OECD's work on corporate governance of non-listed companies (NLCs)

Fianna Jesover, OECD Corporate Affairs Division

15 September 2005
Den Haag, Netherlands

Working definition of non-listed companies

- Definition - Closely held companies whose shares, unlike those of publicly held companies, do not trade freely in impersonal markets, either because their shares are held by a small number of persons or because they are subject to restrictions that limit their transferability (Hansmann/Kraakman, 2004).

- Profile of companies – Large companies, relative to GDP of host country, that are by choice unlisted but that have non-controlling shareholders and/or creditors, i.e. companies partially or completely under founder/family control, with professional management.

What I will talk about today…

I. Background: demand from non-OECD countries

II. The key issues discussed at a kick-off meeting in Istanbul on 19-20 April 2005

III. Conclusions and next steps

I (a) Background: demand from non-OECD countries

- Some of the largest firms are non-listed, founder-owned with financial stakeholders and play a pivotal economic and social role in many countries
- Benefit from recent experience in implementing the OECD Principles of Corporate Governance in listed companies and explore their relevance to NLCs
- Analyse & discuss key challenges/opportunities for NLCs and their policy implications.

I (b) OECD efforts to promote corporate governance reform globally

- Outreach to non-OECD countries:

  Russia, Asia, Latin America, Eurasia, South East Europe, Middle East and North Africa

- Organised by the OECD with the World Bank Group, and supported by the Global Corporate Governance Forum (GCGF), IFC, EU, bilateral donors such as the USAID and the government of Japan, as well as regional development banks and local partners

- Develop policy recommendations (e.g. White Paper and Stock-taking)

I (c) Policy dialogue to identify concrete steps for improving corporate-governance frameworks

Examples of Russian White Paper Recommendations*

OECD Principles of Corporate Governance → Regional Corporate Governance Roundtables → White Papers on Corporate Governance

Legal reforms

- Tighten the rules governing related-party transactions
- Adopt international financial reporting standards

Changes in Administrative Practice

- Improve enforcement
- Improve disclosure regulations

Private Sector

- Improve training of directors
- Companies should communicate with employees and stakeholders

1 (d) From awareness raising to policy design, implementation and enforcement of reform priorities…

Regions

- Russia, Eurasia, Asia, South-eastern Europe, Latin America, and MENA

Objective

- Provide Regional policy-makers, regulators and practitioners with a forum for international dialogue on current corporate governance developments

Format

- Task Force meetings on specific issues for exchange of experience and in-depth analysis
- The topics should be tied to ongoing or planned initiatives

Outputs

- Task Force to develop options for viable policy solutions
- A progress review of corporate governance reforms.

II. Key issues raised at the OECD kick-off meeting in Istanbul on 19-20 April 2005

A. The corporate governance characteristics of non-listed companies

B. The driving forces for changing corporate governance practices in non-listed companies

C. The role of the public policy framework in supporting good corporate governance in non-listed companies

A. Corporate governance characteristics of NLCs

(i) Contemporary corporate governance debate

(ii) The variety of NLCs

(iii) Internal and external mechanisms

(iv) Professional management

(v) Transparency requirements

A(i) Contemporary corporate governance debate

- Need for creating effective measures and improved institutions to stimulate economic growth and social welfare

- A corporate governance framework elaborated for NLCs could help define internal and external stakeholders' expectations *ex ante* and assist judiciaries, auditors, lawyers and other professionals in solving problems *ex post*.

A(ii) The variety of NLCs

- Ownership: family-owned, state-owned, group-owned, private investor-owned, and joint ventures. Also depends on financing sources, i.e. banks, a family, private equity, venture capital, etc.
- Characterized by small number of shareholders, no ready market for company's shares and substantial majority shareholders participation in management and operation.
- Different internal and external corporate governance mechanisms are employed by NLCs (*e.g.* size, board, management, supervision, legal business form).

A (iii) Internal and External Mechanisms

- Motivating managers to take risks: incentive compensation and stock options (need necessary institutions) benchmarked against performance
- Control abuse and underperforming managers: absence of market for corporate control need complex mechanism to protection non-controlling shareholders
- Independent registers and chambers of commerce to ensure compliance and increase trust in market
- Dispute resolution

A (iv) Professional management

- Strong board oversight seems critical
- Director's competence more important than independence
- Training and education crucial to foster professionalism, competence and self-discipline

A (v) Transparency and information disclosure

- Objective: Full and timely access to information enhances corporate governance and reduces information asymmetries between controlling and non-controlling shareholders
- Mandatory versus voluntary disclosure requirements
  - Mandatory disclosure may be costly and risky: loss of personal privacy, loss of competitiveness, direct compliance and administrative costs
  - Mandatory transparency: to stakeholders and managers, encourage analysis and better understanding of business, costs diminish over time, facilitate communication, prevent corruption and serve as risk management tool

B. Driving forces for corporate governance practices in NLCs

i. Access to Capital and Implications for corporate governance

ii. Succession Planning and Dispute Resolution

B (i) Access to capital and implications for corporate governance

- While many NLCs rely on internal funds, debt viewed as a disciplining device to align managers' and shareholders' interests as defaults deprive managers from control
- Banks and credit agencies can promote good governance by insisting on observance as part of risk assessment process
- Private equity investors encourage implementation of good corporate governance
- Venture Capital Associations promulgate principles that help raise respect, integrity, transparency and confidentiality
- More research is needed

B (ii) Succession *Planning and Conflict Resolution*

- Formalising board decision-making processes can help manage conflicts of interest, encourage transparency and increase involvement of non-controlling shareholder
- Family councils may help prevent disputes
- Overemphasis on legal and regulatory protection of non-controlling shareholders might exacerbate potential disputes in family owned businesses
- Careful and timely succession planning with a focus on training and education is crucial in a well-developed corporate governance system for family-owned firms

III. Role of public policy in supporting good corporate governance in NLCs

- Simple and clear company law rules that protect basic shareholder rights (e.g. cumulative voting, periodical information on accounts etc.) should be offered. Rights include:

  -Attendance at AGM and right to ask questions

  -Proposing shareholder resolutions

  -Exercising voting and cash flow rights

  -Preventing non-pro-rata distributions

  -Different classes of shares

- Proper disclosure practices by boards – right of inspection of company records

III cont'd - Role of public policy

- Access to the judiciary - courts need to be accessible to allow shareholders to exercise their rights
- Within the boundaries of company law, NLCs should have discretion to adopt mechanisms through contracts voluntary governance structures
- Corporate governance codes, often based on OECD Principles, could provide improved framework for NLCs WITHOUT requiring comply/explain
- No separate code for NLCs

III. Conclusions and next steps

Now better understanding of challenges/solutions for corporate governance of NLCs. Many issues remain unresolved and further discussion/research needed. Discussions should continue at outreach fora. It was agreed:

- NLCs do not need a separate set of corporate governance principles than listed firms; raise awareness of benefits of existing Principles/Codes
- Internal mechanisms should focus on training/education of managers and shareholders as well as improving transparency of the decision-making process
- Conduct more research on benefits of contractual versus legal/regulatory mechanisms
- IFC's CG methodology for founder-owned unlisted companies practical tool for future discussions

Thank You !

Views and suggestions may be forwarded to Mrs. Fianna JESOVER at
fianna.jesover@oecd.org

Full text of the Synthesis Note is available on www.oecd.org/daf/corporate-affairs