

# Doing Business

## Protecting investors

Mexican investors had a good year in 2006. A new securities law came into effect, replacing outdated regulations with greater investor protections.<sup>1</sup> The stock market soared—equity prices rose by 55% for the year. The good fortune continued into 2007. In June the courts upheld the new law against an appeal by its fiercest opponent, one of the country’s richest businessmen. The ruling preserved the law’s protections for small shareholders.<sup>2</sup> Stock prices rose even further.

Mexico’s reforms helped small investors—by providing for broad disclosure of related-party transactions,<sup>3</sup> clear obligations for company directors and managers and easy access to the courts when investors are harmed. Economies that regulate self-dealing—the use of corporate assets for personal gain—see greater equity investment and lower concentration of ownership.<sup>4</sup> A recent study of Bulgaria found exactly that: tougher investor

protections from a 2002 securities law reform stopped a growing flow of delistings from the stock exchange and led to higher equity values.<sup>5</sup>

New Zealand provides the greatest protection against self-dealing (table 7.1). Singapore comes in second. Self-dealing is just one corporate governance failure, but it is the most important. Other investor protections—such as election of directors, disclosure of remuneration or rules on takeover bids—are relevant mostly for richer countries in a position to develop large share markets.

Several developing countries protect investors well. South Africa ranks among the top 10, and Mauritius comes in at 11. But across 178 economies, it is the rich ones that regulate self-dealing the most (figure 7.1). They require greater disclosure for companies, impose stronger duties on directors and make it easier for investors to

TABLE 7.1

### Where are investors protected—and where not?

Most protected	Rank	Least protected	Rank
New Zealand	1	Guinea	169
Singapore	2	Micronesia	170
Hong Kong, China	3	Palau	171
Malaysia	4	Venezuela	172
Canada	5	Djibouti	173
Israel	6	Suriname	174
United States	7	Swaziland	175
Ireland	8	Lao PDR	176
South Africa	9	Tajikistan	177
United Kingdom	10	Afghanistan	178

Note: Rankings are on the strength of investor protection index. See Data notes for details.  
Source: Doing Business database.

FIGURE 7.1

### Fewest investor protections in Africa

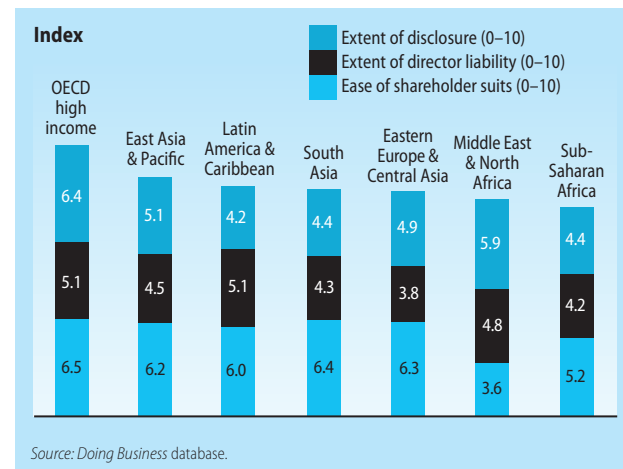
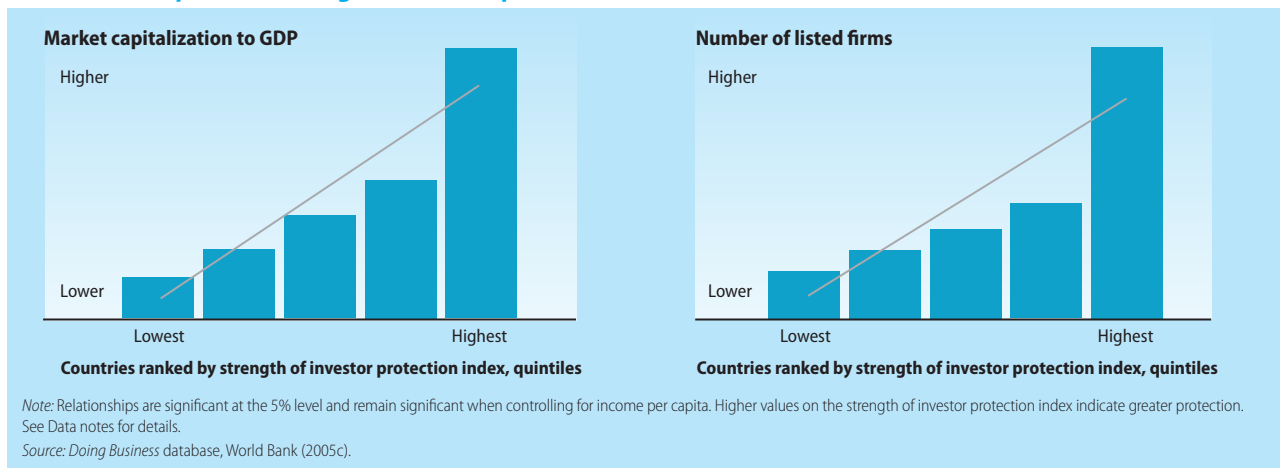


FIGURE 7.2

**Better investor protection—higher market capitalization and more listed firms**



confront negligent or fraudulent directors in court.

Across regions, Latin America requires the least disclosure of related-party transactions. Countries in Eastern Europe and Central Asia regulate directors’ duties only minimally, imposing vague obligations that cannot easily be challenged. And court rules in the Middle East and North Africa make it difficult for small investors to gather evidence. Investors in Syria, for example, have no access to internal company documents when bringing suit. That makes it easy for insiders to hide misconduct.

Both disclosure and extensive approval requirements

and private rights of action for minority shareholders are important for developing strong equity markets. Countries that provide both protections have larger and more active stock markets, smaller block premiums and higher rates of new listings (figure 7.2).<sup>6</sup> One example: 2 months after Georgia adopted new securities rules, the country’s largest winemaker listed on the Tbilisi stock exchange, and 4 other companies have since started the listing process. In addition, reforms aimed at countering self-dealing are associated with higher equity returns. Investors look for upside potential, and they find it in reforming markets.

**Who is reforming?**

Ten economies strengthened their investor protections in 2006/07 (table 7.2). Georgia was the top reformer. A revised securities law limits the possibility of self-dealing in several ways. The law defines “interested parties” in a transaction and requires supervisory board or shareholder approval for related-party transactions. It requires companies to immediately notify the securities commission of a related-party transaction and post a

notice of the deal, its terms and the conflict of interest on their own website or that of the Georgian stock exchange. Firms must also include such information in their annual report.

The Georgian reforms also allow investors to appeal harmful actions of directors to the court and demand compensation—including a refund of the benefiting director’s personal profit. To receive these damages, investors need only prove that the transaction could have had better terms and conditions. “Now directors will think twice before entering into transactions with related parties,” says a corporate lawyer in Georgia. All this comes with a clear goal: “We have reformed; we are offering you protections. Now it is your turn to invest in Georgia,” says a government official.

Mozambique was the runner-up in reforms, adopting a new commercial code that replaced legislation dating to 1888. The new code makes it easier to hold directors and controlling shareholders liable for misconduct in 4 ways. First, it permits derivative suits—suits by minority investors against company directors in the

TABLE 7.2

**Greater disclosure—the most popular reform in 2006/07**

<b>Increased disclosure requirements</b>
Belarus, Colombia, Georgia, Iceland, Indonesia, Vietnam
<b>Defined duties for directors and controlling shareholders</b>
Georgia, Mozambique, Portugal
<b>Regulated approval of related-party transactions</b>
Norway, Slovenia
<b>Passed a new securities law</b>
Vietnam

*Source:* Doing Business database.

TABLE 7.3  
**Where are investor protections strong—and where not?**

<b>Extent of disclosure index (0–10)</b>			
<b>Most</b>		<b>Least</b>	
Bulgaria	10	Afghanistan	0
China	10	Albania	0
France	10	Lao PDR	0
Hong Kong, China	10	Maldives	0
Ireland	10	Micronesia	0
Malaysia	10	Palau	0
New Zealand	10	Sudan	0
Singapore	10	Swaziland	0
Thailand	10	Switzerland	0
United Kingdom	10	Tajikistan	0
<b>Extent of director liability index (0–10)</b>			
<b>Most</b>		<b>Least</b>	
Cambodia	9	Bulgaria	1
Canada	9	China	1
Israel	9	Afghanistan	0
Malaysia	9	Dominican Republic	0
New Zealand	9	Marshall Islands	0
Singapore	9	Micronesia	0
Trinidad and Tobago	9	Palau	0
United States	9	Suriname	0
Hong Kong, China	8	Tajikistan	0
South Africa	8	Vietnam	0
<b>Ease of shareholder suits index (0–10)</b>			
<b>Easiest</b>		<b>Most difficult</b>	
Kenya	10	Afghanistan	2
New Zealand	10	Cambodia	2
Colombia	9	Syria	2
Hong Kong, China	9	Venezuela	2
Ireland	9	Yemen	2
Israel	9	Guinea	1
Mauritius	9	Morocco	1
Mozambique	9	Rwanda	1
Singapore	9	Djibouti	0
United States	9	Iran	0

Source: Doing Business database.

company's name. Second, it provides a detailed list of directors' duties to the company. The previous code assigned directors a vague responsibility to "act in good faith." Third, the code introduced special liability for controlling shareholders, including board approval for decisions that may be harmful to the company. These guidelines for controlling shareholders are demanding—and unique in the world. Finally, the new code gives investors the right to review company documents. If company officials refuse, investors can turn to government inspectors to investigate.

The reform raised Mozambique's score on the extent of director liability index from 2 to 4—and its score on the ease of shareholder suits index from 6 to 9, among the highest in the world (table 7.3). As a local lawyer

says, "More information, more chances to win in court."

Vietnam adopted new securities and enterprise laws. The securities law sets up a new securities exchange and trading center. The enterprise law mandates investor involvement in major company actions—for example, transactions exceeding 35% of the assets of the company. The law also increases disclosure for related-party transactions. And it introduces fiduciary duties for directors—but fails to provide a way to enforce those duties. No commercial tribunals in Vietnam have jurisdiction over investor suits against directors.

Last year Belarus ranked among the countries with the least disclosure of corporate dealings. This year it jumped 22 places in the strength of investor protection rankings. A new law requires greater annual disclosure to shareholders and approval of related-party transactions by disinterested shareholders (those without a personal stake in the deal). But shareholder involvement in major decisions comes at a price: directors cannot be held liable for damages if shareholders approve. So if a director persuades the majority of shareholders to support a deal and the deal goes bad, the opposing minority cannot challenge it in court.

Other countries also increased disclosure. Iceland extended requirements for immediate and annual disclosure to all nonlisted public corporations and leapt 17 places in the strength of investor protection rankings. Indonesia now requires more detailed information on companies' activities in their annual report. And Colombia, under its new Decree 3139, requires listed companies to report more information to investors. Before the reform, listed companies had to report any "relevant" or "extraordinary" event—a subjective standard that was open to abuse. The new decree maintains the broad "relevant" requirement but lists specific events that must be disclosed to the financial authorities. It also requires a company to report extensive information before going public.

European countries continued to strengthen protections. Slovenia now requires boards to obtain the prior approval of shareholders in transactions affecting 25% or more of the company's assets. Norway expanded the definition of related-party transactions that shareholders must approve. Portugal made it easier for shareholders to sue by lowering the threshold for derivative suits from 5% of the share capital to 2%. Finland and Ireland implemented a European Union directive to make capital markets more transparent.<sup>7</sup> And the European Commission opened consultations on creating one-stop shops for company information (such as the prospectus, annual report and ownership levels) in member states.

With these, potential investors in Copenhagen, for example, can access information about a company in Greece. Disagreements about harmonizing disclosure forms have delayed implementation.

The most active financial markets reform continually. Japan and the United Kingdom both have company acts that are less than 2 years old. The U.S. Securities and

Exchange Commission issued more than 50 rules or amendments in the past 3 years. And Hong Kong (China), now a top destination for new listings, has increased disclosure requirements each of the past 3 years. A note to market regulators: if your country’s laws on investor protection haven’t changed in the past 5 years, they’re out of date.

## What to reform?

First, get the basics right. Investor protections are not the first point of reform for many countries. Poor countries would do better to ease business start-up, simplify property registration and strengthen collateral laws first. Too many countries get the order wrong. Take Mozambique. The Maputo stock exchange was established in 1999, before the country had reformed its commercial, investment and trade laws. It lists only 1 domestic company (a brewery, Cervejas de Moçambique), 1 international corporation and 5 government bonds. But a recent overhaul of basic corporate laws will likely attract other listings to the exchange.<sup>8</sup>

Once a country has the basics, it can help protect investors against self-dealing. Since 2005, 43 reforms aimed at this have taken place in 34 economies (table 7.4). Hong Kong (China) is the star reformer, appearing each year among the top 10. Here are the 3 most effective reforms:

- Open company activities to investor scrutiny.
- Require disinterested shareholder approval.
- Where courts are strong, help investors bring suit.

### Open company activities to investor scrutiny

Investor protections start with transparency of corporate dealings. Require public reports for large transactions involving directors, as in Poland. Involve shareholders more in corporate decisions, as in South Africa. And open company books for inspection, as in Egypt. Investors need to know what stakes directors have in proposed deals so they can stop harmful activities—or sue for damages.

More disclosure is possible in rich and poor countries alike. The Internet makes distributing financial and ownership information cheap. Malaysia and Thailand, with among the most stringent disclosure rules, require extensive online disclosure on related-party transactions before they go to a vote by the company’s disinterested shareholders. Ghana requires directors to disclose any personal interest in a proposed transaction to their fel-

TABLE 7.4  
**Simple solutions and where they have worked**

<b>Increased disclosure of related-party transactions</b>	Belarus, Canada, Colombia, Georgia, Iceland, Indonesia, Israel, Italy, Mexico, Pakistan, Peru, Poland, Romania, Spain, Sweden, Thailand, Turkey, United Kingdom, Vietnam
<b>Defined duties for directors and controlling shareholders</b>	Georgia, Jamaica, Mozambique, Namibia, Portugal, Spain
<b>Regulated approval of related-party transactions</b>	Israel, Jamaica, New Zealand, Norway, Thailand
<b>Made it easier to sue directors</b>	Germany, Korea, Mexico, Tanzania
<b>Strengthened audit committees</b>	Costa Rica, India, Indonesia, Thailand
<b>Gave shareholders access to company documents</b>	China, Hong Kong (China), Mozambique
<b>Increased penalties for self-dealing</b>	Malaysia, Pakistan

*Source: Doing Business database.*

low board members, detailing both the nature and the extent of that interest. If the transaction is approved, the company’s annual report must fully describe the terms of the deal and the director’s conflict of interest. In Switzerland, in contrast, no public disclosure is required—not even in the annual report.

### Require disinterested shareholder approval

In Colombia and 2 dozen other countries related-party transactions automatically trigger a vote by the company’s disinterested shareholders. In 9 of these countries an external auditor does a thorough review of the transaction and reports to the shareholders before the vote takes place. Compare that with Ecuador, where large deals involving company insiders need sign-off by only one person—a manager, director, president or whoever is named in the bylaws. This invites abuse.

Shareholder approval is easily undermined by loopholes, however. Investors in Cameroon vote on related-party transactions months after they have taken place. By then it’s too late to undo a bad deal. Lebanese shareholders vote at the annual meeting for all related-party transactions arising during the coming year—turning

shareholder involvement into a meaningless rubber stamp. Still other countries, such as Slovakia, exempt related-party transactions from shareholder scrutiny when they occur in the “ordinary course of business.” The problem is, Slovak law doesn’t say what falls outside the “ordinary course of business.” Companies easily bypass shareholder approval.

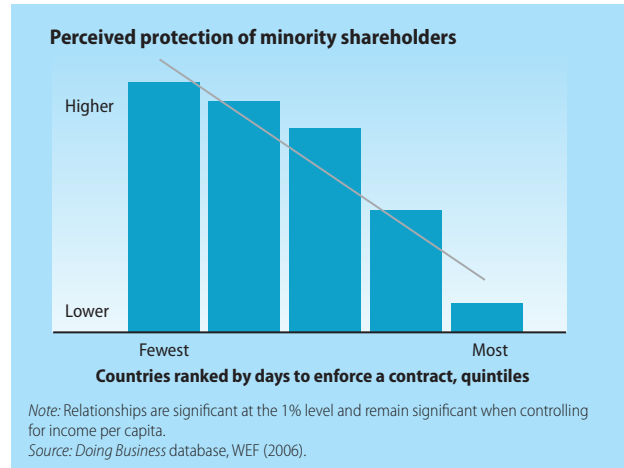
### Where courts are strong, help investors bring suit

Many countries restrict private lawsuits by investors, relying instead on government inspectors to police corporate activities. This has 2 weaknesses. First, no government can investigate every possible crime, especially in poor countries. Second, criminal penalties paid to the state do nothing to repay investors for the loss of their investment. When investors can sue, the damage awards go directly to compensate investors or the company harmed.

Hong Kong (China) does it right. Strict disclosure rules expose company decisions to investors, regulators and the press almost immediately. Unhappy investors can sue directors for multiple misdeeds—including improper personal gains, oppression of minority shareholder interests and negligence in running the company. Once in court, plaintiff investors have full access to company documents to find evidence for proving their case. Cambodia goes only halfway—it permits investors to sue company insiders for a variety of offenses, but

FIGURE 7.3

### Efficient courts help protect minority shareholders



court rules block plaintiffs from gathering the evidence needed to prove their case.<sup>9</sup> The result? No cases are brought because proving them is nearly impossible.

Even the best of rules are useless if courts are weak. Papua New Guinea, Maldives and Slovenia have strong protections on the books allowing investors to bring suit and gather evidence. But even simple commercial disputes take a long time to resolve—591, 665 and 1,350 days, respectively. Less abuse of investors is seen where courts perform well (figure 7.3).

## Notes

1. See Johns and Lobet (2007).
2. Jesus Aranda, “Niega la Corte a Tv Azteca amparo contra artículos de la ley del mercado de valores,” *La Jornada*, June 28, 2007, <http://www.jornada.unam.mx/2007/06/28/index.php?section=economia&article=025n1eco>.
3. Transactions between a director or controlling shareholder and the company, such as the example considered by *Doing Business*.
4. Djankov and others (forthcoming).
5. Atanasov, Ciccotello and Gyoshev (2006).
6. See Djankov and others (forthcoming).
7. European Union Directive 2004/109/EC.
8. Moss (2006).
9. Cigna and Enriques (2005).