

## RECOMMENDATIONS FOR STRENGTHENING CORPORATE GOVERNANCE

The major weaknesses in corporate governance in the five affected countries identified in the country studies and discussed so far can be summarized as follows. First, the boards of directors in many cases have failed to function as oversight bodies on behalf of all shareholders. In particular, the interests of minority shareholders have not been protected adequately because of the dominance of family-based controlling shareholders and the lack of effective mechanisms that could provide checks and balances such as the representation of independent directors and independent subcommittees for auditing, nomination and remuneration. Second, participation by minority shareholders in corporate decision making has tended to be passive, and their role in monitoring and exercising control tended to be weak, because of various obstacles as well as weak incentives. Third, monitoring and discipline by creditors have also been weak and inadequate, due to the close relationships between creditors and borrowers, lax supervision and regulations of the financial sector by government and the creditors' own governance problems. Fourth, the standards of transparency and disclosure have been low, making the monitoring and control by minority shareholders and creditors more difficult, if not impossible. Fifth, the legal protection for minority shareholders and creditors has been inadequate, mainly because of poor legal enforcement, leaving the external discipline weak and unsound practices by controlling shareholders unchecked. Sixth, external discipline has been further eroded due to weak product market competition, the lack of market for corporate control and underdeveloped capital markets.

The country studies point to a number of areas where reforms are required for an improved corporate governance system in the five countries. These reforms can be grouped into four areas: (i) corporate ownership structure; (ii) corporate internal control and shareholder protection; (iii) external monitoring and discipline; and (iv) capital market development and corporate financing. Some of these measures are under discussion, have been proposed, or have already been introduced in the affected countries.

## 5.1 Rationalizing Corporate Ownership Structure

Problems of the concentrated and family-based corporate ownership structure and their negative consequences for corporate governance suggest possible regulations in this area. However, ownership reforms could be politically sensitive and controversial. Ownership concentration also reflects the fact that many companies started as family businesses and are still young. Although family control may have adversely affected the development of capital markets, in many of the affected countries, financial liberalization has occurred only recently, and there are weaknesses in the regulatory framework. These have also hindered capital market development, which has certainly contributed to the preservation of corporate ownership concentration in some of the affected countries. The country reports argue that improvements in corporate governance as a result of the introduction of reform measures in other areas to be discussed below will, in the long term, lead to a more rationalized corporate ownership structure. In the short and medium term, the governments' adoption of piece meal approaches to reforming corporate ownership structure is supported. The following recommendations involve government regulatory authorities commissioning special studies on corporate ownership and related issues and on possible reforms and amending company laws and listing rules whenever appropriate. The concerned regulatory authorities may consider:

- commissioning special studies to examine the possibility of increasing the minimum percentages of outstanding shares required for public listing in the stock exchange to levels compatible with the current development stage of the corporate sector. These should be realizable in the short and medium term, with a view to promoting broader corporate ownership and reducing ownership concentration in the longer term;
- applying the new minimum requirements to companies seeking new listing and requiring that the existing listed companies implement the new requirements within three to five years;
- commissioning special studies to examine the extent of interlocking shareholdings (cross shareholding and pyramiding) and problems associated with these ownership arrangements, and

introducing appropriate measures either to regulate, discourage or prohibit such arrangements; and

- introducing or tightening the requirement for prompt disclosures of underlying ownership of shares held by nominees and holding companies and changes in the ownership; introducing or tightening penalties for non-compliance.

## **5.2 Strengthening Corporate Internal Control and Shareholder Protection**

### ***Strengthening the Board of Directors System and Accountability***

In the absence of adequate external governance from mature capital markets and banks and in the presence of highly concentrated ownership, governments need to strengthen regulations of the behavior of the internal governance agent, the board of directors. The key elements of the regulations to strengthen boards of directors are:

- statutory definitions of the fiduciary duties of directors with corresponding penalties for any violation of these duties;
- mandatory appointments of independent directors and penalties for non-compliance;
- mandatory maximum limits of directorships and penalties for non-compliance;
- mandatory provisions allowing cumulative voting of directors; and
- mandatory procedures for selecting non-executive directors.

A clear specification of the fiduciary duties of directors provides a sound basis for the enforcement of prudential requirements on management of companies and for actions by adversely affected minority shareholders. It is also a necessary provision to support the promotion of shareholder activism. Independent directors tend to adopt the

perspective of minority shareholders in board decisions. To help ensure this, the law should mandate a selection process that guarantees a fair chance for independent directors to be nominated by minority shareholders. The guidelines can be extended to include all non-executive directors. The aim of the statutory limit on the number of directorships is to curb the current practice of appointing prominent individuals as directors but who do not have sufficient time to guide the company's decisions. It complements the provision on mandating the fiduciary duties of directors. Cumulative voting is an important provision that gives minority shareholders the best chance for having their nominees elected to the board. This is a standard provision in developed countries, but not so in East Asia.

It should be emphasized that these recommendations to strengthen the board system complement each other. For example, requiring fiduciary statements of the director's responsibilities will not be effective if minority shareholders cannot elect their own directors through cumulative voting and independent directors are not in the board to monitor the actions of the controlling directors. The formulation of the appropriate legal provisions and their implementation are quite important. Different countries can find their own vehicles for formulating and enforcing these mandates. Some would find it necessary to put these provisions in the company law. Others may find it sufficient to initiate a code of conduct that the securities exchange agency can implement along with other measures affecting PLCs. These provisions should be implemented as part of a sustained corporate governance reform program of the government working in cooperation with PLCs.

### ***Strengthening Minority Shareholder Rights***

Minority shareholders in Asian corporate sectors appear unable to effectively curb the power of controlling shareholders in decision making. During the Asian crisis, these decisions—to expand investments in unprofitable projects and to use unhedged foreign currency debts—turned out to be disastrous. The result is tantamount to the expropriation of wealth of minority shareholders to the extent that minority shareholders were unable to prevent these decisions, or alternatively, take out their investments before the company implemented the decisions. Thus, the Asian crisis demonstrated the inadequacy of legal protection for minority shareholders.

Governments may consider thorough reviews of the company laws to better define and enforce the rights of minority shareholders in the context of dominant ownership and control by a few large shareholders. For example, the traditional forum for disciplining corporate management, the AGMs, is often ineffective for the publicly listed Asian corporations because only a few large shareholders dominate voting at the AGMs. Recommendations for improving protections for minority shareholder rights are:

- ensuring that the company laws provide shareholders the right to raise derivative or class action suits against management;
- instituting mandatory voting rules that protect minority shareholders, such as one-share one-vote and cumulative voting;
- strengthening insider trading regulations; and
- introducing measures to prevent, detect and penalize insider-dealings involving controlling shareholders.

Governments may consider amending the company laws to discipline controlling shareholders by tightening transparency and disclosure requirements, preventing insider-dealings by management and empowering minority shareholders by raising majority percentage votes on critical corporate decisions. Governments may also consider introducing innovative approaches for greater empowerment of minority shareholders. The problem is how to provide minority shareholders with opportunities to influence management decision making while respecting the prerogatives of controlling shareholders by virtue of their larger capital commitments. In short, there has to be a balance between overcoming the free-rider problem of minority shareholders and assuring that controlling shareholders retain the incentives of ownership. The following are the recommended pro-active steps:

- introduce innovative voting rules that grant minority shareholders with the “swing votes” or that reward them for voting/participating in corporate decisions;
- require minimum majority percentages that exceed the percentage of votes controlled by controlling shareholders;

- mandate the minimum representation of minority shareholders on boards; and
- grant veto powers in favor of minority shareholders over corporate decisions that are potentially detrimental to their welfare (e.g., clear cases of self-dealing).

### ***Improving Transparency and Disclosure***

Although many companies in the five countries, especially those publicly listed, claim that they have followed international accounting standards, anecdotal evidence suggests that the quality of accounting, auditing and financial reporting in these countries needs to be improved substantially. A key reason for this apparent discrepancy is ineffective enforcement. Following their Western counterparts, national accounting associations have played an important role in prescribing audit and reporting standards. However, the current self-regulatory system is apparently inadequate because of its high degree of tolerance for deviations from prescribed standards and its inability to penalize those who violate standards. The recommendations for improving accounting, auditing and financial reporting standards and hence transparency and disclosure are as follows:

- specify the degree of compliance with international accounting and reporting standards that PLCs should achieve;
- establish a supervising agency to regulate financial reporting practices and enforce financial reporting standards; if such an agency already exists, examine and strengthen implementation arrangements;
- conduct regular dialogues on reporting and disclosure issues among government agencies that are responsible for supervising corporate reporting and national accounting associations;
- require PLCs, through the stock exchanges, to appoint independent directors and external audit sub-committees and mandate their functions and responsibilities to public investors; impose sufficiently severe penalties for fraudulent financial reporting;

- strengthen company reporting requirements in listing rules of the stock exchanges. Operating, management and financial information contained in company reports should enable investors to evaluate the performance and value of a company. To ensure the accuracy of information in such reports, the stock exchanges should specify the minimum content of the reports and hold responsible directors, management and other professionals who prepared or certified the accuracy of the report.

### ***Developing Institutional Investor Community***

Asian capital markets are characterized by “missing middle” investors that are neither block holders owning shares for permanent control nor short term investors in search of short term trading profits. These investors are usually the institutional shareholders in developed capital markets like insurance companies, pension funds and mutual funds. Due to the nature of their fund sources, they could invest in shares of companies for the long term but will also trade their shareholdings if business opportunities change and for trading gains. These institutions require PLCs to be transparent and provide adequate disclosures. Their presence increases the competition for funds among the PLCs. It is recommended that governments set up the legal and regulatory framework for developing effectively functioning pension and mutual fund industries. Governments may consider reviewing their regulations of the insurance sector and adopting policies that provide insurance companies with viable opportunities for expanding their investments in PLCs without sacrificing their fiduciary roles.

### ***Promoting Shareholder Activism***

A two-pronged approach may be adopted to encourage small shareholders to actively monitor their management. One is to require transparency and disclosures as previously discussed. The other is to install provisions in the company laws to facilitate class action suits against corporate directors, management and external auditors. In a class action suit, all minority shareholders potentially benefit from the fruits of activism by a few shareholders. The threat of such action can be a powerful deterrent to management decisions that could result in the expropriation of wealth of minority shareholders.

The legal provisions for class action suits should cover all the important activities where expropriation may arise and include all parties that may perpetrate such activities. Class actions should cover self-dealing by directors, compensation contracts, information disclosures, dividends and other decisions. The parties that can be the subject of class actions should include members of management, directors, and internal and external auditors. The introduction of legal provisions could encourage the formation of shareholder activist groups. These groups will have an incentive to gather technical expertise, leadership and broad-based political and popular support to pursue cases involving the expropriation of minority shareholders' wealth in companies. Indirectly, these groups can mitigate the free-rider problem, especially in the more prominent PLCs.

### **5.3 Strengthening External Monitoring and Discipline**

#### ***Improving Financial System Regulations***

The Asian crisis demonstrated the need for strengthening the relationship-based finance system that banks rely upon. Governments should improve bank supervision and regulations to enable banks to perform their role as external monitoring and control agents of their corporate debtors. Lessons from the Asian crisis indicate that implicit and explicit guarantees to banks reduce the incentives for banks to monitor and control the investment and financing activities of their corporate debtors. The governments need to conduct thorough reviews of their financial and banking systems. The following recommendations aim to improve banking regulations and supervision in the affected countries:

- remove explicit and implicit guarantees by government in favour of banks;
- introduce a deposit insurance scheme to protect depositors from bank failures and increase confidence in the banking system;
- limit the shareholdings of non-financial companies in banks and of banks in non-financial companies in order to avoid conflicts of interest in making lending decisions by banks;

control relationship-based lending among members of conglomerates and reduce inefficiency of internal capital markets;

- set and strictly enforce limits on lending by banks to affiliated companies, officers, directors and related interests; impose severe penalties for any attempt by banks to circumvent this regulation;
- strengthen regulations and supervision capacities by placing these functions under a specialized organization that may or may not be separated from the Central Bank;
- adopt international standards of capital adequacy and ensure that banks comply with these standards;
- require banks to follow international financial accounting, reporting and disclosure standards; and
- closely monitor, limit or prohibit cross guarantees by companies belonging to affiliated groups.

### ***Promoting Product Market Competition***

It is recommended that the governments review their industrial development policies to eliminate remaining biases toward subsidies, implicit and explicit guarantees, entry and exit barriers and various other forms of protection. They need to review the competition policies to enable entry and exit of domestic and foreign companies while regulating monopolies and anti-competitive practices. Governments should be especially concerned with improving the infrastructure for efficient conduct of business of all possible scales and organizational modes. Governments should give priority to the reduction of graft and corruption, the enforcement of the rule of laws and provision of quality basic services. Governments should continue to privatize state-owned enterprises and divest their shareholdings in banks and other financial institutions. Foreign direct investment is another means of encouraging entry of globally competitive enterprises into domestic economies. It is recommended that administrative procedures for foreign direct investments be simplified and made more transparent.

The concentrated industry structure and practices of organizing firms into industry groups have limited the extent of competition. Large

East Asian conglomerates have promoted internal capital markets and cross-subsidies in finance. They have diversified their businesses to a degree beyond the efficient level. Steps should be taken to correct this situation. Measures should be taken to increase competition and reduce the monopoly power of conglomerates. This can be achieved, for example, by eliminating barriers to entry for new firms that are put in place by earlier industrial policies. The Korean government, for example, has ordered *chaebols* to sell off unrelated businesses after the crisis.

### ***Developing the Market for Corporate Control***

The market for corporate control offers another disciplining device for management of publicly listed companies. It is recommended that the governments review their corporate laws and eliminate possible impediments to the acquisitions of companies by outside investors, such as “poison pills”, limits on acquisitions of shares, among others. Governments may consider formulating takeover codes that adopt internationally accepted practices in order to encourage and open up the market for corporate control and to align local with international practices. The takeover codes should protect the rights of minority shareholders during the process of liberalizing corporate takeovers and acquisitions. They should be formulated in the context of highly concentrated corporate ownership. For this reason, it is important to consider minority shareholder rights in the takeover process. For example, in Philippines, an acquiring investor is required to make a tender offer to all minority shareholders at a price equal to its offer to the present controlling shareholders. At the same time, sufficient disclosures should be given to all shareholders regarding the terms of the offer by the acquiring investors to the controlling shareholders.

### ***Reforming Insolvency Procedures***

Prior to the crisis, insolvency procedures throughout the region were highly ineffective. They provided little recourse for creditors and no discipline on incumbent management. Many reforms have been implemented. However, many problems remain. In immediate response to the crisis, some countries introduced changes in bankruptcy procedures that are in favour of debtors and at the expense of creditors—especially the secured creditors. This may have encouraged strategic defaulting and to some extent could explain the slow progress in corporate

debt restructuring in some countries. These problems need to be carefully evaluated.

Governments need to review their insolvency laws to ensure protections of creditor rights and—in cases of corporate failures—to ensure that corporate management and owners complete settlements of their obligations and absorb their shares of financial losses. At the same time it is important to guarantee that mechanisms are in place for the restructuring of companies for which the going concern values exceed the liquidation values. The Asian crisis revealed the underlying weaknesses of the present insolvency laws.

Well-designed insolvency procedures should allow debtors and creditors to resolve insolvency problems informally if possible. Informal procedures could take the form of workouts supervised by the Central Bank or some other agencies, as in the London Approach, or the pre-packaged Chapter 11, or debt equity swaps. Formal procedures with bank-based finance are likely to require clear rules for receivership or administration. If bond financing is important, a mechanism for reaching agreements between dispersed creditors may be necessary. If introducing a moratorium on creditors' claims and debtors in possession, restructuring must be done in a way that maintains the creditors' incentives to take an active role in governance. A special concern is the tendency for debtors to use loopholes in the laws to access court assistance for rehabilitation and avoid incurring liquidation losses associated with their past business decisions and conduct. Governments should allow the rehabilitation of distressed debtors only under a process consistent with the protection of creditor rights and without constraining the ability of the process to effectively discipline management. The following specific recommendations are some of the crucial steps toward implementation of this policy:

- review the securities laws to ensure that creditors can enforce their rights on collateral assets. Eliminate any impediments to the enforcement of creditor rights and simplify the process of enforcement of these rights;
- review the company laws for consistency with the insolvency and security laws and implement necessary amendments;
- simplify legal procedures for filings of bankruptcy and corporate rehabilitation. Expedite court judgments on non-viable

companies to focus the attention of the corporate sector on the rehabilitation of viable companies;

- simplify the legal process for the liquidation of non-viable companies;
- enhance the use of market-based solutions to insolvency problems through the use, where possible, of debt-equity swaps;
- prevent abuses by debtors of court- or government-supervised restructuring of troubled debts;
- ensure that only companies whose going concern values exceed their current liquidation values qualify for court-supervised restructuring;
- narrow down the eligibility of companies for filing of court-supervised composition and rehabilitation. The court or concerned government agency should be allowed to refuse filings of companies even if their going concern values exceed their liquidation values due to factors that may prevent effective implementation of any composition or rehabilitation plan; and
- ensure a cost-effective rehabilitation; the rehabilitation plan should be formulated and implemented within a fixed period of time. Otherwise, the court should place the company in liquidation.

#### **5.4 Developing Capital Markets and Improving the Efficiency of Corporate Financing**

##### ***Developing Capital Markets***

The governments need to accelerate the development of equity markets. Through their SECs and stock exchanges, the governments should consider formulating policies to increase the supply of quality securities from top-tier local companies in the stock markets. Unless effective policies are instituted, many PLCs will remain under the control of a few large shareholders and other large companies will remain privately

owned. The lack of quality equities that are traded in sufficient volumes and low liquidity deter institutional and individual investors. As a result, share prices become vulnerable to manipulation or insider trading by large shareholders, rather than being responsive to corporate performance.

The governments are aware that as part of the financial system's infrastructure, capital markets need to be organized, expanded and regulated. The government role in capital markets is to ensure that players are well informed and that there are fair rules. The governments need to review the public listing and trading rules and supervision systems in order to ensure that markets are operating efficiently. Of special importance are those related to disclosures, insider trading, public listing and de-listing rules and trading systems. Investors in Asian stock markets have raised the issue of the enforcement of existing rules and regulations at the stock exchanges. The governments should take steps to restore the confidence of international investors in their stock exchanges and their supervisory authorities.

### ***Corporate Finance***

Banks have dominated corporate financing in Asian companies. The corporate sectors relied on bank financing partly because of the unwillingness of large shareholders to dilute their control by issuing equities. The governments should consider introducing measures to accelerate the development of capital markets including local debt markets as important sources of corporate financing. The governments may start with developing a medium-term yield curve for the debt markets by strengthening the government securities market. By issuing government treasury securities in longer tenures, the governments will be able to develop the market for future issues of corporate bonds. The government treasury bonds can then provide bellwether rates for corporate bonds of comparable tenures.

Developing the corporate bond markets requires that the governments take measures to develop trading systems and strengthen capacities for rating corporate bonds. These processes should be undertaken by the private sector under the guidance of the governments. Various international bond dealing and trading systems are already in place. They can be used as models for development by the Asian countries. International credit rating agencies could be invited to establish operations in the Asian region. An important role for governments in this process

is to lay down the legal and tax framework required by efficient functioning bond markets. Of special importance are the regulatory process for issuance of bonds, tax treatment and rules for income from bond trading and holding and rule enforcement in case of default in interest or principal. Similarly, the governments of the affected countries should take measures to broaden and deepen their equity markets. Finally, it is important to underscore the interrelationship between the expansion of the role of securities markets as a source of corporate financing and other factors identified in this study. Corporate sectors are likely to remain dependent on, and continue to prefer, bank financing so long as bank regulations do not strictly enforce prudential lending practices and corporate ownership remains concentrated.

### **5.5 Reform Priorities in the Short and Medium Term**

Some of the reform measures discussed in this section such as developing capital markets, promoting market competition, facilitating the market for corporate control and encouraging participation by institutional shareholders in corporate governance are important. But it may take considerable time either for them to be in place or for their effects to be felt. The governments need to identify a few priority areas where reforms could be most effective in the short or medium term. Among measures aimed at strengthening corporate internal control, improving standards of accounting, auditing and financial reporting systems and their enforcement should be placed on top of the reform agenda. Among measures aimed at strengthening external discipline, prudential regulations and supervision of banks and non-bank financial institutions are priority concerns. Given their dominance in corporate financing, banks and non-bank financial institutions as creditors should and could play a greater role in monitoring and disciplining non-financial corporations, not only in insolvent, but also in solvent states.

It is also important to realise that amending corporate laws and regulations cannot guarantee the strengthening of corporate governance. The *enforcement* of these laws and regulations is at least as important as the laws and regulations themselves. The experiences of the affected countries suggest that rules and regulations were violated, but the guilty parties were often unpunished. Effective legal enforcement requires effective regulatory bodies with statutory powers and an efficient judicial system. In some countries, it also requires significant

improvements in the state of governance in both public and private sectors. There is also a need to review the relationship between legal enforcement and self-regulations.

The corporate governance system of any particular country is a result of the interplay of political, economic, legal, cultural and historical factors. A major challenge the governments face would be to implement sound corporate governance principles and good practices, many of which were developed in advanced economies, in a way that takes into consideration the great diversity of culture, economies and legal systems in each of these countries. The recommendations proposed in this report are not intended to be prescriptive and comprehensive. The recommendations point to several key areas to which the concerned government authorities in the affected countries might want to pay close attention in addressing weaknesses in corporate governance and financing. Each country should formulate its own reform package and implement measures that suit its specific conditions. In fact, some of the recommended measures have already been introduced in the affected countries, some have been proposed and some are being discussed.