Doing Business 2015

Going Beyond Efficiency

Protecting minority investors

Going beyond related-party transactions

- *Doing Business* introduces 3 new measures of minority investor protections this year—indices on shareholders' rights and role in major corporate decisions, on governance structure and on corporate transparency.
- Economies with the most developed securities markets tend to have the highest average scores on the 3 new indices.
- On average, OECD high-income economies offer the strongest protections as measured by the new indices and continue to provide the strongest protections as measured by the existing ones.
- Among 189 economies worldwide, India follows the largest share of the good practices measured by the new indices.
- On average, shareholders of listed companies are more protected than those of nonlisted companies.
- Overall, minority investors are more protected in economies that distinguish between shareholders of listed companies and shareholders of nonlisted ones.

A corporation is a legal entity distinct from its founders. This essential separation enables a business to flourish or fail separately from the personal assets and interests of its members (whether owners, directors or employees). The advantages of untying a business from its founders are such that the corporation has today become the most common form of commercial entity around the world.

But the separation also creates risks. Without a proper structure and allocation of duties and rights, and without clarity in decision-making processes, corporations can quickly become incapable of generating any wealth. Without adequate safeguards, corporations can become vulnerable to abuse, with insiders using corporate assets for personal gain to the detriment of other stakeholders. If such abuses become widespread in an economy, they can deter investors from participating in any corporation. The quality of the rules and regulations governing corporations is therefore fundamental to functioning markets and wealth-generating economic activity.

The *Doing Business* indicators on protecting minority investors analyze the regulation of related-party transactions and shareholder access to judicial redress as a proxy for an economy's overall corporate governance standards and ease of access to financing from capital markets. Stronger protection of minority shareholders in prejudicial related-party transactions is associated with a higher level of development in capital markets—as reflected by such indicators as higher market capitalization, larger numbers of listed domestic firms, more initial public offerings and lower private benefits of control.[1]

For entrepreneurs seeking to develop or expand a business, access to external financing is a crucial concern. Stronger legal protection of minority investors increases the confidence of investors in markets, making them more likely to invest. Econometric research shows that investors' willingness to provide entrepreneurs with equity capital is a significant factor in the development of financial markets, which in turn promotes economic development.

Recent studies provide empirical evidence that corporate governance standards aimed at protecting minority shareholders promote positive economic outcomes at the country and firm level. To that end, certain aspects of corporate governance are particularly important—such as board composition and independence, firm transparency and disclosure, and the rights of shareholders relative to the board of directors and management. Sound rules and regulations in these areas of corporate governance can minimize the agency problem between majority and minority shareholders as well as that between minority shareholders and the board of directors and management.

Specifically, greater shareholder protection is associated with larger capital markets,[2] a lower cost of capital, higher cash flows, more efficient firm-level resource allocation[3] and greater firm valuation[4] and performance.[5] In addition, numerous studies suggest that investors will charge higher rates to provide financing if they are not assured of an adequate return or if they fear expropriation by corporate insiders.[6] In other words, greater shareholder protection reduces the cost of equity by mitigating the agency problem between minority shareholders and managers in relation to diverging interests in the allocation of company resources. Several other studies highlight the positive impact on firm-level resource allocation and long-term returns of having audit committees, of ensuring the independence of the board and of having different people serve as chief executive officer (CEO) and chair of the board.[7]

WHAT DO THE INDICATORS NOW MEASURE?

Since their inception, the *Doing Business* indicators on protecting minority investors have been measuring minority shareholder protections against directors' misuse of corporate assets for personal gain. This is done by positing specific sets of assumptions about a transaction between 2 companies that involves a clear conflict of interest. This transaction is tested against the regulations of each of the 189 economies covered by *Doing Business* to determine who can approve the transaction, what disclosure must be made, who can be held liable if the transaction causes losses, what sanctions decision makers incur and what evidence shareholders can obtain to help them win their case if they choose to initiate a legal action in court.

Doing Business continues this exercise and, starting in this year's report, also measures other aspects of corporate law that are unrelated to this transaction but that are also indicative of the strength of protection of minority shareholders. This is particularly important to identify additional areas of potential improvement for policy makers and to provide researchers with a broader set of data for analyzing the relationship between corporate governance and economic outcomes (box 9.1).

The fundamental development goal of promoting greater access to finance for entrepreneurs by encouraging regulation conducive to investment in capital markets remains the same—and is indeed reinforced by the provision of data on a more comprehensive array of issues. To expand the coverage of the indicators, the *Doing Business* team first used academic literature and institutional reports to identify regulatory good practices that support the relevant policy goals (box 9.2). The team then selected those that could be objectively measured and independently justified, that offer variation across economies and that lend themselves to data collection and verification through the annual *Doing Business* questionnaire on minority investor protections.

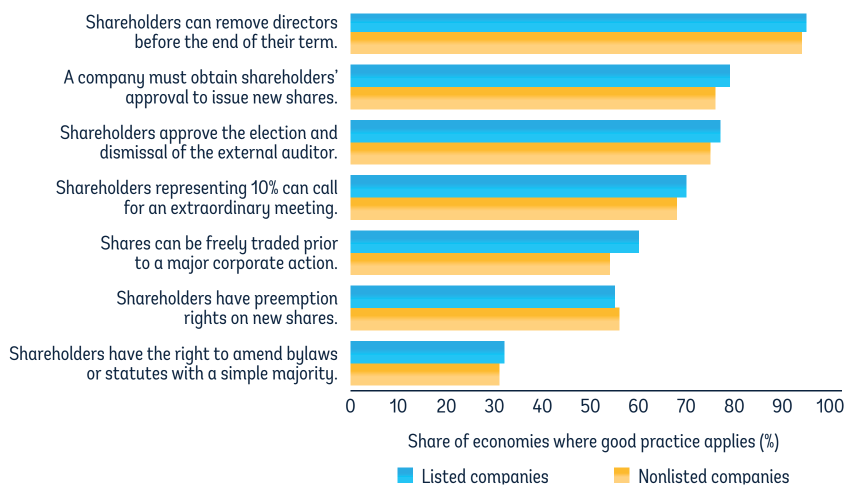
BOX 9.1 What is new in the protecting minority investors indicators?

- Name changed from protecting investors to clarify what is measured by the indicators—and what is not.
- Three indices added to measure protections in matters beyond conflicts of interest: extent of shareholder rights index, strength of governance structure index and extent of corporate transparency index.
- Ease of shareholder suits index expanded to take into account the allocation of legal expenses.

See the data notes for a detailed description of changes and additions to the methodology.

Previously the protecting minority investors indicators assessed 18 components of the quality of regulations. Now 20 additional components that strengthen the rights of minority investors are measured, by 3 new indices: the extent of shareholder rights

FIGURE 9.1 Shareholder rights in listed and nonlisted companies are consistent in most economies



Note: The good practices are those measured by the extent of shareholder rights index.
Source: Doing Business database.

index, the strength of governance structure index and the extent of corporate transparency index. In addition, a new component on the allocation of legal expenses associated with shareholder litigation has been added to the existing ease of shareholder suits index.[8]

Extent of shareholder rights index

The ability of shareholders to influence important corporate decisions—such

BOX 9.2 Standard setters and good practices

Corporate governance practices around the world have been converging over the past 2 decades. This convergence is being driven by a group of global standard setters to which governments look for guidance on how to strengthen their corporate governance, financial reporting and securities regulations. It is also being driven by capital market trends—such as the growing use of cross-listings and dual listings—that lead to the adoption of common regulatory practices.

Corporate governance

The Organisation for Economic Co-operation and Development (OECD) has been establishing increasingly influential good practices in such areas as related-party transactions, conflicts of interest, approval requirements and disclosure obligations. The methodology for the protecting minority investors indicators promotes good practices recommended by the *OECD Principles of Corporate Governance*.[a]

For example, the indicators measure whether the division of responsibilities among shareholders, officers, directors, outside auditors and regulators is clearly articulated in cases of conflict of interest, in line with OECD principle 1 on corporate governance (*ensuring the basis for an effective corporate governance framework*). They also capture the rights of minority shareholders to be informed about, and to participate in, general shareholder meetings and decisions relating to extraordinary transactions, consistent with principle 2 (*rights of shareholders and key ownership functions*). They investigate rules relating to insider trading and whether all shareholders of the same series of a class are treated equally, in line with principle 3 (*equitable treatment of shareholders*). And the extent of disclosure index directly follows principle 5 (*disclosure and transparency*), while the extent of director liability index echoes principle 6 (*responsibilities of the board*).

Financial reporting and accounting

The convergence of accounting standards has helped develop good practices in financial reporting. Two organizations—the International Accounting Standards Board, an independent body that sets the International Financial Reporting Standards (IFRS), and the Financial Accounting Standards Board (FASB), a U.S.-based organization that develops the Generally Accepted Accounting Principles (US GAAP)—have focused on driving this convergence over the past 15 years, issuing unified accounting standards for use by companies worldwide in both domestic and cross-border financial reporting.

IFRS and US GAAP principles mandate strict financial disclosure with the aim of reducing information asymmetries between companies and investors. An important benefit of a single set of high-quality, globally accepted accounting standards is that investors can understand and compare the financial results of any company in the world. For this reason many jurisdictions incorporate IFRS and, to a lesser extent, US GAAP into their domestic reporting systems.[b]

Securities regulations

The International Organization of Securities Commissions (IOSCO) is an association of organizations that regulate securities markets. Its more than 200 members, which oversee more than 95% of the world's securities markets, cooperatively develop, implement and promote standards of regulation, oversight and enforcement to protect both investors and markets.[c]

Another important driver of convergence in securities regulations is the increase in cross-listings and dual listings. To appeal to more risk-averse investors, companies in emerging markets are listing on more developed stock exchanges—such as the London Stock Exchange, the New York Stock Exchange or NASDAQ—in addition to their home country exchanges. Research has found that cross-listing on a U.S. stock exchange by a non-U.S. firm is associated with a significantly positive stock price reaction in the home market.[d] One reason is that cross-listing in the United States forces firms incorporated in jurisdictions with poor investor protection and enforcement systems to commit themselves to higher standards of corporate governance—and this increases the companies' valuation by attracting otherwise reluctant foreign investors.

a. OECD 2004.

b. U.S. Securities and Exchange Commission 2012.

c. "Advancing the SEC's Mission through International Organizations," U.S. Securities and Exchange Commission, http://www.sec.gov/about/offices/oia/oia_intlorg.shtml. For more information on IOSCO, see its website at http://www.iosco.org/about/.

d. Huang, Elkinawy and Jain 2013.

as appointing and removing board members, issuing new stock and amending the company's bylaws—is key to avoiding abuses by corporate insiders. In measuring this aspect *Doing Business* gives particular attention to the allocation of power between shareholders and management; studies have shown that greater power in the hands of shareholders can lead to greater management attention to shareholder interests and therefore to increased investment (figure 9.1).

Strength of governance structure index

Legally mandating separation between corporate constituencies can directly minimize potential agency conflicts. For example, risks associated with conflicts of interest increase exponentially when a CEO can also be chair of the board of directors or when there is no requirement for a minimum number of independent directors. *Doing Business* tracks legal requirements that strengthen the governance structure of companies, such as board independence, functional separation, audit and compensation committees, and limits on cross-shareholding and subsidiary ownership (figure 9.2).[9]

Extent of corporate transparency index

Greater access to corporate information can have beneficial effects for firms. For example, where companies are required to disclose information about their finances, about the remuneration of their managers and directors and about other directorships they hold, research has found that this transparency improves corporate governance and lowers the cost of investment in capital markets.[10] *Doing Business* uses questions relating to a company's audit and financial statements to measure the extent to which companies are required to accurately present their business and financial condition, based on current knowledge and future expectations. Access to complete and accurate financial information is crucial to efficiently deploying investor capital (figure 9.3).

Allocation of legal expenses in shareholder litigation

Comprehensive rights are moot without effective ways to assert them. In optimal regulatory environments, enforcement is the duty both of efficient government agencies with adequate resources and of private shareholders willing to initiate legal actions whenever they suspect that a company in which they have invested is being mismanaged by corporate insiders. But such lawsuits, which often target companies (and directors or managers) with deeper pockets, are unlikely to occur unless

FIGURE 9.2 Some areas of corporate governance continue to be overlooked in some economies

Note: The good practices are those measured by the strength of governance structure index.
Source: Doing Business database.

FIGURE 9.3 Corporate transparency could be enhanced in some areas

Note: The good practices are those measured by the extent of corporate transparency index.
Source: Doing Business database.

shareholder plaintiffs can recover their legal expenses or the payment of their expenses can be made contingent on a successful outcome. The indicators now measure whether legal expenses incurred by shareholder plaintiffs can be charged to the company and whether plaintiffs can pay attorney fees depending on the damages they recover in court.

WHAT DO THE RESULTS SHOW?

Overall, OECD high-income economies have the strongest protections of minority shareholders as measured by *Doing Business*. These economies have the highest average score both on the extent of conflict of interest regulation index, which is the average of 3 existing indices of minority shareholder protections, and on the extent of shareholder governance index, which is the average of the 3 new ones (table 9.1).[11] The average scores for all regions except South Asia reflect stronger performance on protections from conflicts of interest than on shareholder rights in corporate governance as measured by *Doing Business*, with the largest gap between the 2 dimensions in East Asia and the Pacific and Latin America and the Caribbean.

Worldwide, India, France, Albania, Croatia and Switzerland have among the highest scores on the 3 new indices. Coincidentally, both India and Switzerland introduced legislation in the past year that directly addressed some of the new components measured—India with a new companies act and Switzerland with a federal ordinance on abusive compensation.

Among the regions with lower average scores on the 3 new indices, Sub-Saharan Africa suffers from having less developed securities regulations and capital markets, while the results in East Asia and the Pacific and Latin America and the Caribbean are attributable mostly to outdated company laws and the heterogeneity of the economies in these regions. In East Asia and the Pacific financial hubs with strong securities commissions and corresponding regulations—such as Hong Kong SAR, China; Singapore; and Malaysia—score well, in contrast with some of the smaller Pacific islands.

A similar phenomenon is apparent in Latin America and the Caribbean when comparing Brazil and Colombia, which have the region's highest scores, with such economies as Haiti, Grenada and St. Lucia.

Globally, the results are in line with the results of research in this area suggesting positive correlations between

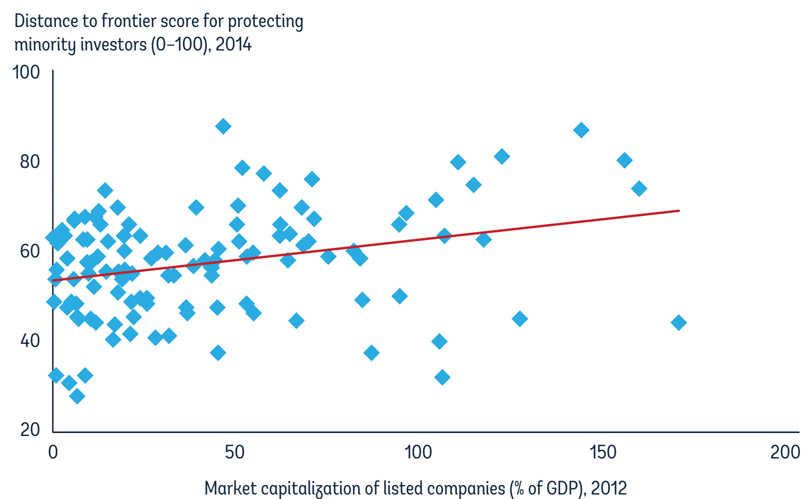
TABLE 9.1 OECD high-income economies offer the strongest protections overall and as measured by the new indices

Region	Average score (0–10)		
	Extent of conflict of interest regulation index	Extent of shareholder governance index	Strength of minority investor protection index
OECD high income	6.4	6.2	6.3
Europe & Central Asia	6.0	5.9	5.9
South Asia	5.2	5.3	5.3
East Asia & Pacific	5.5	4.5	5.0
Middle East & North Africa	4.8	4.6	4.7
Latin America & Caribbean	5.1	4.1	4.6
Sub-Saharan Africa	4.8	4.4	4.6

Note: The strength of minority investor protection index is the average of the 2 other indices shown here. The extent of conflict of interest regulation index is the average of the extent of disclosure, extent of director liability and ease of shareholder suits indices. The extent of shareholder governance index is the average of the extent of shareholder rights, strength of governance structure and extent of corporate transparency indices. For details on how the indices are constructed, see the data notes.

Source: Doing Business database.

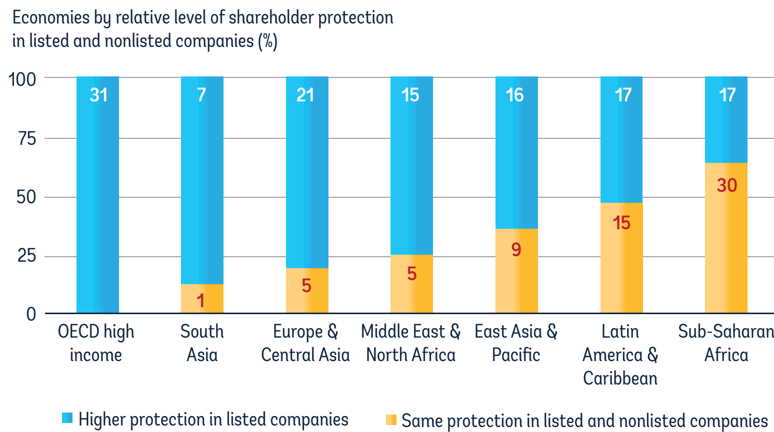
FIGURE 9.4 Greater protection of minority shareholders is associated with greater market capitalization



Note: The correlation between the distance to frontier score for protecting minority investors and market capitalization as a percentage of GDP is 0.34. The relationship is significant at the 5% level after controlling for income per capita. The sample includes 116 economies for which data on market capitalization are available.

Source: Doing Business database; World Bank, World Development Indicators database.

FIGURE 9.5 OECD high-income economies systematically offer more protection for shareholders of listed companies than for shareholders of nonlisted ones



Note: Shareholder protection is as measured by the extent of shareholder rights, strength of governance structure and extent of corporate transparency indices. The numbers shown in the bars are the number of economies in each category within each region.

Source: Doing Business database.

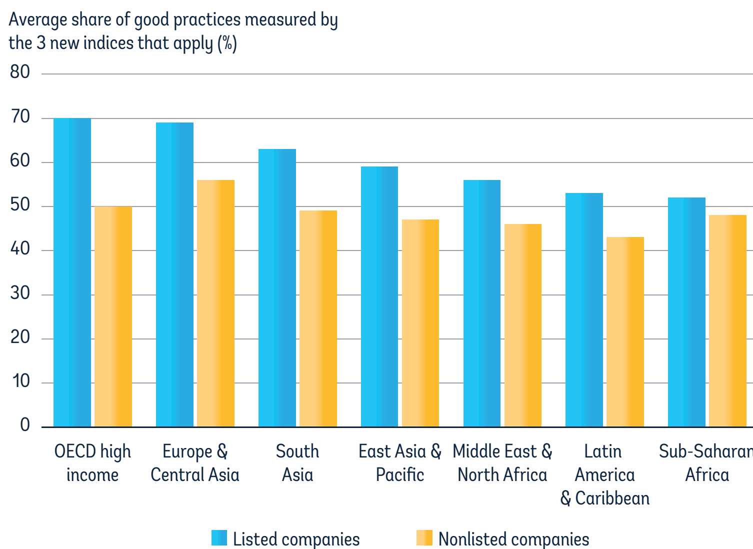
minority investor protection and economic outcomes: economies that have stronger regulation of related-party transactions and a greater minority shareholder role in corporate governance also tend to have, for example, higher market capitalization (figure 9.4).

Moreover, economies that tend to have greater shareholder involvement in corporate governance, as measured by the 3 new indices, also tend to have greater protection of minority shareholders in prejudicial related-party transactions, as measured by the 3 existing indices. The results thus confirm the validity of using the quality of regulation of related-party transactions as a proxy for the overall quality of corporate governance.

Unsurprisingly, the economies that score best on the new indices have active stock exchanges with the requisite legal frameworks and enforcement agencies. Among the 189 economies covered by *Doing Business*, 124 apply stronger regulations to listed companies than to nonlisted ones, so that shareholders of listed companies are more protected.[12] In all OECD high-income economies the regulations that apply to listed companies are more protective of minority shareholders, consistent with the more developed capital markets in these economies (figure 9.5). Sub-Saharan Africa is the only region where the majority of economies provide the same level of protection for minority shareholders in both types of companies, further confirming the link with the level of development of capital markets.

But applying the same standards to both types of companies does not necessarily mean better overall protection of shareholders. Somewhat counterintuitively, data show that the larger the gap, the better the overall protection: minority investors are more protected in economies that distinguish between shareholders of listed companies and shareholders of nonlisted ones (figure 9.6). Indeed, economies that distinguish between these shareholder groups have adopted 55% on average of the good practices captured by the 3 new indices—while those that do not distinguish have adopted 39% on average.

FIGURE 9.6 Minority investors are more protected overall in economies that distinguish between shareholders of listed companies and shareholders of nonlisted ones



Note: The 3 new indices are the extent of shareholder rights, strength of governance structure and extent of corporate transparency indices.

Source: Doing Business database.

CONCLUSION

Results on the 3 new indices highlight great variation across the 189 economies covered in the rights, responsibilities and protections afforded to minority shareholders, whether they are investing in a nonlisted company or in a listed one. The new data set brings attention to areas of corporate governance that are often overlooked by policy makers. It also sheds light on the protection of shareholders in nonlisted companies, an aspect on which data are seldom collected and yet that could prove to be a particularly important area of legislation and source of economic growth in economies with less developed stock exchanges and capital markets.

More generally, the new indices should prove to be helpful in moving beyond a focus on the regulation of related-party transactions and identifying a broader array of features that could be lacking in the corporate law and securities regulations of some economies—contributing to sounder regulations that both protect minority investors and enhance entrepreneurs' access to equity finance.

NOTES

This case study was written by Nadine Abi Chakra and Hervé Kaddoura.

1. Djankov, La Porta and others 2008. Private benefits of control are defined as the economic advantages of a majority ownership stake.
2. Black and others 2010; Dharmapala and Khanna 2013.
3. McLean, Zhang and Zhao 2012.
4. Cremers and Ferrell forthcoming; Balasubramanian, Black and Khanna 2010; Caixe and Krauter 2013.
5. Lima and Sanvicente 2013.
6. Chen, Chen and Wei 2011.
7. Malhotra, Poteau and Fritz 2013; Black and Kim 2012; Guo and Masulis 2013; Lo, Wong and Firth 2010; Hodgson and Ruel 2012.
8. See the data notes for the full list of components added this year.
9. *Cross-shareholding* refers to 2 independent companies acquiring shares in each other.
10. Gilson 2000; Lima and Sanvicente 2013; Bartha, Konchitchkib and Landsmanc 2013; Lang, Lins and Maffett 2012.
11. The 3 existing indices are the extent of disclosure, extent of director liability and ease of shareholder suits indices.
12. For the purposes of the protecting minority investors indicators, nonlisted companies are defined as joint stock companies before they are listed on any stock exchange, or their functional equivalent under the respective legislation of the economies covered by *Doing Business*, and do not include other types of companies such as limited liability companies or sole proprietorships.