



**THE INITIATIVE FOR POLICY DIALOGUE
CORPORATE GOVERNANCE TASK FORCE
OUTLINE AND NOTES FROM SEPTEMBER MEETING, 2002**

The objective of this task force meeting is to outline the main issues of discussion and to make sure that we have not only touched on all the major issues, but also on the major viewpoints. The goal is to develop a work agenda that will result in a draft report to be written over the next several months.

1. Background

Corporate governance is concerned with ensuring that “corporations” behave in ways that reflect the interests they are supposed to reflect. In nineteenth century models of capitalism, corporate governance was not much of an issue: enterprises had a single proprietor who acted to maximize his own well being, hiring workers on competitive labor markets, and obtaining capital from well informed banks. But even in this simplistic world, issues of corporate governance began to emerge: banks might not be well informed and firms could go bankrupt. The actions of the firm could therefore affect others in ways different from those that had been contracted. Workers typically did not sign long term contracts, but they did make long term investments – in housing in the communities in which they lived and in human capital – based on certain expectations concerning their job prospects. They were, in that sense, stakeholders. What the firm did affected them.

In a world of perfect markets, all of these impacts could be included in a contract and all the risks could be insured against. In this scenario, the best of all possible worlds, no conflicts of interests would arise: a firm that undertook greater risks (and disclosed them) would be forced to pay workers a higher wage to reflect the risks which *they* bore. Thus, in its actions, the firm would take into account all the ramifications on others. This is not the world today, and this was not even the world then.

Issues of corporate governance rose to the fore with the rise of the modern corporation, and the separation of management and ownership. Those who manage the firm typically have only a small share of the enterprise’s equities. Incentive structures may be designed to align their interests, say with that of the shareholders, but in practice this alignment is far from perfect. Managers, even collectively, appropriate only a small fraction of the increase in the value of the enterprise to which their actions might give rise.

The modern theory of corporate governance is based on three principles: imperfections of information, problems of public goods, and externalities. It begins with the recognition that there are *conflicts of interests*, that managers' interests are not aligned perfectly with that of shareholders *or other stakeholders*. Therefore, there is no presumption that managers will maximize shareholder value. But worse, because of imperfect information, outsiders will not even generally know the extent to which managers' actions are adversely affecting their interests. And while some shareholder might with considerable efforts and expenditures obtain some information, there are collective action problems: if a shareholder succeeds in using that information as a basis of effecting change, he will be able to appropriate for himself only a small fraction of the gains, and he may be unable to change behavior.

There are some stakeholders who have both a large enough interest to become informed, and the mechanisms by which they might be able to affect behavior, most notably banks. For example, even though there might be distinct risk advantages to long term lending, the short leash provided by short term lending—the withdrawal of funds if a firm behaves in a way which is sufficiently adverse to its interests—provides an important incentive for the firm not to act in ways which are adverse to the wishes of the bank. But while the interests of other stakeholders do not coincide perfectly with those of the bank, there are important externalities: the bank wants the firm to survive, so its loans will be repaid, and this at least provides some protection for shareholders, workers, and other stakeholders who would be adversely affected by a default. But corporate governance problems can arise within the bank, and in the bank/corporation relationship. The managers of the bank may provide loans that adversely affect the bank, if in doing so their own well-being is advanced.

The broad nature of corporate governance problems is highlighted by the discussions of corporate governance in the East Asia crisis. Many contended for instance that part of the problems in Korea resulted from poor corporate governance. In the *traditional* sense of corporate governance, these charges made little sense. East Asian firms were typically family-controlled, so there was no separation of ownership and control. But in a broader sense, there were several problems of corporate governance. One of the reasons for the vulnerability of these countries was the heavy reliance on debt finance, and one of the reasons for the high level of debt was that there were no protections for non-control shareholders. Moreover, it was alleged that much of the bank lending was politically connected; thus bank officers did not take actions that maximized the interests of the bank shareholders (or for publicly owned banks, the taxpayer). And it was clear that there were broad social ramifications from these market failures.

A key part of an intellectual frame is to identify the ways in which market mechanisms may not result in efficient resource allocations, and the reasons for which *disagreements* about actions that the firm should undertake may arise. If there were unanimity about the actions the firm should undertake, then there would be no conflicts of interest: all see the world the same way. While such conflicts do not arise in the perfect competitive equilibrium (Arrow Debreu) model, they may arise whenever there are market imperfections, e.g. incomplete markets, imperfect information, or imperfections of

competition. When there are such conflicts, the first question that corporate governance needs to address is *in whose interests* the firm should act.

There are two dominant models: The first says that the firm should act in the interests of shareholders (maximize shareholder value); the second says that corporate governance needs to take into account all stakeholders. *If* markets were perfect, then the first view would ensure economic efficiency; but if markets were perfect, then there would be no conflicts of interest, so that the second view would produce exactly the same outcomes.

This brings us then to a second major divide: some suggest that *let the market decide*, that is, provide legal structures which allow corporations to choose the rules under which they would operate. More efficient rules (e.g. better corporate governance structures) would prevail. But this approach itself has two limitations. First, *if* it is assumed that the rules that maximize market value win out since original owners, interested in maximizing their wealth would choose these rules, then the argument is largely circular. But second, without good corporate governance rules, management might ensure the selection of corporate governance rules that maximized *their* welfare, at the expense of other shareholders. One needs to have corporate governance rules which specify who can choose the corporate governance rules, if there is to be choice.

Corporate governance rules affect who makes decisions, in whose interests the decisions are being made, and what information gets disclosed. They affect the discretion with which managers operate, the magnitude of the threats that are posed by takeovers, and the nature of the conflicts of interests that arise.

The consequences of inadequate corporate governance structures have been made all the more apparent by the problems facing corporate America today: a loss of confidence in the stock market and a fall in securities prices. More broadly, without good corporate governance it will be difficult to raise capital on securities markets, and capital markets will be illiquid.

2. Task Force Meeting Agenda and Notes

The Initiative for Policy Dialogue Task Force on Corporate Governance seeks to provide governments interested in improving the quality of corporate governance with some guidance to the principle issues involved in the design of good corporate governance structures. We want to go beyond the familiar injunctions that countries should adopt good corporate governance (which used to mean adopting American standards) to formulating an intellectual frame and to identifying key issues and *choices*.

The task force will try to shift the focus of the discussion on corporate governance. While most of the work in this area has concentrated on ‘best practices’, the IPD task force will focus on the trade-offs inherent in different policy choices, as some remedies and policy instruments may help one issue but cause problems in others. There are also agency problems associated with each of the mechanisms. In addition, some task force members

expressed the view that it is only worth discussing these mechanisms in countries where the cost of real debt is tolerable.

Initially the task force will address the question of what do we mean by corporate governance and what are we trying to maximize? The task force will examine the portfolio of control mechanisms and policy tools that are available to policy makers, and the institutional frameworks necessary for different sets of policy options. The task force is interested in answering the questions of: Which mechanisms will work for developing countries, and at what price?

The task force initially identified a list of potential control mechanisms, including:

- Rules of Governance
- Economics of Control
- Regulatory Standards
- Managerial Socialization
- Lawsuits
- Media Pressure
- Social Control Mechanism
- Tax Enforcement
- Bank Monitoring
- Large Shareholder Monitoring
- Executive Compensation Schemes
- Auditors

The Corporate Governance Task Force seeks not only to articulate these broad themes, but also to look at specific issues as they apply to developing countries. Among those issues are the following.

- I. The Broad Framework: Maximizing Shareholder value vs. Multiple Stakeholders
 - a. Is a manager in breach of his fiduciary responsibility if he does not maximize shareholder value
 - b. Should there be a “supervisory board” as in many continental European countries, in which other stakeholders have a voice
 - i. What are other mechanisms for ensuring that interests of other stakeholders are adequately represented?
 - ii. Who are the other stakeholders who should be represented?

Issues: The notion of fiduciary responsibility implies a U.S. perspective, which grew from trust law in the Anglo-American tradition. In other countries, corporations can have purposes other than the purposes of the shareholders. It may be difficult to convince courts to apply laws of fiduciary responsibility to shareholders.
- II. The Market for Managers and the take-over mechanisms

- a. What should be the *legal* framework restricting various practices designed to make take-overs more difficult (like poison pills, golden parachutes, board turnover, voting rules)
- b. Is there anything that can or should be done to prevent green-mail?
- c. What should be the legal framework for payments for control? (See also topic III)
- d. Other issues

Issues: Some literature suggests that takeover mechanisms would stop managerial abuse by acting as a discipline device on firms. However, much evidence shows that takeovers only exacerbate agency problems in firms that have been taken over.

III. Protecting majority and minority shareholders against management in firms with diverse share ownership

- a. The role of outside directors
- b. Auditing committee
- c. Executive compensation
- d. Inside trading
 - i. Disclosure

Issues: The notion of outside directors is a complicated one, which raises numerous questions. Who are they? How are they connected with the firm? What does “outside” or “independent” mean? How can these outside directors make educated decisions if they are not connected to the firm? Currently, an independent directors’ only power is to resign, which could send a signal to the market. If a firm is thought of as collective action, we can view minority shareholders the same way we look at minority members of a society.

Question: How do you make sure that minority shareholders get on a board?

IV. Protecting minority shareholders

- a. Class action suits (getting the balance right; did the U.S. get the balance wrong in 1996?)
- b. Voting rules?

V. The Role of Auditors

- a. Conflicts of interest/consulting
- b. Liability
- c. Rotation
- d. Specific issues like reporting of stock options
- e. Other issues

VI. Banks

- a. Separation between commercial banks and investment banks
- b. Separation between advisory functions and investment bank functions
- c. IPO and related practices
- d. Universal banks/ banks as lenders and banks as owners
- e. Transparency/secret bank accounts

- f. Foreign banks vs. domestic banks and state-owned banks vs. private banks
 - g. Other issues
- VII. Disclosure
- a. Will markets provide the correct incentives for disclosure by management, do disclosure requirements attenuate incentives for gathering information, weaken “price discovery” function
 - i. How important is the price discovery function?
 - b. Disclosure rules for inside trading
 - c. Disclosure rules in the presence of takeover
 - d. Disclosure rules for purchases by large shareholders
- VIII. Institutional issues
- a. The independence and scope of a securities and exchange commission
 - b. The integration of regulation
 - c. Common law versus civil law approaches
 - d. What special problems does the absence of an effective judiciary present in designing corporate governance
 - e. Regulation, political intervention, and the undermining of corporate governance
- IX. Developing country experiences
- a. Examples of breakdowns in corporate governance (in each of these areas), consequences
 - b. Examples of good corporate governance (how have they handled each of these issues)
 - c. Second best issues
 - i. Implications of absence of effective judiciary for corporate governance
 - ii. Use of arbitration and alternative dispute resolution mechanisms
 - iii. “Borrowing” courts or regulatory authorities
 - iv. Use of listings on developed country exchanges as ways of ensuring good corporate government
 - v. Greater reliance on foreign banks
- Issues: Two questions: How do developing countries differ? What has happened in the U.S. that has affected corporate governance?

3. Future Steps

Task Force Composition and Members

This task force should be made up of members from the north and south. Currently, there are no members from the south or east. It is an initial priority to recruit members from the south and east who have experience on the ground with corporate governance policies. Some possibilities for members include:

Recommendations for members from K.S. Jomo, University of Malaysia

and Co-director of IPD Privatization Task Force

Ajit Singh Cambridge
Sushil Khanna IIM, Kokata
Haider Khan Denver

Recommended from Butch Montes, Ford Foundation

William Lazonick INSEAD
James Crotty U Mass
Ha Joon Chang U Cambridge, also member of IPD Macroeconomic Task Force

Recommended from Kittipong Kittayarak, Senior Advisor Thailand’s Ministry of Justice on Legal and Judicial Reform and Co-Director of IPD Rule of Law Task Force

Dr. Prasarn Trairatvorakul, Secretary General of the Security Exchange Commission of Thailand or Mr.Rapee Sucharitkul, Deputy to Prasarn Trairatvorakul (rapee@sec.or.th)
“I suggest that you may start by contacting Mr.Rapee. Rapee is a very nice person and has devoted a lot of time studying and campaigning for good corporate governance. He is also a good source to ask for advice on other appropriate candidates.”

- Kitiipong

Expected Output

The end product of this task force is a 40-60-page overview of corporate governance mechanisms. The report will include a companion volume that will intellectually define the nature of corporate governance issues facing developing countries. The end of the report will include case studies, which will link corporate governance issues with countries that have experienced success or failure with these issues (such as Brazil and the alternative stock market).

Timeframe

Compile list of potential group members	few weeks
Fix date	2-3 months
Second meeting	January or February, 2003
Finished product	10 months