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The False Promise of Global Governance Standards

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In the wake of last year's global financial meltdown, there is now widespread recognition that inadequate investor protection can significantly affect how stock markets and economies develop, as well as how individual firms perform. The increased focus on improving corporate governance has produced a demand for reliable standards for evaluating governance in publicly traded companies worldwide. World Bank officials, shareholder advisers, and financial economists have all made considerable efforts to develop such standards.

The notion of a single set of criteria to evaluate the governance of publicly traded firms worldwide is undoubtedly appealing. Both investors and publicly traded firms are operating in increasingly integrated global capital markets. But the quest for a single set of global governance standards is misguided.

Yes, over the last decade, there has been growing use of global governance standards, largely developed in the United States, to assess how countries and companies around the world protect minority investors. But these efforts have overlooked fundamental differences between controlled companies, which have a controlling shareholder, and widely held firms that lack such a controller. While widely held firms dominate the capital markets of the US and the UK, controlled companies dominate in most other countries.

Widely held and controlled companies differ considerably in the governance problems their investors face. In widely held firms, the concern is about opportunism by managers, who exercise *de facto* control; in controlled firms, the concern is about opportunism by the controlling shareholder at the expense of minority shareholders.

Because the basic governance problems in the two types of firms are considerably different, arrangements that benefit investors in widely held firms might be irrelevant or even counterproductive in controlled firms, and vice versa. As a result, applying a single standard for assessing investor protection worldwide is bound to miss the mark with respect to widely held firms, controlled firms, or both.

Consider, for example, the Corporate Governance Quotient system, developed by the US firm RiskMetrics, the world's dominant shareholder advisory firm. RiskMetrics' system, which is used

by institutional investors around the world, attaches considerable weight to the arrangements governing contests for control.

These arrangements are, indeed, important for investors in widely held firms. When a company has a controlling shareholder, however, control contests are not possible, and the arrangements governing such contests are thus irrelevant.

Investors and public officials in countries where controlled companies dominate should stop using global governance standards based on the designers' experience with widely held firms in the US. Rather, they should strive to develop standards appropriate for controlled firms.

Most obviously, assessments of controlled companies should not give significant weight to arrangements governing contests for corporate control. Similarly, arrangements that make the firm's board of directors more responsive to the wishes of a majority of shareholders, such as making it easier for shareholders to replace directors, can serve the interests of investors in widely held firms, but are counterproductive for investors in controlled firms. In controlled firms, where the concern is diversion from minority shareholders, making directors even more responsive to the controller will likely make minority investors still more vulnerable.

Moreover, in countries that have many controlled firms, close attention should be paid to related-party transactions and to the taking of corporate opportunities – the main ways in which value may be diverted from minority investors in such firms. To address such problems, arrangements that enable a minority of shareholders to veto related party transactions – arrangements which are not warranted in widely held firms – could well be valuable.

Finally, when assessing controlled companies, the independence of directors should not be judged largely by looking at the extent to which they are independent of the company on whose board they serve. Rather, considerable attention should be given to their independence from the controlling shareholder.

To improve corporate governance and investor protection, public officials and investors in countries whose capital markets are dominated by controlled companies should be wary of global governance standards developed for US companies. They should focus on the special problems of controlled companies and on the rules that would work best for protecting smaller investors in such companies.

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