The Governance of Listed and Non-Listed Companies

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Funds Providers and Asset Managers Likely to be Separate

- Given assets should be managed by the most capable management team available
- The most capable team is unlikely to have the wealth and/or capacity to absorb risk necessary to purchase the assets
- Efficiency thus likely to require separation of persons providing funds to purchase assets and the managers of these assets

Separation Creates Need for Corporate Governance

- Need to pair assets with their most capable managers
- Need to prevent “take the money and run” managers
- Need to motivate managers to manage assets in the way that maximizes the expected returns of the providers of funds
- Need to give providers of funds adequate protection since investors that have better protections will pay a lower price for corporate stock and the cost of equity capital will increase

Corporate Governance involves Difficult Tasks

- The structure of large organizations and the complexity of the transactions they enter into make it difficult for shareholders to monitor and discipline managers
- So a simple agreement between the funds providers and managers is not enough
- *Which* bundle of rules can ensure that managers perform well and do not take private benefits for themselves?

Law's Bundle of Rights

- Control rights
  - election of directors, voting at annual meetings
  - significant transactions
  - minority protections
- Financial rights
  - Distribution of retained earnings
  - Further subscription rights
  - Exchange shares for cash: through buy-back
- Information rights
  - Past performance - annual report
  - Current performance and future prospects - financial community
- Different shareholders place different values on different parts of 'bundle'

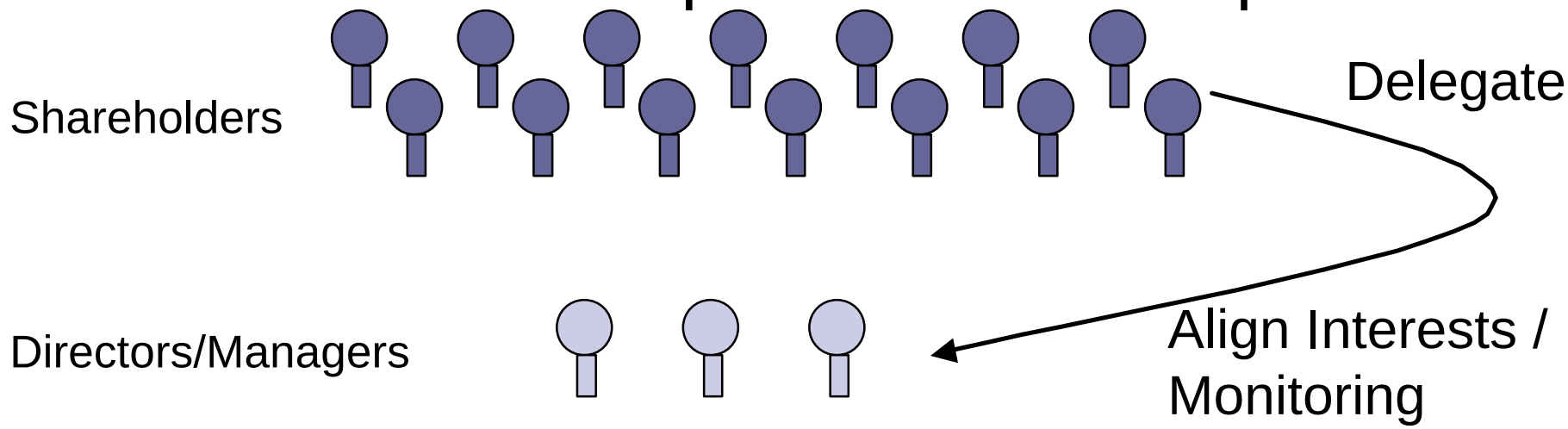
Corporate Governance Involves a Whole System:

- Part of the corporate governance system is the facilitation of a written “corporate contract” between the various categories of participants within a firm - equity investors, creditors, managers, employees, suppliers, etc. and helps fill in the gaps in this contract
- The system can involve other pressures on managers including competition in the product market and a vibrant market for corporate control
- Different national governance systems represent different approaches to protecting public equity investors

Three Different Basic Corporate Governance Structures

- *Listed* firms with dispersed ownership
- *Listed* firms with concentrated block of control shareholders
- Closely held *non-listed* firms
- Which structure is best in any particular circumstance is a matter of debate

Corporate Governance Debate: Listed firm with Dispersed Ownership



Internal Corporate Governance Mechanisms:
-Non-executive managers
-Fiduciary duties: Duty of care / Duty of loyalty
-Executive pay
-Disclosure and Transparency
-Internal and external audit process

What is Needed for Good Corporate Governance in Publicly Listed Companies?

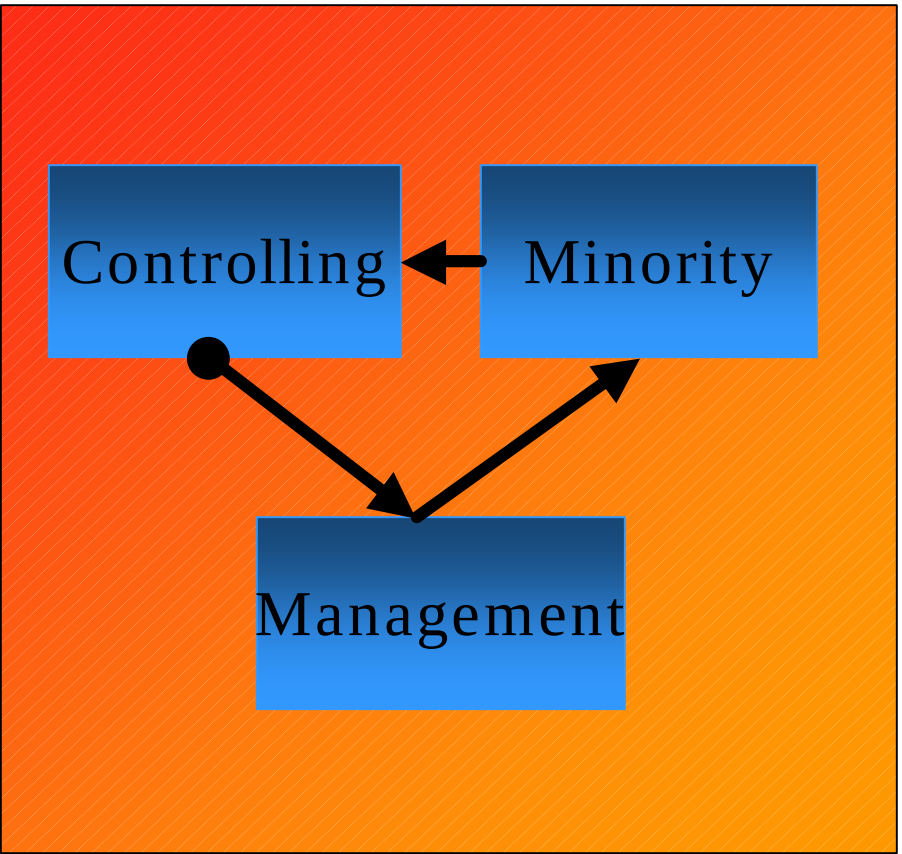
- Strong independent board members
- Strong internal control
- Strong independent accountants
- Financial statements auditable
- Transparency
- Time Loss Recognition

- Effective monitoring by analysts, investors, lenders, rating agencies, etc
- Shareholder litigation imposes discipline
- An independent, effective judiciary
- Politically insulated regulatory agency

Legal Reforms Worth Pursuing

- Clear and simple company law rules and more options
- Safe harbor provisons needed (e.g., explain corporate opportunities, related party transactions)
- Regulatory agency to supply clear and effective disclosure rules
- Strict sanctions needed against issuers and their insiders and against gatekeepers such as accountants and underwriters when disclosure fails to meet the rules
- More training, education and awareness of shareholders and other parties (e.g., simple set of financial statements)

Governance Problems in Listed Firms with Controlling Shareholder



-Private benefits of control not provided to public shareholders

-Ineffective disclosure means material implications regarding related party transactions

-Implications: higher cost of equity capital

-Decrease in firm value if high PBC extraction (Classens et al)

Concentration of ownership – international comparisons

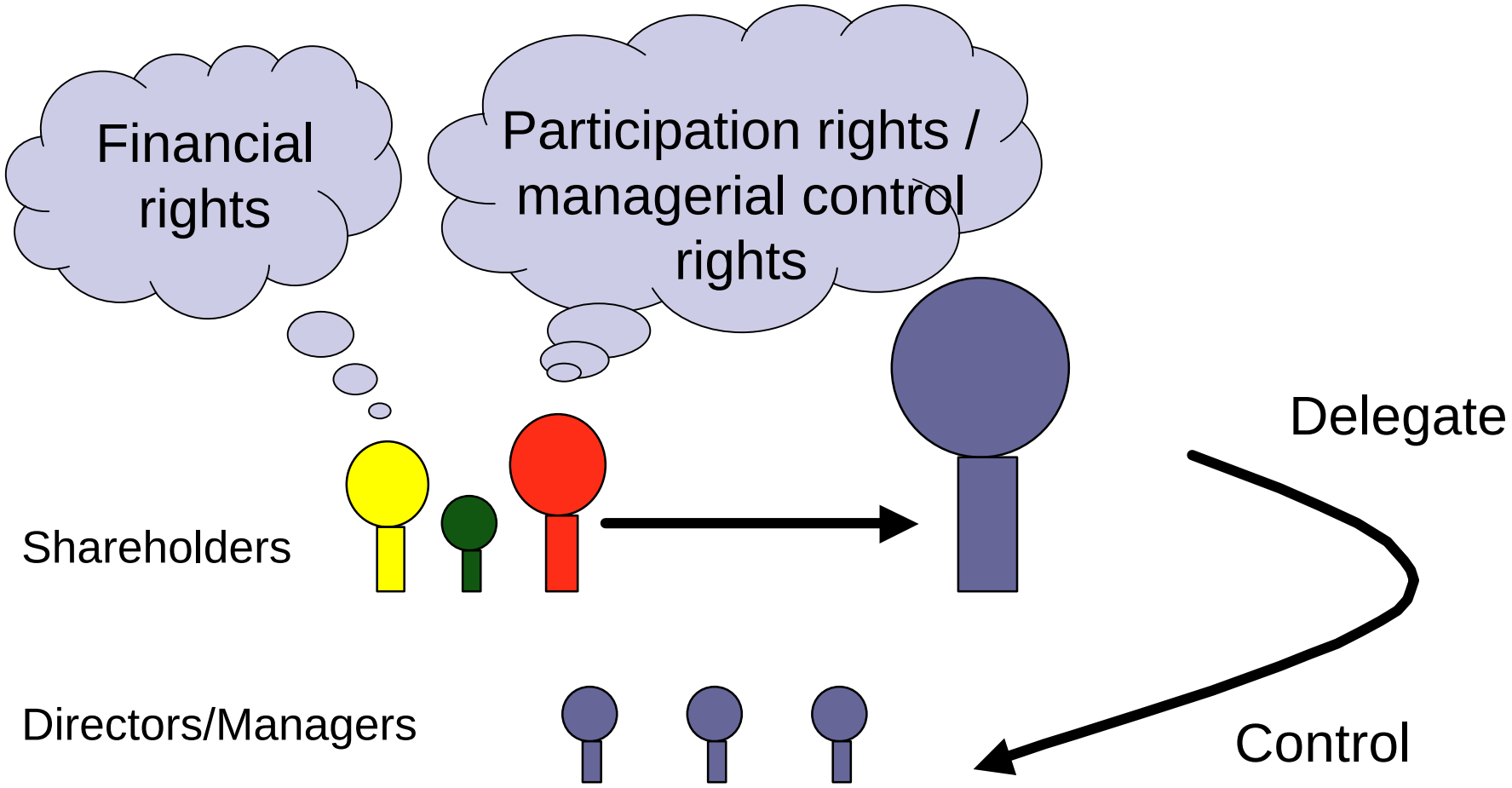
Country	**Average size of the largest stake, %**
Russia	54
Chile	40
Germany	22
Japan	7
US	5

Source: S&P 2004

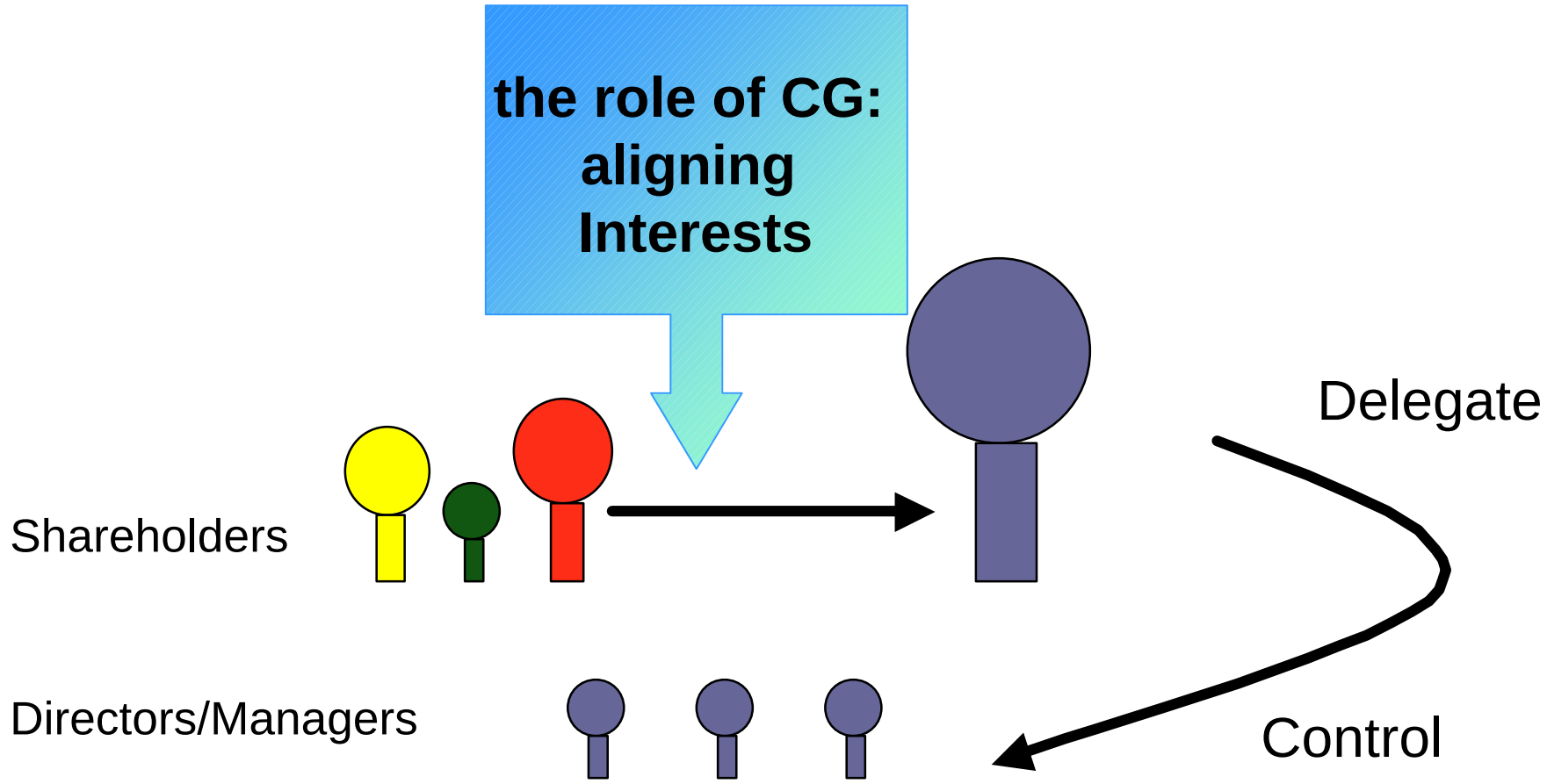
Strategies for Good Governance in Listed Firms with Controlling Shareholder

- Need to distinguish between efficient and inefficient concentrated ownership system
- Need strong disclosure requirements
- Need to disclose affiliate/family relationships
- Need to establish right balance of independent directors on board; opt in measure for some NEDs on audit committee
- Need to eliminate pyramidal ownership structures (linked to high private benefits of control extraction in weak systems)
- Need strong private enforcement mechanisms to supplement public regulation (e.g., Parmalat)

Corporate Governance:
Non-Listed Closely Held Company

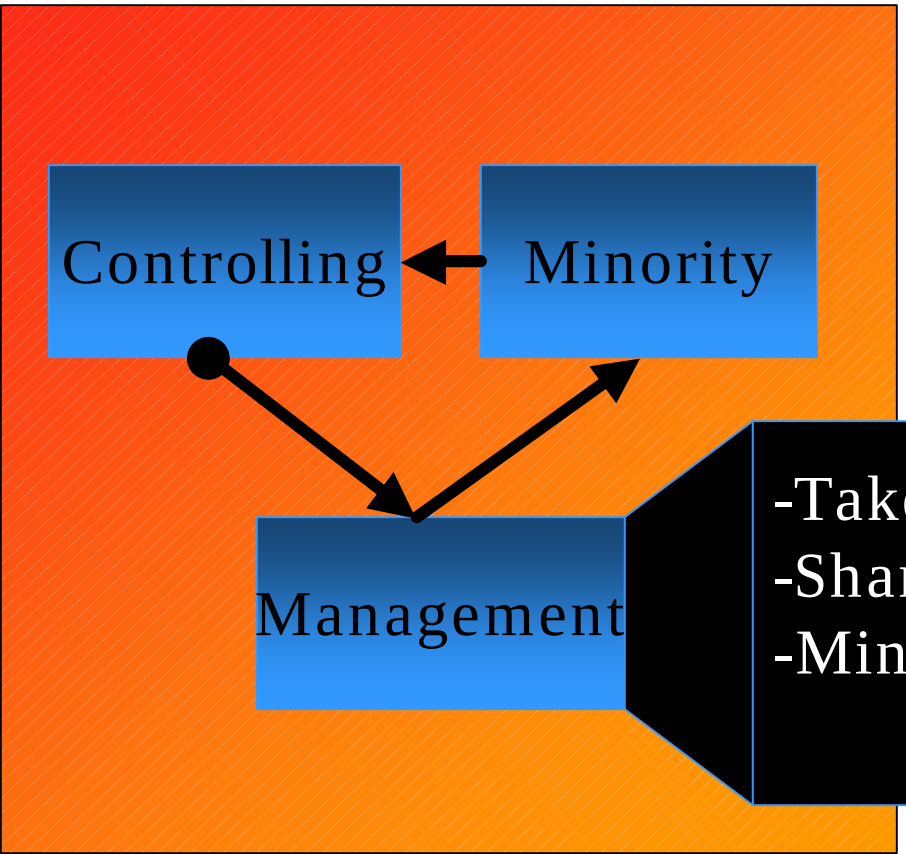


Corporate Governance Debate:
Non-Listed Closely Held Company



Corporate Governance Mechanisms

Company Law: *Board and management*

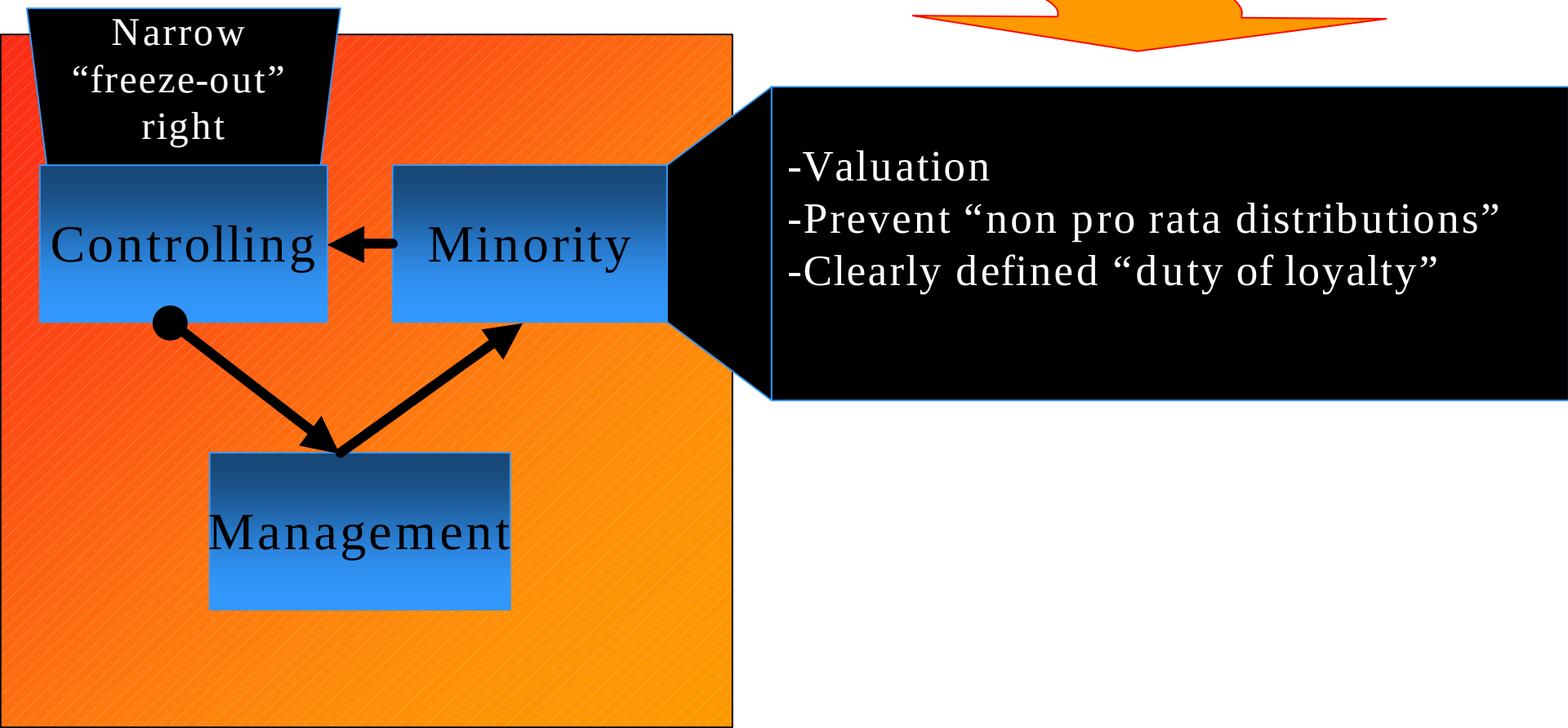


-Take account of minority interests
-Shareholder approval
-Minority representation on the board

Corporate Governance Mechanisms

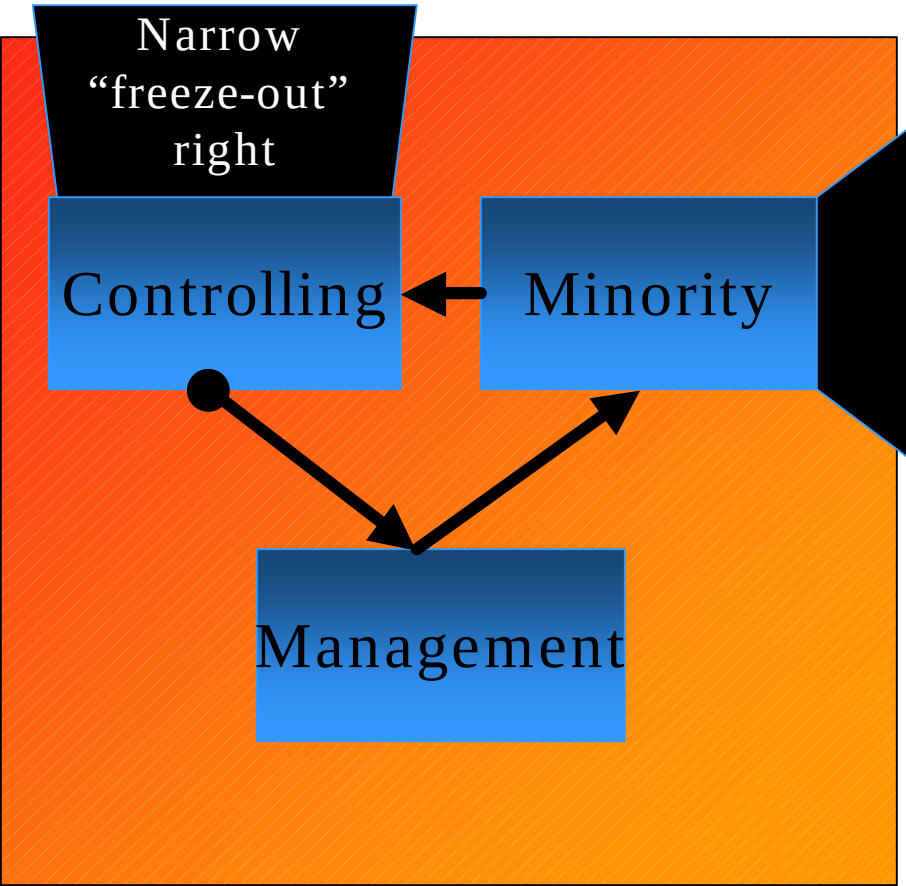
Company Law: *Shareholders' rights*
(exit rules and fiduciary duties)

Shareholders are locked in



Corporate Governance Mechanisms

Company Law: *Information rights*

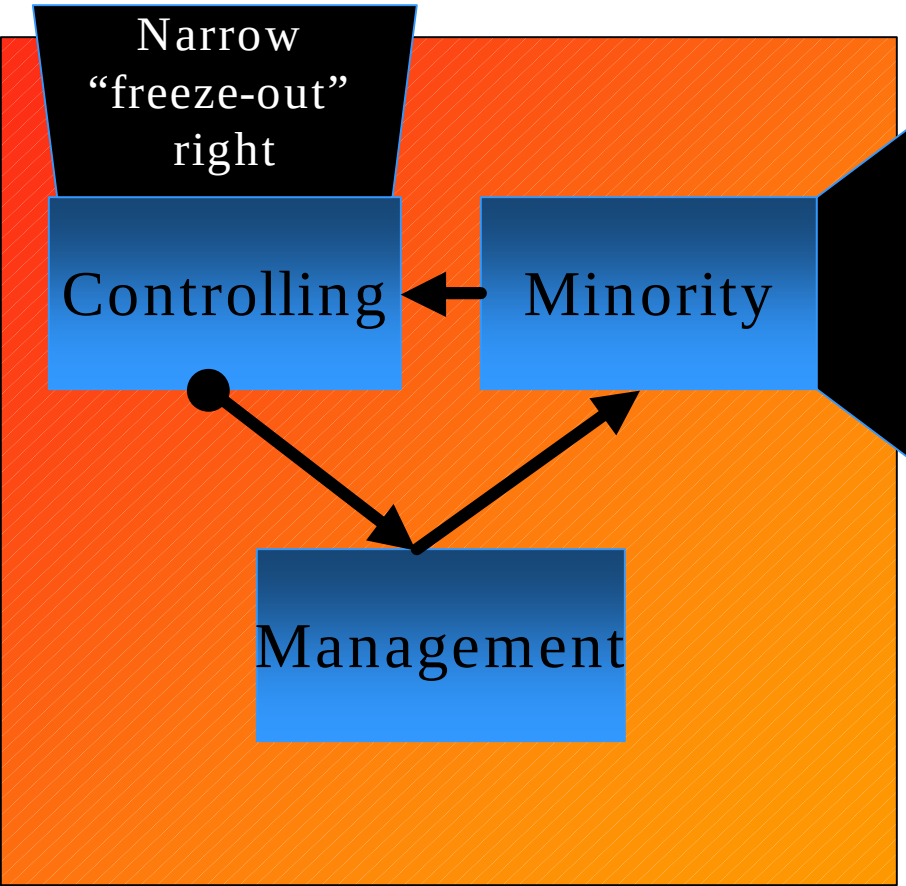


-Valuation
-Prevent "non pro rata distributions"
-Clearly defined "duty of loyalty"
-Information rights

Information rights
-Public information (annual accounts)
-Private information (right to inspect the books)

Corporate Governance Mechanisms

Company Law: *Enforcement*



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-Enforcement

Enforcement
-Direct suits
-Derivative suits

Summary

- Listed Companies with Dispersed Ownership require strong disclosure, good accounting rules, audit process and balanced enforcement culture
- Concentrated ownership regimes need to develop culture of independent directors, expand private enforcement, eliminate inefficient capital structures
- Closely held, non-listed firms require narrow freeze out rights,clearly defined duty of loyalty and good mix of private and public enforcement
- Overall: improve corporate governance through soft law and optional measures, non-legal institutions and creation of models for investors and others