Issue Brief: Corporate Governance in Emerging Markets

BACKGROUND
Key corporate governance risks in emerging markets (EM) are:

Ownership Structure and Stakeholder Rights: EM companies differ from those in developed countries in that they often have more concentrated ownership, either through individuals, families, institutions, or governments. Although more concentrated ownership often avoids the agency problems arising from diffuse ownership in developed markets, it creates different risks for minority shareholders. These risks include the pursuit of private gain by controlling shareholders and a mismatch between economic stakes and voting rights.

Competence of Executive Management: Concentrated company ownership in EMs is often accompanied by a tight coupling between ownership and executive management, which can lead to the absence of meaningful board oversight. Management and boards can be selected without regard to competence. A lack of independent directors, succession planning, and compensation disclosure can signal unreliable or risk-prone executive management.

Disclosure and Transparency: In order to make informed investment decisions, minority shareholders need a clear and complete understanding of company finances, operations, and governance. With less strict regulation on the disclosure of both financial and non-financial information, it is often more difficult for investors to obtain critical information on companies in EMs. Risks include information asymmetry between controlling and minority shareholders, the usage of non-standard accounting principles, and the delayed disclosure of key corporate actions and deliberations.

SUGGESTED ACTIONS
The following are actions investors can take to encourage stronger corporate governance:

1. Engage with management (preferably a specific director for investor outreach) to prompt disclosure of finances and operations
   a. Pursue clarification on ownership structure (particularly beneficial ownership), relationships with third-party affiliates, and the correspondence between economic stake and voting control.
   b. If possible, establish a relationship agreement, whereby the controlling shareholder commits to promoting the interests of the company as a whole. This type of contract protects the rights of minority shareholders and creditors in areas such as the appointment of board members, approval of capital transactions, conflicts where controlling shareholder-appointed directors cannot vote, and related-party transactions involving the controlling shareholder.
   c. Encourage independent directors to have private meetings in order to scrutinize related-party transactions.

2. Exercise due voting rights
   a. An independent valuation exercise can help protect voting rights by removing voting-rights differentials between share classes or consolidating share classes.
   b. If this is not possible, companies should at least guarantee tag-along rights to nonvoting shareholders.

3. Support lobbying and research for increased regulation and better practices
   a. Sign lobbying statements and engagement letters released by groups such as the Forum for Sustainable and Responsible Investment (US SIF).
   b. Seek advice and training from initiatives provided by the Global Corporate Governance Forum, associated with the International Finance Corporation.

Sources:
Issues for Discussion: Emerging Markets Corporate Governance

The asset management industry has historically framed governance in the following terms: How can suppliers of finance to corporations be assured of their return on investment? Is this context appropriate to developing markets? Answering this question can be challenging given the considerable diversity in economic, legal, financial, cultural and institutional settings across countries. An understanding of the various normative “rules” under which firms operate, as well as resultant behaviors with respect to performance measurement, treatment of stakeholders, alignment of incentives, financial dealings, ownership structures, and approaches to efficiency and growth, all lend critical insight in the evaluation of potential returns.

Key issues for discussion include:

(1) What does “corporate governance” mean to asset managers working in emerging and frontier markets? What is an appropriate functional definition? Does any definition simply deal with rules of the road, or does analysis naturally extend to the role of institutions? Does analysis differ between fixed income and equity managers?

(2) Ownership and group affiliation structures vary widely across markets. The classic agency problem in many developed markets stems from diffuse ownership; while in the developing world concentrated ownership is more the norm. This raises important questions about the protection of minority rights. How does concentrated ownership in all its forms (single individual, family, institutional or government) affect governance and the evaluation of potential returns for managers in emerging markets? How do lower overall levels of institutional holdings factor into this equation?

(3) Countless studies, largely from analysis of developed markets, have validated that good corporate governance can lead to lower costs of capital, better access to financing, superior investment returns, and more satisfied stakeholders. Are these studies appropriate to the developing world and what operational metrics, if any, can “confirm” good governance practices in these markets?

(4) What are the obstacles to good governance in emerging markets? What are the specific risks associated with sub-optimal governance? Can they be mitigated through non-traditional means? Also, can good corporate governance overcome inadequate institutions in a firm’s host country? How appropriate is it to compare valuations of companies in the same industry across various markets, given similar governance?

(5) International aid and development organizations, good governance advocates and developing market money managers all have long checklists for evaluating the quality of corporate governance structures. How useful are these lists and what are the most important factors for investment managers? Do they hew to the qualitative or quantitative? Do they complement top down or bottom up analysis, and how can these metrics be improved? Is face-time with management critical, or is all relevant activity fully reflected in the financials?