INTERNATIONAL CORPORATE GOVERNANCE
Governance systems are not uniform across countries.

They are shaped by a variety of factors that are inherent to the business environment:

1. Efficiency of local capital markets
2. Protections afforded by legal system
3. Reliability of accounting standards
4. Enforcement of regulations
5. Societal and cultural values

Differences in these factors impact the prevalence of agency problems and the control mechanisms needed to prevent them.
Governance systems are diverse because these factors combine in different ways in different countries.
1. CAPITAL MARKET EFFICIENCY

- When capital markets are efficient, prices (labor, capital, and natural resources) correctly reflect risk and reward, which improves decision making.

- Efficient capital markets “discipline” corporations:
  - Poor decisions are punished.
  - Stock prices decline.
  - Cost of capital increases.
  - Risk of bankruptcy or being taken over increases.

EFFICIENT MARKETS PROTECT AGAINST:

**Adverse Selection**
One party in a transaction has an information advantage, and uses this advantage to receive preferential pricing or risk transfer.

**Moral Hazard**
One party does not bear the full risk of its actions and so engages in excessively risky transactions.
If a country lacks an efficient capital market, something must take its place:
- Wealthy families
- Large banking institutions
- Other companies
- Governments

These institutions “discipline” corporations in order to protect their investment.

However, their interests may be different from those of minority shareholders and stakeholders.

On average, private parties are less effective at monitoring companies than capital markets.
2. LEGAL TRADITION

• A country’s legal system has important implications on the rights afforded to business owners:
  – Protection of property against expropriation.
  – Predictability of how claims will be resolved.
  – Enforceability of contracts.
  – Efficiency and honesty of judiciary.

• A strong legal system mitigates agency problems because self-interested managers know illegal actions will be punished.

Legal system attributes—bankruptcy code, creditor and shareholder protections, and contract enforcement— influence cost of debt and equity.

A corrupted political system reduces economic development by discouraging investment.

Öztekin (2015)  
Mauro (1995)
3. RELIABILITY OF ACCOUNTING STANDARDS

- Accounting standards give investors confidence that financial reports are correct and can be relied upon to evaluate risk and reward.

- If accounting standards are compromised, manipulated, or lack transparency:
  - Investment decisions will suffer.
  - Oversight of management will suffer.
  - Management incentives will be inappropriate.

International accounting standards (IFRS) adoption is associated with improved capital market efficiency, reporting quality, and greater foreign investment.

De George, Li, and Shivakumar (2016)
4. ENFORCEMENT OF REGULATIONS

- Even if legal system is strong, officials must be willing to enforce regulations in a fair and consistent manner.

- Regulatory enforcement signals that management is being monitored, which contributes to investor confidence that their interests will be protected.

Companies apply more conservative accounting when enforcement of securities regulations is strong.  

Participation in equity markets increases when countries adopt insider trading laws.

Bushman and Piotroski (2006)  

Brudney (1979); Leland (1992)
Managerial behavior is influenced by the society in which the company operates.

Activities that are acceptable in one culture may be unacceptable in another (such as conspicuous consumption).

Executives in a country that values “individualism” may be more likely to take self-interested actions than executives in a country that values “collectivism,” because they do not risk the same level of scorn for their behavior.

Societal values will also influence whether the company takes a more shareholder-centric or stakeholder-centric approach.
• Large and liquid capital markets; active market for corporate control.
• Investor interests protected by the Securities and Exchange Commission.
• Accounting standards defined by professional body (FASB).
• Governance standards established by:
  – Listing exchanges (NYSE, NASDAQ).
  – Legislation (Sarbanes Oxley, Dodd Frank, JOBS Act).
• Developed body of federal and state law gives predictability to how most legal matters will be decided.
• Mostly shareholder centric, although in recent years has seen a rise in stakeholder considerations (ESG).
• Similar to the United States (the “Anglo-Saxon model”).

• Governance standards are recommended in “U.K. Corporate Governance Code”:
  – Separation of chairman and CEO roles.
  – Senior independent director.
  – Independent board and committees.
  – Board, directors, and committees subject to an annual review.
  – Emphasis on transparency of procedures and decisions.
  – Maintain sound internal controls.

• Companies required to disclose reasons for non-compliance with these standards (“comply or explain” approach).
• Two-tiered board structure:
  – Management board: “runs the company”
  – Supervisory board: “oversees the company”

• Supervisory board:
  – Appoints members to the management board
  – Up to 50% labor representatives (“co-determination”)
  – Includes founding family members, financial institutions, retired management, etc.

• Board structure is a legal requirement.

• Public shareholder voting rights are somewhat limited.
• History of strong interconnections among firms (“keiretsu”):
  – Cross-ownership among customers, suppliers, affiliates, and financiers.
  – System encourages business relations and cooperation toward shared objectives.

• Stakeholder-centric:
  – Maintain healthy employment.
  – Preserve wages and benefits.
  – Discourage hostile interactions among firms.

• Large boards comprised mostly of executive directors.
  – 2015 Corporate Governance Code requires 2 independent directors, encourages (but does not require) one-third independent.
• Dominated by “chaebol” (affiliated companies that operate under the strategic and financial guidance of headquarters):
  – Led redevelopment following Korean War.
  – Benefited from subsidized government loans.

• Deficiencies brought to light by Asian Financial Crisis of 1997:
  – Low profitability.
  – Hidden debts.
  – Shielded from disciplining force of capital markets.

• Reforms to stabilize the system:
  – Eliminate inter-group guarantees (foster self-sufficiency).
  – Greater independence standards.
  – Greater rights to minority shareholders.
• Partial transition from communism to capitalism:
  – Government continues to be the primary owner.
  – Protects societal concerns (maintain employment, protect key industries from foreign competition).

• Two-tiered board:
  – Board of directors: mostly company executives.
  – Board of supervisors: 33% employee representation.

• Individual shareholders are minority owners with little voting power.

• Little foreign ownership.
“Clause 49:” improved governance standards for listed companies (adopted 1999, revised 2004):

- Majority of non-executives on the board.
- If chairman is a non-executive (executive), 33% (50%) of board must be independent.
- Board must meet at least four times a year.
- A director cannot be a member of more than 10 committees across all companies.
- Independent, financially literate audit committee.
- Extensive disclosure of related party transactions

Challenges to reform:

- Underdeveloped capital markets.
- Continued dominance of family-controlled business groups.
• Governance characterized by weak protection:
  – Excessive influence by insiders.
  – Low levels of disclosure.
  – Limited voting rights for minority shareholders.

• Deregulation of capital markets is driving reform.

• Three markets for listing based on a company’s governance:
  – Nivel 1 (lowest); Nivel 2 (mid); Novo Mercado (best).

• To list on the Novo Mercado, a company must have:
  – Equal voting rights.
  – 20% independent directors.
  – Financials prepared according to U.S. GAAP or IFRS.
• Weak governance systems:
  – Concentrated ownership of shares.
  – Control by insiders.
  – Weak legal protections for minority shareholders.
  – Lack of disclosure.
  – Inefficient capital markets.
  – Heavy involvement by government.

• Controlling shareholders use influence to gain advantages:
  – Manipulation of transfer pricing to siphon money.
  – Forced dilution of minority interests.

• Government has tendency to intervene in business to promote its own interests.
Governance systems vary greatly around the world.

Formerly “closed” economies face the pressure of globalization:

- Capital market financing.
- International investors demanding rights and returns.
- Hostile market for corporate control (activist investors, hedge funds, private equity).

Trend toward international standards of governance reinforced by global investors and proxy advisory firms.

Unlikely that a standard system will work well in all countries.

Challenge of adapting to international standards while staying true to societal values.


