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# CORPORATE GOVERNANCE

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## 1. Introduction

Corporations play an important role in the economy. Corporations create jobs, generate tax income, produce a wide variety of goods and services at reasonable prices, and increasingly manage our savings and secure our retirement income. Therefore, a nation's competitiveness and wealth depends on the competitive nature of its corporations.

Corporate governance is concerned with the institutions that influence the ways in which business corporations allocate resources and returns. Corporate governance is important for business enterprises because it both enables and proscribes strategic decisions concerning the types of investments they should make and to whom the returns on these investments should be distributed. Corporate governance is also important for national economies, because of the central role of corporations in the allocation of resources and returns on national and international levels.

Corporate governance is only part of the larger economic context in which firms operate. It includes, for example, macroeconomic policies and the degree of competition in product. 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 long-term success of a company.

The burst of the "bubble economy" in Japan, the Asian and Russian financial crises, the notable monitoring failures by German universal banks, and the more recent events starting with Enron scandal and following with a series of revelations of companies misrepresenting their financial statements have made clear to countries around the world why the issues of transparency and accountability in corporate governance are so important to investor confidence and to overall national economic performance.

In developing countries, the issue of corporate governance is even more important because of the weak legal system, which cannot effectively enforce contracts and resolve disputes, poor quality of information that prevents effective monitoring and widespread corruption and mistrust. Recently emerged law and finance literature has highlighted the importance of investor protection for development of financial markets and firms' access to finance.

Corporate Governance structures are relevant to economic efficiency particularly in developing economies, due to their influence over the decision of investors to provide finance – equity or debt – to the firm. The finance will not flow to the firms if investors cannot be assured of their return. The main benefit of improving corporate governance is increase availability of cheaper sources of finance, fundamental for firms in developing countries.

It is evident that Corporate Governance is a very broad subject and could enclose a wide range of issues, thus some definitions of the term "Corporate Governance" are given, from a narrow to a wider perspective. Then, this study focus on the connections between the financial market and the development of the structure of corporate governance, firstly describing the evolution and differences between major countries, primarily the United States, United Kingdom, Germany, and Japan, since they have some of the best corporate governance systems in the world. The intention is to suggest how the types of finance used by firms, considering the historical/cultural aspects may influence enterprise corporate governance characteristics.

Throughout this paper, the focus is on large firms with share capital, since such firms have been the main areas of interest in the finance, corporate governance, and public policy debates.

In the next section, the Brazilian perspective is shown, describing the evolution of its financial market, characteristics of its corporations and finally reforms and policy recommendations are given.

In the following section, a suggestion of best practice is outlined, on the basis of the studies developed by OECD and World Bank. Lastly some broad conclusions are drawn.

## 2.Definitions

As the concept of corporate governance is difficult to define, because it potentially covers a large number of distinct economic phenomena, a few of the different definitions are listed below to give a broader view of this subject.

1. "Corporate governance is the system by which business corporations are directed and controlled. 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", **OECD (**Organization for Economic Co-operation and Development) April 1999. OECD's definition is consistent with the one presented by Cadbury [1992, page 15].

2. "Corporate governance is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of retur n", Mathiesen [2002].

3. “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment,” The Journal of Finance, Shleifer and Vishny [1997, page 737].

4. "Corporate governance - which can be defined narrowly as the relationship of a company to its shareholders or, more broadly, as its relationship to society -….", from an article in Financial Times [1997].

5. "Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, president of the Word bank, as quoted by an article in Financial Times, June 21, 1999.

6. "Some commentators take too narrow a view, and say it (corporate governance) is the fancy term for the way in which directors and auditors handle their responsibilities towards shareholders. Others use the expression as if it were synonymous with shareholder democracy. Corporate governance is a topic recently conceived, as yet ill-defined, and consequently blurred at the edges corporate governance as a subject, as an objective, or as a regime to be followed for the good of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy" Maw et al. [1994, page 1].

As we can see, the term corporate governance is often used narrowly to cover the structure and functioning of boards of directors and the formal systems of accountability of senior managers to shareholders. In this paper, corporate governance is defined more broadly to cover the whole relationship between owners, managers, and other groups or stakeholders with an interest in the firm. It is therefore concerned with who controls the firm and how that control is exercised.

A good corporate governance regime helps to assure that corporations use their capital efficiently. Good corporate governance helps, too, to ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate, and that their boards are accountable to the company and the shareholders. This, in turn, helps to assure that corporations operate for the benefit of society as a whole. It helps to maintain the confidence of investors – both foreign and domestic – and to attract more “patient”, long-term capital.

## 3. Corporate Governance and Financial Markets

There has recently been a growing interest in financial markets and corporate governance among both academic analysts and within popular and political debate. The interest in financial markets may well attest to the so-called globalization of such markets, greater competition within them, and fears of financial market instabilities. Questions of company performance and allegations of corporate wrongdoing have in part influenced a similar growth in interest in corporate governance.

Enterprise social policies and initiatives are of various kinds. First, one may distinguish between internal and external activities. Internal policies refer to employment, training, and welfare measures undertaken by organizations for their own employees. This is the traditional area of enterprise social or human resource policy. Such policies may be benign and have positive effects or they may be less benign and have more deleterious consequences. By contrast, external initiatives are those measures which are undertaken by enterprises for actors outside the organization and within the broader community. These can be either individuals, groups, or other organizations. Individuals and groups are usually to be found within the localities where the firm operates. Outside organizations include business partners and subcontractors, suppliers, customers, and other usually smaller companies; initiatives might also extend to local and national community groups such as schools and voluntary organizations such as charities. Broadly speaking, internal policies are mainly concerned with the firm's own human capital; external initiatives have more of an effect on broader social capital (Putnam, 1995).

Financial markets as defined in this paper are conceived somewhat narrowly to cover how firms raise financial resources and how they reward those who provide such resources. The role of currency markets, futures, and derivatives markets is therefore largely excluded from the current analysis. Although we do not deal explicitly with movements in interest rates, the cost of capital is obviously important since this will have an effect on the financing decisions made by the firm.

In terms of capital structure, large firms may acquire investment and working capital in any one or a mixture of three ways: by drawing on retained earnings out of current cash-flow; by borrowing money from individuals, banks, and other companies; and by issuing share equity.

Traditional finance theory views these sources of capital as standing in a hierarchy of preferences for firms (Modigliani and Miller 1958; Hart 1995a). Retained earnings are the most attractive source of finance to the firm, since in principle the direct cost of capital is zero (though there may well be opportunity costs). For owners of share capital, it can lead to a net increase in the value of the firm. Since capital gains taxation is typically less onerous than income tax on dividends, shareholders may prefer that investment is financed this way. Debt is the next preferred option, since, although interest payments reduce earnings and may lead to financial distress, they can be set against corporate taxation. The least attractive option tends to be equity, since the net earnings upon which dividend payments are drawn are usually subject to taxation. Furthermore, the holders of shares are taxed on the dividends received, so in effect dividend earnings are taxed twice. However, a countervailing attraction of equity finance is that dividend payments, unlike debt servicing, are voluntary. Given these costs and benefits, corporate finance theory has traditionally suggested that debt-equity ratios have been a function of a trade-off between the lower tax cost of debt and the higher risk of financial distress associated with debt (Blair, 1995: 37).

Each type of financing is intertwined with corporate governance issues, as each impinges on managerial decision-making. The use of retained earnings as a source of capital provides managements with greatest control, since in effect they are suppliers of their own capital and are able to determine the level of returns. By contrast, debt exerts discipline on management. As Hart puts it, 'debt limits how inefficient management can be, at least if management wants to repay its debt' (1995b: 685). However, debt does not usually provide explicit rights per se to lenders in relation to either residual earnings or control. Instead lenders typically have a prior claim on the assets of the firm in last resort. The power of lenders to influence management is therefore essentially indirect, though of course lenders may attach conditions to loans. Debt can thereby underpin an implicit dependency relationship, with substantial lenders acquiring an informal say in management decisions.

The fact that the lender clearly has an interest in the performance of the firm over the lifetime of the debt may facilitate long-term relationships in certain circumstances. In Germany, for instance, long-term lending has facilitated intimate relationships between firms and banks, with substantial flows of corporate information to the latter. In turn this provides banks with the knowledge, motivation, and authority to influence management decision-making (Charkham 1994a: 43).

Equity finance also has disciplinary powers, subject to possible weaknesses in the principal-agent relationship to be discussed below. The successful issue and subsequent re-sale of shares requires that the prospects for the firm are reasonable either in the short or long term (depending on investor preferences). In contrast to debt finance, equity investors are usually residual claimants, with their returns being dividends financed out of profits, or gains in stock value, or a combination of the two. Since there is a higher degree of risk associated with the provision of equity finance, investors typically acquire some control rights. In practice, in Anglo-Saxon countries, these tend to be minimal. They usually provide share-owners with the power to vote periodically on board composition, to attend and vote at annual general meetings, and to vote on the acceptance of company accounts. In the corporate governance literature, it has usually been argued that in reality control rights are more effectively exercised via the power to dispose of the shares (the 'Wall Street Walk'). In this way, equity finance feeds into the market for corporate control, since there is the possibility that new owners may acquire sufficient holdings to obtain effective control and to replace the incumbent management (Manne, 1965). Fear of this leads the incumbent management to incorporate the interests of current owners in management decisions.

Turning to corporate governance, the starting point for any analysis is the growth of giant firms and the beginning of the separation of ownership and control from the late nineteenth century onwards. From that date, in certain countries such as the United States and United Kingdom, the capital requirements of large firms meant that individual or family owners have increasingly been superseded by a much larger group of stock-holders. Simultaneously, the size and complexity of managing such firms has led to the emergence of a cadre of professional managers distinct from the suppliers of capital. It has long been suggested that the interests of these two groups may well differ (Berle and Means, 1932).

In recent times, analysis of the relationship between these groups has been approached primarily through the medium of agency theory. Viewing owners as principals and managers as their agents, analysis has focused on the problems which principals have in ensuring that agents function in the desired manner. Two sets of governance problems have been identified in this literature. The first revolves around **the costs of monitoring managerial behavior.** Monitoring problems arise because there are typically too many shareholders to exercise daily control of the

large corporation (Hart, 1995b). There is little incentive for any one shareholder actively to check the day-to-day actions of managers, because monitoring is essentially a public good and any gains will be shared with all other shareholders. Thus, there is a powerful incentive for shareholders to free-ride on the efforts of others. Information asymmetries compound this problem, since managers are likely to have greater access to relevant information than owners and can manipulate information to their advantage. The second problem follows from the first and relates to the provision of appropriate incentives to align agents' behavior with principals' interests

As managers do not have access to residual earnings, managerial incentives derive from other sources. Typically, it is thought that managers attemp t to satisfy their promotional and income maximization objectives by seeking to increase the size of the firm (given the tendency for managerial pay to correlate with company size). Thus, the possibility exists that managerial strategies may take the firm beyond its optimal size and into activities which reduce profitability or otherwise diverge from the interests of shareholders (Williamson 1964; Marris 1964). There are also problems where, if the interests of principals and agents are well aligned, other stakeholders may be excluded from economic benefits.

### 3.1 DIFFERENT NATIONAL SYSTEMS

Having considered some basic features of financial markets and corporate governance, we now turn to how these differ between national systems.

In the United States, traditionally capital requirements of large firms were mainly met by retained earnings. Until the 1980s, managers were wary of debt finance, in part because of fears of excessive bank power (Donaldson 1994; Roe 1994). Those writing from an agency perspective see this aversion to debt finance as a way of evading constraints on managerial discretion (Hart, 1995a). Equity issues meanwhile were used mainly to finance acquisitions of other firms. The modern development of equity finance was therefore closely intertwined with diversification strategies in the 1960s and 1970s (Donaldson, 1994). In the 1980s, however, the use of debt grew substantially in the form of leveraged buy-outs and other restructuring transactions. This restructuring was viewed by some as a reaction to earlier managerial strategies of 'excessive' growth via merger and acquisitions (Jensen, 1993). In the United Kingdom, a traditional aversion to debt is often attributed to the high cost of loan finance, emanating from a reluctance of City financiers to provide long-term capital to industry (Hutton, 1995; Scott, 1997).

This, it is argued, has led to a reliance on equity finance to supplement the use of retained earnings.

By contrast, in Germany, there is much greater use of debt finance provided by banks and other companies. A high proportion of large companies are privately rather than publicly-owned. This is reflected in market capitalization rates. Thus, in the early 1990s, stock market capitalization in Germany as a proportion of GDP was only 29 per cent compared with 65 per cent in the United States and 112 per cent in the United Kingdom (Clarke and Bostock 1997: 235). As a result, governance structures have been different in Germany, with major bank lenders typically acquiring seats on supervisory boards of industrial firms. In addition, the voting rights attached to equity shares held by banks on behalf of investors accrue to the banks, thus entrenching the power of lender institutions. A further difference between Germany and both the United States and United Kingdom has been a much greater emphasis on company expansion through organic growth. This orientation to growth has meant that large and sudden injections of capital, which at various times have propelled major expansions of equity markets in the United States and United Kingdom, have been less in demand.

Japan shares some important capital market features with the United States and United Kingdom. There are a large number of publicly-listed firms and stock market capitalization rate is 125 per cent of GDP (Clarke and Bostock 1997: 235). However, it has more significant features in common with Germany. A significant proportion of shares in large firms are held by banks and other firms; firms have tended to grow organically, drawing on retained earnings and on long-term funds from banks and other firms; and there is no significant market in corporate control.

In terms of equity ownership, in the United States, the traditional pattern has been one of highly dispersed ownership. Typically, the largest shareholders in a company have only a small proportion of equity. In part, this dispersal of ownership stems from legal regulations designed to protect the interests of small private investors relative to those of financial institutions and to preserve the security of the financial system (Blair 1995). In the United Kingdom, the role of small private investors in equity markets has been in decline for many years and financial institutions have come to occupy the dominant role in such markets. However, such institutions seek a diversified portfolio and hence own only a small proportion of each company's stock. In Germany and Japan, as already stated, the holding of large stocks by a relatively small number of major investors has been a traditional feature of the financial system.

Recently there have been some changes in the Anglo-American structure of equity ownership in the direction of concentration.

Institutional investment has come to dominate at the expense of private shareholders, though households are still substantial investors in the United States. Such institutional dominance has been most marked in the United Kingdom, where over 60 per cent of equity shares are held by financial institutions, compared with 48 per cent in Japan, 29 per cent in Germany, 11.3 per cent in Italy, and 6.5 per cent in France. Within these structures, there are also differences in the balance of institutional investment. In the United Kingdom and United States, pension funds and insurance companies occupy a central role, whereas banks play a relatively minor role in equity markets. In Germany and Japan, by contrast, banks are very significant holders of equity capital.

An important differentiating feature between Anglo-American and other financial markets resides in pension provision. In both the United Kingdom and United States, pension funds are not usually managed directly by the firm but are held by trustees with a fiduciary duty to manage them in employees' long-term interests. This typically precludes significant investment in the firm itself as this is seen as generating an unacceptable level of risk. Indeed, in the wake of recent scandals, regulations distancing the firm from the management of pension funds have become more stringent. Pension funds typically contract the management of their assets to specialist fund managers. In turn, given their fiduciary responsibility, the primary objective of such managers is to maximize returns, and monitoring is typically based on quarterly performance. Fierce competition between fund managers leads to pressure to achieve high short-term returns (Sykes, 1994).

The situation is different in other countries. In Germany, pension contributions are typically held within firms as retained earnings and substantial proportions of them are used for investment in the firm. In Japan, pensions are also paid out of retained earnings and are not placed in funds, which invest in equity markets.

Although institutional investors play a dominant role in the United States and United Kingdom systems, the ownership stakes of any individual investor tend to be insufficiently large to promote any identity with the long-term development of the firm. Frequently the investment in any particular firm will be part of a 'balanced portfolio', with the possibility that ownership can be transferred to other firms in the event that the returns from the initial firm fail to meet the investor's objectives. Thus, the current structure of ownership in the United States and United Kingdom would seem to provide owners of publicly-listed firms with a high degree of influence, but this influence focuses primarily on stock market returns and is exerted through the market for corporate control. As is commonly remarked in the literature, influence is achieved through 'exit' rather than 'voice' (Blair 1995; Keasey, Thompson, and Wright 1997).

By way of final comments on the finance literature, it is relevant to note that two main forms of investor behavior have been deduced from the above (Charkham, 1994b). Type A investors concentrate on a small number of stocks, tend to maintain large holdings over a long period of time, and take considerable interest in the internal management of firms. Type B investors hold diversified portfolios, with a relatively small number of shares in each company, are primarily interested in short-term returns, and have little interest in active governance. Drawing on the arguments outlined earlier, we might expect Type A owners to display an interest in social initiatives, either internal or external. By contrast, Type B owners are likely to exhibit little interest in such matters, other than in key outcomes, and only then in so far as these affect asset management.

Pulling together various dimensions of financial markets and corporate governance, some commentators have attempted to develop broad classifications of systems. A suggestive typology distinguishes between 'market' and 'relational' methods of financing and between 'outsider' and 'insider' methods of governance (Mayer, 1990). The market model is one where the firm raises a significant proportion of its capital from equity markets. These shares have voting power and are widely dispersed. This creates a decentralized 'outsider' system of governance where control and monitoring of the firm is market-based, with performance in terms of share price and dividends being a crucial factor in judging the firm's performance. Under such a system, good performance by senior management is rewarded by their survival at the top of the firm and by higher salaries and benefits; poor performance is punished by the risk of take-over and dismissal. Under such an outsider system, there is thus an active corporate control market, with firms or parts of firms being bought and sold.

By contrast, the 'relational' model is one where ownership is less dispersed, with extensive individual or family, bank, and inter-corporate shareholdings. In such a case, there is a less active equities market and less of a market in corporate control. Governance and monitoring of the firm's performance take on more of an 'insider' form, with representatives of families or banks or other firms sitting on the company's board.

### 3.2 EVIDENCE FROM NATIONAL SYSTEMS

Linkages between financial systems, corporate governance, and enterprise social policy and initiatives may be investigated historically and contemporaneously, at a micro or systemic level, within one country or across countries.

In the United States and United Kingdom, two broad periods may be discerned. In the first period up to the early 1970s, capital requirements of large firms were satisfied mainly by retained earnings and, to a more limited extent, by equity finance. There was a long-term shift away from private towards institutional ownership, but ownership was sufficiently dispersed and shareholder activity sufficiently quiescent to allow for effective managerial control of large enterprises.

This allowed for investment in human capital and the growth of internal labor market-type arrangements, with labor being treated as a quasi-fixed cost (Donaldson, 1994). According to Cappelli et al, firms developed a psychological contract with their employees in which the employer's investment in employment development and job security was repaid by employee loyalty and performance (1997: 38). In the second period, the two Anglo-Saxon countries moved away from financial self-sufficiency and towards more equity-based systems, partly to finance expansion by merger and acquisition. Later, shareholder reactions to the declining performance of large conglomerates led to major restructuring in the 1980s and 1990s.

The market for corporate control became much more intense, with a very high level of take-over activity. At the same time, new forms of ownership developed, financed by innovative methods of short-term debt financing (e.g. junk bonds).

Coupled with continuing consolidation of the role of institutional investors, ownership interests were able to exert a greater degree of influence on the management of firms. As a result, in the United States and United Kingdom, internal labor market-type arrangements started to come under pressure, with labor being treated more as a variable cost and with low levels of investment in human capital.

By contrast, in Germany, finance and governance systems have for a long time been relationship-orientated and based on insider arrangements. As a result, financial market pressures are less strong on firms. This in part explains the development and persistence of strong internal labor markets, with more in-house training, longer job tenures, and greater job security. This is not to say that financial pressures are absent. The presence of banks on supervisory boards means that financial interests operate in close proximity to the management of the firm. However, these institutions tend to view their interests and those of the firm as essentially intertwined rather than potentially contradictory. In Japan, there has also been more reliance on long-term borrowing and on insider governance arrangements. This in turn facilitated the growth of long-term employment, in-house training, and seniority-based pay systems over the postwar period. It has been suggested that close banking relationships mitigate the agency problems found in arms-length relationships in equity-based capital markets with the result that such firms have been less prone to cut investment when there are cash-flow shortfalls (Bolton and Scharfstein 1998: 106). In both Germany and Japan, less use is made of short-term performance related pay, and wage dispersion within the enterprise is less than in the Anglo-Saxon countries (Aoki, 1994).

At the present time, the conventional wisdom is that there are major pressures on the German and Japanese financing and governance systems which may move them more in an

Anglo-Saxon direction. Thus, there is a growth of equity market pressures and some loosening of long-term lender relationships in both countries. These may be significant factors making for changes in their systems e.g. for a weakening of internal labor markets and a strengthening of firm-specific industrial relations.

However, change is slow and uneven. There may also be some less powerful pressures on the American and British systems making for stronger insider governance. In the United States, both Useem (1993) and Blair (1995) have shown how managers have been able to resist shareholder pressures and in some states have been able to secure legislation which has constrained the market for corporate control. In both countries, there have been pressures for greater involvement of institutional investors in governance by making it mandatory for them to exercise their voting powers. As institutional investors come to occupy a larger role in financial systems, their fortunes may become dependent on those of companies in their portfolio with the result that exit becomes a less viable approach to governance. Such developments would have important implications for internal and external social policies.

## 4.Brazil Perspective

A major concern for emerging economies like Brazil is the availability of long-term finance, at competitive rates, for private-sector development. The lack of such finances is widely considered an important handicap for the competitiveness of Brazilian industry, especially in those sectors dominated by locally owned enterprises that face greater difficulty accessing foreign capital markets. The problem of finance for private-sector development became acute in the 1980s when the State could no longer provide enough funding. The crisis of Brazilian public finance, which is still severe today, increased the need for private sources of long-term finance.

The Brazilian banking sector, long accustomed to very high interest rates, has never been able to provide long-term credit for industrial development, and it is doubtful that the lowering of interest rates will lead banks to show interest for this kind of risk. Local capital markets are also quite underdeveloped, particularly in the area of equity finance. Since the early 1980s, local business groups have thus been relying practically entirely on retained earnings and (when macroeconomic conditions allow) on foreign capital markets to finance growth.

Finance is the main link between corporate governance and economic development. It is often argued that improved governance structures foster local capital-market development and thus provide the private sector greater access to long-term funding. While we agree in principle with this thesis, the cause-effect relationship is probably not as direct as one might wish. This part of the paper provides clear evidence that there is considerable scope for the expropriation of minority shareholders in Brazil's system of corporate governance. As a result, investors may be less willing to provide equity. It is therefore to be hoped that the improvement of the legal and institutional framework that regulates the relationships of minority shareholders and lenders with controlling shareholders of corporations will foster the development of local capital markets.

The recent approval in the lower chamber of the Brazilian Congress of a new Corporate Law, granting greater protection to minority shareholders, is evidence that this discussion has gained importance in the business and political communities. The São Paulo Stock Exchange (BOVESPA) has also recently introduced a structure very similar to that of the German *Neue Markt* in the hope of stimulating Brazilian firms to adopt better government practices. Another benefit of an adequate corporate-governance system may be greater efficiency in the allocation of resources in the economy.

Ownership concentration is quite high in Brazil and most large Brazilian-owned corporations are under family control. This structure hinders the effect of market discipline on managerial turnover (particularly in the case of corporations that are owner-managed) thereby allowing sub-optimal managerial practices to persist longer than would occur in a system where capital markets exert stronger signals.

The recent histories of many large Brazilian family-owned and -managed business groups illustrate well the difficulty of removing owner-managers that are clearly destroying value. Another harmful practice is to allocate resources in a manner that favors the private interests of controlling owner-managers at the expense of the corporation.

The privatization process initiated in the early 1990s, the growing role and activism of institutional investors (pension funds) and the influx of foreign capital in the Stock Exchange were expected to produce important effects in Brazilian corporate governance. The new arrangements that emerged in this process continued to be characterized by a high degree of ownership concentration, although control in some privatized firms is shared among a small group of shareholders (family-controlled business groups, pension funds and local and foreign investment funds). In many cases where the privatized firm was acquired by a multinational company, a process of buying the remaining shares from minority shareholders followed, reducing the liquidity of the firm's shares in the market. Foreign investors generally avoided adopting a more activist stance, probably afraid of the complicated and inefficient Brazilian legal system.

We must deal now with the main obstacles to changes in the Brazilian corporate governance system. Given the relatively high degree of minority shareholder expropriation it follows that private benefits of control are sizeable. In the few cases that we could analyze, it was clear that the selling of control blocks of shares carries important premiums. It is not clear, therefore, if the promise of greater access to long term funding sources will entice controlling shareholders to grant more rights to minority shareholders. The long period of time and the concessions required for the approval of Brazil's new corporate law clearly attest to the importance of resistances to change in the structure of corporate governance in Brazil.

Another important obstacle is the nature of Brazil's legal system. All administrative processes judged by the local securities exchange commission (CVM) may be brought to courts, where a final resolution is always long, and frequently costly. The ability of CVM effectively to monitor capital markets is hampered by a lack of appropriate funding and staff. The new corporate law seeks to correct these matters, and also grants CVM enlarged autonomy.

The stabilization of the Brazilian economy following the 1994 Real Plan has been crucial in the development of better corporate governance. However, the high vulnerability of Brazil's balance of payments does not yet allow for solid long-term macroeconomic perspectives, with much lower and stable interest rates, which would provide conditions necessary for the growth of capital markets. Such a scenario, if it emerged, would stimulate the development of long-term savings vehicles, particularly the private pensions industry. As in many other countries, pension funds tend to play an important role in local capital markets and, given their sheer size, are able to develop a better monitoring structure over corporate-sector performance than small investors. A positive sign has been the large issue of corporate bonds in the first months of 2001with longer maturity periods.

The fact that Brazilian corporations had to pay higher capital costs undoubtedly put them at competitive disadvantage *vis-a-vis* their competitors, and this certainly was an important driving factor both of the poor performance of large Brazilian firms and of the process of denationalization in the 1990s.

The second half of the 1990s also witnessed the speeding-up of the privatization program, which created a number of opportunities to enhance corporate governance structures. While the Brazilian State historically played a major role in the development of basic infrastructure (electricity, telecommunications, transportation) and of basic capital-intensive industries (steel, mining, petrochemicals) through State enterprises, the debt crisis of the 1980s over burdened these state-owned firms and rendered them dysfunctional in terms of capital accumulation.

**4.1 CAPITAL MARKETS, CORPORATE GOVERNANCE AND ECONOMIC DEVELOPMENT**

One must also today reinstate the question of the relevance of stock market development for the Brazilian economy. Should the growth of capital markets be a major issue for public policy, and which measures might foster this growth? There is a respectable literature arguing that financial development positively affects economic growth (King and Levine, 1993; Levine and Zervos, 1998; Rajan and Zingales). LaPorta et al. (1999), citing some more recent research

(Beck et al., 2000 and Morck et al., 2000), list three channels through which a broader finance base can contribute to growth: saving, factor accumulation, and efficiency improvements.

An efficient stock market can be an important component of financial development. Local stock markets could be particularly important when it comes to providing capital to indigenous emerging firms and to technology-based enterprises (including biotechnology). Knowledge and expertise about the potential of these firms certainly requires the existence of local financial institutions and a national capital market that are able to perceive and support such opportunities.

One might posit that the growing use of foreign stock markets by Brazilian firms could eventually replace the need for a local stock market. In fact, many Brazilian firms are issuing ADRs in the New York Stock Exchange, and recently the Madrid Stock Exchange has allowed Brazilian firms to list their shares directly (without the use of 45 depositary receipts), which makes the process less expensive.

One of Brazil's largest companies, CVRD, is already listed there. But there are two caveats here. One is that informational asymmetries will certainly restrict access to foreign stock markets to a limited number of Brazilian firms; new ventures will have difficulty tapping equity finance in foreign stock exchanges. The other is the question of how much a country without a convertible currency and subject to speculative crisis can depend on foreign sources of finance. These sources are quite volatile, as was clearly shown by the effects of the Mexican, Asian and Russian crisis on international financial flows to Brazil.

A local stock market is also necessary to facilitate the growth of the private pensions industry. Even in countries where pension funds are allowed to invest in foreign assets, the great majority of investments are made in the local market. Recent government measures may foster the growth of private pension assets in the medium run. Efficient governance structures – i.e. effective mechanisms for the protection of the rights of outside investors (shareholders and creditors) -- are also a sine qua non condition for the expansion of the supply of long-term savings and therefore for the development of capital markets. It is basically through its influence on financial development that improved corporate governance will enhance the competitiveness of Brazilian firms.

### 4.2 REFORMS AND POLICY RECOMMENDATIONS

A broad array of reforms and policies would be required to speed up the modernization of corporate-governance rules and practices in Brazil. Proposals for these reforms and policies are listed below:

**a) Legal and regulatory reforms**

Destined to foster capital-market development maybe classified in three categories: (a) increasing the efficiency of the securities exchange commission (CVM); (b) change in the Public Companies Law to enhance the rights and protection of investors and of society's interests; and (c) reform of the judicial system.

Clearly, legal changes are not sufficient to guarantee investor protection. Enforcement mechanism are crucial, and constitute an Achilles' heel in the corporate-governance system of many developing countries.

**b) Improving the Efficiency of Boards**

Brazilian corporate law establishes two types of boards for public companies: a board of administration (the commonly understood "board") and the fiscal board (an audit committee). The audit committee has no veto power over decisions taken by the board; its sole function is to monitor the firm's accounts and to publicly denounce any proven irregularities.

Only shareholders with voting shares can participate in the election of board members. The number of board members and criteria for shareholder representation are established by the firm's statutes. The law, however, establishes some minimum criteria to assure voting rights of minority shareholders. According to the value of the firm's capital contributed by owners, a minimum percentage of shares with voting rights is required to call for a process of multiple voting. In this process, to each share with voting rights is attached a number of votes equal to the number of board members, and the shareholder can concentrate these votes on only one candidate or distribute them among various candidates. The law also establishes minimum requirements for the creation of audit committees. These minimum requirements have just been lowered by CVM. Once the audit committee is created, shareholders with non-voting shares have the right separately to elect one committee member.

Minority shareholders are granted the same right provided they have at least 10% of shares with voting rights. As a result of the dual-class share structure, of Brazilian corporate law, and the prevailing ownership pattern, we have boards where only controlling shareholders are represented. Therefore, boards are very rarely an effective **locus** for the defense of minority shareholders' rights.

**c) Enhancing The Role of Institutional Investors (Pension Funds and Investment Funds)**

A factor that may have a great modernizing effect on governance mechanisms in Brazil is the growth of institutional investors, particularly pension funds (Rabelo, 1998). The scope and effectiveness of pension fund activism is certainly a major issue in the discussion of the future of corporate governance in Brazil.

When we looked at the privatization process it was possible to see the extent of their participation in the control blocks of many important privatized companies. Pension funds are important shareholders and exercise effective governance activity in such companies as Embraer, Perdigão, Parapanema, Acesita and Inepar. Considering that at the end of 1999, Brazilian pension funds had around US$ 60 billion in assets and 30% of this amount was invested in shares, we may say that these funds own approximately 15% of the total value of companies listed in the São Paulo Stock Exchange (Bovespa).

Of the about 358 Brazilian pension funds, 11 of them have stakes in major companies that exceed 5% of voting shares, which makes them major potential actors in corporate governance. The largest of these pension funds is Previ, that has a stated policy to be active in the sphere of corporate governance, always exercising its right to nominate members of boards. In two companies where Previ and other pension funds had significant shareholdings (the aeronautics firm Embraer and the steel firm Acesita), the fund stimulated the sale of important minority stakes (a controlling one in the case of Acesita) to foreign groups, who are important players in their respective sectors. Previ is developing what it considers a model of corporate governance, through which it will monitor the relation between the pension fund, their appointed board members in portfolio firms and the firms. It will be the board members' duty to fill out this control instrument with the required information indicated by the pension fund. Most of these appointed board members are retired employees of the fund's sponsor (Banco do Brasil). In the future, the fund intends to appoint up to 15% of board members from outside the sponsor's ranks. A premise of this model is a policy of respect for minority shareholders, and to demand transparency and disclosure of information from management.

## 5.Best Practices

The Best Practice of Corporate Governance has been issued by many countries (United Kingdon, United States, France, Russia etc), according to each reality and the local needs. In this part of the paper are presented the principles of the OECD (Organization for Economic Co-operation and Development). The OECD groups 30 member countries sharing a commitment to democratic government and the market economy. These principles were chosen because they are very wide-ranging, including the major concerns of all countries.

The Principles presented below were built upon experiences from national initiatives in Member countries and previous work carried out within the OECD, including that of the OECD Business Sector Advisory Group on Corporate Governance. The purpose of the principles is to serve as a reference point.

There is no single model of good corporate governance. At the same time, work carried out in Member countries and within the OECD has identified some common elements that underlie good corporate governance. The principles build on these common elements and are formulated to embrace the different models that exist.

They can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.

The Principles presented cover five areas:

5.1) The rights of shareholders;

5.2) The equitable treatment of shareholders;

5.3) The role of stakeholders;

5.4) Disclosure and transparency; and

5.5) The responsibilities of the board.

## 5.1 THE RIGHTS OF SHAREHOLDERS

**The corporate governance framework should protect shareholders' rights.**

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

**B.** Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:

1) amendments to the statutes, or articles of incorporation or similar governing documents of the company;

2) the authorization of additional shares; and

3) extraordinary transactions that in effect result in the sale of the company.

**C.** Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

2) Opportunity should be provided for shareholders to ask questions of the board and to place items on the agenda at general meetings, subject to reasonable limitations.

3) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

**D.** Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

**E.** Markets for corporate control should be allowed to function in an efficient and transparent manner.

OECD special recommendations

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management from accountability.

**F.** Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting right.

## 5.2 THE EQUITABLE TREATMENT OF SHAREHOLDERS

**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.** All shareholders of the same class should be treated equally.

1) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.

2) Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

3) 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.

**B.** Insider trading and abusive self-dealing should be prohibited.

**C.** Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

### 5.3 THE ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

**The corporate governance framework should recognise 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.**

**A.** The corporate governance framework should assure that the rights of stakeholders that are protected by law are respected.

**B.** Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

**C.** The corporate governance framework should permit performance-enhancing mechanisms for stakeholder participation.

**D.** Where stakeholders participate in the corporate governance process, they should have access to relevant information.

### 5.4 DISCLOSURE AND TRANSPARENCY

**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.**

**A.** Disclosure should include, but not be limited to, material information on:

1) The financial and operating results of the company.

2) Company objectives.

3) Major share ownership and voting rights.

4) Members of the board and key executives, and their remuneration.

5) Material foreseeable risk factors.

6) Material issues regarding employees and other stakeholders.

7) Governance structures and policies.

**B.** Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

**C.** An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

**D.** Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

### 5.5 THE RESPONSIBILITIES OF THE BOARD

**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.**

**A.** Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

**B.** Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

**C.** The board should ensure compliance with applicable law and take into account the interests of stakeholders.

**D.** The board should fulfil certain key functions, including:

1) Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2) Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

3) Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.

4) Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

5) Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.

6) Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.

7) Overseeing the process of disclosure and communications.

**E.** The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.

1) Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.

2) Board members should devote sufficient time to their responsibilities.

**F.** In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.

## 6. Conclusions

The institutions of corporate governance have the objective to enhance performance by creating and maintaining a business environment that motivates managers and entrepreneurs to maximize firms' operational efficiency, returns on investment and long-term productivity growth. They assure corporate conformance with investors' and society's interests and expectations by limiting the abuse of power and avoiding all the damages that the self-serving behavior of managers and insiders can be expected to impose on investors and society in their absence.

The role of government, capital market and institutions of corporate governance is important in the process of development in a country, stimulating sustained productivity growth, through macroeconomic policies, competitiveness degree among products and market factors and improvement of the legal, institutional and regulatory framework.

This paper has sought to perform three main functions. These may be summarized as follows:

Firstly, the paper has highlighted aspects of financial markets and corporate governance systems which may influence the firm's internal and external social policies. In the outer environment, the paper has stressed the nature of capital markets; in the inner environment, it has stressed the corporate governance system of the firm. We do not discount the importance of other factors, such as product and labor markets, the role of the state and trade unions, or differences in national culture, but here we wish to draw attention to the potential importance of the largely neglected factors of capital markets and governance arrangements.

The paper has explored a typology of financial and governance systems in terms of relational-insider and market-outsider systems. These different approaches to finance and governance have plausible consequences for enterprise social activities. In the area of employment relations, this typology can be used to understand such tendencies as long- and short-term approaches to job tenure and training, a tendency to use fixed or variable pay systems, and the size of pay differentials within firms. In the area of external social policies, it can be used to understand the degree of integration of various policies and initiatives into the actual routines and strategies of firms.

For analytical reasons we have focused on the United States and United Kingdom, which tend towards market and outsider systems, and on Germany and Japan, which tend towards relational and insider arrangements. It is hoped that the framework may help discern certain patterns in these countries, while conceding that a more detailed account will introduce nuances stressing diversity within national systems. Other countries may tend towards one or other of the polarities, but will also provide more complex hybrid examples. Nevertheless, taking a long-term perspective, it was tentatively suggested that there appears to be movement towards market and outsider systems, especially in recent years, though to-date this has been slow and uneven.

Secondly, a Brazilian perspective was presented, This study has shown that ownership concentration and the quasi-absolutist exercise of power by family/controlling shareholders is a fundamental characteristic of Brazilian corporate governance structures. The existing ownership structures in Brazil are primarily a response to the domestic legal and macroeconomic environment in which companies operate. It is evident that Brazil has more significant features in common with Germany and Japan, which tend towards relational and insider arrangements.

Throughout the 1980s and 1990s, Brazil witnessed extremely high interest rates and recurrent uncertainty, which virtually eliminated any local source of long-term financing for corporations. It is unquestionable that serious difficulties in tapping adequate sources of finance (which translates into very high capital costs) have hindered the competitiveness and growth of local business groups.

The Brazilian capital market, particularly the stock market, is small and illiquid. Capital market operations account for a small fraction of total financial needs of the private sector. It is currently widely discussed whether changes in legislation would foster development of the stock market. Better disclosure rules and more effective protection to minority shareholders appear to be necessary conditions for the growth of this market.

One should stress that the reform of the Brazilian judicial system, slow and inept, is a sine qua non condition for the effective impact of the new corporate law. Investors, particularly minority investors, undoubtedly need a reliable and speedy justice system in order to feel secure and reassured to engage in capital-market channeled investment opportunities.

Thirdly and lastly, principles of best practices of corporate governance presented by the OECD (Organization for Economic Co-operation and Development) were presented. The purpose of the principles is to serve as a reference point. Many countries have issued their principles according to their economic development and characteristics.

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