

Overview

Starting a business

Dealing with construction permits

Employing workers

Registering property

Getting credit

# Protecting investors

Paying taxes

Trading across borders

Enforcing contracts

Closing a business

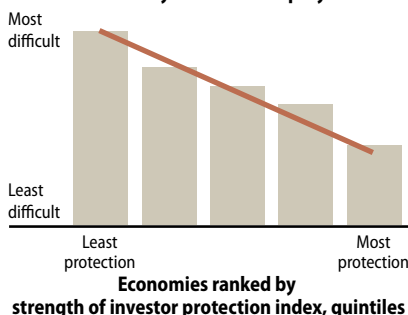
Investing in Costa Rica can be a risky business. Diego, a Costa Rican entrepreneur, is well aware of that: “Why would I buy shares in a company if I know its management can approve large transactions between interested parties without ever disclosing them to its shareholders?” In Costa Rica, as in many other countries around the world, minority investors are not protected against self-dealing—the use by company insiders of corporate assets for personal gain.

Companies grow by raising capital—either through a bank loan or by attracting equity investors. Selling shares allows companies to expand without the need to provide collateral and repay bank loans. But investors worry about getting their money back—and look for laws that protect them. A recent study finds that the presence of legal and regulatory

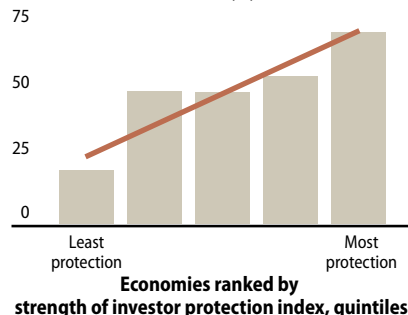
FIGURE 7.1

## More investor protections associated with greater access for firms to equity markets and faster stock turnover

### Perceived difficulty in access to equity



### Turnover of stocks traded (%)



Note: Relationships remain significant at the 5% level when controlling for income per capita. Economies are ranked on the perceived difficulty in access to equity, with 131 being the most difficult. See Data notes for details.

Source: Doing Business database; WEF (2007); World Bank, World Development Indicators database.

protections for investors explains up to 73% of the decision to invest. In contrast, company characteristics explain only between 4% and 22%.<sup>1</sup> Thus both governments and businesses have an interest in reforms strengthening investor protections.

Without investor protections, equity markets fail to develop and banks become the only source of finance. The result: businesses fail to reach efficient size for lack of financing, and economic growth is held back. Research in 22 emerging market economies shows that where investors have little recourse against actions that damage the company, they invest in a few companies in which they take majority stakes.<sup>2</sup> In contrast, good protections for minority shareholders are associated with larger and more active stock markets.

Vibrant stock markets are not the only reason to introduce stronger investor protections. Tanzania started reforms of investor protections as part of a larger initiative to reduce corruption and create an environment that inspires the trust needed to do business.<sup>3</sup> Such an environment strengthens investor confidence in local businesses and government alike.

Economies that rank high on the strength of investor protection index have extensive disclosure requirements and give shareholders broad access to information both before and during trials to determine director liability. New Zealand and Singapore, which top the

rankings on the index with 29 and 28 of 30 possible points, both require immediate disclosure of a related-party transaction and of the conflict of interest (table 7.1). They require prior approval of the transaction by the other shareholders. They enable the shareholders to hold the directors liable and to have the transaction voided if it damages the company. And in New Zealand shareholders can inspect all internal documents before deciding whether to sue.

Vietnam shows the benefits of reforms to strengthen investor protections. In 2005, before Vietnam adopted clear legislation, its unregulated stock market saw 60–100 daily trades with a value of \$10,000–16,000. That was 3–6 times the trading volume of the regulated Ho Chi Minh Stock Exchange.<sup>4</sup> After reform of the Law on Securities and the Law on

TABLE 7.1

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

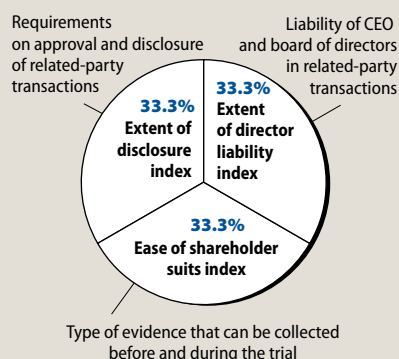
Most protected	RANK	Least protected	RANK
New Zealand	1	Micronesia	172
Singapore	2	Palau	173
Hong Kong, China	3	Rwanda	174
Malaysia	4	Venezuela	175
Canada	5	Vietnam	176
Ireland	6	Djibouti	177
Israel	7	Suriname	178
United States	8	Swaziland	179
South Africa	9	Lao PDR	180
United Kingdom	10	Afghanistan	181

Note: Rankings are based on the strength of investor protection index. See Data notes for details.

Source: Doing Business database.

FIGURE 7.2

### Rankings on protecting investors are based on 3 subindicators



Note: See Data notes for details.

Enterprises, the number of listed firms climbed from 41 in 2005 to 193 today—and 107 of these are listed on the Ho Chi Minh Stock Exchange. Despite the recent difficulties in the Vietnamese securities markets, market capitalization increased from less than \$1 billion in 2005 to more than \$13 billion today.

Across regions, Latin America regulates related-party transactions the least, imposing the weakest requirements for disclosure and approval. Many Latin American economies have commercial laws that have not been reformed since the 1920s. Economies in Eastern Europe and Central Asia have stronger requirements for disclosure and approval. But once a transaction is approved and disclosed, the company directors are not liable for any damage resulting from it.

Economies in the Middle East and North Africa, such as Djibouti and Oman, limit access to information. That makes it difficult for minority shareholders to obtain the evidence needed to prove their case in court.

**WHO REFORMED IN 2007/08?**

Twelve economies strengthened investor protections in 2007/08 (table 7.2). Albania was the top reformer. It adopted the Law on Entrepreneurs and Commercial Companies, which regulates conflicts of interest by requiring shareholder approval of related-party transactions involving more than 5% of company assets. The law also provides for extensive disclosure requirements and makes it easier for minority investors to sue directors. And minority shareholders can now request compensation from directors for harm resulting from a related-party transaction, including repayment of all profits from the transaction. With the new law, Albanian company directors have strong incentives to be responsive to investor interests.

The runner-up reformer was Thailand. After being the top reformer in protecting investors 3 years ago, Thailand made new efforts to strengthen minority shareholder rights, particularly in

TABLE 7.2  
**Greater disclosure—the most popular reform feature in 2007/08**

Increased disclosure requirements	Albania, Azerbaijan, Egypt, Saudi Arabia, Tajikistan
Made it easier to sue directors	Albania, Botswana, Kyrgyz Republic, Thailand
Allowed derivative or direct suits	Greece, Kyrgyz Republic, Slovenia
Regulated approval of related-party transactions	Albania, Azerbaijan, Tajikistan
Passed a new company law	Albania, Botswana, Tajikistan
Required an external body to review related-party transactions before they take place	Egypt, Turkey
Allowed rescission of prejudicial related-party transactions	Tunisia

Source: Doing Business database.

the area of director liability. Directors damaging the company’s interests can no longer rely on having obtained shareholder approval of a transaction to avoid liability. If they are held liable, sanctions will be harsh. They will have to compensate the company for all damages, pay back all profits made from the transaction and pay fines to the state. They even risk jail time.

Central Asian economies also strengthened minority shareholder rights. Tajikistan, Azerbaijan and the Kyrgyz Republic brought their company laws into line with modern regulations and corporate governance principles.

Tajikistan adopted a new joint stock companies act. The law defines “interested parties” and requires shareholder approval of transactions between such parties. It also requires interested parties to immediately disclose conflicts of interest to the board of directors. In addition, derivative suits are now possible: shareholders with at least 10% of shares can file a lawsuit on behalf of the company against company directors.

Azerbaijan reformed its civil code, and its State Securities Commission adopted new rules regulating related-party transactions. The new law defines what is meant by “related transactions between interested parties” and requires shareholder approval when such transactions exceed 5% of company assets. However, interested parties are allowed to vote at the shareholders meeting. The law also includes requirements for disclosure

both to the market regulator and through the company’s annual reports. As in Albania, minority shareholders can now request compensation for damages to the company resulting from related-party transactions.

The Kyrgyz Republic reformed its joint stock companies act. From now on, shareholders can sue in their own name the directors who damaged shareholders’ interests and request compensation from them.

Botswana defined related-party transactions and clarified disclosure provisions in its Companies Act of 2004, which came into force in July 2007. Establishing the liability of directors is now easier: shareholders can file suit against them if the transaction proves prejudicial to the company. If directors are held liable, they not only have to cover damages but also have to pay back all profits made—a good reason to think twice before attempting to misuse company assets.

The Egyptian Capital Market Authority made improving disclosure requirements a priority when it amended the listing rules of the Cairo Stock Exchange. The amendments are aimed at increasing transparency both before and after related-party transactions are concluded. Such transactions now have to be assessed by an independent financial adviser before they take place, ensuring that shareholders will be better informed. The amendments also clarify requirements for disclosure through companies’ annual reports. In March 2008 Turkey

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	Ukraine	1
China	10	Afghanistan	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	Tunisia	0
<b>Extent of director liability index (0–10)</b>			
<b>Most</b>		<b>Least</b>	
Albania	9	Tajikistan	1
Cambodia	9	Togo	1
Canada	9	Zimbabwe	1
Israel	9	Afghanistan	0
Malaysia	9	Dominican Republic	0
New Zealand	9	Marshall Islands	0
Singapore	9	Micronesia	0
Slovenia	9	Palau	0
Trinidad and Tobago	9	Suriname	0
United States	9	Vietnam	0
<b>Ease of shareholder suits index (0–10)</b>			
<b>Easiest</b>		<b>Most difficult</b>	
Kenya	10	Lao PDR	2
New Zealand	10	Syria	2
Colombia	9	United Arab Emirates	2
Hong Kong, China	9	Venezuela	2
Ireland	9	Yemen	2
Israel	9	Guinea	1
Mauritius	9	Morocco	1
Poland	9	Rwanda	1
Singapore	9	Djibouti	0
United States	9	Iran	0

Source: *Doing Business* database.

undertook similar reforms. The listing rules of the Istanbul Stock Exchange now require an independent body to assess all related-party transactions before they are approved.

Saudi Arabia amended provisions of its company law. Interested directors may no longer vote at a shareholders meeting to approve related-party transactions. And just as in Albania, Botswana and Thailand, directors found liable for damage to a company due to a related-party transaction will have to repay all profits made from it.

Greece adopted a new company law

that lowers the threshold for derivative suits. Now shareholders need to have only 10% of the company's shares, down from 33% before. Slovenia changed its laws to allow minority investors with at least 10% of shares to bring derivative suits before the court.

Tunisia adopted a law giving shareholders the right to directly access internal company documents and to ask for the appointment of an independent inspector. That will make it easier to gather evidence to support a court claim. The new law also gives 10% shareholders the right to request a judge to rescind

prejudicial related-party transactions.

Reforms of corporate governance and, in particular, of company laws took place worldwide—from Syria to Sri Lanka, from Indonesia to Vietnam. Argentina further strengthened corporate governance principles by introducing a comprehensive set of “comply or explain” rules for listed companies.

Ongoing reforms to implement the European Union Transparency Directives are taking place in several EU member countries, such as Austria and Luxembourg, and in candidate member countries, such as Croatia. Implementing these EU directives often requires amending the company and securities laws. Bulgaria and Romania amended their company laws in the past 2 years, and both countries are now implementing these amendments.

#### **WHAT ARE THE REFORM TRENDS?**

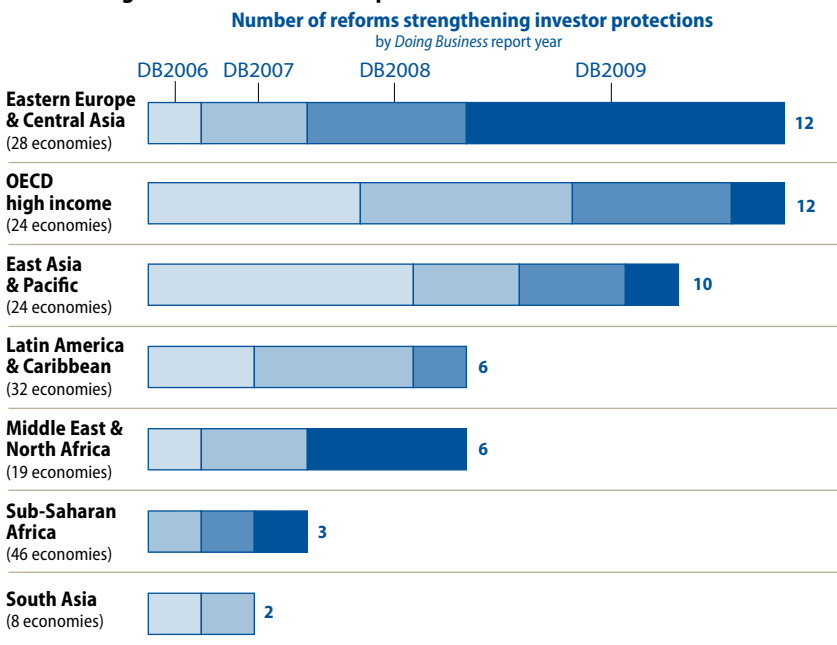
Experience over the past 4 years shows that economies can successfully enhance the protections they provide to minority shareholders. It often takes time, even when the necessary political will exists. But economies like Albania, Azerbaijan and the Kyrgyz Republic demonstrate that it can be done in months, not years.

Sometimes the private sector opposes reforms that are designed to protect minority investors, especially in economies with a high concentration of ownership. One possible reason is that complying with extensive disclosure requirements can represent a financial burden for companies, particularly in developing economies. In Mexico, for example, the most vocal opponent of reform was one of the country's wealthiest businessmen.<sup>5</sup> In Georgia it was one of the largest commercial banks.

Such opposition has not prevented reform: *Doing Business* has recorded more than 50 reforms to strengthen investor protections in 41 economies over the past 4 years. Eastern Europe and Central Asia and the OECD high-income economies have had the most reforms, with 12 each (figure 7.3).

FIGURE 7.3

**Accelerating reforms in Eastern Europe & Central Asia**



Note: A reform is counted as 1 reform per reforming economy per year. Source: Doing Business database.

In Eastern Europe and Central Asia the main driver of the reforms was accession to the European Union. Economies such as Poland, Romania and Slovenia updated company and securities laws to EU standards. These reforms focused on developing regulations requiring more transparency in the day-to-day management of companies. The reforms raised the region’s average score on the extent of disclosure index from 4.7 in 2005 to 5.8 today.

OECD high-income economies protect minority investors the most. Why would they continually reform? There is a logical reason: sophisticated and active financial markets must respond rapidly to challenges that are constantly evolving, such as fraud. Among the repeat reformers are Hong Kong (China) and the United Kingdom—both in the top 10 on the strength of investor protection index. Both economies reformed twice during the past 3 years, by strengthening disclosure requirements and expanding shareholder access to internal corporate documents.

Fewer reforms have taken place in Latin America and the Caribbean, Africa

and South Asia. In 2007/08 only one reform was recorded in these regions—in Botswana. But in previous years reforms strengthened investor protections in such economies as Colombia and Mexico in Latin America and Mozambique and Tanzania in Africa.

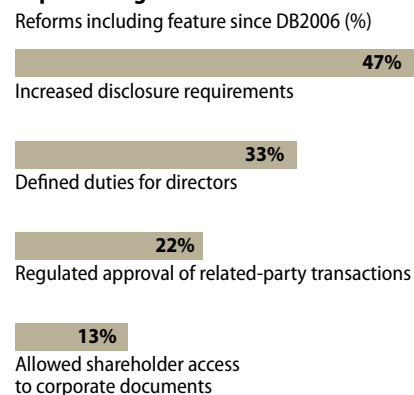
**GOING FOR MORE DISCLOSURE**

Across regions, the most popular reform feature has been to require greater disclosure of related-party transactions (figure 7.4). The results of a 2002 global survey on corporate governance provide one explanation: around 90% of the investors surveyed want more transparency in the day-to-day management of companies.<sup>6</sup> What do they mean by more transparency? Unified accounting standards, immediate disclosure of major transactions and more involvement of minority investors in major decisions and transactions.

Requirements for greater disclosure, while popular, are unlikely to succeed everywhere. Extensive disclosure standards require the necessary infrastructure to communicate the information effectively and, more importantly, people such as

FIGURE 7.4

**Top 4 reform features in protecting investors**



Note: A reform may include several reform features. Source: Doing Business database.

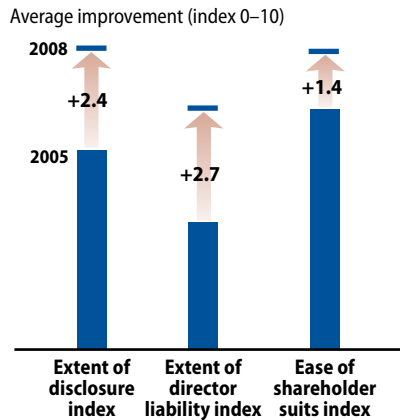
lawyers and accountants to comply with the standards. Many poor countries lack both. They may have stock exchanges—but no website to post the information on. And they may have certified accountants—but in such small numbers that complying with disclosure requirements is virtually impossible. Take Vietnam. Its securities law has significant disclosure and reporting requirements, but the country still lacks the systems to store and monitor the information electronically.<sup>7</sup>

**FINDING INSPIRATION FOR REFORM**

Crisis can be an important engine of reform. The East Asian financial crisis and corporate scandals such as those involving Enron, Parmalat and WorldCom triggered regulatory reforms around the world. These crises exposed weaknesses in markets previously considered models of sound regulation. Countries affected by the crises reformed their laws. So did other countries, using the experiences to avoid the same mistakes. Mexico, for example, used the U.S. experience to create impetus for its regulatory reforms.

Countries that want to reform can

FIGURE 7.5  
**Top reformers in 2005–08  
 in protecting investors**



Source: *Doing Business* database.

choose to amend existing regulations or start from scratch, depending on how up-to-date their current legislation is. In 2007 Georgia amended its securities legislation by adding provisions regulating disclosure and approval of transactions between interested parties. Belarus, Colombia and Thailand did the same. Other countries, such as Mozambique and Slovenia, started from scratch. Adopting an entirely new law offers an opportunity to reform other areas—such as business registration, directors’ duties, disclosure rules and issuance of shares.

Reformers often find inspiration in economies with a similar legal origin or in their main commercial partners. Mexico’s securities law reform took into account aspects of a U.S. law—the Public Company Accounting Reform and Investor Protection Act of 2002, commonly known as the Sarbanes-Oxley Act. Botswana and Mozambique followed the South African model. As a reformer from Mozambique explains, “Our previous code was inherited from Portugal. Today our main commercial partner is South Africa, and we are surrounded by countries that have the same model. We prefer to adopt legislation that would enable us to attract more investment from South Africa and make life easier for our main investors.”

Even the best regulations will make little difference if the court system is weak. Bangladesh and Montenegro have laws setting out strong disclosure requirements and extensive obligations for directors. But with the most basic commercial disputes taking more than 1,000 days to resolve in Bangladesh and more than 500 in Montenegro, these laws may not have the desired effect.

## NOTES

1. Doidge, Karolyi and Stulz (2007).
2. Dahya, Dimitrov and McConnell (2008).
3. Sitta (2005).
4. World Bank (2006c).
5. See Johns and Lobet (2007).
6. McKinsey & Company (2002, p. 8).
7. Lobet (2008).