

Reform Strategies for Boards of Directors in Emerging Markets:

How the Private Sector can be Involved
in the Development and Implementation
of Modern Business Standards

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ABSTRACT

This article recognizes the important role of boards of directors in the implementation of modern corporate governance standards in emerging markets. As internal monitors of management, independent directors are uniquely positioned to protect the rights of shareholders. In a properly functioning corporate governance system, independent directors have access to detailed information, are informed about a company's strategic direction and are supported by effective internal control systems to guide and monitor management. Boards of directors and the systems in which they operate have their limitations, however. Following high profile scandals in Western financial markets, trust in directors is low, the effectiveness of corporate governance systems is heavily debated and increasing responsibilities and personal liability make it difficult for companies to attract qualified directors. Although new legislation and self-regulatory initiatives are essential for developing effective boards of directors, transplanting Western corporate governance systems to emerging markets requires a substantial understanding of a country's history, culture and business practices. The successful introduction of modern corporate governance standards calls for an in-depth understanding of standards and how they can be introduced to local markets most effectively. While coercive corporate governance reform strategies may be useful, participatory reform is more effective in markets with poor enforcement and low acceptance of new standards. Although more legislation may be warranted to guide directors in their role as agents of investors and shareholders, this article concludes that the focus in private sector reform in emerging markets should shift from legislative development and legal transplantation to innovative forms of self-regulation, implementation and education.

1. Introduction

While financial markets in Western countries have gradually developed over hundreds of years, capital markets in emerging markets have been hastily introduced as a result of dramatic changes in economic and political systems. Mass privatization programs have transformed hundreds of thousands of state-owned companies into joint stock companies. Voucher privatization by itself has created millions of new but poorly informed retail shareholders. Along with the privatization reform, the first generation of company laws in the 1990s introduced new corporate governance instruments and concepts to post-communist countries. Their implementation, however, did not generate the expected results of fair distribution of state-owned assets, economic prosperity, the protection of investors and shareholder democracy (Megginson and Netter, 2001). As noted by Black et al. (2000), “writing good laws can take years and building good institutions takes decades, but the privatizers weren’t willing to wait.”

1.1 Complicating Factors

A lack of institution building, education and implementation may have been a cause for the failure of privatization programs. This also may have been a complicating factor for the introduction of modern corporate governance practices. In the absence of supporting institutions, the challenges of reformers are enormous. Although securities and exchange commissions (SECs) should play an important role in the education and enforcement of market participants, their establishment has not always been a first priority in new markets. Once established, SECs are often not adequately funded and staffed to enforce securities legislation and regulations.

Existing court systems historically have not been designed to adjudicate complex commercial cases that involve the protection of shareholders and creditors. Specialized commercial courts are not common. Judges are inadequately educated and informed about new corporate governance systems, and frequently rotated, overloaded and underpaid. Financially sustainable institutes of directors that focus on the education and self-regulation of their members are rare.

Business services industries that provide continuing board education are not feasible due to a lack of interest and support from business communities. In a similar vein, organized shareholder activism through NGOs is generally poorly developed and underfunded. Journalists are not informed and large scale educational TV and radio programs on

shareholders’ rights to reach out to shareholders through the media are rarely sponsored by governments and their ministries.

Faced with these problems, lawmakers and regulators must attempt to implement modern corporate governance standards and develop a professional class of independent directors. This is not an easy task. It takes dedication, highly specialized expertise, substantial financial resources, and a long term vision to change a country’s business culture and shareholder protection systems.

2. The Role of Boards of Directors in Corporate Governance

Independent boards of directors are often seen as an essential element of a country’s corporate governance system. Fama (1980) sees the board as the ultimate internal monitor whose “. . . most important role is to scrutinize the highest decision-makers within the firm.” In an ideal corporate governance world, boards of directors provide oversight, monitor management and give credibility to a firm. They give advice to senior management and balance the interests of shareholders, employees and other stakeholders of the firm. As the shareholders’ agent, a director is ideally independent of management, well educated and highly skilled. A director preferably has a long standing track record in the company’s industry, understands financial terminology and is willing to defend shareholder value.

“It takes dedication, highly specialized expertise, substantial financial resources, and a long term vision to change a country’s business culture and shareholder protection systems.”

The nature of recent financial scandals has alerted law makers across the globe that directors and the governance systems in which they operate have not been sufficient to avoid the largest bankruptcies and destruction of shareholder value in history. In both the US and Europe, legislative programs have been recently introduced to improve the role and independence of boards of directors, the internal control systems of companies, the audit profession and companies’ disclosure requirements.

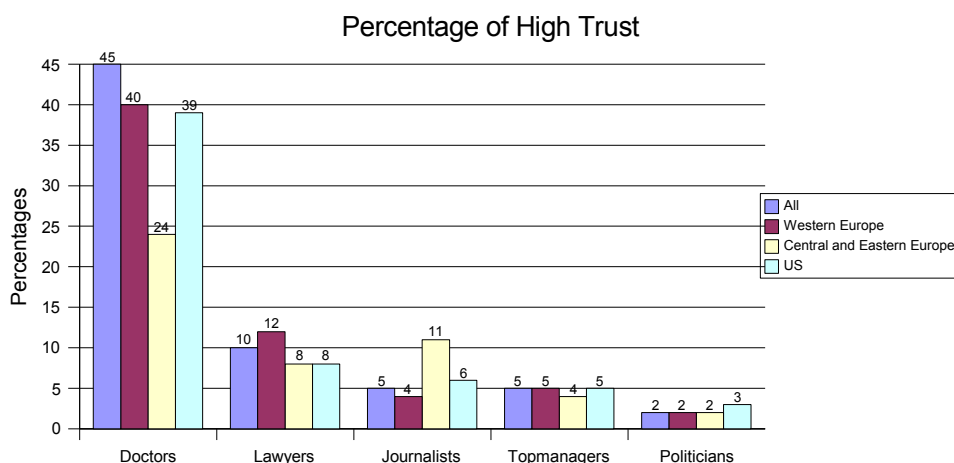
Following the 2002 Sarbanes-Oxley Act in the US, a comprehensive EU Corporate Governance Program was launched in 2003 to restore trust in financial

markets and the role of directors in protecting investors.

2.1 Directors' Poor Image

Although recent high profile financial scandals may have severely undermined the trust in boards of directors in Western markets, trust levels among the public always have been low. A survey among 1,085 full time workers in 1998 indicates that only 11 percent of all workers in the UK strongly agreed with the following statement: "I trust and believe what the directors of my company say" (Mori, 1999). A similar survey in 2003 did not show much of an improvement: four in five people in Britain (80%) did not agree with the statement "Directors of large companies can be trusted to tell the truth." In addition, 78 percent felt "directors of large companies are paid too much for the job they do" (Mori, 2003).

Illustration 1: Trust Among 22,000 People in Top-Managers.



Source: Wall Street Journal Europe (2003).

A survey by the Wall Street Journal Europe (2003) among some 22,000 people in 20 European countries and the United States revealed that 5 percent of the respondents had high trust in managers compared to 45 percent for doctors. The highest level of trust in top management came from Denmark (18%) and the lowest was from Germany (2%). Directors in emerging countries seem not to do much better.

A unique study among 1,000 shareholders in Macedonia found lower levels of trust in large companies (read management and directors) than in the country's financial police (USAID, 2005).

2.2 Directors' Remuneration

Bad publicity surrounding the remuneration of CEOs has also negatively affected the public's trust in boards and their directors.

According to the AFLCIO (2002), the average CEO made 42 times the average blue-collar worker's pay in 1980, 85 times in 1990 and 531 times in 2000 (in the US). In 2004, the average CEO of a major US company received \$9.84 million in total compensation.¹

In contrast, the average non-executive director of S&P 500 companies in the US received \$50,000 for an average of 7 meetings (median) with the board and an average of 9.4 times in audit committees (Spencer Stuart, 2005a).² In Europe, directors are facing similar reputation problems as both national legislators and the European Commission are requiring directors and their companies to be more transparent about their remuneration packages.³

2.3 Where are the Independent Directors?

The most experienced directors with established track records are beginning to leave the profession. Those that remain stay longer on boards and serve on fewer boards.

Due to changing legislation and interpretations of

- 1 www.aflcio.org/corporatewatch/paywatch/pay
- 2 In comparison, independent non-executive directors of the top 100 listed companies in the Netherlands received a retainer of € 38,000 in 2004 while stock options for non-executive directors are uncommon (Spencer Stuart, 2005b).
- 3 See the European Commission's recommendation on directors' remuneration available on http://europa.eu.int/comm/internal_market

standards of good conduct, directors are required to meet ever higher standards to fulfill their duties of loyalty, care and good faith to avoid personal liabilities. New corporate governance standards are imposing greater responsibilities and liabilities on directors. Professional standards are increasingly complex and compliance requires significant investment in time and education.

Recruiters are faced with the impossible task of finding good candidates that meet independence requirements of multiple jurisdictions. According to Spencer Stuart, a large headhunter that specializes in executive search, “. . . the recruiting task is more challenging and complex than ever, given a shrinking pool of traditional candidates, growing demand for specific director expertise and heightened sensitivity about director selection” (Spencer Stuart, 2005a). With shrinking pools of qualified candidates, directors who meet independence and professional capacity requirements are harder to find. The competition among corporations for qualified individuals is fierce (Griesedieck and Nahas, 2005).

2.4 Increasing Liabilities

A determining factor in the declining appetite of candidates to serve on boards of public companies is the increasing personal liability of directors. Although the business judgment rule has been providing protection to directors in some jurisdictions, an increasing number of cases such as Enron⁴ and WorldCom⁵ have forced non-executive directors to pay millions of dollars to settle claims by shareholders that are neither covered by Directors and Officers (D&O) insurance nor indemnified by their corporations.

A study found that 25% of directors who sat on almost 500 US-boards in 2001 turned down a new offer to serve on a board or resigned from previous board directorships in part due to liability concerns (McKinsey & Co, 2002). The same study asked directors to rate their colleagues on their performance as non-executive directors. The results of the study

4 “Ex-Directors at Enron to Chip in on Settlement” by Kurt Eichenwald in the New York Times of January 8, 2005: “Ten former directors of Enron agreed to pay \$13 million as part of a \$168 million settlement of a lawsuit brought by shareholders.”

5 “Ten Ex-WorldCom Directors Agree to Settlement” by Brooke A. Masters and Kathleen Day in the Washington Post of January 6, 2005: “Ten former outside directors of WorldCom Inc. have tentatively agreed to pay \$54 million, including \$18 million out of their own pockets, to settle part of a class-action securities lawsuit stemming from the company’s accounting scandal.”

were revealing: almost half were rated as low or average performers and over a quarter were not considered to be truly independent (i.e., no ties to the company or management except through being a director).

3. Boards of Directors in Emerging Markets

While boards are criticized in Western Markets for being highly overpaid cronies of management, the situation in emerging markets appears to be bleaker. Independent directors are difficult to find. Market forces and enforcement mechanisms that provide checks and balances in the West are absent. Functioning markets that would control corporate behavior do not exist. Personal liability of directors is not developed, and in the absence of clear interpretation and jurisprudence, difficult to enforce even when they are provided by law.

“With the development of a class of directors who exhibit high standards of integrity, commitment and independence and who adhere to business ethics, the emphasis in reform can shift from enforcement to implementation.”

Despite these drawbacks, the role of boards of directors and the private sector in the development of corporate governance standards cannot be underestimated. Especially in markets where regulatory systems and enforcement are not optimal, a strong pool of independent directors is invaluable and indispensable. With the development of a class of directors who exhibit high standards of integrity, commitment and independence and who adhere to business ethics, the emphasis in reform can shift from enforcement to implementation.

The challenge to accommodate this development lies in finding reform strategies that work. As stated by Klein et al. (2004) of the IFC/World Bank: “The OECD’s new Principles of Corporate Governance, approved in April 2004, are a welcome effort to set out the best possible standards. . . The task now is to make those high standards a reality for developing countries. The challenge is to create approaches that work well in developing countries, where some of the problems are different.”

3.1 Limitations of Legal Transplants

As with the introduction of most Western management practices, the transplantation of corporate governance models and oversight systems requires an understanding of the culture and history of a country (Gatian and Kenneth, 1996). Imposing independence requirements common in the West on the business elite in emerging markets may not always be feasible.

3.1.1 Conflicting Standards

Conflicting standards are a complicating factor for the introduction of corporate governance standards to emerging markets. In the Netherlands, a non-executive director who holds at least ten percent of the shares in the company does not qualify as an independent director under the rules of the New Tabaksblat Code.

The listing requirements of the NYSE concerning directors' shareholdings do not "view ownership of even a significant amount of stock, by itself, as a bar to an independence finding."⁶ Since most joint stock companies in emerging markets have been created by mass privatization, share ownership and family relationships among directors, managers and employees are common. Hence, requiring directors not to be a shareholder or a family member may not always be a realistic and workable solution.

Both the NYSE and the NASDAQ use a benchmark of more than \$100,000 in director's compensation from a parent company to disqualify a non-executive director as being independent. This standard is too high for developing countries, where lower thresholds are more suitable.

Independent directors also require independent structures such as oversight committees (audit, nomination and remuneration committees), sophisticated internal control systems and highly qualified and independent external auditors and appraisers. Imposing independent oversight board committees on companies may only be effective when the supporting infrastructure is in place. Board committees do not strive in protecting investors in a business culture where the disclosure of information among directors is uncommon, where directors' fiduciary duties are not well defined and where

⁶ See Final NYSE Corporate Governance Rules, Section 303A. In a similar vein, Nasdaq "does not believe that ownership of company stock by itself would preclude a board finding of independence." See NASDAQ, IM-4200. Definition of Independence, Rule 4200(A)(15).

International Financial Reporting Standards (IFRS) and International Valuation Standards (IVS) are commonly not accepted and enforced.

3.1.2 Ownership Structures in Emerging Markets as a Limiting Factor

A factor that complicates the implementation of Western corporate governance standards in emerging markets relates to the ownership structure of companies. Emerging markets tend to have a greater concentration of ownership and cross-ownership than developed financial markets. Klein et al. (2004) suggest that sophisticated corporate governance systems common in developed countries that rely on dispersed share ownership patterns, may not be as effective in markets where ownership is concentrated in the hands of small groups of majority shareholders.

In Ukraine, 55.7 percent of capital assets of privatized companies were held by the state in 1997 (Pivovarsky, 2001). In Russia, at the close of the voucher privatization process, 56.3 percent of all shares were held by insiders, while outsiders had 23.3 percent and the state had 20.4 percent (Earle, 1998). Ownership concentration as a result of the mass privatization program measured by the average stake held by a "single largest owner" was between 38 percent and 59 percent in Czech Republic (Hanousek, et al., 2005).

The general meeting of shareholders is an instrument that requires dispersed ownership to be effective. Voting requirements in most company laws require a simple majority of votes registered at the meeting to pass resolutions for the election and dismissal of directors, the approval of dividends and the election of the accountant. Only in a few circumstances, such as changes in the legal status of the company, do company laws have greater voting requirements. While financial markets in countries with dispersed ownership are facing numerous problems with general meetings of shareholders (Maassen and Brown, 2005), the effectiveness of the instrument in protecting shareholders may be even more limited in emerging markets when most decisions can be made by a dominant group of shareholders.

With large block holders dominating the voting process at general meetings of shareholders, expropriation can take a variety of forms that may be perfectly legal under company law in emerging

markets. According to La Porta (et al. 2000): “insiders simply can steal the profits. In other instances, the insiders sell the output, the assets, or the additional securities in the firm they control to another firm they own at below market prices. Such transfer pricing, asset stripping, and investor dilution, though often legal, have largely the same effect as theft. In still other instances, expropriation takes the form of diversion of corporate opportunities from the firm, installing possibly unqualified family members in managerial positions, or overpaying executives.”

3.1.3 Cumulative Voting and the Election of Directors

Another useful illustration of Western models' limitations in protecting minority shareholders in emerging markets is cumulative voting. The system is designed to improve shareholder representation on boards to alleviate the effects of concentrated share ownership. Under a normal voting arrangement, each director is elected separately by a simple majority vote of shareholders present at and registered for the general meeting of shareholders. In contrast, cumulative voting is designed to ensure that minority shareholders can elect a representative to the board of directors.

According to Maassen and Brown (2005), cumulative voting originated in the US as an outgrowth of political reform. Although popular in the beginning of the 20th century, usage of the system has steadily declined since the 1950s. By 1992, only six states maintained mandatory cumulative voting, 44 provided for voluntary inclusion while one state, Massachusetts, prohibited cumulative voting (Gordon, 1994). Most jurisdictions, both in Anglo-Saxon and Continental-European countries, do not require mandatory cumulative voting (La Porta et al. 2000).

Its complexity is a compelling reason why lawmakers should be reluctant to make the system always mandatory for shareholders and their directors. While institutional investors may benefit from the system, smaller minority shareholders may not be able to use the system effectively. As stated by Klein et al. (2004), complex rules such as cumulative voting for minority shareholders are largely irrelevant for emerging markets.⁷ Shareholders should meet certain

⁷ Under prior Russian law, cumulative voting was required if the number of a company's voting shareholders exceeded 1,000. A recent amendment to the Russian Law on Joint Stock Companies in March 2004 has made cumulative voting mandatory for all companies with a board of directors. A company is required to have a board of directors if it has 50 or more shareholders with

requirements that are often not feasible in emerging markets in order for the system to function. Among others, shareholders should have:

1. Been educated about the system and fully understand its potential;
2. A good understanding of the company law;
3. Skills to strategically use cumulative voting and avoid manipulation;
4. Access to shareholders' lists;
5. An interest in electing directors;
6. Financial resources and skills to campaign for their candidates for the board of directors;
7. Willingness to be actively engaged in contacting other shareholders prior and during the shareholders meeting.

Source: Based on Maassen and Brown (2005).

Even when these requirements have been met and the system is functioning, one can question the value of having one director on the board. Although these directors may represent the minority shareholders and be able to voice disconcert in the media about a company's strategies, most board decisions can be made under law by a simple majority of directors present at the meeting without the consent of “minority directors.” As has been documented for the co-determination system in Germany, in which boards of listed companies are divided in representatives of shareholders and the employees, cumulative voting also may polarize the board (Gorton and Schmid, 2000).

3.2 The Inconclusive Relationship Between Board Characteristics and Corporate Performance

Another complicating factor in the introduction of Western legislation and standards to emerging markets is the growing body of evidence that disputes the relationship between board characteristics and the financial performance of corporations.

Boards composed of independent directors who are chaired by an independent non-executive chairman and who operate in independent oversight committees are not necessarily more effective than insider driven boards. Dalton et al. (1998) found no evidence of a systematic relationship between board composition and financial performance after they reviewed a large number of studies. Contrary to the conventional wisdom of corporate governance reformers, Donaldson and Davis (1994) state: “We believe that it would be unwise at the present time to go along with

voting rights.

calls to require boards of corporations to be dominated by non-executives.” Bhagat and Black (1999, 2000) found no convincing evidence that greater board independence correlates with greater firm profitability or faster growth. In an earlier study, the authors propose: “. . . the burden of proof should perhaps shift to those who support the conventional wisdom that a monitoring board – composed predominantly of independent directors – is an important element of improved corporate governance” (Bhagat and Black, 1997).

The few academic studies of boards of directors in emerging markets seem to support the inconclusive relationship between board independence and the performance of corporations. Peng (2004) found among 405 listed firms in China that outsider directors do make a difference in firm performance, if such performance is measured by sales growth, but that they have little impact on the financial performance of the corporation such as return on equity (ROE). In Russia, Peng et al. (2003) found little support for the hypothesis that non-executive board members and new managers are positively related to firm performance (based on a survey of 314 privatized firms).

On the other hand, Liang and Li (1999) found in China a positive relationship between the presence of outside directors and higher returns on investment. In addition, an impressive body of research has found strong relationships between corporate governance standards, firm performance (The Patterson Report)⁸ or the market value of corporation (McKinsey and Co., 2002b).

3.3 Partial Approaches to Corporate Governance Reform

An inherent problem with corporate governance reform in emerging markets is the inability of reformers to capture the complexity of variables that may determine the performance of boards and their corporations. A useful model to demonstrate this complexity is developed by Zahra and Pearce (1989). The model recognizes multiple relationships between contingencies, boards attributes, boards’ decision making processes and the performance of corporations (see also Illustration 2).

Each of these variables - many of which are difficult to quantify – can determine the financial performance of corporations. Directors, for example, can be classified using a binary variable: Based on a list of criteria often found in corporate governance

standards, a director is independent or not independent. Anything in between is extremely difficult to quantify and to measure. Hence, being an independent director not only means that one meets a list of independence requirements in relation to his/her position to management, directors and shareholders of a company. An equally important criterion of independence is the capability of a director to act independently of management and vested interests. Being able to act independently requires education in business and managerial skills.

Although reform of board structures in which directors operate is valuable, formal requirements are only part of the equation that makes boards successful in emerging markets. The requirement that boards be composed solely of independent directors does not make a board act independently of management. Requiring a board to have audit committees composed of only independent directors does not necessarily mean that the audit committee will be successful in developing and implementing an internal control system. Corporate governance reform requires a combination of structural reform and strategies that encourage the private sector’s acceptance of modern business standards.

3.4 A Lack of Ownership

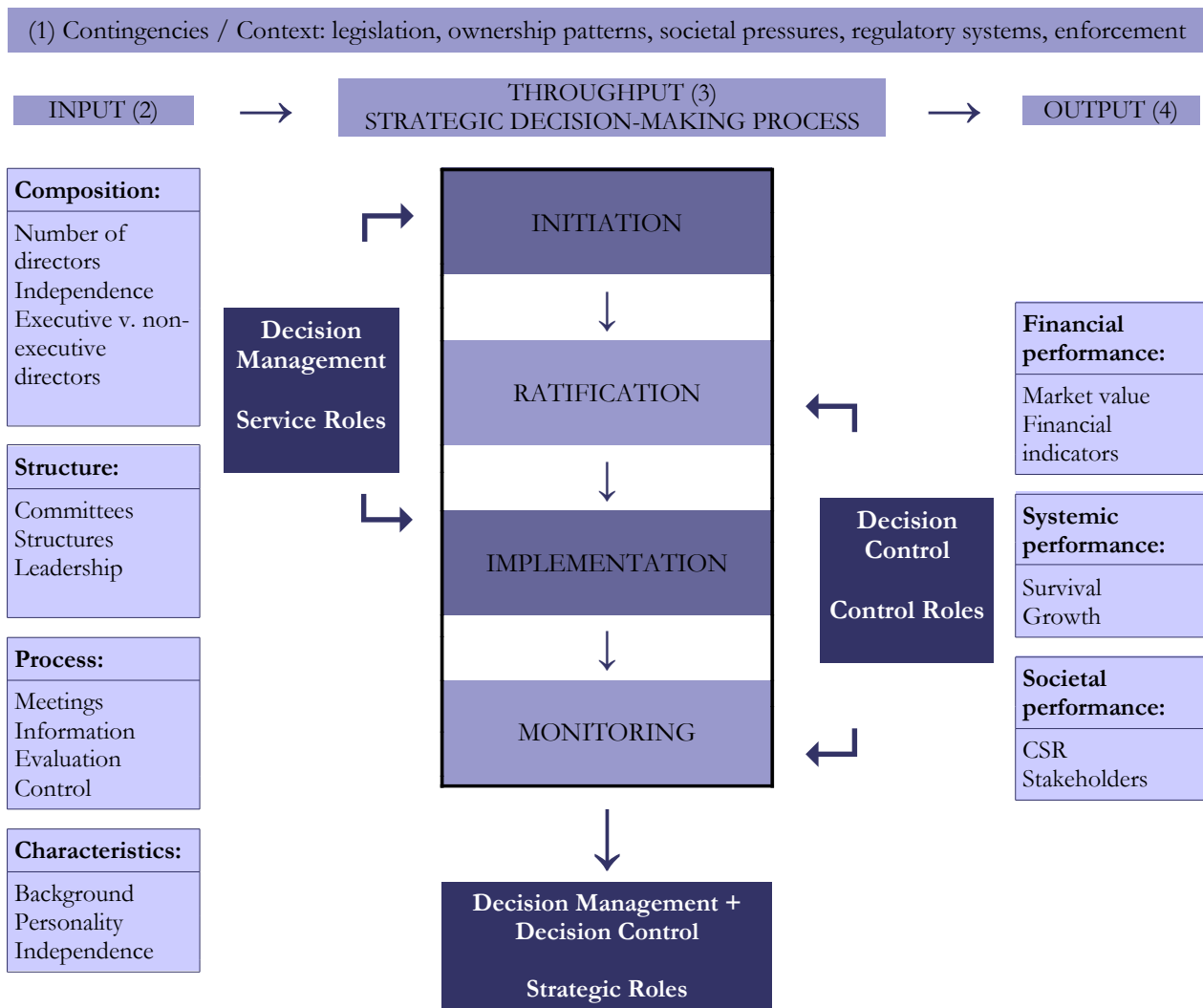
According to Channell (2005), lack of ownership within the business community is a persistent problem related to the development of new commercial legislation in developing countries.

Under pressure from the international donor community, laws and corporate governance standards have been literally translated or adopted wholesale from other systems without the involvement of stakeholders affected by the new standards and legislation. As noted by Anderson (2005): “Experts from developed countries often give advice to developing countries about the policies, laws, and institutions that are needed to promote economic development. A frequent problem with their advice, however, is that the experts only recommend what they know, namely, what exists in their own countries.” Legal transplants also tend to be complex. The benefits of complex securities legislation based on, for example, the US 1933 and 1934 Securities Acts in a market with fewer than 100 listed companies and a total market cap of a few hundreds of million dollars may not outweigh the costs of education, implementation and enforcement.

Legal transplants are regularly a necessity for emerging markets that seek accession to the European

8 Available on www.thecorporatelibrary.com

Illustration 2: The Complexity of Corporate Boards



Based on Zahra and Pearce, 1989.

Union (EU) or the World Trade Organization. The EU's accession program requires candidate member states to literally adopt thousands of new laws and regulations in short periods of time to harmonize legislation with EU standards.

Due to time constraints and the limited capacity of governments to absorb all these changes, new laws and regulations are often enacted with little room for inclusive consultations, education and implementation. As a result, laws are not always introduced with careful and patient adaptation to the local circumstances. Reform strategies have not always been used effectively.

4. Reform Strategies

To set and introduce new corporate governance

standards, reformers can apply a variety of strategies that fall in two broad categories of reform: 1) participatory reform and 2) coercive reform. The Company Law Reform Bill in the UK illustrates a participatory legislative reform strategy. The introduction of the Sarbanes-Oxley Act is an example of a coercive reform strategy.

4.1 Implementation

In March 1998, the Department of Trade and Industry (DTI) launched a long-term fundamental review of the company law and began a process of research and consultations. It would take more than seven years to complete the Bill when it was introduced in the House of Lords on 1 November 2005.⁹ This participatory process gave companies and

⁹ www.dti.gov.uk/cld/index.htm

their legal advisers ample opportunity to respond to legislative changes, to be educated and to prepare company documentation, if any, before the Bill would be in force.

Although rare in emerging markets, a similar but shorter process was used in Macedonia to develop its new 2004 company law. Over the course of the drafting of the company law, 27 public hearings with more than 2,000 participants were held (20 hearings after First Reading, 7 hearings after the Second Reading of Parliament). The hearings served both to educate and solicit feedback on drafts of the laws (See Case 1: The Passage of a New Company Law in Macedonia and the Involvement of the Private Sector).

4.2 Shock Therapies

The introduction of the Sarbanes-Oxley Act, on the other hand, was a “shock therapy” used in response to dramatic financial irregularities. In less than six months, one of “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt” was signed into law.¹⁰ A first version of the bill was introduced on February 14, 2002. The final act was passed by Congress on July 25, 2002 and signed into law on July 30, 2002.¹¹

Although “shock therapies” may be useful, they only work when enforcement mechanisms such as strong specialized and commercial courts and well funded and disciplined independent regulators are in place that can impose severe penalties and personal liabilities on directors and managers. The regulatory system in the US enables lawmakers to quickly introduce new legislation such as the Sarbanes-Oxley Act and enforce new standards, even with limited public consultation when there is no room for long term consultation processes.

5. Coercive Reform Strategies

5.1 Director and Officer Disqualification

A bar by the court or a national securities regulator to future service of directors is a strong deterrent for directors’ misconduct. In the US, Section 305 of the Sarbanes-Oxley Act (SOX) provides the Securities and Exchange Commission greater powers to bar directors and officers. Pursuant to this section, if any person’s conduct “demonstrates unfitness” to serve as an officer or director, the SEC may bar that person from acting as such for a public company. Although figures

10 www.whitehouse.gov/news

11 www.govtrack.us/congress/bill.xpd?bill=h107-3763

on bars are not systematically collected, the SEC released a report in 2003 as a requirement of SOX-Section 704 that gave some insight in officer and director bars (Securities and Exchange Commission, 2003a). See also Table 1.

Table 1: Director Disqualification in the US

| Fiscal Year | Number of Officer and Director Bars Sought |
|-------------|--|
| 1998 | 36 |
| 1999 | 44 |
| 2000 | 38 |
| 2001 | 51 |
| 2002 | 126 |
| Total | 295 |

Source: Securities and Exchange Commission (2003a).

In the UK, directors can be barred for a maximum of 15 years under the 1986 Company Directors Disqualification Act. Under three categories of conduct, the court can disqualify directors and managers from being involved in the management of companies: 1) general misconduct in connection with companies, 2) disqualification for unfitness and 3) other cases for disqualification. According to a study by Wright (2005), the number of directors disqualified by UK courts rose from 399 in 1993-1994 to 1,267 in 1997-1998. Between 2003 and 2004, over 1,500 directors were disqualified from management for between two and fifteen years (the minimum and maximum terms under the law).

5.1.1 Empower Securities and Exchange Commissions

As in developed markets, director and officer disqualification only works when effective enforcement mechanisms are available. For director disqualification to be an effective deterrent, fast resolution of disputes is important. Since courts are notoriously slow in emerging markets, regulators should be empowered to investigate market manipulation and enforce regulations and legislation with adequate resources and expertise (IOSCO, 2000).

SECs are not always respected in emerging markets and should be empowered to suspend directors as part of a well defined disciplinary process with set time lines, clear cut rules and appeal procedures. Especially when court proceedings can take several years even to commence, independent administrative law judges in administrative courts within securities and exchange regulators may provide greater efficiency in disciplining directors.

Case 1: The Passage of a New Company Law in Macedonia and the Involvement of the Private Sector

The USAID Corporate Governance and Company Law, implemented by EMG, provided intensive technical assistance in the drafting of a new company law in Macedonia over a period of eighteen months. The law passed Parliament in April 2004 and incorporates OECD corporate governance best practices and is compliant with EU Directives. The law can be seen as Macedonia's "private sector constitution" since it regulates all types of commercial legal entities in the country (from economic interest groups and joint stock companies to sole proprietors and small scale traders). According to the World Bank (2005a): "The process used to prepare the 2004 Company Law can be a model for going forward, in that it engaged the private sector and allowed sufficient time for review and revision of the draft."

Promoting Public Dialogue on New Company Law: Over the course of the drafting of the company law, 27 public hearings with more than 2,000 participants were held (20 hearings after the First Reading, 7 hearings after the Second Reading of Parliament). The hearings served both to educate and solicit feedback on drafts of the laws. Government and project websites provided the legislation and bases to send written submission. Suggested amendments were reviewed by the drafting committee resulting in numerous changes in the draft laws. Following the enactment of the law, an intensive two year nation wide educational program was implemented for lawyers, judges, journalists, accountants and directors and managers of 416 active joint stock companies.

Cooperation with the OECD: With the introduction of the OECD White Paper on Corporate Governance for South Eastern Europe in Skopje in June 2003, the participation in the High Level Working Group in Paris in November 2003, and the organization of the international OECD corporate governance conference in Ohrid, Macedonia in June 2004, Macedonian delegations had an excellent opportunity to discuss and present corporate governance developments to an international audience.

Source: www.emergingmarketsgroup.com

In order to empower regulators, clear cut rules and definitions of "unfitness" are essential to provide guidance to directors, officers and regulators on what is acceptable behavior and what is not. These guidelines and their interpretation should be made available on the regulator's website. Transparent appeal procedures within a SEC's administrative court and appellate courts are required to guarantee the integrity of the process.

5.2 Liabilities of Directors

Directors' liabilities, both criminal and civil, also are effective deterrents for misconduct. As with director disqualification, legislation introducing director liabilities can only be effective when circumstances in which liabilities may arise are well defined and when standards are being enforced. For financial markets to be able to attract the best directors, standards need to be predictable and easy to understand. Directors must be able to assess the risks associated with serving on a board of directors and D&O insurance should be available to protect directors from malicious lawsuits.

5.3 The Business Judgment Rule

While a business judgment rule may shield directors

from liabilities in emerging markets, the courts in emerging markets may not be able to understand such a complex concept. The rule provides that courts will not second guess the decisions of a director, even if they turn out to be mistakes in judgment when: 1) they have been made within his authority, 2) when they have been on a rational basis, 3) and when they are made in good faith. This requires a judge's understanding of "rational behavior" and "good faith." It also requires a judge's understanding of a director's vision, the company's long term strategic plans, common business practices and industry standards.

As noted by the Michigan Supreme Court in 1919 in a case between the Dodge Brothers and Ford Motor Co., "judges are not business experts."¹² This certainly may be true for judges in developing countries who often lack the educational background and necessary commercial law experience to interpret business decisions. Judges in less developed markets should therefore abstain from reviewing the substantive merits of business decisions. As stated by Paredes (2005), developing countries need clear cut

¹² See Dodge v. Ford Motor Co. Mich. 170 N.W. 668 (1919).

rules that are easy to understand and to interpret by regulators and the private sector. This also applies to rules and standards that may impose liabilities on officers and directors.

6. Participatory Reform Strategies

By definition, coercive reform strategies and shock therapies are less desirable for the introduction of new corporate governance standards. In emerging markets, they may not work. The acceptance of corporate governance reform initiatives is often low at the outset of new programs, and courts and regulators are not sufficiently developed to enforce new standards. To induce change in business practices and culture, both in the West and developing countries, additional demand-driven instruments are needed such as educational programs and self-regulatory initiatives that accompany legislative reform programs (see also Illustration 3).

Illustration 3: Corporate Governance Reform Strategies

| | | | |
|-----------------|------|---|--|
| Enforce ment | High | I Shock Therapy 2002 Sarbanes-Oxley Act - US | II Implementation 2005 Company Law Reform Bill - UK |
| | Low | III Education 2004 Company Law - Macedonia | IV Self-Regulation Corporate Governance Codes |
| | | Low | High |

Acceptance

- I Coercive Reform Strategies
- II - III - IV Participatory Reform Strategies

A priority in implementing corporate governance legislation in emerging markets is to ensure that the private sector is involved in the process of standard setting. It seems logical to have directors and managers participate in public debates and consultations on legislation that will directly affect them. Involvement of the private sector in drafting processes nevertheless has been minimal in emerging markets. Laws are often drafted in isolation by law professors with limited private sector experience. Open consultations, regulatory impact assessments and public debates are rare.

6.1 Self-Regulation of Directors

While it may not always be feasible to have the private sector involved in legislative reform, self-regulatory initiatives seems to be an alternative to more legislation when risks and impact of non-compliance with standards are low on society (Maassen et al., 2004). Although a majority of developed markets have initiated self-regulatory corporate governance initiatives, they are relatively new. The first initiatives were taken in the UK with the Cadbury Code in 1992. A majority of initiatives were launched after the mid 1990s.

Codes of conduct that are embraced by the private sector are less common in emerging markets. An estimate based on the European Corporate Governance Institute's repository of corporate governance codes shows that some 15 developing countries have developed a voluntary code or are currently working on one.¹³ Self-regulation may be less popular in emerging markets because their financial markets are less organized through associations and stock exchanges and have fewer resources. A demand driven reform strategy as self-regulations also only works when the private sector is aware of the benefits of setting greater standards in lowering operational risks and in attracting investors. But, whenever feasible, by building upon an inclusive process of consultations and debates, corporate governance codes can be a useful addition to legislation for enhancing corporate governance practices, to raise standards and to drive reform efforts at the national level in emerging markets (World Bank, 2005b).¹⁴

6.2 Director Accreditation as a Form of Self-Regulation

Director accreditation is an example of self-regulation that can be successfully applied in emerging markets at relatively low costs.

The Thai Institute of Directors Association, for example, offers certification and director accreditation for directors of listed companies. The participants who pass the program receive a certificate certified by the Stock Exchange and the Securities and Exchange Commission of Thailand.¹⁵

An innovative form of self-regulation that combines

¹³ See www.ecgi.org for an overview of corporate governance codes.
¹⁴ The Corporate Governance Forum of the World Bank recently launched a toolkit for the development of corporate governance codes in developing countries. The toolkit is available at www.gcgf.org
¹⁵ www.thai-iod.com/eng

directors education with norm setting initiatives is being used by the National Association of Corporate Directors (NACD). This Directors' Institute in the US requires participants to sign a code of conduct to affirm the value of continuing education as part of directors' fiduciary duties. Participants who sign the code of conduct pledge to maintain their certificate of director education by completing eight hours of continuing education annually.¹⁶

Case 2: Purpose Statement for Director Accreditation in New Zealand

“The purpose of Director Accreditation is to enhance corporate governance standards in New Zealand by providing a register of directors who can show evidence of their professional status in terms of their knowledge and experience. It will allow accredited members of the Institute to demonstrate a commitment to professional standards and provide shareholders and stakeholders with reassurance that boards are knowledgeable, experienced and committed to their profession. Accreditation is not intended to be a certification of the competence of a member. This assessment can only be made of individuals on a case by case basis, but Director Accreditation will set an expectation of behaviour and standard of conduct.”

Source: <http://www.iod.org.nz/accreditation>

6.3 Director Training and Development

Although drafting more legislation may be warranted to continue the development of corporate governance standards in emerging markets, educational programs and capacity building efforts are equally important. Along with programs that raise the awareness of shareholders' rights through the media and the development of NGOs, a number of technical assistance instruments can be employed to build incentives for directors to professionalize.

Whether organized through a dedicated institute of directors, universities or through local business service providers, on-line or in the classroom, the need for corporate governance training is greater than ever. Lacking formal training in business ethics, legislation, regulations and international standards, new generations of directors require continuous training efforts. A vast majority of donor driven educational

¹⁶ www.nacdonline.org/cdinstitute

programs have at their best improved the business elites' awareness of corporate governance standards. They were not designed to change values over long periods of time that traditionally have driven business cultures in emerging markets. Intensive, long term institutionalized educational programs are needed to ensure that directors, who typically resist training for a variety of reasons, have incentives to adhere to new standards.

But formal training is not enough. Directors need the kind of sophistication and experience that only come from on-the-job training (Paredes, 2005). An innovative approach to achieve this goal would be the development of programs in which Western directors and their colleagues in developing countries team up in peer-to-peer consultation and mentoring programs. An example of such program is administered by the Center for Business Ethics and Corporate Governance in St. Petersburg, Russia.¹⁷

7. Regulatory Impact Assessments

Regardless of the combination of reform strategies that can be used, an assessment of the costs implementing and enforcing these is a requirement. The implementation of new legislation and corporate governance codes can be costly. Before introducing more legislation and standards, impact assessments should be conducted to assess the financial implications of enforcement and compliance. Regulatory impact assessments are common in the West. In emerging markets, corporate governance standards are regularly introduced while impact assessments are not required or conducted as part of the legislative reform process.

It is estimated that the aggregate annual costs of implementing Section 404(a) of the Sarbanes-Oxley Act are around \$1.24 billion or \$91,000 per company (SEC, 2003c)¹⁸. This section requires companies to include in their annual report a management report on the company's internal control over financial reporting.

FEI (2004) found the total costs of compliance with Section 404 to be \$3.14 million for listed companies with average revenues of \$2.5 billion.

Table 2: Company Law Reform Initiatives

¹⁷ www.ethicsrussia.org/mentoring_engl.htm

¹⁸ Section 23(a)(2) of the Exchange Act and other legislative acts require the SEC to consider the impact that any new rule would have on competition and to determine whether an action is necessary or appropriate in the public interest.

Financial markets across the globe are overhauling their corporate governance systems with the introduction of new company laws. The following list illustrates the emphasis of regulators on the development of new standards. Most laws require a substantial investment in education of the judiciary and legal profession, accountants, shareholders, directors and managers.

| | |
|----------------------|--|
| China: | The 'Revised Company Law' was adopted by the Standing Committee of the 10th National People's Congress on 27 October 2005 and is in effect as of 1 January 2006. |
| Japan: | A draft of the new law was submitted to the Diet for deliberation on March 22 2005 and the new law is in force as of May 2006. |
| UK: | The Company Law Reform Bill was introduced in the House of Lords on 1 November 2005. |
| Oman: | Oman is expected to enact a new company law by March 2006. |
| India: | The Expert Committee on the new Company Law presented its report to the Government on 25 May 2005. |
| Macedonia: | A new company law came into force in April 2004 that incorporates the latest OECD principles and that is harmonized with EU Directives. |
| Serbia: | The new Company Law was enacted on 22 November 2004 (Official Gazette of the Republic of Serbia no 125/04). |
| Taiwan: | The Legislative Yuan approved an amended Company law at the end of October 2001. |
| South Africa: | A Companies Bill is expected to enter the parliamentary process in January 2006. |
| Jamaica: | The Companies Act 2004 passed in the Honourable Senate on 4 March, 2004. |
| US: | The Sarbanes-Oxley Act was passed by Congress on 25 July 2002 and signed into law on 30th July 2002. |
| EU: | EU corporate governance action plan was launched in 2003. |
| Iraq: | A new Company Law/Order 64 has been adopted in 2004, which replaces Company Law Number 21 of 1997. |

On the contrary, the regulatory impact assessment of the new companies act in the UK (the Companies Law Reform Bill) shows that with very few exceptions, existing companies "will not be required to do anything at the point when the new law comes into

force or at any particular point thereafter" (DTI, 2005). The new bill focuses on deregulation and is expected to save businesses up to £250 million a year - including £100 million for small businesses.¹⁹

Self-regulatory initiatives also require impact assessments. A study by Ernst and Young (2003) showed that implementation of the new Dutch Tabaksblat Code requires 15 working days for a small listed company and 40 days from managers and directors for a typical mid-sized listed company (Midcap company). Initial one-time costs are € 350,000 for a small listed company and € 1,000,000 for a mid-sized listed company. Annually, a small listed company would spend € 180,000 and a mid-sized company would spend € 450,000 on the voluntary implementation of the Code.

8. Conclusions

The introduction of new company laws and corporate governance standards in emerging markets requires a paradigm shift in the orientation of governments and the international donor community. As a requisite of new legislation, reformers and regulators should involve directors and their companies in legislative drafting and other standard setting processes and be aware of the limitations of "Western models." Impact assessments are necessary to understand the costs associated with implementation and enforcement. Legislative "shock therapies" do not always work in financial markets with poor enforcement and low acceptance of modern corporate governance standards.

The implementation of corporate governance systems in emerging markets undoubtedly requires regulatory reform. Although refinement of laws will continue to be necessary, the focus should be on the implementation and enforcement of modern standards. Formal training in business ethics, legislation, regulations and international standards are equally important to develop new generations of independent directors and business leaders. Self-regulation, director accreditation, continuing education and peer-to-peer consultation networks can be useful instruments to provide directors incentives to develop their skills and working procedures. This not only requires a considerable investment in time and resources, but also recognition of the limitations of coercive reform strategies in emerging markets and the importance of demand-driven programs that will provide incentives to the private sector to make changes in business attitudes and practices.

¹⁹ www.dti.gov.uk/news/newsarticle041105.html

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