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# APEC Economic Policy Report 2010

APEC Economic Committee

Advancing Free Trade for Asia-Pacific Prosperity

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# 1. Corporate Governance and Sustainable Economic Growth

Corporate governance has been on the agendas of APEC member economies for years. It is part of the structural reform agenda of the Economic Committee and the Finance Ministers' agenda covering the "deepening and strengthening of the region's financial systems," and is a perennial topic at meetings of the APEC Business Advisory Council. The joint statement issued for the 2008 APEC Ministerial Meeting read:

We welcomed the Economic Committee's efforts to intensify the ongoing work under the five priority areas of the Leaders' Agenda to Implement Structural Reform (LAISR). LAISR addresses issues related to the responsibility of governments for the transparent development and implementation of legislation in order to effectively regulate business in the interests of the citizens. We noted the Committee's work to promote good corporate governance, including by affirming the "OECD Principles of Corporate Governance" and working on a plan to ensure APEC's continued implementation of the Principles in the Asia-Pacific context.

Corporate governance became prominent on the APEC agenda in step with globalization, especially as globalization spread from international trade to capital markets. It became even more prominent in the wake of the Asian Financial Crisis of 1997, and was included as one of five priority items in the Leaders' Agenda to Implement Structural Reform (LAISR) featured in the 2006 APEC Economic Policy Report.<sup>1</sup> When APEC Ministers met in Lima in August 2008, and the EC hosted a workshop on corporate governance, tremors from a new financial crisis were being felt.

The most recent crisis has generated a new round of professional and public interest in enhancing the efficacy of corporate governance and the performance of boards, particularly at financial institutions. Analysts are examining causes of the crisis, and policymakers are exploring, proposing and implementing reforms to correct deficiencies and reduce the risk of repeated crises.

In the rest of this chapter, we revisit the main reason why APEC economies have placed corporate governance on the common agenda—because of its contribution to sustainable economic growth. We review historical insights into the relationship between corporate governance and growth, the formal analysis supporting that relationship, salient issues and recommendations related to perceived weaknesses in governance, and practices recently

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## **What is Governance?**

Governance is the set of rules adopted and followed by people with a shared interest in an institution or enterprise for the purpose of directing and managing that institution or enterprise.

## **What is Corporate Governance?**

Corporate governance is governance applied to private companies, primarily those with many shareholders and publically traded shares.

## **As Defined in OECD Principles**

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

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<sup>1</sup> Between 2000 and 2003, a series of corporate collapses in the US and Europe—Enron, Tyco, Global Crossing, Royal Ahold and Parmalat—prompted far-reaching reforms to strengthen financial accounting, financial reporting and corporate governance.

adopted in some economies to improve standards and strengthen corporate governance in ways that enhance corporate performance and sustainable economic growth.<sup>2</sup>

In Chapter 2 we explore the legal structure of corporate governance in APEC economies, presenting some common features and variations in the systems currently in use. In Chapter 3 we present Individual Economy Reports (IERs) and describe selected activities underway in many economies to strengthen corporate governance in ways that respond to shareholders' concerns and enhance the ability of companies to contribute to sustainable economic growth.

## **WHY CORPORATE GOVERNANCE IS IMPORTANT TO APEC ECONOMIES**

The August 2008 APEC Workshop on Corporate Governance included presentations from Australia, Chile, Singapore and Chinese Taipei, all making a convincing case for the value of corporate governance to APEC economies, individually and collectively. Key points were as follows:

- Good corporate governance is important to companies and shareholders as an integral part of a company's value creation activities.
- Confidence in corporate governance is essential in attracting individual and collective or contractual savings into securities issued by companies.
- Good corporate governance is critical to financial deepening and the smooth functioning of the financial system in any economy and to operations of capital markets in economies that have them.
- A reputation for reliable governance is a prerequisite for attracting foreign investment.
- In many economies, corporate governance is raising awareness about the importance of enterprise, productivity, and competitiveness and the challenges and risks inherent in trying to achieve a higher standard of living over time.

In the wake of the global financial crisis, we can add to this case: corporate governance must be improved to help rebuild investors' confidence, to restore liquidity and health to financial markets and enterprises, and to reduce the frequency and severity of financial crises.

## **HISTORICAL INSIGHTS**

### **Roots and Evolution of Business “Companies”**

In the early 17<sup>th</sup> century, businessmen in Great Britain and the Netherlands were the first to form “joint stock companies”. These precursors of today's corporations were formed to undertake a variety of difficult, risky and expensive ventures—including exploration and development of largely unknown lands in North America and trade routes to the East.<sup>3</sup>

The company structure quickly proved itself a useful way to organize a business venture and attract investment funds. Groups of businessmen without titles or royal lineage, unrelated to each other by blood or marriage began using a company-type arrangement to organize, manage

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<sup>2</sup> This report focuses on corporate governance as it applies to private companies listed on the leading stock exchange in an economy and therefore subject to rules imposed by that exchange; however, many of the principles apply in whole or in part to other types of corporations including not-for-profit, state-owned and large family-owned corporations.

<sup>3</sup> The British East India Company was chartered by Queen Elizabeth I in 1600. The Dutch East Indies Company was granted a royal charter in 1602. *Corporate Governance*, 4<sup>th</sup> Edition, p. 97.

and govern larger and increasingly more complex undertakings. Under this new form of organization investors and directors agreed to trust each other and be bound by rules and procedures for making decisions about sharing costs, risks, and rewards and for choosing and supervising managers. These agreements, rules and processes were the foundation and precursors of modern corporate governance.

## Added Advantages of Incorporation

Over time the company<sup>4</sup> model for business organization managed to achieve special recognition and status under law.<sup>5</sup> Today most economies have a “Company Law” that spells out the basic requirements and special attributes that the law affords to businesses that elect to organize as incorporated companies. The special attributes include:

- Legal personage
- Perpetual life (determined by owners/shareholders)
- Limited liability of owners
- Divisibility of ownership.

Together these features make it easier and somewhat safer for people to pool resources in larger ventures. Legal personage endowed a company with other basic powers—the right to enter into contracts, own property, issue obligations, sue and be a party to legal proceedings.

Legal personage also meant the corporation’s existence and activity did not necessarily have to end with the death of any one individual or generation. Investors were responsible (liable) for debts incurred or damages caused by the corporation only up to the limit of their investment. The divisibility of ownership facilitated transferability of ownership interests without disrupting the structure of the organization. Any shareholder could sell his or her shares to any other party. This, in turn, facilitated the buying and selling of shares in the secondary market, which made this type of investment more acceptable for smaller investors who may avoid investments that cannot be turned into cash in an emergency.

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<sup>4</sup> In this report, “company” denotes a business organization whose ownership structure is based on shares held by shareholders, with a legal personality and limited liability for shareholders. This term is commonly used in APEC economies to refer to business ventures that have incorporated under the prevailing “company” law. Other terms are “society”, “corporation” and “sociedad anonima”.

<sup>5</sup> Students of business and law in the US are required to read the Supreme Court’s decision in the 1819 case of *Dartmouth College v. Woodward*, written by Chief Justice John Marshal legally recognizing the basic features of corporations.



## Exhibit 1-1

*Art Reflects Business Life*

Portraits of guild masters and businessmen in 17<sup>th</sup> century Netherlands, by Rembrandt and other artists, represented a revolution in art based simply on their subject matter. Until that time most art dealt with religious figures or classical myths and legends. Portrait art was reserved for the nobility or church hierarchy. These businessmen were showing an increased willingness and capacity to pool their talents and fortunes together into joint enterprises. And some of these groups had become successful and important enough to commission group portraits of themselves – reflecting in art the new trend in commerce. The subjects in this painting by Rembrandt are the members of cloth dyeing guild in the Netherlands. (Source: *The Ascent of Man* by Jacob Bronowski)

These features have enabled companies built on shareholdings to grow and spread to many economies. But they have not insulated them or shareholders from a problem intrinsic to all arrangements in which one person turns responsibility for something he values (e.g., hard-earned savings) over to another. Within 20 years of their creation, shareholders in some of the joint stock companies in the Netherlands resorted to pamphleteering and public protest to complain about their treatment and rights.<sup>6</sup> And within 100 years shareholders saw the value of their shares and savings shrink drastically with the collapse of the South Sea Company (1720) and other “bubble” corporations. This gave rise to serious questions about the way shareholder companies were governed and managed and what rights or protections shareholders could expect.

### **Intrinsic Problem of Corporations**

The “pooled investment” structure of the corporation embodies a particular problem that arises any time a person is given power over resources (investments) that belong to another. Managers or directors of a company vested with control over resources that do *not* belong to them cannot

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<sup>6</sup> Smaller investors in the Dutch East Indies Company were called “participants”, with rights to a share of profits, but no other rights of ownership or control. This led to one of the earliest episodes of shareholder activism in the Netherlands in 1622, when “participants” published pamphlets seeking to have a greater voice in governance and citing the example of rights that shareholders in England enjoyed. [*Shareholder Activism at the Dutch East India Company in 1622*, J Matthis de Jongh, October 28, 2009.]

always be expected to manage those resources with the same care and attention that they would in managing their own resources. Some business texts call this the dilemma of managing “other people’s money” or OPM; economists call it the “agency” problem.

The agency problem was less of a concern for some early 17<sup>th</sup> century small companies whose few shareholders lived in the same town or district. As a rule, the directors and the major shareholders were one and the same, and the directors knew both their business and their fellow directors very well. The shareholders would elect one among them to preside over the meetings from a special chair (Chairman). This helped put practical limits on the agency problem. However, such conveniences and limits diminished as corporations grew larger and began to raise capital from larger numbers of smaller investors with neither the time nor the capacity to participate in the governance of the company.

Convening meetings of numerous, widely dispersed shareholders became more expensive and less practical. Out of necessity corporations adopted more formal rules of representative governance but still based on the principle of one share=one vote. On that basis, only the largest shareholders could be directors, and they were “expected” to act on behalf of all shareholders not just in their own personal interest. This practical but partial response to the agency problem has been followed by many others even as an enduring or comprehensive solution remains elusive. Some scholars suggest that the search for such solutions is unrealistic and that corporate governance should be seen as the best way to address the inescapable agency problem. See Exhibit 1-2.

#### Exhibit 1-2

#### *Corporate Governance and the Agency Problem*

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Corporate governance is our mechanism for addressing the core conundrum of capitalism, the agency problem. Corporate governance is a way of addressing and answering the questions:

- How do we make a manager as committed to the creation of long-term shareholder value as he/she would be if he/she were managing his his/her own money?
- How do we manage corporate value creation in a manner that minimizes the externalization of costs onto society at large?

Good corporate governance requires a complex system of checks and balances to work well. In the last decade (1990-2000) we saw a perfect storm of failures, negligence and corruption in every single category of principal and gatekeeper: managers, directors, shareholders, securities analysts, lawyers, accountants, compensation consultants, journalists and politicians. But the primary focus [should be] on the three key actors in the checks and balances of corporate governance: management, directors and shareholders.

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SOURCE: Monks, Robert A.G. and Nell Minow, *Corporate Governance*, 4<sup>th</sup> Edition, John Wiley & Sons, Ltd., 2008, p. 3-4.

## **COMPANIES AND CORPORATE GOVERNANCE TODAY**

The company as a form of business organization has spread around the world. Most economies have adopted some form of a “company law”. The company form would not be so widespread if companies had not created value and contributed to the growth of economies governed by laws that have allowed them to flourish. Still, it is a mistake to think that companies inherently generate value, wealth and economic growth. Companies can also misdirect, diminish, and destroy value and hinder economic growth—especially if they deviate significantly from the principles of sound corporate governance.

## Performance, Governance and Growth

The contribution of any company to the growth of an economy depends on the company's ability to create something of economic value to buyers in local or export markets. Unfortunately, there is no guarantee that a company, however well intentioned, inspired, or equipped, will create products or services that buyers will always consider the best value. Even full adherence to the best practices of corporate governance cannot provide such a guarantee. Under market rules, buyers are the ultimate judges about how "valuable" a company's products and services are, and the collective purchasing decisions of buyers determine which companies succeed and grow.

Indeed, the historical record of company performance and economic growth is not one of unbroken progress, but a complex tale of winners and losers rich with examples and episodes of failure and collapse as well as success. When the winners—those who create better value—are encouraged and allowed to prevail, the tale also describes a trend that favors economic growth.

Most company failures are part of the normal process of trial and error, risk, and market discipline with which every company must cope in competing for a buyer's attention and purchases. The failure of a single company—while losing value for a company's shareholders and creditors—does not necessarily diminish contributions to economic growth. In fact, the survival and growth of better companies strengthen and accelerate general economic growth.

Good corporate governance, therefore, should not be seen as a guarantee against the underperformance or failure of an individual company, but as a mechanism for bolstering how company success contributes to economic growth.<sup>7</sup> The standards of good governance do this by requiring companies to provide accurate and timely information about performance and status to key participants and decisions makers (e.g., buyers, investors, lenders, governments), as well as boards of directors.

When companies conform to high standards of governance, information about performance is readily available, and buyers and investors can make informed decisions about the ability of a company to create or add value. But if companies conceal, exaggerate, or disguise important aspects of performance, participants, including investors, will be misled. A failure in company performance *and* corporate governance can be lethal, leading to a crisis or collapse more sudden, severe and widespread than would have occurred if standards of good governance had been observed.

In 2002, the United States experienced seven of the 12 largest bankruptcies in its history—until that record was broken in 2008. A partial list of major corporate collapses in the last eight years includes the names of companies held in high esteem until better knowledge about their performance and condition became available:

- Enron, Tyco, Global Crossing (USA, 2002)
- Royal Ahold (Netherlands, 2002–2003)
- Parmalat SpA (Italy, 2003)
- Thai Petrochemical Industries (TPI) (Thailand, 2002–2003)
- Bear Sterns, Lehman Brothers, AIG (USA, 2007–2008)
- Satyam Computer Corporation (India, 2008–2009)

While the company managers in each of these cases were able to blame unexpectedly adverse commercial developments for the cause of their failures, in most cases it became increasingly

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<sup>7</sup> As will be shown later, there is considerable evidence that companies that do not follow the standards of good governance tend to perform worse than those that do.

clear that managers had avoided measures to disclose or reveal – or had taken steps to conceal important information about the companies’ true condition and performance from reaching directors, shareholders or the general public. The suddenness and severity of the ensuing collapse, bankruptcy, or loss of shareholder value were caused therefore not only by unexpected market forces but by market forces adjusting to information that contradicted – in the extreme – previous information.

The extent of these failures raised legitimate questions about the accuracy and integrity of accounting and audit firms and the effectiveness of regulatory oversight. The failures also renewed interest in the role of the board of directors, who, according to the principles of corporate governance, should be in a position to spot potential problems and question anomalous results. Were decisions and actions that imperiled a company taken with full knowledge and approval of the board of directors? Were directors misled, or were they derelict in their responsibility? Some examinations made after the fact include statements by some directors indicating that, in retrospect, they recognized that they had not been not fully aware of the particular gravity of the situation, and so felt no need to be exceptionally diligent in examining or questioning management or seeking additional information.<sup>8</sup>

To address weaknesses that contributed to the wave of corporate collapses between 2002 and 2004, some economies instituted reforms. These included reforms of accounting and auditing standards to preclude conflicts of interest, as well as reforms holding company officers accountable to a higher standard of financial information. After only a few years, however, there was a succession of crises and collapses among major financial institutions. Once again, in some cases, statements from one or more directors indicated that—in retrospect—they recognized that they were less than fully cognizant of the financial situation of their companies, especially of the risks of new financial instruments being traded.

Causes of the recent financial crisis are still being assessed and analyzed, but it appears that managers in some financial companies were disguising the extent of liabilities and risks. Again it appears that directors—not to mention the investing public—were not fully aware of financial conditions or risks. Reforms are once again being explored, including reforms that demand that directors exercise a moderating influence on company decisions, especially risky ones.<sup>9</sup> Directors, can, of course, legitimately adopt or endorse a high risk, high-yield strategy, without necessarily violating the principles of good governance. However, at the very least, directors should ensure that policies and decisions that could put a company’s survival at risk are examined and deliberated much more attentively.

## **What Is Necessary for Corporate Governance to Work Better?**

To strengthen corporate governance one must understand the basic purpose and functions of governance and the context in which companies and corporate governance operate. For example, other entities, such as audit firms and securities trading exchanges, influence the functioning of corporate governance. Supporting institutions and the prevailing environment for business, including openness to international standards and influences, determine in part what can reasonably be expected from those directly responsible for a company’s corporate governance—chief officers, directors and shareholders. In the first subsection below we examine conditions necessary for companies and good governance to develop and flourish in

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<sup>8</sup> Gillespie, John and David Zweig, *Money for Nothing*, Free Press, 2010.

<sup>9</sup> As in engineering, the main function of a “governor” (director) is to moderate the tendency of some operations to exceed recommended performance parameters.

the first place. We then explore reasons why governance can fail or underperform even when basic conditions are favorable.

### ***Preconditions for Effective Corporate Governance***

Despite their growth and spread, corporations have not flourished everywhere and in all times and situations. Certain conditions favor the development of corporations and of corporate governance. Among those conditions are the following:

1. The rule of law.
2. General peace, order and macroeconomic stability.
3. A market-based economy including competition.
4. A growing number of educated savers interested in more options for their savings.
5. A government in favor of a business-enabling environment.
6. An enhanced capacity for financial accounting and reporting and maintenance of public records, such as shareholder registries.
7. Financial institutions and intermediaries competing to serve investors and corporations.
8. A secondary market for trading securities.

The first six conditions can be considered prerequisites for the emergence of corporations and a robust capacity for corporate governance. Rule of law is a basic condition as opposed to anarchy or the arbitrary exercise of force. Special laws are also needed to protect the institutions of private property and the principles of ownership and contracts. Laws that encourage market-based enterprise and competition are yet another requirement, along with laws recognizing and regulating the role of securities and securities trading.

The establishment of these laws improves the climate for private sector and market-led activities. Businessmen will choose to organize themselves using the best legal options available. Gradually, more and more firms, even older, successful family-owned private firms will recognize the advantages of choosing to incorporate. As the number and size of corporations continue to grow, so will the need for educated and qualified persons to serve as:

- Managers
- Corporate directors
- Regulatory staff (both public and private sector agencies)
- Accountants and auditors
- Financial analysts and investment advisers
- Financial journalists and other media
- Investment fund managers

In brief, an economy intent on accelerating growth by encouraging the development of companies funded by private investment must have in place laws and institutions that allow private companies and private investment to flourish. Prime among these institutions is an educational system that meets the demand for occupations such as those listed above, and that enlightens the general public about the value of saving and investment for themselves and for the economy in general. Corporate governance can be an important element in an educational system that raises awareness of citizens' roles and responsibilities.

### ***How Can Corporate Governance Be Strengthened?***

Efforts by APEC member economies and other economies to strengthen corporate governance fall into two categories:

1. Efforts that focus on the roles and accountability of the three constituent elements of corporate governance by improving communication and ensuring useful checks and balances among shareholders, directors and managers.
2. Efforts that focus on improving supporting institutions, such as audit agencies and regulatory agencies.

In some economies, more attention has been paid recently to options in the first category: what can be done to strengthen corporate governance at the shareholder and director levels. Figure 1-1 illustrates the perception and argument by some shareholder rights and governance experts that corporate governance as practiced today in some companies has diverged from the basic precepts of company laws. The discretionary powers of CEOs have increased at the expense of the proper role of directors and the voice of shareholders in the selection of directors. These powers also give a CEO more control over policies and decisions about dividends, retained earnings, and executive compensation (lower portion of Figure 1-1) as well as over risk management policies and other strategy-level decisions that should be the purview of the board of directors. The CEO can be particularly dominant in companies where shares are widely held and no single shareholder or allied block of shareholders controls a majority of the voting shares. This is one reason why shareholder advocacy has focused on increasing the number and role of independent directors on company boards and increasing shareholder voice in director selection.<sup>10</sup>

To strengthen supporting institutions, some economies have reformed laws and regulations or issued government-sponsored guidelines. But, as we show below, many important improvements arise in the private sector. Trading exchanges, professional associations of directors, and shareholder rights associations are spearheading efforts to improve corporate governance. Their recommendations and guidelines may not have the force of law but they do influence standards and practice and help keep directors, shareholders and regulators abreast of issues, problems and solutions.

Of course, interest in corporate governance is not confined to the APEC economies, which have benefited from governance guidelines and standards that reach across borders for the sake of the common goal of economic development.

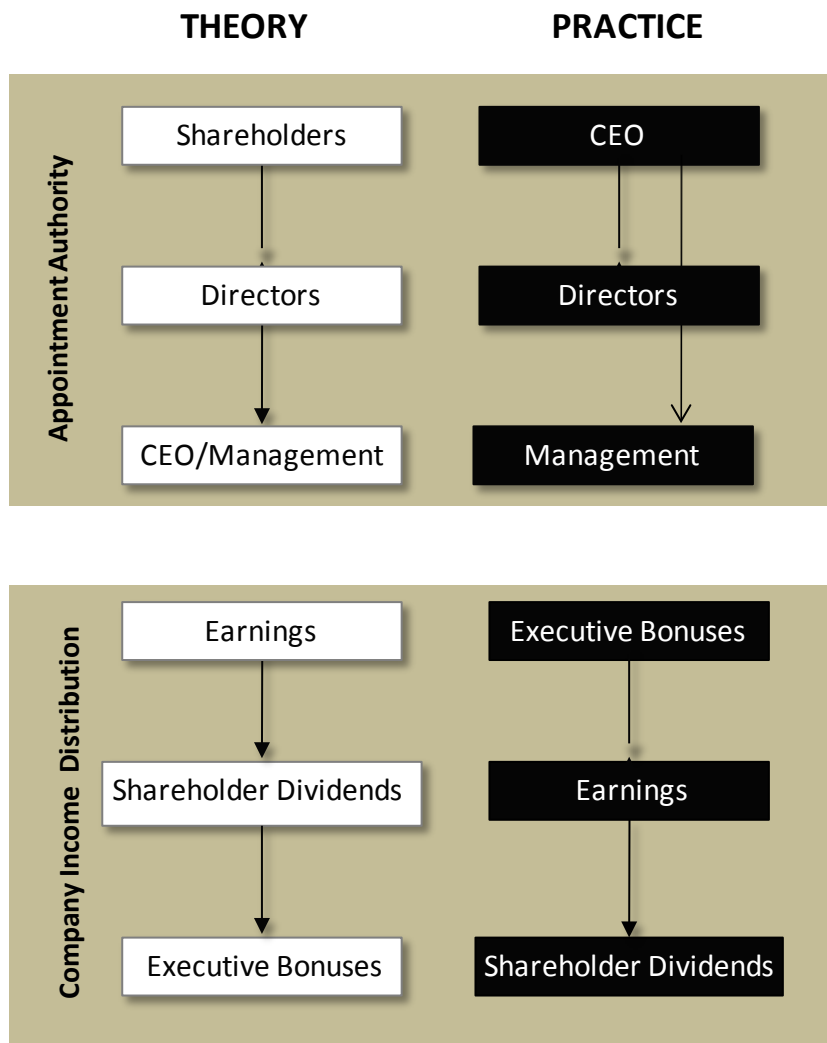
## **RECENT INTERNATIONAL REFORMS**

The Asian Financial Crisis of 1997–1998 prompted leaders around the world to examine the role of corporate governance and implement reforms that would make governance a more effective safeguard against crisis-inducing behavior. Leaders from many economies helped develop the OECD Principles of Corporate Governance issued in 1999 to serve as guidelines for improving corporate governance. Many economies have used the guidelines to draw up and adopt reforms in governance law, regulations and practices. Subsequent episodes of corporate collapse, including the global financial crisis of 2007–2009, have kept governance in the spotlight and renewed concerns about how to make governance more effective—either by reform or by better implementation and enforcement of existing rules, or both. In the following subsection we review reform developments and initiatives that have gained acceptance in the international community

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<sup>10</sup> Observers note the tendency of shareholders to react passively to the increasing power of a CEO as long as the market price of shares is increasing; they become concerned and active only when prices cease to rise or begin to decline.

Figure 1-1  
Corporate Governance Models



## Governing Institutions and Rules

### *International Standards and Best Practices: OECD Principles*

The OECD Principles of Corporate Governance have set the standard for many economies.<sup>11</sup> The principles were developed by OECD member economies in consultation with non-member economies, including developing and transition economies.<sup>12</sup> They were revised in 2004 in light of experience with implementation and the experience of economies reforming governance in response to concerns about shortcomings and failures of corporate governance revealed in 2001-2002 in Europe and the United States. The Preamble to the Principles states the nature of corporate governance and its purpose:

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper

<sup>11</sup> <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

<sup>12</sup> A number of APEC economies participated in the OECD-led effort.

incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring (p. 11).

The principles are intended primarily for publicly traded companies. Thus, the financial and institutional resources required to comply with many of the principles can be considerable and full compliance can be challenging for companies lacking access to capital markets. Nevertheless, the principles can clearly benefit a range of company types and sizes including medium-sized companies that are not publicly traded, large nonprofits, and state-owned enterprises. There are six basic principles:

1. Ensuring the basis for an effective corporate governance framework
2. The rights of shareholders and key ownership functions
3. The equitable treatment of shareholders
4. The role of stakeholders in corporate governance
5. Disclosure and transparency
6. The responsibilities of the board

These principles are elaborated through numerous subprinciples. The following paragraphs present a fuller statement of the basic principles and comments on selected subprinciples under the first four principles.<sup>13</sup>

**1. *The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.*** An element of a related subprinciple is *Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner.* Authorities in many economies, including some of the world's wealthiest, have been less than effective in enforcement. Vigilance by shareholders and directors should be the first line of defense of corporate governance rules, and if such vigilance is lacking, there is one less reason to expect supervisory and enforcement authorities be aware of a potential problem and marshaled to address it. Insufficient shareholder vigilance may be due to rapid growth in capital markets and in the number and size of listed companies. Given the large and steadily growing number of publicly traded companies in many economies, it has become increasingly difficult for supervisory and enforcement authorities to monitor corporate governance effectively and routinely. Moreover, coordination among such authorities has often been lacking or ineffective, especially when criminal prosecution is required.

**2. *The corporate governance framework should protect and facilitate the exercise of shareholders' rights.*** A related subprinciple defines basic shareholders' rights:

Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation.

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<sup>13</sup> A complete statement of the principles themselves are available in several languages at the OECD website: <http://www.oecd.org/daf/corporateaffairs/principles/text>



One subprinciple in this area has been problematic. *Shareholders should have the opportunity to ask questions to the board... to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations.* What “reasonable limitations” should be is sometimes misunderstood. Agenda items and resolutions proposed by shareholders should be those that are properly matters for shareholders’ determinations. Sometimes shareholders have attempted to propose matters that are not within the purview of shareholders but of the board of directors or company management. Some shareholders have not recognized the limited decision-making power of shareholders inherent in the separation of ownership and management in a publicly traded company.

In most economies, shareholders’ key governance responsibility and inherent decision-making power under company law relate to the important right to elect members of the board of directors. Elections usually occur annually. Other matters for shareholder determination occur infrequently, if at all. Examples include voting on a merger or acquisition, sales of a substantial portion of a company’s assets, or changes in shareholders’ rights through amendment to the company charter or bylaws. Thus, shareholders’ powers are subject to significant limitations in scope and timing. If shareholders are not content with the performance of a company in which they own shares, they have two options: (1) elect at the next voting opportunity new board members who will seek to change the direction of the company, or (2) sell their shares if they can find a buyer for a price they deem acceptable. Since the latter option is limited for shareholders whose shares do not have a liquid market, even if publicly traded, a competent and effective board of directors is of paramount importance.

In the company laws of some economies, the right of shareholders to “remove” members of the board is exercised in ways not conducive to good governance. Some laws state that directors may be removed at any time by a majority or supermajority vote.

With respect to executive compensation, a subprinciple states that: *Shareholders should be able to make their views known on the remuneration policy for board members and key executives.* This is consistent with the movement in some economies for shareholders to have a “say on pay” especially in light of what many believe is excessive compensation for directors and key executives of companies whose revenues or share prices have not increased (or have even declined) in comparison to the relevant market index or the shares of rival companies.

Another part of the same subprinciples provides: *The equity component of compensation schemes for board members and employees should be subject to shareholder approval.* Equity components can be in the form of grants of shares that can be sold immediately or whose sale must be deferred, or in the form of stock options. The grantee of stock options has the right to purchase company shares in the future at a stated price. This gives grantees an incentive to raise the prevailing share price before the right to exercise the option expires. This is consistent with

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The OECD Principles are a model for many economies. In July 2002, a committee of seven financial service and business organizations chaired by the National Supervisory Commission of Companies and Securities (CONASEV) of Peru issued the Principles of Good Governance of Peruvian Companies. Five parts are very similar in concept and wording to the OECD Principles, although principles for the responsibilities of the board of directors are much more extensive than those of the OECD Principles.<sup>14</sup>

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<sup>14</sup> [http://www.bvl.com.pe/descarga/principles\\_good\\_governance.pdf](http://www.bvl.com.pe/descarga/principles_good_governance.pdf). Also see in Chapter 3 of this report Peru’s IER for additional information about not only July 2002 principles, but also general management rule issued by CONASEV in 2003.

the theme of “pay for performance” and aligning executives’ incentives with shareholders’ interests of company performance over the medium rather than short term. Especially in economies where executive compensation has become controversial, shareholders’ awareness has increased along with exploration of reforms to avoid disconnects with performance or excessive incentives for risk taking and short-term performance only.

Another subprinciple provides:

Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

Institutional investors in this context refer mainly to collective investment funds that typically have hundreds or thousands of investors. These include pension funds, investment funds and hedge funds. Disclosure of corporate governance and investment policies as urged by the subprinciple is straightforward and relatively easy to comply with. By contrast, the exercise of ownership influence by beneficial owners of investment funds or pension funds presents challenges. In principle, investment fund investors, if not satisfied with disclosed policies by fund management companies on corporate governance and voting, could sell their investments. However, beneficiaries of company-sponsored pension funds are usually more captive.

Advocates of shareholders’ rights have proposed that shareholders in investment funds be empowered to exercise their own voting rights rather than having fund managers automatically exercise voting rights with respect to shareholdings in companies in which investment funds invest. Indeed, a subprinciple is that *Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares*. This is considered appropriate because of the conflicts of interest faced by many institutional investor managers, particularly those who are part of financial services conglomerates.<sup>15</sup> The requirement to disclose management of any such conflicts of interest is acknowledged in a subprinciple of Principle 2.

**3. The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.** A subprinciple states:

Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

A frequent complaint in this area relates to remote voting at shareholders’ meetings. Some economies do not permit shareholders to vote by telephone, facsimile transmission, or the Internet and recognize only votes delivered in person or by proxy at shareholders’ meetings. Unless there is a contested election, proxy voting is usually facilitated only for voting as recommended by the board of directors of a company. Direct remote voting may allow for a more diverse expression of shareholder interests. Foreign shareholders frequently complain that prior notice of shareholder meetings is inadequate. This problem could be easily remedied by posting a notice on a company’s website and extending the period of prior notice when it is too brief to allow effective marshalling of shareholders’ interests.

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<sup>15</sup> This could be an area where terminology in use by different APEC economies has different meanings, resulting in different practices. In some economies the expression “nominees and custodians” might not be understood as including trustees or custodians designated by investment fund managers.

Another subprinciple is that *Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.* Abusive related-party transactions between company directors or executives and the company that they serve have been a source of significant losses for companies in many economies. Disclosure of family and business relationships of directors and executives has improved in many economies, but disclosure of other “outside” interests such as a director’s relationship to third parties with prior business interests has not been an area of significant progress.

**4. *The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.*** The practical import of this principle is stated succinctly in a subprinciple: *The rights of stakeholders that are established by law or through mutual agreements are to be respected.* Another subprinciple states:

Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.

This refers to encouragement of and protection for so-called “whistleblowers”. Usually the best source of information about corporate misconduct is a person with firsthand knowledge of the wrongful action and information from such individuals has been important in prosecuting illegal conduct in some economies. While not advocated in the principles or subprinciples, it is increasingly popular among companies to establish a comprehensive code of ethics that describes avenues for whistleblower communication and investigation of allegations, and that prohibits retaliation against whistleblowers when information is communicated in good faith.

**5. *The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.***

**6. *The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board’s accountability to the company and the shareholders.*** These self-explanatory principles are supportive of each other and of the first four principles.

Experts from many economies took great care in elaborating these principles, which are available in multiple languages on the OECD’s website.<sup>16</sup>

### ***Financial Sector Assessment Program Benchmarking***

The Financial Stability Forum (now the Financial Stability Board) designated the OECD Principles of Corporate Governance as one of 12 international standards for sound financial systems.<sup>17</sup> The principles provide a framework for information exchange about implementation within OECD and other economies, and this framework has formed the basis for the corporate governance component of the World Bank and IMF Financial Sector Assessment Program

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<sup>16</sup> The official text of the 2004 revision of the principles can be downloaded in more than a dozen languages from the OECD website: [www.oecd.org/daf/corporateaffairs/principles/text](http://www.oecd.org/daf/corporateaffairs/principles/text)

<sup>17</sup> The Financial Stability Forum was established in 1999 to coordinate national financial authorities and international standard setting bodies in developing and promoting regulatory, supervisory and other financial sector policies. In 2009, the institutional underpinnings of the Forum were strengthened and its membership expanded, and it was renamed as the Financial Stability Board.

(FSAP). The FSAP includes a report on the observance of standards and codes (ROSC) with respect to the principles. Ten APEC members have had a ROSC on corporate governance—two were published in 2006, two in 2005, and the other six between 2001 and 2004.<sup>18</sup> In general, the now-dated ROSCs found that most economies had basic rules for corporate governance standards and requirements in place but that company practice fell short of full compliance and enforcement was weak.<sup>19</sup> Many APEC economies have since used the assessments as a basis for reforms.

## CORPORATE GOVERNANCE AND SUSTAINABLE ECONOMIC GROWTH

We began this chapter with insights gleaned from APEC's 2008 meeting in Lima about the importance of corporate governance to member economies. All the presentations on governance at that meeting support the following conclusion: *Corporate governance is important because it helps generate and sustain economic growth.* **Corporate governance:**

- Improves performance at the company level;
- Helps an economy attract foreign investment;
- Leads to better allocation decisions by intermediaries in capital markets;
- Improves long-run returns for savings including contractual savings (e.g. pensions, insurance and retirement funds); and
- Broadens and deepens understanding among professionals and investors about the value of self-reliance, responsibility and accountability.

Most economies find it worthwhile to pursue these benefits. Note, however, that investment and capital market benefits all depend on the first benefit—better performance at the company level—combined with improved accounting and disclosure practices. Most observers of company behavior find the link between good corporate governance and company performance obvious. At the very least, the historical record of company scandals, earnings restatements, share price collapses and bankruptcies are regularly linked to failures in corporate governance. Less well known is the statistically based evidence of a significant correlation between measures of corporate governance and company performance. A sampling of such studies is presented in Table 1-1.

Table 1-1

*Excerpts from Studies of Corporate Governance and Company Performance*

Source	Excerpt
Gompers, Paul A. and Joy L. Ishii and Andrew Metrick. 2003. Corporate Governance and Equity Prices. <i>Quarterly Journal of Economics</i> 118 (1). February. 107-155. <sup>20</sup>	We used an incidence of 24 indicators of governance to construct a "Governance Index" as a proxy for shareholder rights for 1,500 large firms in the 1990s. A hypothetical investment strategy that bought firms in the lowest decile of the index (Strongest shareholder rights) and sold firms in the highest decile of the index (Weakest rights) would have earned abnormal returns of 8.5% per year during the sample period. We also found that firms with stronger shareholder

<sup>18</sup> Chile; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Mexico; the Philippines; Peru, Thailand; and Viet Nam.

<sup>19</sup> Chapter 3 of this report contains information on the state of corporate governance in [16] APEC members.

<sup>20</sup> Also available through Wharton Financial Institutions Center.

Source	Excerpt
	rights had higher firm value, higher profits, higher sales growth, lower capital expenditures and made fewer corporate acquisitions.
Brown, Lawrence D. and J. Mack Robinson and Marcus L. Caylor. 2004. Corporate Governance and Firm Performance. December.	We created a broad measure of corporate governance, Gov-Score, based on a new dataset provided by Institutional Shareholder Services. Gov-Score is a composite measure of 51 factors encompassing eight corporate governance categories: audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices, and state of incorporation.
Agrawal, Anup and Shaiba Chadha. 2003. Corporate Governance and Accounting Scandals. July.	The probability of restatement of earnings is lower in companies whose boards or audit committees have an independent director with a background in accounting or finance.
Biao Xie, Wallace N. Davidson, III, and Peter J. DaDalt. 2003. Earnings management and corporate governance: the role of the board and the audit committee. <i>Journal of Corporate Finance</i> , Volume 9, Issue 3. 295-316.	Supporting an SEC Panel Report's conclusion that audit committee members need financial sophistication, we show that the composition of a board in general and of an audit committee more specifically, is related to the likelihood that a firm will engage in earnings management. We conclude that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management.
Black, Bernard S., Jang, Hasung, Kim, Woonchan. 2004. Predicting Firms' Corporate Governance Choices: Evidence from Korea. University of Texas Law School Working Paper No. 39.	Well-governed firms in Korea traded at a premium of 160% to poorly governed firms.
Black, Bernard. The Corporate Governance Behavior and Market Value of Russian Firms. <i>Emerging Markets Review</i> , Vol. 2, March 2001.	A study of Russian firms showed that a worst-to-best improvement in corporate governance predicted an astronomical 700-fold (70,000%) increase in firm value

The works noted in Table 1-1 are persuasive, but not all academic work supports the same conclusion. Rather there is vast disagreement among academics and other experts and practitioners over the best way to measure governance and its relation to performance. In fact, measuring aspects of good corporate governance and progress in economic governance presents problems for scholars, for proponents of governance reforms, and for agencies that monitor standards of behavior. One lesson offered by both scholars and proponents is that formalistic approaches to measurement (e.g., boxes ticked) are not very useful.

Measurement difficulties pale, however, when compared to the damage that the failure of a single company can wreak on shareholders and bondholders, damage that in some cases infects financial sectors and even entire economies. While good governance will not prevent companies from underperforming or failing, it will help an economy's participants distinguish between companies that create value and those that do not—and that will help ensure that the competitive process contributes to economic growth.

Globalization has raised the stakes for leadership and sound decision-making in top companies in every economy, and corporate governance has a role to play. Improving governance requires more education and more responsibility on the part of major corporate stakeholders. Alternatives to private-sector led efforts to improve governance—such as vastly increased regulation or state intervention—pose risks and costs that could hobble a company and an economy. Effective and more efficient regulation is surely needed, but any economy that can

eliciting better corporate governance using cultural and ethical norms will lighten its enforcement burden.

Better corporate governance can start with a single company. Every director and CEO in every company should be keenly aware that lapses in governance hurt more than a single company's balance sheet and shareholder value. In large companies, poor governance can generate a shock wave of failure that cascades throughout a sector. Likewise, the benefits of sound governance can extend far beyond a company's boardroom and financial statements by contributing to sustainable economic development in an economy and even beyond its borders.