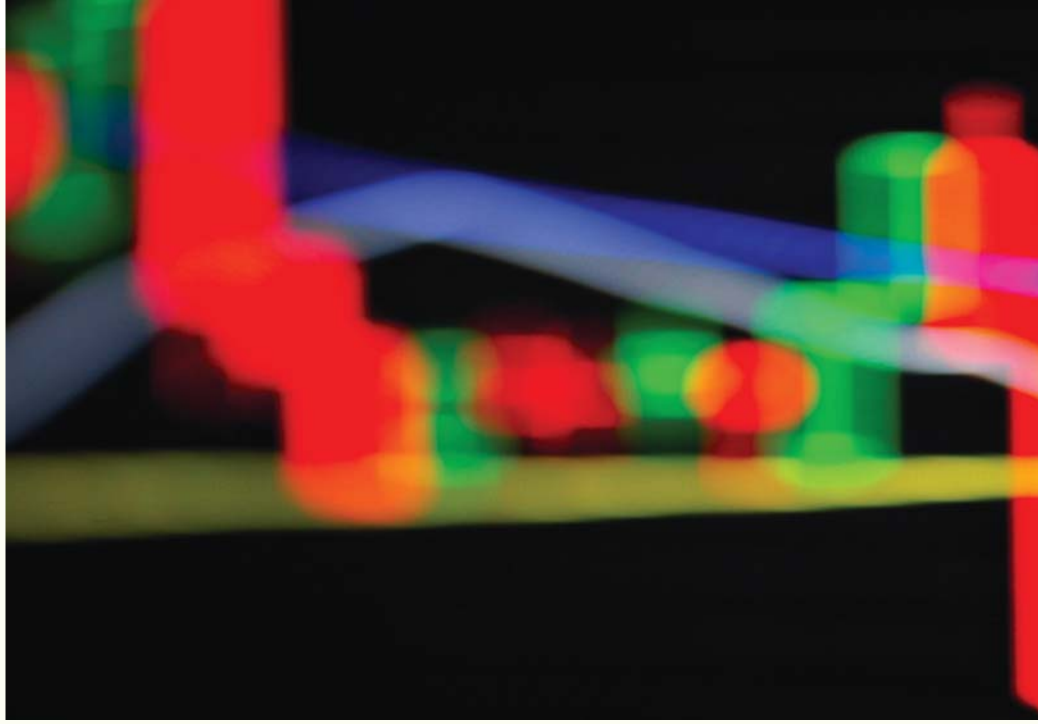

Controlled Companies
Are They Inherently Different?

Many academic and industry researchers continue to evaluate the impact that corporate governance factors can have on company performance. As investors look toward global markets, they are beginning to take governance standards into account when assessing the potential profitability of these investments. Thus, there has been an initiative to develop a single governance factor that can accurately predict the corporate governance standards of companies around the world. Specifically, ranking systems have been developed that ignore company ownership structure and use key categories to assign each company or country being assessed a raw score.

It is easy to see how having such a standard global measure could seem beneficial. In practice, however, these single metrics for assessing corporate governance prove to be inadequate. Often ignored are the fundamental differences in corporate governance threats faced by controlling shareowner firms and non-controlling shareowner firms. A 2009 study performed by Lucian Bebchuk and Assaf Hamdani, assesses the most influential governance standards currently: the Anti-Director Rights Index, the Anti-Self-Dealing Index and the Corporate Governance Quotient (renamed "GriD"). In, "The Elusive Quest for Global Governance Standards," the authors' conclusion is that academics and investors should abandon the effort to develop a single governance metric. Rather, they should develop separate methodologies for assessing the governance of companies with and without a controlling shareowner.

Assessment of Current Ranking Systems

Anti-Director Rights Index

The Anti-Director Rights Index is one of the most influential global metrics developed by an academic. It was created by a team of four financial economists: La Porta, Lopez-de-Silanes, Shleifer, and Vashny. The index consists of six components, focusing on shareholder rights, preemptive rights, cumulative voting, and rights of opposing minority shareholders. Three of the six components focus on shareholder rights. These components assess a shareholders ability to vote by mail, to vote without depositing shares, and to call a special meeting.

The main problem with the Anti-Director Rights Index lies with its focus on shareholder rights. When applying this index to a global environment, it proves faulty when assessing firms with a controlling shareowner. These firms, regardless of their arrangements in place, do not allow the non-controlling shareowners to have these rights. When investors purchase shares in a controlling shareowner company they are not purchasing based on their desire to change the company and have input. Investors purchase shares in this type of company because they trust the controlling shareowners and believe that the company is being managed in a successful way. Because of the focus on shareowner rights, the Anti-Director Rights Index is not a viable tool for addressing companies that are influenced by a controlling shareowner.

Anti-Self-Dealing Index

This index was developed as an alternative to the Anti-Director Rights Index. The Anti-Self-Dealing Index focuses on disclosing insiders self-dealing transactions and thus, protecting outside investors from such corruption. Some of the relevant measures include: disclosure, public enforcement and the ability to hold insiders liable for self-dealing transactions. While the Anti-Director Rights Index has been criticized for focusing solely on the threats faced by companies with a controlling shareowner, the Anti-Self-Dealing Index faces criticism from the opposite

direction.

The Anti-Self-Dealing Index over-compensates for the shortcomings of the previous Index. The main issues considered are only relevant to companies with a controlling shareowner. Companies that do not have a controlling shareowner, typically, do not face as many issues with corruption involving insiders. This index does not do an adequate job of focusing on issues that companies face when they do not have a controlling shareowner. Thus, the Anti-Self-Dealing Index is not an adequate measure to be used when assessing all global companies.

> "It is important for investors to apply different methodologies when assessing the governance of companies with and without a controlling shareholder. Investors used to companies without a controller, the type most common in the US capital markets, must learn to use different yardsticks when turning their attention to the controlled companies that are dominant in most capital markets around the world."
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> ***Lucian Bebchuk***
> ***Friedman Professor of Law, Economics, and Finance***
> ***Director of the Program on Corporate Governance***
> ***Harvard Law School***

Corporate Governance Quotient

The Corporate Governance Quotient, developed by RiskMetrics Group, is the most influential ranking system to be developed by a shareholder advisor. This ranking system has two set of criteria, one for ranking U.S. companies and one for Non-U.S. companies. The Corporate Governance Quotient provides two scores. First, the company is ranked on their compliance with the applicable set of criteria. Then, they are scored based on their comparison to other companies within their same industry group.

Although the Corporate Governance Quotient does take into account the differences in U.S. and Non-U.S. companies, it fails to take into account the differences between companies with and without a controlling shareowner. The index divides corporate governance into eight criteria: board size, audit, charter/bylaws, antitakeover provisions, executive compensation, progressive practices, ownership, and director education. As before mentioned, an index cannot be universally applied if it does not take into account the differences in issues faced based on company ownership. Therefore, while the Corporate Governance Quotient is an improvement, it is not a solution for a global standard corporate governance index.

Controlling vs Non-Controlling Shareowner Companies

When assessing corporate governance standards it is important that fundamental differences between controlling shareowner companies and companies without a controlling shareowner not be ignored. For instance, in companies that do not have a controlling shareowner, investors must assess the existence of agency problems. It is difficult, in these companies, for shareholders to exercise control over the dealings of management and inside directors. Companies with a controlling shareowner, in contrast, do not face these same issues. Because a controlling shareowner has such a large stake in the company they have more incentive to closely monitor the dealings that are occurring inside the company. Because inside directors know this, it is unlikely that a company with a controlling shareowner would have to deal with agency problems to the degree that companies without a controlling shareowner do.

In controlling shareowner companies there is no contestability of control, so there is no need to prepare for control contests. However, that is not the case in non-controlling shareholder companies. In these companies, however unlikely it is that a takeover could happen, it is still possible. When assessing the corporate governance standards of these companies it is important to take into account threats of contestability of control. Also, it is important that when assessing non-controlling shareholder companies, the assessment index being used does not derive a large amount of its assessment from measuring the ability of shareholders to influence decisions. It can be assumed that these shareholders of non-controlling shareholder companies will not use their collective power to influence management, due to their small percentage of potential benefits received. In controlling shareholder companies, however, the opposite is true. Because of their large investment in the company, controlling shareholders have a lot more to gain from the company being profitable, and thus, should be considered when assessing the overall governance of the company.

When assessing the corporate governance of a company it is important to note that while dealing with controlling shareholder companies one must consider the outside dealings of the controlling shareholder. It is imperative that a company guard against large self-dealing transactions as there is a great incentive of moral hazard on controlling shareholders. When assessing non-controlling shareholder companies it is much easier. The main concerns in these types of companies are executive compensation and managerial shirking. Because there is no controller to monitor the reduction in share value, it is vital that investors consider the risks that this type of fraud can present when assessing the value of a company.

Recommendations and Conclusion

While a single global rating system would be ideal, due to the fundamental differences in controlling shareowner and non-controlling shareowner companies, it is necessary to use separate rating systems in order to accurately evaluate the risks associated with each company. The most commonly used governance rating systems, the Anti-Director Rights the Anti-Self-Dealing and the Corporate Governance Quotient Indices, all fail to make this distinction, and thus when applied universally may produce an inaccurate or even distorted picture of company or country governance standards. The criteria of the desired indices are as follows:

Non-Controlling Shareowners

An appropriate evaluation system for non-controlling shareowner companies would have to take special circumstances into consideration. As explained earlier, control contests place a certain risk on non-controlling shareowner companies, thus, any measures being used to evaluate these companies must place considerable weight on arrangements governing hostile takeovers and proxy fights. In addition, special consideration must be given to the rights of shareholders to vote. Shareholders should be given the right to vote by mail, by proxy or written consent, and to vote without being required to deposit shares. Shareholders in non-controlling shareowner companies should be given the right to place governance proposals and board nominees on the company's ballot and should be protected by confidential voting.

Besides voting requirements, when dealing with non-controlling shareowner companies, special consideration must be given to the assessment of executive compensation agreements. Due to the absence of a controlling shareowner, there is little incentive for any one shareowner to monitor the amount of executive compensation and assess the fairness of such compensation packages. Because of this lack of shareowner governance, it is also essential that an evaluation system take into account director independence from management. A suitable index would examine the ties between managers and directors and also the ties between directors and other boards on which they serve.

Controlling Shareowner

An evaluation for a controlling shareowner company would be slightly different. A main concern when assessing these companies is the protection placed on the outside shareholders. It is important that these shareowners have power to block certain corporate transactions that as a whole, they do not approve. In order to assess the true value of a firm, the index used should pay special attention to the arrangements that empower minority shareholders. In addition to assessing power held by minority shareholders, a suitable index should also regulate the power held by a controlling shareowner. In large companies with one controlling shareowner there is a large incentive for this shareowner to participate in self-dealing transactions and freeze outs. If left undetected, these transactions can divert firm value away from the firm and into the pockets of these controlling shareholders. In order for an index to be sufficient it must give a heavier weighting to the protection against self-dealing transactions in controlling shareowner companies than it would in non-controlling shareowner companies.

Any index developed to evaluate controlling shareowner companies should also take into consideration director independence and control contests. When assessing non-controlling shareholder companies you simply look at the director's connection with management. Controlling shareholder companies are more complicated where a director cannot have a connection to management, but they also may not be truly independent unless they have no ties to the companies controlling shareholder or any of its affiliates. This requires additional research and any index used to assess these companies must take that into account. ●●●