Corporate governance principles and practice in emerging countries. Case of Romania

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Abstract
Most of the literature on corporate governance emphasizes that firms should be run in the interests of shareholders. This is a suitable objective function when markets are perfect and complete. In many emerging economies this is not the case: markets are imperfect and incomplete. Corporate governance issues are especially important in emerging countries, since these countries do not have the long-established financial institution infrastructure to deal with corporate governance issues. This paper discusses how emerging countries are dealing with corporate governance issues and the extra obstacles they have to overcome due to a lack of established principles and best practice. Romanian case study is examined.

Keywords: corporate governance principles, corporate governance practice, emerging country

Introduction

The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has therefore become a necessary prerequisite for any corporation to manage effectively in the globalized market.

The term “corporate governance” is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776).In the last two decades, however, corporate governance issues have become important not only in the academic literature, but also in public policy debates. During this period, corporate governance has been identified with takeovers, financial restructuring, and institutional investors' activism. One can talk about the governance of a transaction, of a club, and, in general, of any economic organization. In a narrow sense, corporate governance is simply the governance of a particular organizational form - a corporation.

Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan assert that governance determines how the firm’s top decision makers actually administer such contracts (Garvey and Swan, 1994).

Shleifer and Vishny define corporate governance by stating that it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997). A similar concept is suggested by Caramanolis-Cötelli, who regards corporate governance as being determined by the equity allocation among insiders and outside investors (Caramanolis-Cötelli, 1995).

John and Senbet propose the more comprehensive definition that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (John and Senbet, 1998). They include as stakeholders not just shareholders, but also debt holders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart closely shares this view as he suggests that corporate governance issues arise in an organization whenever two conditions are present (Hart, 1995). First, there is an agency problem, or conflict of interest, involving members of the organization – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract.

Zingales defines corporate governance as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm (Zingales, 1997). He considers that all the governance mechanisms discussed in the literature can be reinterpreted in light of this definition.

An OECD study considers that corporate governance is the system by which business corporations are directed and controlled (1999). The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

Roe define corporate governance as the relationships at the top of the firm - the board of directors, the senior managers, and the stockholders (2004). In his opinion institutions of corporate governance are those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm.

Core corporate governance institutions respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders).

A few studies have examined corporate governance in emerging markets. Researchers (Claessens, Djankov and Lang, 1999; La Porta, Lopez-de-Silanes and Shleifer, 1999; Lins, 2000) have studied the implications of the concentrated corporate ownership that is common in many emerging and developed markets and conclude that the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders.

Principles for corporate governance

Corporate governance is only part of the larger economic context in which firms operate, which includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long term success of a company.

Although instituting corporate governance is clearly beneficial for firms and countries, the rapid pace of globalization has made the need urgent. Doing so requires that firms and national governments make some fundamental changes. Companies must change the way they operate, while national governments must establish and maintain the appropriate institutional framework.

Efforts to improve corporate governance by establishing international standards began roughly 15 years ago and have recently gained enormous momentum.

In my opinion, the most significant codes of corporate governance are OECD and ASX principles, described as following.

OECD have assembled a system of principles that are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. Briefly those principles are:

1 The corporate governance framework should protect shareholders' rights.
2 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.
3 The corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
4 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.
5 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.

Other set of eight core principles are articulate by ASX (Australian Securities Exchanges) Corporate Governance Council. Each Principle is explained with implementation guidance in the form of good practice recommendations:

1 Lay solid foundations for management and oversight. Companies should recognize and disclose the respective roles and responsibilities of board and management.

2 *Structure the board to add value*. Companies should have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.
3 *Promote ethical and responsible decision-making*. Companies should actively promote ethical and responsible decision-making.
4 *Safeguard integrity in financial reporting*. Companies should have a structure to independently verify and safeguard the integrity of their financial reporting.
5 *Make timely and balanced disclosure*. Companies should promote timely and balanced disclosure of all material matters concerning the company.
6 *Respect the rights of shareholders*. Companies should respect the rights of shareholders and facilitate the effective exercise of those rights.
7 *Recognize and manage risk*. Companies should establish a sound system of risk oversight, risk management and internal control.
8 *Remunerate fairly and responsibly*. Companies should ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to performance is clear.

The principles are primarily intended to provide assistance to governments in creating a corporate governance framework. They can indeed be a useful point of reference for many emerging markets and economies in transition. Not only do the principles provide a benchmark for internationally accepted standards, they also offer a solid platform for analysis and practices in individual countries taking into account country specific circumstances, such as legal and cultural traditions.

Principles of Corporate Governance in Emerging Countries

Corporate governance is receiving substantial attention in developed countries. Think tanks and business associations throughout the developing world and in the transitional economies are also focusing resources on corporate governance.

In order for corporate governance measures to have a meaningful impact in any economy, a set of core democratic, market institutions, including a legal system to enforce contracts and property rights, needs to be up and running. Yet, in most developing economies, even the most basic democratic, market institutions may be weak. Given these circumstances, instituting corporate governance in developing and emerging markets requires more than merely exporting well-established models of corporate governance that function within the developed economies. Special attention needs to be given to establishing the necessary political and economic institutions that are tailored to a country’s specific needs and that give corporate governance effectiveness (CIPE, 2002).

Each region is in a different stage of establishing a democratic, market-based framework and a corporate governance system. Hence, each nation has its own particular set of challenges.

Most emerging economies have adopted a corporate governance code. Whereas we can find differences within the scope of the codes, they have in common that they abide closely by the OECD Principles. Given the characteristics of the corporate governance systems` institutional surrounding in emerging economies and the specific corporate governance problems in these countries, formal legal rules which may arise from such codes cannot rely only on a basis of broad minimum standards, as it is often the case in the developed economies, but on binding legislation (mainly directives adopted in the harmonization process), that can at least partially reduce the existent shortcomings.

In Table 1 are presented the main countries which develop full texts of corporate governance codes, principles of corporate governance and corporate governance reforms both in developed countries and developing countries. CGI (corporate governance index) is the product between years of development and number of acts.

Table 1: Corporate governance index

Countries	Development period	Number of acts	CGI
Developed countries			
Australia	1995-2007	9	117
Austria	2002-2007	4	24
Canada	1994-2007	7	98
Denmark	2000-2007	4	32
Finland	2003-2007	2	10
France	1995-2007	6	78
Germany	1998-2007	11	110
Iceland	2004-2007	2	8
Ireland	1999-2007	1	9
Italy	1998-2007	5	50
Japan	1997-2007	5	55
New Zealand	2003-2007	5	25
Norway	2004-2007	4	16
Portugal	1999-2007	6	54
Sweden	2001-2007	5	35
Switzerland	2002-2007	3	18
Netherlands	1997-2007	6	66
United Kingdom	1992-2007	21	357
USA	1997-2007	12	132
Emerging countries			
Bangladesh	2004-2007	1	4
Brasil	1999-2007	3	27
Bulgaria	2007	1	1
China	2001-2007	2	14
Cipru	2002-2007	3	18
Czech Republic	2001-2007	2	14
Estonia	2006-2007	1	2
Greece	1999-2007	2	18
Hungary	2002-2007	2	12
India	1998-2007	3	30
Indonesia	2000-2007	3	24
Jamaica	2005-2007	3	9
Latvia	2005-2007	1	3
Lithuania	2003-2007	1	5
Mexico	1999-2007	1	9
Peru	2001-2007	2	14
Poland	2002-2007	4	24
Romania	2000-2007	2	16

Russia	2002-2007	1	6
Turkey	2003-2007	1	5
Ukraine	2003-2007	1	5

Source: European Corporate Governance Institute, "Index of all codes", http://www.ecgi.org

There appear to have been improvements in establishing principles and codes that regularize corporate governance in a few emerging countries (Poland, Brasil, India etc). This suggests a tendency toward convergence in corporate governance quality across emerging countries. Most of the emerging countries are at the beginning of the developing corporate governance framework process.

Countries that have developed a solid institutional environment can generally offer an effective legal framework. Nevertheless, good laws on the books are not enough to guarantee the effectiveness of a system. The corporate environment needs to be coupled with a corporate governance framework in line with international standards and with an effective civil and/or administrative procedural framework.

Corporate Governance Principles and Practice in Romania

Romania has two distinct trading systems, which were merging in 2004. The Bucharest Stock Exchange (BSE), founded in 1995, is Romania's primary stock exchange. The secondary stock exchange is RASDAQ, founded in 1994.

Romania's corporate governance framework is based on civil law, although securities legislation has been influenced by common law. Law 31/1990 (Company Law) was most recently amended in 2003 and sets the framework for all company forms. Only joint stock companies may be publicly held, and all publicly held companies must be quoted on a regulated market. The Capital Market Law (Law 297 of 2004) sets the basic rules for the equity market. Enhancements to the securities laws since 2002 have significantly improved investor protection for shareholders of publicly-held companies.

The securities regulator (CNVM), supervises the activities of the stock exchanges, financial intermediaries, enforces disclosure requirements and insider trading laws, and oversees takeovers. As an independent agency, CNVM may issue legally binding regulations. CNVM has administrative powers, including the authority to impose fines. CNVM has recently placed a higher priority on corporate governance reform. In 2003, the number of issuers sanctioned for failing to comply with disclosure regulations rose significantly, owing to greater CNVM enforcement efforts. CNVM is self-funded, but its budget must be approved by Parliament. It has approximately 199 employees; the pay scale is low compared to the private sector. The CNVM has relatively strong authority over supervised and licensed entities (brokers), but more limited authority over securities issuers, and has no general duty to protect shareholder rights.

Ownership is consolidating, and the number of listed companies is declining based of following reason:

- the tender offers,
- withdrew from the markets following bankruptcy or mergers,

- delisted because of takeovers by international strategic investors.

Romania’s corporate ownership structure is a legacy of the privatization program of the mid-1990s. Listed companies are mostly companies that have been privatized. Initially, their ownership structure was dispersed. Today, most listed companies have one or more controlling shareholders.

My evaluation of corporate governance for Romania (the analysis of the existent framework of corporate governance through corporate governance principles) and other analysis highlighted a series of recommendations:

The Legal Framework

The accent is put on the application of existent laws. It is essential that discard exceptions from privatization programs and privatized companies. The transactions operated by insiders must be published. Other recommendations are:

- The clarification of managers’ tasks, functions, responsibilities and obligations;
- The authorization of the employment of an outside auditor by the stakeholders through Commercial Societies’ Law;
- The establishment of a minimum number for board of directors (administration council);
- The extension of corporation's board authority in order to include the analysis of financial statements;
- The change of censors’ role (censors – independent members of corporation's board taking the form of audit committee);
- The clear demand for board of directors members to act with the needed attention and diligence and in the companies’ interests;
- The disassociation of the general manager function from that of corporation's board President;
- The requirement that sales and assets’ transfer should be realized at market prices also in the case of affiliated or connected parties;
- Stakeholders’ meeting will appoint external auditors for the company;
- The enlargement of property’s definition in order to include the relations of indirect control (in the Law of stocks and shares);
- The requirement of the announcement of direct or indirect control relations;
- The requirement that insiders of a company should announce their sales and purchases of shares.

The Institutional Framework

CNVM (Stocks and Shares National Commission) should focus on following information’s transparency and the implementation of international accounting standards by the companies. It is crucial to apply the CNVM jurisdiction for all the listed companies, including those from RASDAQ (secondary financial market) and clarify status for the latter (that implies obligations of transparency and protection of stakeholders’ rights).

Voluntary/Private Initiatives

One of important action is the updating of Corporate Governance Code, with a focus on some problems regarding the functioning of the corporation's board, in correlation with changes of Commercial Societies' Law. The Code has to include recommendations of good practices regarding the independence, the functionality and the work procedures of corporation's board. The Code has to be voluntary, being followed by the companies, as a condition for their listing to the stock exchange; an Institute of Administrators (through Bucharest Stock Exchange) should offer training (for managers, administrators and judges), accreditation, disseminate good practices and participate at the dialogue between the public and the private sectors.

Also Bucharest Stock Exchange initiated a Corporate Governance Institute (2003) that sets itself to develop information and formation activities regarding corporate governance standards. The official launch of "BSE Corporate Governance Institute" took place in June 2005. Previously, BSE established the PLUS Tier at the Stock Exchange at which companies that had adopted Corporate Governance Code of BSE (included in BSE Regulation no. 3) are listed.

This procedure will be changed with the proposal of voluntary adherence to the set of principles regarding corporate governance with total or partial acceptance. Even in these new conditions the implementation of corporate governance standards by the Romanian companies won't be total and immediate but gradual.

Conclusion

The crusade to institute rigorous corporate governance is not over once these key political and economic institutions are in place. Well-designed, well-functioning institutions can only enforce existing corporate governance guidelines and codes. If these guidelines or codes fail to address key corporate governance issues, even the best institutions will be unable to offer solutions. Many codes, including the OECD principles, fail to address some corporate governance issues. A crucial weakness of existing guidelines is that the rules do not apply to all corporations equally. The guidelines, for example, do not apply to unlisted corporations many of which are family-owned. Yet family-owned companies dominate many developing country economies and figure prominently in certain developed economies as well.

In order to be effective, existing guidelines need to be supplemented to address these types of corporate governance issues as well.

In Romania a working group reviewed global best practices, assessed Romanian corporate governance legislation and practices, and then developed a corporate governance strategy for Romania entitled, Blueprint for Action. Parts of the code were adopted by the Bucharest Stock Exchange. Afterwards Bucharest Stock Exchange has created a Corporate Governance Institute for development of own corporate governance code.

The most important conclusion of this paper is that the extent of legal reform in these areas of the law has been impressive. In fact, many of the emerging countries can today boast higher levels of investor rights protection than some of the most developed market economies. Yet, the development of the law has not been matched so far by the development of financial markets. Improving the law in such an environment is at best a partial solution, but will not be rewarded unless a commitment to rule-based governance of markets is made credible.

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