

Institute of
International
Finance, Inc.



*The Global Association
of Financial Institutions*

IFF Equity
Advisory Group

Policies for Corporate

Governance and Transparency

in Emerging Markets

February 2002

PREFACE

Recognizing that fundamental changes in the structure and volume of capital flows to emerging markets have taken place over the past decade, including a shift from debt to equity financing, the Institute of International Finance (IIF) has called for new approaches and policies to create more stable financial systems domestically and strengthen private capital flows. In light of the growing importance of providers of equity capital to emerging markets, the IIF formed the Equity Advisory Group (EAG) in January 2001. This group is a primary vehicle for leading financial firms with portfolio equity positions in emerging markets to strengthen the environment for liquid, resilient capital markets that will help support a stable and rising flow of portfolio and private equity to emerging markets.

The Institute's work on corporate governance has been conducted under the overall guidance of the EAG (whose participants are listed after the Executive Summary). The EAG has helped ensure that the views expressed in this report reflect the judgments of many of the most experienced practitioners in global equity finance today. Experts from more than 25 IIF member firms have participated in this project.

The Working Group on Corporate Governance and Transparency, under the aegis of the EAG, has drawn on the expertise of representatives of leading international asset management firms (listed after the Executive Summary). The purpose of this report is not to create a body of law or a precise set of regulations for transparency and corporate governance. Rather, it should be seen as a set of practical guidelines for good corporate governance from the collective experience and perspective of investors and asset managers in emerging markets. The specific guidelines set forth in this report differ from broader frameworks, such as the OECD Core Principles of Corporate Governance, in that these guidelines are more detailed and aimed at implementation. The Working Group fully recognizes that for some countries the implementation of these guidelines would be more difficult than for others. The Code provides as much flexibility as possible to allow the guidelines to be adapted to each country's individual circumstances while maintaining the essential features of the Governance Code.

The Institute thanks the members of the Working Group, as well as the participants in the EAG and the Board of Directors, for the efforts and advice contributed to and the ideas synthesized in this report. No individual person or institution participating in this effort should necessarily be held responsible for the full set of views set forth here, which seeks to represent a broad consensus of complicated issues that inevitably give rise to an array of perspectives. The Institute will continue to work with its member institutions, emerging market authorities, and others to implement the report's recommendations and improve corporate governance in emerging markets, especially in certain priority markets. ■

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EXECUTIVE SUMMARY

The Working Group on Corporate Governance and Transparency was established in 2001 to develop a practical Code of Corporate Governance Principles from an investor's perspective. The work of the group has been conducted under the overall guidance of the Equity Advisory Group (EAG), composed of senior executives from member financial institutions.

Based on the desire to improve corporate governance in emerging markets and to create a more stable financial environment, the Working Group on Corporate Governance and Transparency has developed a Code of Corporate Governance covering the following broad elements:

- Minority shareholder protection
- Structure and responsibilities of the board of directors
- Accounting and auditing
- Transparency of ownership and control
- The regulatory environment.

The Code is primarily articulated in a matrix (see Appendix) that details recommendations in these five areas. The matrix considers how these elements should be treated in company practices and policies, exchange rules and listing requirements, and security and company law.

The guidelines presented in this report are derived from the issues that the Working Group members see as being particularly important and do not necessarily represent a complete set of guidelines for corporate governance. Nevertheless, if implemented, this practical Code of Corporate Governance would likely contribute to financial sector soundness, growing private sector capital flows, and stronger emerging market growth. In this regard, the Working Group looks forward to engaging emerging market authorities in a dialogue to help improve corporate governance and transparency and advance implementation of the Code.

The Working Group fully recognizes that for some countries the implementation of these guidelines would be more difficult than for others. The Code provides as much flexibility as possible to allow the guidelines to be adapted to each country's individual circumstances while maintaining its essential features. Although historical developments have led to different legal traditions with both stronger and weaker shareholder rights, recent competition for global capital is motivating an increasing number of countries to attract capital by developing better protection for shareholders. The guidelines presented in this report are designed to allow a variety of countries with different legal traditions the opportunity to enhance their system of corporate governance.

Even when good corporate governance principles form a part of company bylaws and are incorporated into security regulations and listing requirements, the principles may have no practical meaning if they are not enforced and observed as part of day-to-day business. The responsibility for good corporate governance lies not only with the company but also with the regulators and investors who must firmly support good principles. The proper functioning of a country's legal system is key to the implementation of corporate governance principles and the protection of shareholder rights. ■



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INTRODUCTION

Fundamental changes in the structure and volume of capital flows to emerging markets over the past decade call for new approaches and policies for creating stable financial systems.

Net flows of private capital to the major emerging market borrowing countries have grown much more rapidly than official flows. Since the early 1990s, net private flows averaged \$170 billion per year, compared with \$30 billion in net official flows. The largest component of private flows has been direct equity investment, which averaged about \$130 billion a year for the past five years. In contrast, nonbank private lending, mostly in the form of net international bond flows, has been steadily declining. Moreover, commercial banks, which accounted for virtually all private lending in the 1980s, received average net repayments of \$11 billion per year for the past five years.

Direct equity investment grew strongly during the 1990s but has plateaued in recent years as privatization has tapered off. In contrast, private portfolio equity investment in emerging markets has declined and has averaged about \$10 billion per year since 1998. Important factors restraining portfolio investment include poor institutional, regulatory, and legal frameworks that have hampered the development of market structure and liquidity and, in turn, dampened investor confidence. In fact, because of these weaknesses, some leading emerging market companies have chosen to delist their shares in local markets and instead list in larger, more established markets. A dramatic illustration of this phenomenon is the fact that one of the most sought after places in the world for listing by publicly traded companies is the United States, which is also one of the most heavily regulated markets when it comes to disclosure and protection of minority shareholders.¹

In January 2001, senior executives from 16 leading fund management firms—holding about \$70 billion in portfolio equity stakes in emerging markets—met to discuss ways of deepening emerging financial markets at the inaugural meeting of the IIF's Equity Advisory Group (EAG). Based on their experience, sound macroeconomic and structural policies are a prerequisite for portfolio equity investment, while good corporate governance and transparency are necessary for long-term financial market depth, performance, and stability. This view has also been supported by recent empirical evidence.² Consequently, good corporate governance and transparency are in the interest of international and domestic investors as well as emerging market authorities that wish to improve market access for their companies and enterprises and lower their cost of capital.

As a first step, the EAG formed the Working Group on Corporate Governance and Transparency to develop a practical Code of Corporate Governance Principles from an investor's perspective. The Working Group believes that governments, regulators, stock exchanges, companies, and securities commissions share a common interest in the development of emerging financial markets. If implemented, a practical Code of Corporate Governance would likely contribute to financial sector soundness, more stable private sector capital flows, and stronger emerging market growth. In this regard, the Working Group looks forward to engaging emerging market authorities in a dialogue to help improve corporate governance and transparency.

¹See Coffee (1999).

²La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000).

This Working Group report seeks to:

- Outline why corporate governance and transparency are important to financial sector development.
- Present some practical elements of good corporate governance from an investor's point of view.
- Provide a checklist for investors, governments, and regulators for evaluating corporate governance in emerging markets. ■

WHY ARE CORPORATE GOVERNANCE AND TRANSPARENCY IMPORTANT?

Before the CEO of Russia's natural-gas monopoly, Gazprom, was fired by Russian President Vladimir Putin in May 2001 and a new team of senior management was installed, the company's managers were under constant suspicion of asset stripping. Shareholder concerns about the competence and trustworthiness of management helped to drive Gazprom's market value to around \$11 billion, less than one quarter of the value of its proven hydrocarbon reserves.

When investors finance firms, whether in Russia, Indonesia, or even the United States, they face a risk that the profit on their investment will evaporate because controlling shareholders or managers will keep it for themselves. Corporate governance is to a large extent a set of mechanisms through which outside investors protect themselves against fraudulent asset diversion by the insiders (i.e., individuals, including controlling shareholders and senior managers, who have the ability to influence or make decisions on behalf of the firm).³

As has been the experience of minority shareholders in a variety of markets, asset and cash flow diversion can take many forms. In some instances, insiders simply steal the company's earnings; in other cases they may go through more hidden and elaborate means of diverting profits, such as selling company assets or output to an entity they own at below-market prices. In other cases, profit diversion can take the form of insiders hiring friends or members of their family for senior management positions. As noted by a variety of analysts, corporate governance issues arise whenever the interests of company managers differ from those of the shareholders and shareholders are unable to fully monitor the actions of managers.⁴

Although the inherent conflict between insiders and outsiders can never be completely eliminated as long as insiders act on behalf of outsiders, it can be reduced through good corporate governance policies. In particular, the appropriate application of laws and regulations guaranteeing disclosure and the rights of shareholders can help reduce fraudulent behavior and conflicts of interest. Investors should recognize that there is a risk of fraudulent behavior and penalize firms (by charging a high cost for capital) that fail to provide adequate disclosure and protection of investors' interests. Because firms bear these costs when they issue securities, they have an incentive to bind themselves to contracts with investors and limit profit diversion.⁵

Of course, this argument requires that contracts are enforceable, which is not always the case in many countries. For a given level of enforcement, several empirical studies have found that private contracting is not sufficient to protect investor rights. If corporate governance laws and regulations do matter, then one should find that there is less outside financing (smaller stock markets) in countries with weaker investor protection. This is, in fact, what tends to be found. In comparing the

³ This is a point noted by La Porta et al. (2000).

⁴ Jensen and Meckling (1976) were one of the first to show that the corporate governance problem is similar to the classic agency problem in economics. The agency problem arises when the interests of the manager of the company (the agent who is acting on behalf of the company owner) are different than those of the owner.

⁵ See, for example, Jensen and Meckling (1976) and Stigler (1964).

experience of those countries with the Anglo-American common-law tradition, which historically has very strong investor rights, with countries with the Franco-German civil-law tradition, which has maintained relatively weaker investor rights in favor of a broader definition of “shareholder” rights that includes employee rights, it is typically found that outside financing is much higher in Anglo-American common-law countries and much lower in Franco-German civil-law countries, where the tradition of strong investor protection is not as prevalent.⁶

A more basic prediction of good shareholder rights is that they should encourage the development of equity markets. A study completed by CLSA in April 2001 found that firms with better corporate governance were those with the best financial performance ratios, including rate of return on equity and the ratio of economic value added (EVA) to invested capital. Others have found that countries that have stronger shareholder rights have more valuable stock markets (market capitalization relative to GDP), larger numbers of listed securities relative to the population, and a higher rate of IPO activity than do countries that have weaker shareholder protection.⁷ Consequently, good corporate governance can be extremely helpful to the development of emerging financial sectors. ■

⁶ See, for example, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998). Also, in a study of nearly 3000 firms from nine East Asian economies (which tend to have weak investor protection), Claessens, Djankov, and Lang (2000) found that the top 15 families in each country, with the exception of Japan, controlled between 20 percent and 61 percent of the total value of listed corporate assets. In Japan, the top 15 families only control 2.8 percent of the value of listed equities.

⁷ La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997).

PRACTICAL ELEMENTS OF A CODE OF CORPORATE GOVERNANCE

Based on the desire to improve corporate governance in emerging markets and to create a more stable financial environment, the Working Group on Corporate Governance and Transparency has developed a Code of Corporate Governance presented in the Appendix. It covers the following broad elements:

- Minority shareholder protection
- Responsibilities of the board of directors
- Accounting and auditing
- Transparency of ownership and control
- The regulatory environment.

The Working Group has examined how these elements should be treated in securities and company laws, exchange listing requirements, and company policies and practices. Specific “threshold” standards as well as “best practices” have been defined, as well as priorities for implementation.

- A top priority standard is one that should be implemented as soon as possible and that represents an issue that is particularly important for overall corporate governance.
- A threshold standard is one under which the average “conservative” investor would feel comfortable investing, whereas the best practice should be regarded as a target standard.

The Working Group fully recognizes that for some countries the implementation of these guidelines of corporate governance and transparency would be more difficult than for others. The draft Code provides as much flexibility as possible to allow the guidelines to be adapted to each country’s individual circumstances while, at the same time, maintaining the essential features of the Governance Code. For example, the Working Group determined that continuity in the board of directors over a sustained period was important for a company, but they also recognized that a director who spent a large number of years on the board could no longer claim to be independent. Although the guidelines do not specify the exact number of years, they do stipulate that a country’s listing requirements should set a reasonable limit on the number of years a director can sit on the board and still maintain independence.

The purpose of this report is not to create a body of law or a precise set of regulations for transparency and corporate governance. Rather, it should be seen as a set of practical guidelines for good corporate governance from the collective experience and perspective of investors and fund managers in emerging markets. Indeed, the guidelines presented in this report are derived from issues that the Working Group members see as being particularly important and do not necessarily represent a complete set of guidelines for corporate governance. The specific guidelines set forth

in this report differ from more broad frameworks, such as the OECD Core Principles of Corporate Governance, in that they are more detailed and are aimed at implementation.

Whereas these guidelines were developed with the intention of improving corporate governance and transparency in emerging markets, there are several best practices presented in this report that are not yet observed even in many mature markets. Consequently, the Code presented here can contribute to improving corporate governance practices in industrialized countries as well.

Even in the best of circumstances, when good corporate governance principles form a part of company bylaws and are incorporated into security regulations and legal code, the principles may have no practical meaning if they are not enforced and observed as part of day-to-day business. The responsibility for good corporate governance lies not only with the company but also, perhaps more importantly, with the regulators and investors who must demand adherence to good principles.

The proper functioning of a country's legal system is key to the implementation of corporate governance principles and the protection of shareholder rights. Because it is impossible to create a contract or write a law covering all possible contingencies, the courts will often have to decide on corporate governance issues. For example, if a company director is grossly negligent in monitoring management actions and the effect is substantial shareholder loss, can the director be held liable for the resulting damage? How the court interprets the fiduciary duty of company directors and whether shareholders can sue directors for a breach of that duty can be a powerful force in determining practical shareholder rights. Likewise, the legal right of attorneys to accept contingency fees for class action suits filed on behalf of shareholders can help establish minority shareholder protection.

While historical developments have led to different legal traditions with both stronger and weaker shareholder rights, recent competition for global capital is motivating an increasing number of countries to attract capital by developing better protection for shareholders. The guidelines presented below are designed to allow a variety of countries with different legal traditions the opportunity to enhance their system of corporate governance.

Minority Shareholder Protection

A fundamental question in corporate governance is whether the rights of minority shareholders are protected. As discussed earlier, investing in markets with poor corporate governance leaves open the possibility that minority shareholder rights will be ignored, or even worse, that insiders will conspire to expropriate company assets at the expense of outside investors. Whereas some issues of minority shareholder protection are more or less self-evident, such as the right to vote on important matters, others are less obvious, such as issues related to share buybacks.

As in all matters related to minority shareholder rights, a top priority should be that foreign shareholders are treated equally with domestic shareholders. Because foreign investors often times comprise one of the largest groups of minority shareholders in major emerging market companies, rules or practices limiting foreign ownership rights have at times been thinly disguised avenues by which domestic controlling interests are able to divert company profits or assets for their own benefit.

The Working Group has identified three main areas in which minority shareholder protection is important:

1. Voting rights
2. Changes to the company and its capital structure
3. Shareholder meetings and other issues.

Voting Rights

Whereas the right to vote on all material issues affecting a firm should be an obvious prerogative of shareholders, the mechanisms allowing for fair voting on important issues do not exist in all firms or in all markets. In this regard, a top priority for firms should be to issue a clear and well-defined statement regarding those matters that require only board approval and those matters that require shareholder approval. Moreover, shareholders should have the legal right to vote on all matters of importance, including mergers and acquisitions as well as the sale of substantial assets. By clearly delineating matters for shareholder and board approval, there is less latitude for abuse of minority shareholder rights.

Another top priority is to limit new issues to “one share, one vote.” One-share, one-vote capital structures are the simplest and ensure the most accountability because influence is proportional to ownership. Mexico, Malaysia, Hong Kong, and South Africa, for example, now have rules or laws limiting shares with multiple voting rights. Other capital structures encourage management’s entrenchment and unresponsiveness, which diminishes shareholder value over the long term. Furthermore, the interests of parties with voting control may not be the same as the interests of shareholders constituting a majority of the company’s capital. A best practice for existing issues would be to eliminate eventually all shares with super-voting rights as well as nonvoting shares. Although many firms with multiple voting rights have had an excellent history of good corporate governance practices, multiple voting rights can lead to abuses and are, in general, inconsistent with good governance.

Although cumulative voting rights can also lead to abuses, they should be permitted because they allow minority shareholders to concentrate their voting power on issues they find of particular importance. In the case of choosing directors, for example, cumulative voting allows minority shareholders to concentrate all of their votes on one individual with the hope of that person being elected. This is a way of preserving minority shareholder representation on the board of directors. The cumulative voting formula is defined as follows: [number of votes allowed to cast] = [number of shares held] x [number of choices on which to be voted]. For example, if a shareholder owns 2 shares and there are 10 directors to be elected, the shareholder can cast 20 votes—either for a single candidate or divided among several candidates.

A system for proxy voting also should be encouraged because it decreases the costs of voting and allows shareholders who cannot attend meetings a chance to vote. However, all uncast proxy votes (including those assigned to ADRs and GDRs), should remain uncast and not be automatically voted on behalf of management. Automatically assigning uncast proxy votes to management can create a

significant bias against minority shareholders. As a best practice, proxy systems should be universally available to all voters, both foreign and domestic.

Changes to the Company and Its Capital Structure

One particular concern of investors is that shareholders may not have an adequate voice in the company's decision to accept a merger or a buyout offer. They are concerned that the price offered to minority shareholders, in the event of a merger or buyout, may not be as favorable as that offered to controlling shareholders. In general, rules should be created to limit the possibility that the entire company, or a substantial company asset, is sold to benefit controlling shareholders and managers at the expense of minority shareholders. As a general rule, any offer to acquire shares above some minimum threshold of outstanding stock should trigger a requirement that a significant portion of the purchase be made through a public offer. The Hong Kong and South African exchanges, for example, require that offers above 35 percent of outstanding shares must be extended to all shareholders.

Minority shareholder rights should take precedence during takeover attempts. The primary concern is that although a takeover may sometimes be viewed as unwanted from management's or the controlling shareholder's point of view, from the perspective of minority shareholders it may be value enhancing. Anti-takeover practices such as "poison pills" and "golden parachutes" should not be prohibited, but they should be approved by a general shareholder vote. The same process should apply to mergers and buyouts. As a best practice, the vote should be a substantial majority (e.g., at least two-thirds).

Share dilution actions, such as capital increases and the issuance of convertible bonds or stock options, which have the potential for weakening shareholder rights, are also important. Although some low-level dilutive activity due to normal operations should be permissible without a general shareholder vote, beyond a certain threshold such measures should require shareholder approval. Moreover, any dilution of voting rights or ownership should apply on a pro rata basis across all shareholders, and, as a best practice, a substantial majority of votes should be in favor of such an action. The NASDAQ requires voter approval for increases in shares above 5 percent of outstanding stock.

Mandatory redemptions, initial public offerings, and share buybacks should all be disclosed to the shareholders and should be subject to a general shareholder vote. Transparency is of critical importance to ensure that shareholders are treated equally and that such proposals reflect their best interest.

Shareholder Meetings and Other Issues

To allow investors sufficient time to prepare for agenda items addressed at meetings, shareholders should be given adequate advance notice of meeting dates and the proposed agenda. As a best practice, meeting notices and agendas should be sent at least one month prior to the meeting. The common practice now typically requires only a two- or three-week advance notice before meetings. Hong Kong and South Africa, for example, require 14 days' notice prior to meetings on issues that require a simple majority vote and 21 days for meetings, on issues that require a supermajority vote. Both Korea and Mexico require only 14 days' notice prior to all meetings.

Shareholders should be supplied with a sufficiently detailed agenda so that they can vote knowledgeably. Minority shareholders should also be able to call special meetings on matters of importance to the company. However, to prevent capricious behavior on the part of only a small number of shareholders, a minimum threshold of share ownership should be set before a group or an individual may call a special meeting. Mexico and Poland, for example, require at least 10 percent minimum shareholding to call a special meeting. When a meeting is called, the required quorum should not be set too low so that the meeting outcome is not representative of the shareholders or too high so that it is too difficult to get the required number of votes to pass a measure. Moreover, all key company decisions should require a qualified quorum. The NASDAQ requires that at least one-third of outstanding voting shares be represented. In general, a top priority should be that foreign shareholders are treated equally with domestic shareholders.

Many firms require that shareholders be prohibited from selling their shares around meeting dates (shareblocking) as a way to ensure voting only by registered shareholders. Extended periods of shareblocking, however, can act as a deterrent for shareholders to participate in meetings due to the cost of illiquidity. Consequently, the law should provide for a specific registered date before meetings that assigns the voting rights of a share to the current owner. Shares may be traded after the registered date, but the right to vote would not be transferable until subsequent meetings. The notice of the registered date should be given at the same time as the meeting notice.

To resolve conflicts between minority shareholders and controlling shareholders, there should be some mechanism, disclosed under company practice, to trigger arbitration. As a best practice, minority shareholders should have the right to formally present an issue to the board of directors if they own some predefined minimum threshold of outstanding shares.

The Structure and Responsibilities of the Board of Directors

Company performance and shareholder value can suffer from a lack of oversight and excessive power among senior executives. Absolute power held by senior management can breed complacency; lack of competitiveness; and, at worst, nepotism, cronyism, and theft. Thus, the board of directors needs to be structured so that it provides an independent check on management. As such, it is vitally important that a significant number of board members be independent from management. It is also important that the board of directors be responsible for disclosure of information to shareholders. This facilitates corporate transparency and more accurate assessments of the value of the company.

Structure of the Board and the Definition of Independence

The board of directors plays the role of being an independent check on management. In this capacity it is important that a significant number (at least one-third) of board members be independent from management. The best practice would suggest that a majority of directors should be independent. The current practice across markets varies quite a lot, however. Malaysia, for example, requires that at least one-third of the board be independent, whereas Korea requires one fourth. Hong Kong and NASDAQ rules specify actual numbers of independent directors—two and three, respectively—whereas South Africa's rules state that a majority of nonexecutives should be independent.

At a minimum, firms should define “independence” in addition to disclosing biographies of directors and making a formal statement about independence. As a best practice, an independent director should not (a) have been an employee of the company in the past three years, (b) have a current business relationship with the company, (c) be employed as an executive of another company at which any of the company’s executives serve on that company’s compensation committee (i.e., no cross-compensation committee links), and (d) be an immediate family member of an executive officer of the company or any of its affiliates. An independent director should have adequate competency and understanding of business. Moreover, at least for large firms, non-executive directors should have to come up for re-election every three years, and a best practice would be for both large and small firms to have re-elections every three years.

More often than not, directors who serve on boards for an extended period find that their interests fall more in line with management than with shareholders. As a result, after serving some predetermined number of years on the board (perhaps 10 years, as is the case under U.K. rules), directors should no longer be considered independent. The term limit applied should ensure actual and perceived independence.

Board Committees

To monitor company operations effectively, boards should establish various subcommittees to enhance their efficiency and the effectiveness of their involvement. Board members with skills specific to the task of the committees can be elected to chair and/or participate on the committees. There are three essential committees that the board should form: (1) a nominations committee, which seeks to find top management talent for the company and review nominations for the board; (2) a compensation committee, which determines remuneration for senior management and attempts to align it with the interests of shareholders; and (3) an audit committee, which has the special function of not only ensuring the proper documentation of company cash flows, but also reviewing the adequacy of internal controls and risk management as well as selecting independent auditors. The details of the audit committee are outlined in the Accounting and Auditing section below.

The current practice across markets is to require the board to form an audit committee (usually with some number of independent directors), but there are only a few markets that make specific rules concerning nomination or compensation committees.

An independent director should chair the nomination and compensation committees in large companies and, as a best practice, in small companies too. An independent director should always chair the audit committee in large and small companies. As a listing requirement, the best practice would also have a majority of independent directors on each committee. To help ensure that board members are well informed, board meetings should be held every quarter, while the audit committee should meet at least every six months.

Disclosure

A dominant theme in all issues related to corporate governance is the vital importance of disclosure. The more transparent the internal workings of the company and cash flows, the more

difficult it will be for management and controlling shareholders to expropriate company assets or mismanage the company. Disclosure requirements should be incorporated into exchange listing requirements and securities regulations.

The most basic and all-encompassing disclosure requirement is that all material information (i.e., anything that could potentially affect share price) should be publicly disclosed. Examples would include earnings results, the acquisition or disposal of assets, board changes, related party transactions, shareholdings of directors, and changes to ownership. Other information that should always be disclosed includes remuneration (including stock options) of all directors and senior management, corporate strategy, and off-balance-sheet transactions. All disclosed information should be released via the approved stock exchange system for company announcements, as well as through the company's website and annual report.

Other Responsibilities of the Board

If an actual or potential conflict of interest should arise on the part of directors or senior executives, it should be fully disclosed and the audit or ethics committee should review the situation. Another responsibility of the board, in the framework of company practices, should be to develop an investor relations program that reaches out to all shareholders and fully informs them of corporate activities. Better avenues for the free flow of information can only enhance corporate governance. As a best practice, the chief financial officer or chief executive officer should have oversight of the investor relations program and should actively participate in public activities. In addition, the company should detail a formal social responsibility policy (i.e., environmental and social issues) and provide reasonable resources to ensure its distribution. As a best practice, the social responsibility policy should be stated in the company's reports and accounts.

Accounting and Auditing

Poor disclosure by the corporate and banking sectors, even when national standards for accounting and reporting have been met, may have exacerbated the impact of several recent crises by eroding confidence as investors found it difficult to distinguish between sound and distressed firms. The Asia crisis brought to light many examples of poor disclosure, such as in Indonesia, where the Sinar Mas group was reported to have backdated accounts and created dummy companies to hide transactions. In some cases, national standards coincided with international standards but enforcement was lax or auditing procedures incomplete, leaving balance sheets and income statements difficult to understand.

There is a general agreement among market participants that the information available in many regions is inadequate for investors and others to accurately assess risks and make informed decisions on a global level. The absence of transparency and reliable financial information is a particular issue in emerging markets, but it is also an issue in some developed countries. Although all relatively large markets have some form of local accounting standards, standards and enforcement can vary quite a bit. In Malaysia, for example, adherence to the International Accounting Standards (IAS) is a statutory requirement, but rigorous enforcement of the law is lacking.

Accurate accounting and auditing are at the core of transparency and good corporate governance. As such, the accounting standards a company adheres to as well as the structure and independence of the audit committee are extremely important. Capital providers, in setting the criteria that they use in making their financing decisions, have a very strong influence on accounting and auditing practices.

Accounting and Auditing Standards

At a minimum, listing requirements in the country should require that firms conform to local general accounting and auditing practices and use annual consolidated accounting for all subsidiaries in which sizable ownership exists (i.e., ownership including cross-holdings that amount to 20 to 50 percent of outstanding shares). As a best practice, firms should comply with IAS or U.S. GAAP. In addition to the standard disclosure practices, the reports and accounts should include detailed information on off-balance-sheet transactions and business risks as well as a mechanism for periodic review of risk by auditors. The frequency of reporting and auditing should be at least every six months, with a best practice of every quarter. Audits should be reviewed by an independent auditor, and, as a best practice, the complete accounting process should conform to the global standards of the International Forum on Accountancy Development.

The Audit Committee

The integrity, capability, and independence of the audit committee are essential elements of transparency and good corporate governance. Not only does the audit committee serve to enhance corporate governance, but also it is a crucial element in corporate risk management.

The audit committee should be chaired by an independent director and, as a best practice, should have a majority of independent directors. At least one independent director should have a financial background, meaning that he or she is able to read and understand fundamental financial statements, including a company's balance sheet and income and cash flow statement, or will be able to do so in a reasonable amount of time after appointment. Asking tough questions is an important function of audit committee members, and, as a best practice, all communications between the committee and external or internal auditors should be without the company management present. Moreover, the whole board should approve the audit process and must disclose any departures from accounting standards in the annual report.

Transparency of Ownership and Control

Who controls a company and who has significant ownership should be a disclosure requirement in exchange rules and listing requirements. Disclosure of significant shareholdings is crucial in evaluating whether company actions, such as the sale of substantial assets, are being made in the interest of shareholders constituting a majority of the company's capital or in the interest of controlling parties. Firms should disclose accurate, adequate, and timely information so as to allow investors to make informed decisions about acquisitions, ownership obligations and rights, and the sale of shares.

As a best practice, minimally significant ownership (5–10 percent) should be disclosed, and significant ownership (on the order of between 20 and 50 percent) should be disclosed as a controlling

interest. In current practice, when controlling interest is defined, it is typically at least 35 percent of outstanding shares. Any increase in ownership over 35 percent of outstanding shares should trigger a buyout offer in which all shareholders are treated equally. For the purposes of disclosure, connected party ownership should be included in total share ownership.

Regulatory Environment

To create a credible foundation for corporate transparency, good accounting practices, and protection of shareholder rights, the regulatory environment must also be credible and transparent. An essential element of credibility in the regulatory environment is that it must not be perceived to be under the control or influence of any particular interest group. At a minimum, regulators should be independent from industry and, as a best practice, should be independent from the executive branch of government as well. Although the government likely is less subject to bias in regulating corporate governance practices than is industry, it may still be subject to outside influence. For example, during election periods, government regulators may be enticed to “look the other direction” in the hope of soliciting political support for contributions. Officials who head the regulatory body should be independent from political parties and should undergo a public confirmation process.

Despite having the best intentions and the best rules for corporate governance on the books, in practice this may mean little if the regulatory bodies have no enforcement or oversight capabilities. Exchanges should have the power to grant, review, suspend, or terminate the listing of securities. They should also be responsible for monitoring all listed securities. ■

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APPENDIX

Working Group on Corporate Governance and Transparency: Policies for Corporate Governance in Emerging Markets

	Company Practices and Policies	Exchange Rules and Listing Requirements	Security and Company Law	Priority*
Minority Shareholder Protection				
Voting Rights				
Defined rights on matters that require voting approval	Should have a formal statement that defines actions that require shareholder approval or board approval. Should have a mechanism that allows minority shareholders to object to majority decisions.		Minority shareholders should have legal right to vote on all matters of importance, including mergers and the sale of substantial assets.	Top
Proxy systems		Firms are encouraged to allow proxy voting. Best Practice: Proxy systems should be universally available to all shareholders — foreign and domestic.		High
Multiple voting classes	“One share, one vote” should be a threshold requirement for new issues. Best Practice: Firms are encouraged to reduce and eventually eliminate the number of nonvoting and supervoting shares.	“One share, one vote” should be a threshold requirement for new issues. Best Practice: Firms are encouraged to reduce and eventually eliminate the number of nonvoting and supervoting shares.		Medium
Cumulative voting	Cumulative voting should be permitted.			Medium
Firm/Capital Structure				
Takeover/buyout/merger procedures	Shareholder approval of takeover/buyout/merger should be required.	Exchanges should require that if an offer is made above a reasonable minimum threshold of outstanding stock, then a significant portion of that purchase must be through a public offer. For offers above an even larger threshold, all shareholders need to be presented with an offer. Any anti-takeover measures must be approved through shareholders’ vote. Anti-takeover measures include actions such as poison pills, golden parachutes, and issuance of bonds with special rights in the event of a takeover. Best Practice: Same as threshold, but shareholder vote should be by a substantial majority.	Law should require that shareholders be notified of a takeover. Shareholder approval of a buyout/merger should be required. Under a merger or takeover, minority shareholders should have a legal right to sell shares at appraised value.	Top
Anti-dilution measures		Dilution of voting or ownership rights should not be permitted without a majority vote by all shareholders. If agreed upon by shareholders, any dilutive activity should apply <i>pro rata</i> across all shareholders. Best Practice: Same as threshold, but any change in voting or ownership rights should require a substantial majority vote.	Shareholder approval should be required beyond legally defined thresholds.	Top
Mandatory redemptions		In the event of a takeover or delisting, all shareholders should be offered the same terms as the best price offered during the takeover.		Top
IPOs	If a significant subsidiary is being spun off, shareholder approval should be required. There should be a majority of shareholders voting yes.			Top
Capital increases	There should be constraints on sales to the majority shareholder group.	Shareholder approval is required. Any capital increase, over a period of a year and above a minimum threshold, must first be offered to all existing shareholders.	Shareholder approval is required. Any capital increase, over a period of a year and above a minimum threshold, must first be offered to all existing shareholders.	Top
Share buybacks		Details of share buybacks should be fully disclosed to shareholders. Best Practice: Significant share buybacks require shareholder approval. Firms should disclose information on the source of funds used to repurchase shares, the number of shares repurchased, the price, the method of repurchase, and other information required in the public interest or for the protection of shareholders.		High
Shareholder Meeting/Other Rights				
Meeting notice and agenda	Meeting notice and agenda should be sent to shareholders within a reasonable amount of time prior to meetings to prepare the proxy system and to be released publicly. Best Practice: Meeting notice and agenda should be sent at least one month prior to meeting.	Notice and agenda should be sent within a reasonable amount of time in advance of meetings to prepare the proxy system and to be released publicly. This is applicable to all meetings. There should be an annual shareholder meeting within 6 months after FY end. Best Practice: Meeting notice and agenda should be sent at least one month prior to meeting.	Company law should be same as listing requirement.	Top
Meeting structure	Meetings should be conducted in a timely and efficient manner. Reasonable efforts to prevent vote fraud should be implemented, as well as mechanisms allowing for the right to recount contested votes.	Meetings should be conducted in a timely and efficient manner. Reasonable efforts to prevent vote fraud should be implemented, as well as mechanisms allowing for the right to recount contested votes.	Company law should be same as listing requirement.	Top

*Low-priority measures are not included in the policies matrix.

APPENDIX (continued)

Working Group on Corporate Governance and Transparency: Policies for Corporate Governance in Emerging Markets

	Company Practices and Policies	Exchange Rules and Listing Requirements	Security and Company Law	Priority*
Minority Shareholder Protection				
Shareholder Meeting/Other Rights				
Special meetings		Minority shareholders should be able to call special meetings with some minimum threshold of the outstanding shares.	Company law should be same as listing requirement.	Top
Treatment of foreign shareholders	Foreign shareholders should be treated equally with domestic shareholders.	Foreign shareholders should be treated equally with domestic shareholders.	Company law should be same as listing requirement.	Top
Conflicts between shareholders	Should have mechanism whereby a majority of minority shareholders can trigger an arbitration procedure to resolve conflicts between minority and controlling shareholders.			Top
Share blocking			The law should provide for a registered date before meetings that assigns the voting rights of a share to the current owner. Shares may be traded after the registered date, but the right to vote would not be transferable until after the meeting. The notice of the registered date should be given at the same time as the meeting notice.	Top
Quorum	Should not be set too high or too low. Suggested level would be around 30 percent and should include some independent non-majority-owning shareholders. All key corporate decisions require a qualified quorum.			High
Petition rules/objection to majority shareholder actions		Best Practice: Minority shareholders should have the right to formally present a view to the board if they own some predefined minimum threshold of outstanding shares.	Company law should be same as listing requirement.	High
Structure and Responsibilities of the Board of Directors				
Board Structure				
Definition of independence of directors	Define independence, disclose biography, and make statement on independence.	Define independence, disclose biography, and make statement on independence. Best Practice: Definition of <i>independence</i> : an independent director cannot (a) have been an employee of the firm in the past 3 years, (b) have a current business relationship with the firm, (c) be employed as an executive of another firm in which any of the company executives serve on that firm's compensation committee (i.e., no cross-compensation committee link), and (d) be an immediate family member of an executive officer of the firm or any of its affiliates. An independent director should have an adequate understanding of and competency in business. After serving some predetermined number of years on the board, directors should no longer be considered to be independent.	Definition of independence should be a listing requirement, but it could also be stated in company law. Definition of <i>independence</i> : (a) cannot have a business or personal relationship with the management or company, and (b) cannot be a controlling shareholder such that independence, or the appearance of independence, is jeopardized.	Top
Share of independent directors	At least one-third of the board should be nonexecutive, a majority of whom should be independent. Best Practice: A majority of independent directors.	At least one-third of the board should be nonexecutive, a majority of whom should be independent. Best Practice: A substantial majority of the board should be independent.	The share of independent directors on the board should be a listing requirement or stated in company law.	Top
Frequency and record of meetings	For large companies, board meetings every quarter, audit committee meetings every 6 months. Minutes of meetings should become part of public record. Best Practice: Rule would also apply to small companies.	Board meetings every 3 months. Audit committee meetings every 6 months. Minutes of meetings should become part of public record.	Should be stated in listing requirements, but it could also be stated in security law.	Top
Quorum	Should consist of executive, nonexecutive, and independent nonexecutive members.	Must be specified by firm. Best Practice: Representatives of both executive and independent directors.	Definition of quorum should be a listing requirement, but it could also be stated in company law.	High
Nomination and election of directors	Should be committee, chaired by independent nonexecutive, that nominates new board members. Minority shareholders should have mechanism for putting forward directors at Annual General Meeting (AGM)/Extraordinary General Meeting (EGM).	Same requirement as company practice.	Should be stated in listing requirements, but it could also be stated in security law.	High
Term limits for independent directors	For large companies, re-election every 3 years. Best Practice: Rule would also apply to small companies.	Best Practice: Re-elected every 3 years.	Should be stated in listing requirements, but it could also be stated in security law.	High

*Low-priority measures are not included in the policies matrix.

APPENDIX (continued)

Working Group on Corporate Governance and Transparency: Policies for Corporate Governance in Emerging Markets

	Company Practices and Policies	Exchange Rules and Listing Requirements	Security and Company Law	Priority*
Structure and Responsibilities of the Board of Directors				
<i>Board Structure</i>				
Compensation committee	For large companies, must be chaired by independent nonexecutive director with majority of committee nonexecutive and preferably independent. Best Practice: Rule would also apply to small companies.	Chaired by independent director with majority of committee nonexecutive. Best Practice: For large firms only: chaired by independent director with majority of independent directors.	Should be stated in listing requirements, but it could also be stated in security law.	High
Nomination committee	For large companies, must be chaired by independent nonexecutive director. Best Practice: Rule would also apply to small companies.	Chaired by independent director. Best Practice: For large firms only: chaired by independent director with majority of nonexecutive directors.	Should be stated in listing requirements, but it could also be stated in company law.	Medium
Formal evaluation of board members	For large companies, nominating committee must review directors ahead of formal re-election at AGM. Best Practice: Rule would also apply to small companies.	Best Practice: Nominating committee must review proposed directors ahead of first election at AGM.	Should be stated in listing requirements, but it could also be stated in security law.	Medium
<i>Disclosure</i>				
Immediate disclosure of information that affects share prices, including major asset sales or pledges		Listing requirements should specify disclosure by stock exchange of all material information. <u>Material information is anything that could affect share price.</u> Examples include results, acquisition/disposal of assets, board changes, related party transactions, shareholding of directors, changes to ownership, etc.	Issue for securities regulation.	Top
Procedures for information release	Through local exchanges. Best Practice: Through company website and through exchange.	Via approved/required stock exchange system for company announcements and public company announcement, including website and annual report.	Issue for securities regulation.	Top
Remuneration of individual executive and nonexecutive directors		Remuneration of all directors should be disclosed in annual report. All major stock option schemes should be fully disclosed and subject to shareholder approval.	Issue for securities regulation.	Top
Responsibilities of directors and management	The responsibilities of directors and managers should be stated in the articles of association or company bylaws and be accessible to all shareholders.			High
Remuneration of individual senior executives		Remuneration of highest-earning senior executives should be disclosed in annual report. All major stock option schemes should be fully disclosed and subject to shareholder approval.	Issue for securities regulation.	Medium
Corporate strategy	Should be chairman or CEO statement in reports and accounts.	Strategic aim review to be included in annual report.		Medium
<i>Other</i>				
Conflict of interest	Any potential or actual conflicts of interest on the part of directors or senior executives should be disclosed. Head of audit committee should not have any such conflicts of interest. Board members should abstain from voting if they have a conflict of interest pertaining to that matter. Audit or ethics committee is required to review conflict-of-interest situations.	Any potential or actual conflicts of interest on the part of directors or senior executives should be disclosed. Head of audit committee should not have any such conflicts of interest. Board members should abstain from voting if they have a conflict of interest pertaining to that matter. Audit or ethics committee is required to review conflict-of-interest situations.		High
Integrity of internal control and risk management system	Best Practice: Should be a function of the audit committee.		Should be a listing requirement or company law.	High
Investor relations	Should have an investor relations program. Best Practice: CFO or CEO assumes this job as officer.			Medium
Social responsibility and ethics	Make a statement of policy concerning environmental issues and social responsibility. Best Practice: ILO principles of social policy.			Medium
Accounting/Auditing				
<i>Standards</i>				
National/International GAAP		Identify accounting standards used. Comply with local practices and use consolidated accounting (annually) for all subsidiaries in which sizable ownership exists (see "Majority ownership" on next page for definition). Best Practice: Comply with IAS or U.S. GAAP.		Top

*Low-priority measures are not included in the policies matrix.

APPENDIX (continued)

Working Group on Corporate Governance and Transparency: Policies for Corporate Governance in Emerging Markets

	Company Practices and Policies	Exchange Rules and Listing Requirements	Security and Company Law	Priority*
Accounting/Auditing				
Standards				
Frequency	Semi-annually audited report at FY end.	File audited annual and nonaudited semi-annual reports. Best Practice: File audited annual and nonaudited quarterly reports. Reports should be filed within a stated amount of time after the end of the reporting period.		High
Audit quality		Independent public accountant. Best Practice: Should adhere to the global standards developed by the International Forum on Accountancy Development.		High
Off-balance-sheet transactions		Listing requirements should specify disclosure of off-balance-sheet transactions (e.g., operating leases, contingent liabilities) in annual report with materiality level for disclosure.		High
Risk factors/ monitoring procedures	Should be statement from audit committee in reports and accounts addressing business risks. Need a mechanism for review by auditors.			High
Audit Committee				
Audit committee	For large companies, must be chaired by qualified independent director. Best Practice: For small and large companies, must be chaired by a qualified independent nonexecutive director. Best practice would also allow committee to call for second independent director.	Chaired by independent director. Best Practice: Chaired by independent director with majority of independent directors.	Should be stated in listing requirements, but it could also be stated in security law.	Top
Financial background	Must be chaired by an independent director with a financial background.	At least one independent director with a financial background. Definition of <i>financial background</i> : a person who is able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement, or who will become able to do so within a reasonable period after his or her appointment.	Should be a listing requirement or company law.	High
Due diligence and documentation	A minimum of one week should be allocated for any committee review of audit.	Board must have an audit process and must approve the audit.	Should be a listing requirement or company law.	High
Explanation and quantification of departures from accounting standards		Any departures from accounting standards must be explained in the annual report.	Should be a listing requirement or company law.	High
Relationship/ communication with internal auditor and external auditor	Best Practice: Without executives present.	Best Practice: Without executives present.		Medium
Transparency of Ownership and Control				
Majority ownership		Best Practice: Significant ownership (20-50%, including cross-holdings) is deemed to be control.	Same as listing requirements.	High
Buyout offer to minority shareholders		Best Practice: Ownership exceeding 35% triggers a buyout offer in which all shareholders are treated equally.	Same as listing requirements.	High
Related-party ownership		Companies should disclose directors' and senior executives' shareholdings, and all insider dealings by directors and senior executives should be disclosed. Senior executives' and directors' share transactions should be disclosed within 3 days of execution. Best Practice: Total share ownership of connected parties must be disclosed if greater than 5-10% of outstanding shares. Total ownership exceeding 30% would trigger a buyout offer in which all shareholders are treated equally.	Same as listing requirements.	High
Significant shareholders		Best Practice: Shareholders with minimally significant ownership (greater than 3-10%) of outstanding shares must disclose their holdings.	Same as listing requirements.	Medium

*Low-priority measures are not included in the policies matrix.

APPENDIX (continued)

Working Group on Corporate Governance and Transparency: Policies for Corporate Governance in Emerging Markets

	Company Practices and Policies	Exchange Rules and Listing Requirements	Security and Company Law	Priority*
Regulatory Environment				
Enforcement powers		The exchange should have the power to grant, review, suspend, or terminate the listing of securities.	Enforcement is an issue for securities regulation and the judicial system. Enforcement authorities should have adequate training and an understanding of the judicial process. Judges and courts should be independent. Exchanges should have the power to grant, review, suspend, or terminate the listing of securities.	Top
Oversight			Oversight is an issue for securities regulation. The exchange should be responsible for monitoring all listed securities.	High
Independence from industry and government	Best Practice: There should be independence between industry and government.	The exchange must be independent from industry. Best Practice: The exchange should be independent from industry and government.		High
Ethical rules of conduct for management and employees	Should be rules outlining acceptable employee and management conduct.	Should be rules outlining acceptable employee and management conduct.		Medium
Number of commissioners from same political party and appointment policy		Best Practice: Commissioners should be independent from political parties and have competent training as regulators. Commissioners should undergo a public confirmation process.	Best Practice: Commissioners should be independent from political parties and have competent training as regulators. Commissioners should undergo a public confirmation process.	Medium

*Low-priority measures are not included in the policies matrix.

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