

SUMMARY NOTE
Focus group meeting on corporate governance of non-listed companies
2 December 2005
Paris, France

I. Background

The focus group was convened as a follow-up to the International Experts Meeting held in Istanbul in April 2005, which launched the Global Network for Corporate Governance of Non-Listed Companies¹. While the Istanbul meeting greatly contributed to a better understanding of global corporate governance challenges for non-listed companies, participants noted that many corporate governance issues concerning non-listed companies (NLCs) remain unresolved and further discussion/research are necessary in order to assess the conclusions and remarks made at the meeting.

It was suggested in Istanbul that key issues for follow-up, taking into account the diversity in geographic circumstances, should include: (i) the legal/regulatory framework, (ii) transparency and disclosure, as well as (iii) ownership structures and financing. The focus group met in Paris in December 2005 to discuss these issues in order to advance thinking on specific aspects that should be examined in-depth. The ultimate objective is to raise awareness amongst policy-makers on the challenges faced by NLCs and improve the quality/design of public policy to facilitate companies' contribution to investment and economic growth.

II Summary of key issues discussed

A. Developments in the legal and regulatory framework

Participants discussed recent legal and regulatory reforms in some OECD, emerging and developing economies that have an impact on the internal and external framework for corporate governance of NLCs. Reforms are increasingly motivated by macro-economic objectives such as economic growth and the ability to attract investment. Participants noted that improving corporate governance practices of NLCs is not only about improving access to capital, but is also in the general interest of creating incentives to help companies grow.

With respect to hard law, recent reforms seek to raise the competitiveness of companies by providing clear and simple rules as well as favouring flexibility through innovative corporate legal forms. New company law rules aim to: lower transaction costs, improve the structure of corporate relationships, and raise trust/credit worthiness of companies. In some emerging markets, such as India, legal reforms are aimed at promoting sustainability and improved implementation by building broad consensus. As a result of widespread debate, reform is increasingly seen as being built nationally rather than imposed externally. This need for consensus also demonstrates the importance of continued education and awareness raising about the benefits brought by better corporate governance practices.

Participants also discussed recent reforms in soft law, such as the Belgian Code on Corporate Governance of NLCs as well as industry guidelines produced by the European Venture Capital Association (EVCA).

¹ By "non-listed companies", we are referring to closely held companies whose shares, unlike those of publicly held companies do not trade freely in impersonal markets, either because the shares are held by a small number of persons or because they are subject to restrictions that limit their transferability. We have decided to focus on large (relative to their economies) limited liability companies that are by choice unlisted but that have financial stakeholders (equity and/or creditors) beside their controllers.

These voluntary codes aim to provide simple guidelines and emphasise benefits. The process of developing the Belgian Code has served the important purpose of raising awareness of the specific corporate governance issues of NLCs. Also participants in some emerging economies noted that codes for listed companies appear to have attracted a great deal of interest from NLCs, such as in Brazil and Chile where the latter form a vibrant part of the economy. Participants agreed that codes are a useful tool but that they should remain voluntary and used as optimal benchmark, a reference for NLCs.

Participants stressed the importance of encouraging policy-makers to examine the costs and benefits of the rules, which should focus on creating incentives for companies to follow best practices. There was some discussion on what elements should be (i) standardised through the law, (ii) left to contracting or (iii) voluntary self-regulation. Some participants argued that certain core principles of corporate governance in NLCs could be embedded in the law such as the role of independent directors and auditors, committee structures, disclosure requirements to access risk as well as improve reliability of information and minimum protection of shareholder rights, particularly during exit and cases of dispute resolution. But they also stressed that these requirements could, and probably should, vary depending on the size of the company and its corporate form.

Nevertheless, there was scepticism about promulgating more legislation². Rather, participants emphasised the importance of promoting education and awareness of the benefits of better corporate governance practices in NLCs in order to demonstrate incentives for companies, such as for example access to capital, and more competitive companies with growth potential.

A particular challenge for family-owned NLCs is coping with succession, which is often not covered by regulations or codes. Participants noted the importance of adapting corporate governance practices to the specific needs of the company, as part of its own strategic development and life cycle. Instead of regulation, which is difficult to standardise given the diversity of NLC needs, some countries such as Brazil are focusing on developing best practices. Also, disclosure of quality and timely information may alleviate the need for other requirements, especially for locked-in non-controlling shareholders.

B. Transparency and disclosure

Participants discussed what information should be disclosed, why and to whom by NLCs. A key challenge is how to facilitate due diligence by shareholders and creditors in view of selective information.

In terms of what information should be disclosed, participants noted that over the long term, requirements on financial information could be standardised according to IFRS also for NLCs. There was also a debate concerning disclosure of non-financial information on corporate governance issues, which may be difficult to standardise given the diversity of NLC ownership structures and corporate forms. Some participants noted that at a minimum all shareholders should have a right to know what is happening in the company, including its purpose, principal changes, who serves on the board, and remuneration.

Participants noted the benefits and costs of disclosure by NLCs. The benefits include: quality and timely information serves to improve accountability, strategic decision-making, operations and profitability as well as long-term stability of the company. Transparency also promotes trust and can reduce tensions, particularly in family-owned companies. The costs include: producing and auditing information, leaks of sensitive information that may impact competitiveness, as well as loss of privacy that is especially sensitive in family-owned companies. In order to take these concerns into account, participants noted that creative solutions need to be envisaged that would allow for maximum communication with discretion.

²This is particularly important in those jurisdictions where compliance, enforcement and judicial systems are weak.

For example, through designated fora such as family meetings or restricted sites or “trustees” that can be found in audit committees in some countries. Also, new technology may alleviate some costs of disclosure.

Participants discussed the quality of information and importance of a reliable independent audit. A key challenge is verifying the credibility of non-financial information and the true value of forward looking information. Some participants suggested that the audit committee should be a minimum requirement for all NLCs, regardless of their ownership structures. Also, emphasis should be put on raising the standards of professional audits.

Overall, participants agreed that disclosure should be market driven, with increased focus on education and training, using when applicable codes of best practice. It is important that companies understand that quality and timely disclosure can bring a competitive advantage. However, if too many requirements became mandatory this may only cause more window dressing. Some participants stressed that there is no excuse for non-disclosure, even for NLCs, and that it’s the price to pay for limited liability, irrespective of company size.

C. Ownership structures and financing: means to attract cheap capital

NLCs, in some emerging markets like Chile, tend to have higher ownership concentration and rely more heavily on suppliers and bank financing than listed companies. There is also a separation of cash flow from control rights, for example with the presence of pyramids and dual class shares. A key challenge in these firms is investor protection of non-controlling shareholders, where often controlling shareholders can easily misappropriate resources. Participants noted that professional investors and banks are often treated *de facto* as shareholders by NLCs, although the latter prefer not to be involved in boards because of potential conflicts of interest and risk.

III. Conclusions and future direction

Participants agreed that the Global Network on Corporate Governance of NLCs could serve as the “eyes and ears” for policy-makers on the corporate governance needs of NLCs, with the objective to gather global experience on the pitfalls of “over-regulation” and facilitate information gathering/sharing. The Network will develop a checklist/reference document that would raise awareness and inform policymakers on where they can facilitate lowering burdens for NLCs. Participants noted that the process itself of developing this ultimate output is as important as the final product.

In terms of next steps, it was suggested that an effective way to proceed would be to examine on the one hand specific issues that require further research/study and on the other hand benefit from on-going and new initiatives around the world that could in-put to a better understanding of NLCs needs. Maximum use should be made of research by business schools such as Insead and IMD as well as organizations such as the ECGI, the Family Business Network and IFC’s experience via their methodology for assessing corporate governance of NLCs.

The OECD Secretariat, with input from the Focus Group, will prepare a paper providing an overview of initiatives and a first assessment at its next global meeting, to be held in Paris in November 2006. Prior to that, the Proceedings publication compiling papers from the 2005 Istanbul meeting will be published in February 2006 and disseminated to all Istanbul and Roundtable participants.

A. Proposed issues for further study/research

(i) Incentive structures : Examine NLC incentive structures for following good corporate governance practices, looking at the experience to-date with the impact of carrots/sticks on improving corporate

governance in NLC. Some questions to consider include: how to create incentives for NLCs to improve CG, such as strategic advantage, good business strategy, educational effects, why do it? What is the demand-driven aspect by finance providers? What could be the pitfalls of regulatory over reach? Can criteria for 'good CG' be defined for NLCs?

(ii) Dispute resolution/remedies: Examine global experiences on dispute resolution in NLCs, including enforcement capacity. What conflict resolution mechanisms are available, especially in family owned companies? What remedies are available, in particular for non-controlling shareholders?

(iii) Disclosure: Conduct a comparative study of differences in disclosure treatment of listed companies and NLCs. Some questions to consider: what are the merits and costs of disclosure? Who can demand what and from whom in the company? How is selective information handled between different financial stakeholders? What are the truths and fallacies in determining part of "pretexts" in rejecting disclosure requirements? Does the fact that NLCs are so diverse both in their size and corporate form have consequences on the level of disclosure? Is size a determinant of disclosure, should there be a threshold where one can be demanding? May NLCs disclose less than listed firms? In terms of the quality of information, how can the role of independent auditors and the audit committee be reinforced?

(iv) Boards: Examine the role of independent non-executive directors in NLCs and how they contribute to more effective decision-making and accountability. Specific questions to consider: how are conflicts of interest and insider dealings handled, including related party transactions and preferential disclosure? Should this be regulated?

B. New and on-going initiatives

(i) Inventory/case studies of best practice from Latin America – The Latin American Roundtable has included corporate governance of NLCs as a priority area for future work. The Brazilian Institute of Corporate Governance is planning to undertake 15 case studies on corporate governance of NLCs, analysing different situations of firms in order to set best practice. The Roundtable may also oversee a survey or questionnaire that would draw lessons learned and bring this information back to the Global Network of Non-Listed Companies in the fall of 2006.

(ii) Education/training and awareness-raising – Given the need to broaden awareness-raising and education, it is important to follow developments in OECD countries as well as emerging and developing markets to keep a finger on the pulse of both legal/regulatory developments and the needs of NLCs. It would also be useful to stay up-to-date on experiences with the IFC methodology on founder/family – owned (unlisted) companies.