distressed corporations. Furthermore, to change investor rights many hurdles need to be passed; in some countries, changes to the constitution are necessary, whereas improvements to the judicial systems are often mere administrative choices. Nevertheless, changes to investor rights do occur, often following financial and other crises. Changes in enforcement appear much more difficult over short periods of time. A number of explanations exist.

Investment in enforcement of corporate governance, and more generally in building institutions supporting market functioning, compete with other uses of government funds, including demands for redistribution and general public goods.

Capacity-building is also a longer-term effort that is less visible and less politically rewarding. Finding sufficient support within the government for such efforts is thus often difficult. Public enforcement also involves several bodies. Sometimes these bodies are involved in sequence, e.g., police-courts-police, and sometimes within a hierarchy, e.g., several layers with supervisory functions (e.g., stock exchange, SEC, court). Changing multiple institutions is not only complicated, it is also costly. And in a less developed economy with limited resources and high discounting, the short-term gains may not be sufficiently large, in particular relative to competing needs in other parts of society.

Overcoming these constraints is typically also difficult since the gains from improvements in the functioning of these institutions are not distributed evenly among all citizens; in particular, large parts of the electorate may not get any direct benefits at all from increased enforcement. When strong business interests are against reform and the general population, including the poor, enjoys only limited benefits, it is hard to push through reform. With close ties between government and business, enforcement reform in the interest of minority shareholders is even less likely to see the light. Even in countries with the institutional capacity to build better enforcement, the political will is consequently often not present. Poland, for example, has a strong regulatory framework and ample competence in the Securities and Exchange Commission and the Warsaw Stock Exchange, but corporate governance and its enforcement has not been very high on the political agenda leaving the bodies without the necessary political backing. In Brazil, Korea and many other middle-income countries, the capacity in SECs, Ministries of Finance and Justice, and elsewhere is often also adequate, but actual enforcement remains limited.

Thus, the level of enforcement is ultimately a matter of political priorities (Berglof and Bolton, 2003). How to build political constituencies for reform is always hard, especially when the benefits are not evenly distributed. The problem in enforcement, as in some other areas, is that there are bad equilibriums. At low levels of development, investments in enforcing rule of law may exceed the benefits they generate. Moreover, given the costs involved and the difficult priorities, the “political will” to invest in rule of law may not be present even when sufficient resources are available and the returns to investment in enforcement are high. To get out of these traps is hard. Sometimes, indirect methods can be helpful to get reforms going.

Assuring wide access to finance is important so as to create a broader constituency for enforcement reforms.

Financial development may help to increase the constituency for rule of law enforcement. Access to finance will allow more households to invest and thus strengthen the support for the protection of property rights. But financial development may also go to consumption or public investment/consumption, in both cases possibly crowding out private investment. Furthermore, if some particularly influential groups care strongly about enforcement of property rights, the outcome may be too much enforcement, at the expense of other public goods and, ultimately, growth. In many countries, the laws and judicial systems give banks much power over their borrowers, also in bankruptcy, which is not necessarily good for overall economic growth as it suppresses the emergence of new, more risky firms. Yet, reform of the bankruptcy systems in these countries has often been slow due to lobbying by the banking industry. Assuring wide access to finance is important so as to create a broader constituency for enforcement reforms.

Another channel can be from corporate sector ownership to reform. By broadening ownership to the corporate sector to the general public should strengthen the push for reforms of enforcement. Specifically, some privatization strategies may create more support for enforcement than others (Biais and Perotti, 2001). The large-scale privatizations in Europe and the wider distribution of equity ownership have built constituencies for financial sector reform. Given large state-ownership in many developing countries, say after a crisis or coming from transition, it can be useful to pursue privatization strategies aimed at widening ownership. The design of reforms and privatization strategies will be difficult, nevertheless. In many places, reforms did not go deep enough as they initially targeted the wrong issues, such as changes in laws rather than institutions, including those involved in enforcement. In Russia and the Czech Republic, for example, insiders and incumbents also hijacked the privatization and the resulting ownership structures undermined the drive for enforcement reforms.

Making enforcement a priority may also have implications for the desirability of different types of real sector reform. In particular, more competition and other external pressures can help create better property rights and greater enforcement. Perotti and Volpin (2003) develop a model in which richer entrepreneurs lobby politicians for a low level of investor protection in order to prevent potential new

entrants to raise financing. They find that the degree of investor protection increases when technology or demand shocks decrease profitability and when financial integration improves access to capital. They also find that when wealth distribution becomes more equal and the country more democratic, in the sense of politicians becoming more accountable to voters, investor protection improves. Finally, they argue that large financial crises may weaken established business allowing for improvements of better protection of minority investors.

7. CONCLUSIONS

While it is very difficult to draw any strong conclusions given the lack of specific research on enforcement and corporate governance, our review of the literature has highlighted some general lessons, not necessarily limited to enforcement:

- Private sector efforts to enhance enforcement are often more effective than government-led efforts, but the two forms of enforcement often complement each other. Experience from securities regulation in the United States also suggests that private ordering can precede and serve as a basis for public laws, and private and public enforcement of these laws.
- The balance between private ordering and private enforcement of public law obviously depends on the quality of public laws and the strength of enforcing institutions. When the general enforcement environment is weak, private ordering may be the only hope. But more generally evidence, at least from securities regulation, suggests that private enforcement is very important.
- Improvements in enforcement are more often the result of bottom-up approaches, rather than top-down efforts. Capacity-building is often important to support private initiatives (from rating agencies to banks) and will help build constituencies for reform.
- Top-down efforts to improve the legal and enforcement environment are difficult and rarely successful. The record of transplanting (elements) of foreign legal systems is generally not encouraging, but the experience of EU accession in Central and Eastern European countries suggests that outside anchors also can play a positive role in the implementation of reforms.

- In designing strategies for improved enforcement of corporate governance both the likely impact of a particular governance mechanism and the scope for improvement of this mechanism should be considered. A particular corporate governance may play a very important role in reducing agency costs, but leave little room for improvement of enforcement, and vice versa.

The review also makes clear the limited knowledge on the issue of enforcement. A number of issues could be researched further.

- The balance between private enforcement of public standards and public enforcement. The empirical work on securities markets law has shown the benefits of relying more on private means in enforcing some minority shareholder rights, disclosure and other regulations to develop capital markets. An investigation of the same issue for (other) aspects of corporate governance would be very interesting. Is private enforcement more effective than public enforcement in terms of corporate governance?
- The tradeoffs between the extensiveness of the law and its effectiveness in different contexts.
- The effectiveness of self-regulatory agencies and organizations in encouraging better standards and greater enforcement of these standards. When, for example, are stock exchanges effective in the promotion of good corporate governance? What does the move to a more for profit status of many stock exchanges mean for the incentive structures of stock exchanges to pursue higher corporate governance standards?
- The role of competition more generally in improving the environment for enforcement.
- Both case studies and cross-country research are necessary to shed light on these issues.

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POINTS OF INTERVENTION (DRAFT MATRIX)

Issue	Securities Regulator	Listing Rules Enforcer	Court	Registrar/Companies Regulator	Arbitration Court	Voluntary country-level acts	Voluntary company-level acts	Special Departments/Agencies
Actors / Fields of enforcement								
Shareholder rights: <ul style="list-style-type: none"> AGM rights Equal rights for all classes Related party transactions Insider trading Takeover rules Other rights Company Law Securities Law Listing rules Company charter CG Code 	Public firms: Equitable treatment rules in the Securities Law, e.g. equal price provisions in takeovers.	Public firms: Listing rules may specify some of the issues that otherwise would be in the Securities Law (e.g. shareholder rights in IPOs)	Public and private firms: To the extent shareholder rights are not enforced by the SEC or another body (e.g. Registrar), and in all cases of appeal, the court enforces shareholder rights in Company Law, Securities Law, and listing rules. E.g. in India company law is enforced by the specialized NCLT.	Public and private firms: The Registrar / Companies Department (e.g. Egypt) may enforce some shareholder rights in the Company law may be enforced by the Registrar, or else by court (e.g. pre-emptive rights, equality of classes of shares, etc).	Public and private firms: Arbitration courts may exist, where by prior commitment parties take their disputes, agreeing to bypass the court. In this case, arbitration courts would take court competence over Company Laws, Securities Laws and listing rules (e.g. Chile).	Public: Voluntary Codes of Corporate Governance specify some of the shareholder rights that would otherwise be in the Company Laws, Securities Laws and listing rules.	Public and private firms: Companies may include provisions in their Charter / founding documents specifying some of the shareholder rights that would otherwise be in the Company Laws, Securities Laws, and listing rules.	Public firms: n.a. Private firms: Bodies other than the Registrar can enforce shareholder rights provisions, e.g. the Central Bank for banks.
Shareholder redress: <ul style="list-style-type: none"> Right to call a meeting Withdrawal rights Right to overturn meeting decisions Redress from regulators Redress from court 	Public firms: Some shareholder redress options are found in the securities law provisions, and are enforced therefore by the Securities Regulator.	Public firms: Shareholder redress options are rarely found in the listing rules.	Public and private firms: The court is the main provider of shareholder redress, in four main forms: <ul style="list-style-type: none"> direct suits derivative suits (by shareholders in the company) class action suits 	Public and private firms: Companies Regulators can provide redress, e.g. the Jordan Companies Controller is present at AGM meetings and assures the right of shareholders to ask questions, guarding against irregularities.	Public and private firms: If shareholders and the company have a prior commitment to resolve disputes by arbitration, arbitration courts would take court competence over shareholder redress.	Public firms: n.a. Private firms: n.a.	Public and private firms: Companies may include shareholder redress provisions in their Charter / founding documents.	Public firms: n.a. Private firms: n.a.
Creditor rights: <ul style="list-style-type: none"> Right to information on financial situation, credit history Rights per law on debt collection, collateral sale, foreclosure Rights per law on bankruptcy 	Public firms: n.a. Private firms: n.a.	Public firms: n.a. Private firms: n.a.	Public and private firms: Court is the main enforcement mechanism for creditor rights. A bankruptcy court may exist. The General or commercial court still enforces debt collection outside of bankruptcy.	Public firms: n.a. Private firms: n.a.	Public and private firms: If creditors and the company have a prior commitment to resolve debt disputes by arbitration, arbitration courts would take court competence over creditor rights.	Public firms: n.a. Private firms: n.a.	Public and private firms: Companies would contractually commit to certain disclosures, keeping their accounts at the creditor bank, and other conditions securing creditor rights.	Public and private firms: Credit registries and public property registries enforce creditor rights with respect to their collateral, as well as making an informed lending decision.

POINTS OF INTERVENTION (DRAFT MATRIX)

Issue	Actors / Fields of enforcement					Special Departments / Agencies		
	Securities Regulator	Listing Rules Enforcer	Court	Registrar/Companies Regulator	Arbitration Court		Voluntary country-level acts	Voluntary company-level acts
Disclosure: <ul style="list-style-type: none"> Ownership / shareholder Share class Annual report Periodic reports / material facts RPT details AGM notice Takeover / delisting Insider trading 	Public firms: The securities regulator enforces the disclosures specified in the Securities Law (e.g. ownership disclosure by the company, share class information, RPTs, takeover / delisting, etc). Private firms: n.a.	Public firms: The securities regulator or the stock exchange enforces the disclosures specified in the listing rules (e.g. annual and periodic report contents, material facts, takeover and insider trading disclosure) Private firms: n.a.	Public and private firms: The court can force the disclosure of any information, summon any witness, and require third parties to provide any information it deems necessary.	Public and private firms: The Registrar / companies regulator enforces the disclosures specified in the Companies Law (e.g. ownership disclosure by the shareholders, share class information, RPTs, etc).	Public and private firms: To the extent the parties have agreed to arbitration and denied their right to court, arbitration court has the rights to requiring information of the two parties (which do not extend to third parties, however). Private firms: n.a.	Public firms: Corporate Governance Codes may specify as desirable the dissemination of some company information, e.g. electronic publication of annual reports, ownership, etc. Private firms: n.a.	Public and private firms: Companies may (and frequently do) voluntarily disclose information beyond what the law requires on their websites or in publications to the shareholders or the general public.	Public and private firms: Credit rating or analyst services may sell company information to the public.
Boards: <ul style="list-style-type: none"> Independence Size and frequency of meetings Disclosure rel. to meetings Director duty: loyalty / care Key board functions Disclosure of director details Nomination and election Board committees Director access to information Conflicts of interest and insider issues 	Public firms: Board matters are usually regulated in the Companies Law. Private firms: n.a.	Public firms: The court enforces director liability issues, and issues of conflict of interest, as well as any shareholder disputes with directors or director-related procedures. Private firms: n.a.	Public and private firms: Arbitration court has little relevance in practice to resolving such issues in most countries.	Public and private firms: Board issues are regulated in the Company law, and are enforced by the registrar / companies regulator to the extent of their general enforcement of the Companies Law.	Public firms: CG Codes would frequently prescribe independence of a certain share of the board, as well as a board size and other relevant CG provisions. Private firms: n.a.	Public and private firms: Companies may voluntarily invite on their board independent directors, or adopt internal mechanisms to assure better and more transparent board practices.	Public firms: Institutes of directors may provide instruction and guidance on director duties, rights, and proper practices. Private firms: n.a.	

POINTS OF INTERVENTION (DRAFT MATRIX)

Issue	Actors / Fields of enforcement							
	Securities Regulator	Listing Rules Enforcer	Court	Registrar/Companies Regulator	Arbitration Court	Voluntary country-level acts	Voluntary company-level acts	Special Departments / Agencies
Accounting & Auditing: <ul style="list-style-type: none"> Compliance with IFRS and enforcement Audit / audit oversight Auditor independence Auditor qualifications Liability 	Public firms: n.a. Although in Armenia the SEC controls the list of "eligible auditors" for listed firms. Private firms: n.a.	Public firms: n.a. Private firms: n.a.	Public firms: The court enforces auditor liability for false / misleading statements or failure to identify corporate misdeeds. Private firms: are not usually required to abide by international accounting standards or have an annual audit.	Public firms: n.a. Private firms: n.a.	Public firms: n.a. Private firms: n.a.	Public firms: CG codes may encourage companies to abide by international A&A standards. Private firms: n.a.	Public firms: Companies may voluntarily abide by international A&A standards. Private firms: n.a.	Public and private firms: The respective ministry would license and oversee the accounting and auditing profession. Accounting Associations would govern ethics and professional integrity.

Tatiana Nenova is an Economist with the IFC/World Bank Corporate Governance Department and this draft matrix is a simple visual tool that is part of a project on Corporate Governance in Frontier Markets, which she is leading.

Co-founded by the World Bank and the Organisation for Economic Co-operation and Development (OECD), the Global Corporate Governance Forum is an advocate, a supporter, and a disseminator of high standards and practices of corporate governance worldwide, especially in developing countries and transition economies. Through its co-founders and other donors, including the governments of India, Luxembourg, the Netherlands, Norway, Sweden, Switzerland, and the United States, the Forum brings together developed and developing countries.



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