

Building Sound Corporate Governance **for Global Competitiveness**

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Good afternoon ladies and gentlemen, distinguished guests. I am delighted and honored to have been invited by Confecámaras to join you.

It's a special honor for me that Senator Carlos Arturo Ángel and Doctor Bernard Gilchrist, executive director of the Chamber of Commerce here in Cartagena, will be commenting later on my brief presentation.

Throughout the Andean region, democracy is under challenge from a wide variety of sources—for many different reasons. One of the common factors behind these challenges, however, is the ability of the region to generate jobs, create enterprises, and generate high levels of growth. Attracting new investment, both foreign and domestic, is obviously one of the keys and is a theme running throughout your conference today. The theme of this talk, corporate governance, is one part of the answer.

Your elections for departmental and local officials a little more than two weeks ago are also part of the answer and the challenge. My colleagues and I are not experts on Colombia, but we are here to learn and to continue working with Confecámaras and other business groups in Colombia. We've been privileged at CIPE to have built many relationships with business groups like yours and ACOPI here in Colombia, COPARMEX in Mexico, FEDECAMARAS in Venezuela, and others throughout the region. Many new currents are stirring the waters now, and your friends across the Americas want to be active in realizing positive changes, with you. We want to help build flourishing foreign trade and a healthy business sector that is internationally competitive and attractive to investors.

We at CIPE are not new to Colombia. At the request of Confecámaras, for more than a year we've been supporting the efforts of the Corona Foundation in Bogotá and Confecámaras to combat corruption through a very innovative program on ethics called "Probidad." As some of you may know, the basic idea behind the project is to build awareness among private-sector firms and government procurement officials of the need for creating transparent procurement, developing corporate codes, and piloting a project to make the procurement process more transparent. This project is building a great foundation for moving on to the general area of corporate governance.

By way of background, let me take a moment to explain a little more about what our Center does, and why. Begun in 1983, CIPE is an affiliate of the US Chamber of Commerce and is funded by the National Endowment for Democracy and the US Agency for International Development. Our mission is to build market economies abroad, which is a cornerstone of genuine democracies. We do this because good business methods offer every country its best chance at growth with democratic participation. Our interest is simple: our members at the US Chamber—like you, the members of Confecámaras—want to see the market economy grow in the Americas.

A central aspect of CIPE's work in the past few years is corporate governance—a means whereby society can be sure that large corporations are well-run institutions to which investors and lenders can confidently commit their funds. A transparent and fair system to govern markets, fair treatment of investors and creditors, and a chance for every entrepreneur with a good product to be successful, are every bit as important to democracy as political institutions. As I noted, we've been supporting one of the efforts of Confecámaras to strengthen the market economic system in Colombia through the "Probidad" program, and we are in discussions to work together on a larger program focused specifically on corporate governance reforms.

In addition to the support we provide through grants and technical assistance to over 110 organizations in some 70 countries, we also offer training programs and specific technical assistance through field offices. In fact, the late Gastón Abello of Confecámaras was one of the early leaders in helping CIPE build up its training program for business association executives that today has more than 2,000 graduates from more than 70 countries around the world. We recall Señor Abello's contributions with much respect and gratitude.

In addition to our regular grants and training programs, CIPE is developing a training program on corporate governance which, like our association-training program, will be tested first in Latin America and then adapted to fit other emerging markets. The work that we are doing with Confecámaras can be one of the building blocks for this new course.

Like most international groups, CIPE has also moved into the field of electronic communications in recent years. We are especially proud of our electronic journalists' network in our Web site. *The Financial Times* of London selected it as the best business site on the Web among non-profit groups. (Our Web address, plus more detail on useful resources and programs from CIPE, is printed on the handout I brought here.) I might add that we hope to be delivering some of our training initiatives, including the corporate governance course, through the Internet as a distance learning program.

We support vigorous, questioning economic journalism and business research as underpinnings for good corporate governance. Not only because sunshine is the best disinfectant, as the great United States jurist Learned Hand observed, but because it's the

necessary growth medium for good business and good government. The two go forward hand in hand.

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Today I've been asked by your conference organizers to explore why and how achieving first-class corporate governance is a necessary step toward energizing Colombian businesses to compete vigorously in a global economy. As I noted earlier, I'm not an expert on Colombia but I can offer you an international perspective based on a series of projects we've supported around the world and based on the perspective of the international business community.

Let's begin with a definition of "corporate governance." In the classical definition used in the developed industrial nations, essentially it is how companies deal fairly with problems that result from **the separation of ownership and effective control**. In developing economies, one also must look to **supporting institutions**—for example, shoring up weak judicial and legal systems in order to better enforce contracts or protect property rights.

Corporate governance in all types of economies focuses on:

1. building a structure and rules to govern a company board of directors;
2. creating independent audit committees made up of the enterprise's board members;
3. ensuring disclosure of all relevant information to shareholders and creditors, including business risk analyses; and
4. controlling management.

In all nations, the critical role of accurate information and disclosure means that thorough and reliable business and financial reporting are essential to encourage good corporate governance.

Just as an aside, let me point out that it was the failure of corporations to disclose accurate information on credit lines, on business risks, and on highly leveraged investments that led to the recent Asian crisis. That crisis demonstrated to the world that investors and governments have to take corporate governance seriously.

The Asian crisis—as well as what has happened in post-Soviet Russia—also exposed another flaw in the way we've been thinking about economic development. How often have we heard it said that "the government should just get out of the way and let the market function?" That's a myth. Government is absolutely essential in setting up a sound framework for a market economy. Without binding rules and structures that govern all players, anarchy follows. Business then becomes nothing but "casino capitalism" where investments are only bets: bets that people will keep their word and that companies tell the truth; bets that workers will be paid; and bets that debts will be honored. In larger terms, corporate governance means setting up structures that allow a good deal of

freedom within the rule of law. These arrangements then build a foundation for trust—one of the most important ingredients in effective business.

Concern about weak or inadequate corporate governance isn't limited to developing economies. It's a global trend. For example, recent years have seen mounting concern in the US about whether "independent audits" are truly independent and unbiased, given that some accounting firms also do consulting work for some of their audit clients. The UK's Cadbury Commission and France's Vienot Commission, as well as the OECD, have all issued more rigorous guidelines. In the United States, institutional investors have done everyone a great service by insisting that corporate governance standards be raised and that management be made to disclose far more information than was the case just a few years ago.

Recognizing the worldwide need for better corporate governance, CIPE currently supports this kind of projects in Indonesia, Romania, Egypt, Russia, West Africa, and a number of other nations. We do this because if the private sector doesn't begin creating its own vision of good corporate governance, governments and international organizations will do the job without adequate input from the private sector.

Let me offer you five key points that we've distilled from our experiences in these projects.

- (1) The question is not whether—but when—businesses that want to succeed in the new global economy will begin remaking corporate governance. The need is urgent, the time to act is now.
- (2) The urgency emerges from a rapid convergence of standards, just as capital flows across the world now converge very quickly. How you run a business isn't a matter of local tradition or age-old practice any more. Family management is giving way to professional employees in many Latin American countries. Domestic and international investors, creditors, multilateral institutions, and international organizations are clamoring for better corporate governance.
- (3) Retooling corporate governance adequately won't happen by tightening a few procedures here, adding a few rules there, and hiring a press representative. It requires refashioning institutions to achieve transparency, equity, accurate reporting, and free flows of information.
- (4) The bad news is—to repeat—if business itself does not meet the challenge of transforming corporate governance, others will do it for us. Yet our enterprises, local stakeholders, and national needs will suffer if the urgency of this task is left to national governments or to the international financial institutions.
- (5) Finally, the reward of good corporate governance is a thriving democratic society with a feisty civic culture that supports economic growth. It is worth some effort to get there. A recent survey by McKinsey and Company found that

investors are willing to pay a premium for companies that demonstrate sound corporate governance systems.

Let me expand on these points a bit before Senator Ángel and Dr. Gilchrist comment and we discuss your questions.

Why is reforming corporate governance so urgent? The answer is the rapid pace of globalization. To participate fully in the world economy, most countries need to make enormous changes. In Latin America, businesses must persuade investors and creditors that they can confidently invest in the region. This means displaying clearer relationships between participation and control, more transparency, consistent and detailed financial statements, as well as maintaining good relations with financial and market analysts. As I noted earlier, if we wait until the last minute to make these basic changes, they will be made by others, not by the people who know your businesses best: yourselves.

César Souza, senior vice president of Odebrecht, a major Brazilian construction firm operating in 14 countries including Colombia, expresses the urgency: becoming efficient and globally competitive “requires a revolution in the way companies organize themselves.” However, he points out that more and more companies in this region are rising to the challenge. In Souza’s words, there’s a “new generation that is moving into ‘the driver’s seat’ in corporate Latin America.” And they, who are younger and well-educated, are in turn hiring professionals. The result? Increasing numbers of firms in Latin America “are becoming more sophisticated in finance, marketing techniques, and so forth.”

John Bohn, chairman of CIPE’s board and former president of Moody’s Investors Service, a key international corporate ratings agency, also puts “promoting sound corporate governance” very high on his list of important trends that are reshaping businesses across the globe. He notes that responsible governance and best business practices maximize growth and minimize abuses of power such as insider trading, discrimination against minority shareholders, and poor accounting practices. Bad practices not only defeat growth by driving away investors, but, says Bohn, they “bleed the corporate enterprise and squander its spirit.”

A very rapid convergence of forces that have been building for 15 years or more is also driving the urgency of improving corporate governance. For more than a decade, the international accounting bodies and national associations of accountants have been moving closer to an international set of accounting standards. They have been pressed by the WTO and, more importantly, by their domestic corporate clients, to develop international standards that will help companies grow across borders.

The need is obvious. Before committing resources investors and institutions in Bogotá or Boston, Beijing or Berlin, want to be able to analyze and compare potential investments by the same standards of transparency, clarity and accuracy in financial statements. They

want to have risk assessments. More and more, nationally based companies that seek global reach by attracting new capital are also listing their shares on the stock exchanges of other nations. Daimler-Chrysler, Telebras of Brazil, the Mexican phone company and other Latin American communications firms are only a few examples. Being credible businesses that can withstand the scrutiny of international investors is more than just a matter of global marketing: it has become essential for local companies to grow and prosper.

What's more, good corporate governance not merely fertilizes healthy growth, it is a shield against widespread financial crisis. The Asian financial crisis of a few years ago underlined the urgency for business of transforming the way it governs itself. One lesson learned from that crisis is that poor corporate governance can create huge liabilities for both individual companies and society. Last year, CIPE sponsored a regional conference on CG reform in Bangkok, where this point was underscored by the governor of the Bank of Thailand, M.R. Sonakul:

“The Asian crisis showed,” he said, “that even strong economies lacking transparent control, responsible corporate boards and shareholder rights can collapse quite quickly as investors' confidence erodes.”

Foreign direct investment (FDI), part of the overall flow of private finance worldwide, has grown especially important in globalization. Money flowing into stock markets and other short-term equity investments is significant, but recent experience during the Asian crisis and elsewhere shows that such flows can reverse quickly and easily, with devastating effect. By contrast, FDI is the most important source of so-called “patient capital.” Patient capital brings investment partners who are willing to support your enterprises and hold firm to their course of development through both rough seas and smooth sailing. It also brings very important companion benefits to recipients by transferring to them state-of-the-art technology, stimulating trade, and sharing management innovations.

However, especially with the Asian crisis in mind, foreign direct investors insist more and more on transparent corporate governance that reflects emerging international standards of fiscal and managerial responsibility. They want good information, too—one reason CIPE supports a number of programs on freedom of economic information. To meet these urgent demands of convergence and capital investors, corporate governance must be transformed, not just dressed up a bit.

Recognizing the urgency of corporate governance reform, The Organization for Economic Cooperation and Development in 1998 established a task force on corporate governance. The mission of this group of trading partner countries, other international organizations and the private sector, was to develop a set of non-binding principles to guide reforms.

In summary, the OECD principles include these elements:

(1) Protecting the rights of shareholders. This includes the right to secure ownership, full disclosure, voting rights, participation in decisions to sell or modify corporate assets including mergers and the issuance of new shares.

(2) Treating shareholders fairly. This means protecting minority shareholders' rights by preventing insiders, including managers and directors, from taking advantage of their privileged positions and information. Insider trading, for example, is prohibited. Directors are asked to disclose any material interests they may have in the company's transactions.

(3) Recognizing the role of stakeholders as well as shareholders. Stakeholders are others who are directly concerned with the company: workers, suppliers, bondholders, banks, and local institutions affected by the company's activities.

(4) Ensuring disclosure and transparency. The OECD suggests provisions for disclosing and communicating key facts about the company, from financial details to the compensation and terms of its board of directors. Annual audits are also required, performed by outside auditors enforcing high standards.

(5) Clarifying responsibilities of the board of directors. The OECD guidelines offer much detail about a board's responsibilities for protecting the company, its shareholders and stakeholders: forming corporate strategy, assessing risk, setting executive compensation, evaluating performance, and so on.

The OECD guidelines are general, and there's growing pressure to equip them with more teeth by strong enforcement mechanisms. Let me suggest a few specific ways to introduce more explicit governance standards:

1. Countries should be required to establish independent share registries.
2. Standards for transparency and reporting sales of underlying assets are needed, together with mechanisms whereby investors can seek damages.
3. International accounting standards should be explicitly required, and national standards should be aligned with these.
4. Specific rules are needed to govern internal company audits, and they must also mandate that only outside directors be allowed to serve on audit committees.

There are also specific model codes of corporate governance that can be helpful, such as General Motors' code and that of the California State Pension System (CalPers), a leader in insisting on sound governance of the corporations it invests in. (Copies of the GM code are available at www.CIPE.org.)

Several years ago, the International Finance Corporation commissioned an analysis of the law and practice of corporate governance in Latin America. Then, the group of experts IFC brought together from every country involved identified 5 current issues "common to

the four major markets in the region and probably also to many other [Latin American] countries.” These issues, the panel thought, must be resolved by whatever form of corporate governance is chosen.

The issues they raise are quite technical but each points to some of the fundamental matters that are also addressed in the OECD guidelines. The key corporate governance issues identified for Latin American companies were:

The status and treatment of non-voting shares is an important matter, especially given the temptation to issue these kinds of shares to maintain a closed form of investment. While non-voting shares may be successful in the short term in generating some additional investment, in the medium run it is likely that their existence will be harmful to attracting the scale of investments that will be needed. Most of the international specialist groups that have looked at this issue have recommended against non-voting shares, or even classes of shares.

Handling changes of control for publicly listed companies and the question of the family-controlled companies that may be sold to strategic investors or to the public is a relatively new development. However, as the quote from César Souza pointed out, this trend is likely to continue and ways have to be worked out to protect investors and creditors during such ownership changes.

The role of institutional investors both foreign and domestic may be a longer term issue for Colombia. In some countries, such as Chile, pension funds are a major factor, and other countries will probably follow with variations of this model. At present, there is a temptation for institutional investors to “vote with their feet” by withdrawing, not standing firm against poor management practices. The question is, “Can these institutional investors begin to play the kind of role they do in the developed markets?”

The problems of related party transactions are very obvious in Latin America given the prevalence of industrial interlocking groups. An interesting related question is “What happens when one individual gains control of a public company and then begins to direct investments into areas that benefit private co-investors?” Some cases of this kind of practice have come to light recently in Mexico, for example.

Finally, the IFC Latin American panel identified the role of special organs of corporate governance, which are variously known as *síndicos*, *comisarios* or, in Brazil, *conselhos fiscais*. Though the IFC concluded that these groups “have been historically ineffective” for the most part, there is renewed interest (especially in Brazil) in whether they hold any promise for keeping management honest. The growing interest in these and other mechanisms is basically a reflection of the need to increase transparency in business transactions.

My final point about the urgency of transforming corporate governance is that, if companies don’t undertake it themselves, others will do it. There is high risk of inefficiency and misregulation when the iron fist of outside authorities intervenes.

Instead of cooperative work among companies, investors, stakeholders and government regulators, the alternative can prove troublesome. As César Souza points out: “Companies have to face dramatic changes.” Highly centralized decisionmaking in a few hands doesn’t work any more, especially in the hypercompetitive environment of globalization and privatization that’s transforming many Latin American economies. Companies have to face the paradox that their decisionmaking must be simultaneously both highly international and highly local.

The future of a business that ignores the need to begin now to improve its corporate governance can be jeopardized by intervention from outsiders—national or international institutions—that don’t know your enterprise as well as you do. Political motives and corruption can get in the way of long-term prosperity and healthy growth. They can interfere with new investment flows, supply chains, and local community and stakeholder relationships.

What governments do best is provide the national fiscal discipline and infrastructure that can help businesses by assisting regional integration. What they do least well is to intervene in the details of business operations and management by over-regulation—or worse—by poor and cumbersome regulation. CIPE has found that, in some cases in the former Soviet bloc nations, the bad regulatory system is caused by the government’s failure to correctly identify the cause of business problems rather than sticking to the tasks that government performs well.

Over-regulation is indeed one of the major problems entrepreneurs like yourselves face in Colombia and in other Latin American nations, and a major objective is to improve and clarify the legal structures and rules under which business can exercise its creative muscle freely.

Peruvian economist Hernando de Soto has written a new book called *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*. This book has already attracted the attention of the international media and has been translated into a number of languages. In it, de Soto argues that the reason some nations have been unable to develop is not cultural, but legal. Tangled property rights, government over-regulation and Byzantine legal systems have kept business people from turning their skills and property into capital.

But it is up to business persons to take the leadership in creating these missing institutions. Again, if you wait for government to take the lead, you may well regret the result. While you need laws and rules to set up the playing field that are developed through a democratic process, unless business persons participate in that process, government officials will make the rules without you.

In conclusion, investors in the global economy seek sound corporate governance backed by strong associations of businesses, such as Confecámaras, helping one another to shape their own destinies. These are essential democratic institutions. Growth economies are

more likely to be democratic ones in the long run. Certainly they will be more flexible and capable of surviving crises.

CIPE is eager to join with you in making global competitiveness a reality for Colombian enterprises. Just this week, we are sponsoring simultaneous conferences on corporate governance in several regions of the world. One of them is in Moscow, held in cooperation with the OECD, the World Bank and the Russian Federation of Chambers of Commerce. Another conference is going on in Manila, where the Philippine Institute of Directors has called together market participants from throughout that key region so that they—not governments—can set their own process of creating Asian business standards.

I'm also pleased to note that just a few days from today we will co-host with the OAS a regional conference for business journalists here in Cartagena that, we hope, will complement your work. While corporate governance can improve the standards of business disclosure, we also have to pay attention to standards of government disclosure and, especially, standards for the media to report on economic and financial information.

Again, let me thank you for inviting us to be with you today, and we hope that we will be able to continue our very productive association with Confecámaras.

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