

# CORPORATE GOVERNANCE REGULATION IN EMERGING COUNTRIES. CASE OF ROMANIA

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## *Abstract:*

*Most of the literature on corporate governance emphasizes that firms should be run in the interests of shareholders. This is a suitable objective function when markets are perfect and complete. In many emerging economies this is not the case: markets are imperfect and incomplete. Corporate governance issues are especially important in emerging countries, since these countries do not have the long-established financial institution infrastructure to deal with corporate governance issues. This paper discusses how emerging countries are dealing with corporate governance issues and the extra obstacles they have to overcome due to a lack of regulations. Romanian case study is examined.*

*Keywords: corporate governance principles, corporate governance key actors, emerging country*

## **Introduction**

The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has therefore become a necessary prerequisite for any corporation to manage effectively in the globalized market.

The term "corporate governance" is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776). In the last two decades, however, corporate governance issues have become important not only in the academic literature, but also in public policy debates. During this period, corporate governance has been identified with takeovers, financial restructuring, and institutional investors' activism. One can talk about the governance of a transaction, of a club, and, in general, of any economic organization. In a narrow sense, corporate governance is simply the

governance of a particular organizational form - a corporation.

Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan assert that governance determines how the firm's top decision makers actually administer such contracts (Garvey and Swan, 1994).

Shleifer and Vishny define corporate governance by stating that it deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny, 1997). A similar concept is suggested by Caramanolis-Cötelli, who regards corporate governance as being determined by the equity allocation among insiders and outside investors (Caramanolis-Cötelli, 1995).

John and Senbet propose the more comprehensive definition that corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected (John and Senbet, 1998). They include as stakeholders not just shareholders,

but also debt holders and even non-financial stakeholders such as employees, suppliers, customers, and other interested parties. Hart closely shares this view as he suggests that corporate governance issues arise in an organization whenever two conditions are present (Hart, 1995). First, there is an agency problem, or conflict of interest, involving members of the organization – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract.

Zingales defines corporate governance as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm (Zingales, 1997). He considers that all the governance mechanisms discussed in the literature can be reinterpreted in light of this definition.

An OECD study considers that corporate governance is the system by which business corporations are directed and controlled (1999). The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

Roe define corporate governance as the relationships at the top of the firm - the board of directors, the senior managers, and the stockholders (2004). In his opinion institutions of corporate governance are those repeated mechanisms that allocate authority among the three and that affect, modulate and control the decisions made at the top of the firm.

Core corporate governance institutions respond to two distinct problems, one of vertical governance (between distant shareholders and managers) and another of horizontal governance (between a close, controlling shareholder and distant shareholders).

A few studies have examined corporate governance in emerging markets. Researchers (Claessens, Djankov and Lang, 1999; La Porta, Lopez-de-Silanes and Shleifer, 1999; Lins, 2000) have studied the implications of the concentrated corporate ownership that is common in many emerging and developed markets and conclude that the principal agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by the controlling shareholders.

### **Key actors of corporate governance**

Good corporate governance requires a clear understanding of the respective roles of the board and of senior management and their relationships with stockholders and stakeholders. The relationships of the board and management with stockholders should be characterized by transparency; their relationships with employees should be characterized by correctness; their relationships with the communities in which they operate should be characterized by social responsibilities; and their relationships with government should be characterized by a conformation with international and internal laws.

The key actors of corporate governance are board of directors and senior management led by the Chief Executive Officer.

### **Board of directors**

Corporation is managed under the direction of the corporation's board. The board makes the selection, compensation and evaluation of a well

qualified and ethical CEO. On behalf of directors, CEO manages the everyday affairs of the corporation. The board of directors acts for the corporation's stockholders.

Also responsibilities of corporation's board must include (The Business Roundtable, 2002, pp. 4-6):

- Planning for management succession
- Understanding, reviewing and monitoring implementation of the corporation's strategies
- Understanding and reviewing annual operating plans and budgets
- Focusing on the integrity and clarity of the corporation's financial statements and financial reporting
- Advising management on significant issues facing the corporation
- reviewing and ratifying systems of risk management and internal control, codes of conduct and legal compliance
- approving and monitoring the progress of major capital expenditure, capital management and acquisitions and divestitures
- Reviewing management's plans for business resiliency
- Overseeing the company, including its control and accountability systems.

Boards of directors operate using committees to assist them. Effective corporate governance requires audit, corporate governance (nominating) and compensation committees.

### **Audit committee**

Every publicly owned corporation should have an audit committee comprised solely of independent directors. Audit committees typically consist of 3 to 5 members. Audit committee members should assure compliance with financial standards. At least one of the committee members should have accounting or financial management expertise, as required by the listing standards of the major securities markets.

The functions of the audit committee are:

- Makes corporation's risk assessment and audits management practices
- Supervise the corporation's relationship with its outside auditor,
- Assess the performance and independence of the external auditors
- Review and discuss with management and the outside auditor the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management
- Review the corporation's procedures addressing compliance with the law
- Review with outside auditors the adequacy of internal controls system
- Assess the management processes supporting external reporting
- Assure communication between board for the outside auditor and internal auditors

### **Corporate governance committee**

The corporate governance committee's role is to recommend director nominees to the full board and the corporation's stockholders. Others functions of corporate governance committee are:

- Monitor and keep independence of the board
- Makes evaluation of the board and management
- Supervises process of providing information to the full board
- Develops and recommend a set of corporate governance principles and best practices applicable to the corporation.

### **Compensation committee**

Compensation committee oversees the corporation's overall compensation programs, and setting CEO and senior management compensation. The structure of

management compensation should directly link the interests of management, both individually and as a team, to the long-term interests of stockholders.

### **CEO (Chief Executive Officer)**

CEO manages the corporation in an effective and ethical manner. The most important undertakings of a CEO are:

- Run the corporation's day-to-day business operations;
- Take the lead in strategic planning;
- Develops annual operating plans and annual budgets for the corporation;
- Establishing a quality staff and an effective organizational structure;
- Identifies and manages risks;
- Is responsible for the integrity of the corporation's financial reporting system.

### **Principles of corporate governance in emerging countries**

Corporate governance is only part of the larger economic context in which firms operate, which includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which it operates can also have an impact on the reputation and the long term success of a company.

Although instituting corporate governance is clearly beneficial for firms and countries, the rapid pace of globalization has made the need urgent. Doing so requires that firms and national governments make some fundamental changes. Companies must change the way they operate, while national governments must establish

and maintain the appropriate institutional framework.

Efforts to improve corporate governance by establishing international standards began roughly 15 years ago and have recently gained enormous momentum.

The principles are primarily intended to provide assistance to governments in creating a corporate governance framework. They can indeed be a useful point of reference for many emerging markets and economies in transition. Not only do the principles provide a benchmark for internationally accepted standards, they also offer a solid platform for analysis and practices in individual countries taking into account country specific circumstances, such as legal and cultural traditions.

Corporate governance is receiving substantial attention in developed countries. Think tanks and business associations throughout the developing world and in the transitional economies are also focusing resources on corporate governance.

In order for corporate governance measures to have a meaningful impact in any economy, a set of core democratic, market institutions, including a legal system to enforce contracts and property rights, needs to be up and running. Yet, in most developing economies, even the most basic democratic, market institutions may be weak. Given these circumstances, instituting corporate governance in developing and emerging markets requires more than merely exporting well-established models of corporate governance that function within the developed economies. Special attention needs to be given to establishing the necessary political and economic institutions that are tailored to a country's specific needs and that give corporate governance effectiveness.

In Table 1 are presented the main countries which develop full texts of corporate governance codes, principles of corporate governance and corporate

governance reforms both in developed countries and developing countries. CGRI (corporate governance regulation index) is the product between years of development and number of acts.

**Table 1**

**Corporate governance regulation index**

| <b>Countries</b>           | <b>Development period</b> | <b>Number of acts</b> | <b>CGRI</b> |
|----------------------------|---------------------------|-----------------------|-------------|
| <i>Developed countries</i> |                           |                       |             |
| Australia                  | 1995-2008                 | 9                     | 117         |
| Austria                    | 2002-2008                 | 4                     | 24          |
| Canada                     | 1994-2008                 | 7                     | 98          |
| Denmark                    | 2000-2008                 | 4                     | 32          |
| Finland                    | 2003-2008                 | 2                     | 10          |
| France                     | 1995-2008                 | 6                     | 78          |
| Germany                    | 1998-2008                 | 11                    | 110         |
| Iceland                    | 2004-2008                 | 2                     | 8           |
| Ireland                    | 1999-2008                 | 1                     | 9           |
| Italy                      | 1998-2008                 | 5                     | 50          |
| Japan                      | 1997-2008                 | 5                     | 55          |
| New Zealand                | 2003-2008                 | 5                     | 25          |
| Norway                     | 2004-2008                 | 4                     | 16          |
| Portugal                   | 1999-2008                 | 6                     | 54          |
| Sweden                     | 2001-2008                 | 5                     | 35          |
| Switzerland                | 2002-2008                 | 3                     | 18          |
| Netherlands                | 1997-2008                 | 6                     | 66          |
| United Kingdom             | 1992-2008                 | 21                    | 357         |
| USA                        | 1997-2008                 | 12                    | 132         |
| <i>Emerging countries</i>  |                           |                       |             |
| Bangladesh                 | 2004-2008                 | 1                     | 4           |
| Brasil                     | 1999-2008                 | 3                     | 27          |
| Bulgaria                   | 2008                      | 1                     | 1           |
| China                      | 2001-2008                 | 2                     | 14          |
| Cyprus                     | 2002-2008                 | 3                     | 18          |
| Czech Republic             | 2001-2008                 | 2                     | 14          |
| Estonia                    | 2006-2008                 | 1                     | 2           |
| Greece                     | 1999-2008                 | 2                     | 18          |
| Hungary                    | 2002-2008                 | 2                     | 12          |
| India                      | 1998-2008                 | 3                     | 30          |
| Indonesia                  | 2000-2008                 | 3                     | 24          |
| Jamaica                    | 2005-2008                 | 3                     | 9           |
| Latvia                     | 2005-2008                 | 1                     | 3           |
| Lithuania                  | 2003-2008                 | 1                     | 5           |
| Mexico                     | 1999-2008                 | 1                     | 9           |
| Peru                       | 2001-2008                 | 2                     | 14          |
| Poland                     | 2002-2008                 | 4                     | 24          |
| Romania                    | 2000-2008                 | 2                     | 16          |
| Russia                     | 2002-2008                 | 1                     | 6           |
| Turkey                     | 2003-2008                 | 1                     | 5           |
| Ukraine                    | 2003-2008                 | 1                     | 5           |

Source: European Corporate Governance Institute, "Index of all codes", <http://www.ecgi.org>

Each region is in a different stage of establishing a democratic, market-based framework and a corporate governance system. Hence, each nation has its own particular set of challenges. Some of the general challenges confronting developing, emerging and transitional economies include (CIPE, 2002):

- Establishing a rule-based (as opposed to a relationship-based) system of governance;
- Combating vested interests;
- Severing links such as cross shareholdings between banks and corporations;
- Establishing property rights systems that clearly and easily identify true owners even if the
  - De-politicizing decision-making and establishing firewalls between the government and
  - Protecting and enforcing minority shareholders' rights;
  - Preventing asset stripping after mass privatization;
  - Finding active owners and skilled managers amid diffuse ownership structures;
  - Cultivating technical and professional know-how.

There appear to have been improvements in establishing principles and codes that regularize corporate governance in a few emerging countries (Poland, Brasil, India etc). Most of the emerging countries are at the beginning of the developing corporate governance framework process.

### **Corporate governance principles and practice in Romania**

The evaluation of corporate governance for Romania (the analysis of the existent framework of corporate governance through corporate governance principles) and other analysis highlighted a series of recommendations:

### **The legal framework**

The accent is put on the application of existent laws. It is essential that discard exceptions from privatization programs and privatized companies. The transactions operated by insiders must be published. Other recommendations are:

- The clarification of managers' tasks, functions, responsibilities and obligations;
- The authorization of the employment of an outside auditor by the stakeholders through Commercial Societies' Law;
- The establishment of a minimum number for board of directors (administration council);
- The extension of corporation's board authority in order to include the analysis of financial statements;
- The change of censors' role (censors – independent members of corporation's board taking the form of audit committee);
- The clear demand for board of directors members to act with the needed attention and diligence and in the companies' interests;
- The disassociation of the general manager function from that of corporation's board President;
- The requirement that sales and assets' transfer should be realized at market prices also in the case of affiliated or connected parties;
- Stakeholders' meeting will appoint external auditors for the company;
- The enlargement of property's definition in order to include the relations of indirect control (in the Law of stocks and shares);
- The requirement of the announcement of direct or indirect control relations.

### **The institutional framework**

CNVM (Stocks and Shares National Commission) should focus on following information's transparency and the implementation of international

accounting standards by the companies. It is crucial to apply the CNVM jurisdiction for all the listed companies, including those from RASDAQ (secondary financial market) and clarify status for the latter (that implies obligations of transparency and protection of stakeholders' rights).

### **Voluntary/private initiatives**

One of important action is the updating of Corporate Governance Code, with a focus on some problems regarding the functioning of the corporation's board, in correlation with changes of Commercial Societies' Law. The Code has to include recommendations of good practices regarding the independence, the functionality and the work procedures of corporation's board. The Code has to be voluntary, being followed by the companies, as a condition for their listing to the stock exchange; an Institute of Administrators (through Bucharest Stock Exchange) should offer training (for managers, administrators and judges), accreditation, disseminate good practices and participate at the dialogue between the public and the private sectors.

Also Bucharest Stock Exchange initiated a Corporate Governance Institute (2003) that sets itself to develop information and formation activities regarding corporate governance standards. The official launch of "BSE Corporate Governance Institute" took place in June 2005. Previously, BSE established the PLUS Tier at the Stock Exchange at which companies that had adopted Corporate Governance Code of BSE (included in BSE Regulation no. 3) are listed.

This procedure will be changed with the proposal of voluntary adherence to the set of principles regarding corporate governance with total or partial acceptance. Even in these new conditions the implementation of corporate governance standards by the Romanian

companies won't be total and immediate but gradual.

### **Conclusions**

The crusade to institute rigorous corporate governance is not over once these key political and economic institutions are in place. Well-designed, well-functioning institutions can only enforce existing corporate governance guidelines and codes. If these guidelines or codes fail to address key corporate governance issues, even the best institutions will be unable to offer solutions. A crucial weakness of existing guidelines is that the rules do not apply to all corporations equally. The guidelines, for example, do not apply to unlisted corporations many of which are family-owned. Yet family-owned companies dominate many developing country economies and figure prominently in certain developed economies as well.

In order to be effective, existing guidelines need to be supplemented to address these types of corporate governance issues as well.

In Romania a working group reviewed global best practices, assessed Romanian corporate governance legislation and practices, and then developed a corporate governance strategy for Romania entitled, Blueprint for Action. Parts of the code were adopted by the Bucharest Stock Exchange. Afterwards Bucharest Stock Exchange has created a Corporate Governance Institute for development of own corporate governance code.

The most important conclusion of this paper is that the extent of legal reform in these areas of the law has been impressive. In fact, many of the emerging countries can today boast higher levels of investor rights protection than some of the most developed market economies. Yet, the development of the law has not been matched so far by the development of financial markets. Improving the law in

such an environment is at best a partial solution, but will not be rewarded unless a commitment to rule-based governance of markets is made credible.

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