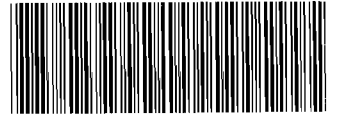


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**A COMPARATIVE AND CRITICAL ANALYSIS OF THE
CORPORATE GOVERNANCE STRUCTURE OF SOUTH AFRICA**

**A DISSERTATION SUBMITTED TO THE
DEPARTMENT OF ACCOUNTING
UNIVERSITY OF CAPE TOWN**

**IN PARTIAL FULFILLMENT
OF THE REQUIREMENTS FOR THE
MASTER OF COMMERCE
DEGREE IN
FINANCIAL MANAGEMENT**

By

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Declaration of originality

I certify that this thesis is my own work and all references have, to the best of my knowledge, been accurately reported.

Signed by candidate

Hanneke Louw

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Abstract

The King Reports, as well as legislative developments culminating from these reports, are aimed at enhancing corporate governance standards in South Africa and aligning them with international best practice. Notwithstanding these measures, a number of significant failures in corporate governance rocked South African business during this period, severely denting the perception of the quality and standard of corporate governance.

Given the importance of international investors' confidence, a continuous review of the South African corporate governance structure is imperative. This dissertation aims at performing a comparative and critical analysis of the corporate governance structures in South Africa. The objective is to seek alternative or improved corporate governance mechanisms that will enhance the current dispensation. For this purpose, various international corporate governance models are analysed and their monitoring mechanisms identified. The possibility of utilising some of these mechanisms to enhance corporate governance in South Africa is examined.

The institutional environment in South Africa (i.e. the controlled shareholder environment, inactive and illiquid markets) prevents the market model mechanisms of the US and UK from playing a greater monitoring role. Further market model mechanisms aimed at promoting the independent monitoring of management have to a large extent been incorporated into the South African corporate governance framework. However, the ongoing failures of large listed and unlisted companies, including smaller banks in South Africa, that appear to indicate poor levels of, or ineffective, corporate governance, calls for the enforcement and acceptance of the monitoring guidelines set out in the King Reports.

The German and Japanese bank governance model has a limited application in South Africa. The level of bank debt financing is generally lower than

equity financing, thereby restricting banks' ability to become monitors through their debt control rights.

Even though regulatory reform in South Africa has supported transformation into a market model dispensation, the continued existence of an institutional framework that fails to support total reform to the market model, remains a reality that must be addressed. As South Africa features a strong institutional shareholder environment, it is proposed that institutional investors should play a more significant monitoring role in corporate governance, by becoming active shareholders and by assuming the ownership responsibilities inherent in the shares under their control.

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1 INTRODUCTION

Background:

The focus on corporate governance in South Africa has increased over the last decade. Corporate governance was institutionalised by the publication of the King Report on Corporate Governance in South Africa (King Report) in 1994 that aimed to promote higher standards of corporate governance in South Africa. Local and international developments following South Africa's democratic elections in 1994, were subsequently incorporated in the second King Report, published in 2002. These reports culminated in legislative developments aimed at enhancing corporate governance standards in South Africa and aligning them with international best practice. These include the 1995 revision of the listing requirements of the JSE Securities Exchange in South Africa, which were again revised in 2000. Other legislation amended as a result of the 1994 King Report included the Companies Act (No. 61 of 1973) and Banks Act (No. 94 of 1990) to enforce compliance with substantially higher standards of corporate governance compliance.

Notwithstanding these measures, a number of significant failures in corporate governance rocked South African business during this period. Investors lost large amounts of money due to mismanagement and the alleged wrong doing by the directors of Leisurenet, Regal Treasury Bank, Unifer and Saambou Bank¹. Common features of these cases include inadequate levels of disclosure to stakeholders, as well as a lack of the necessary controls to prevent mismanagement and the abuse of power. These failures have severely dented the perception of the quality and standard of corporate governance in South Africa.

The recent published second King Report (2002) has made a significant contribution towards reforming corporate governance within the corporate

¹ Source: www.news24.com (refer to section 7 for further reference)

environment. However, in itself it does not address the main focus of this thesis which is the broader international corporate governance mechanisms including market governance and monitoring by large institutions e.g. banks.

The perceived quality of corporate governance in a country is important for attracting global capital. This means that in order to attract investment from significant international players, and as an emerging market, South Africa must practice and maintain high standards of corporate governance. Failure to do so will cause capital to flow elsewhere. According to McKinsey's Investors Opinion Survey (McKinsey and Company, 2000), more than 84% of over 200 global institutional investors surveyed, indicated a willingness to pay a premium for shares in a well-governed company over one considered poorly governed, but with comparable financial results. This survey therefore emphasises that investors' perceptions that a market is well governed can potentially add significant shareholder value.

Problem statement:

The problem to be addressed by this dissertation is the increasing occurrence of corporate governance failures in the South African economy, leading to declining levels of investors' confidence.

Research objective:

This dissertation aims at performing a comparative and critical analysis of the corporate governance structures in South Africa. The objective is to seek alternative or improved corporate governance mechanisms that will enhance the current dispensation.

Research approach:

This study performs a critical comparative analysis of international corporate governance models and their inherent monitoring mechanisms. This is followed by an evaluation of the extent to which these governance mechanisms exist in South Africa in the context of the unique circumstances

that influence the particular governance mechanisms suitable for South African conditions. Concluding from this evaluation, the incorporation of some of the international governance mechanisms into the existing governance framework is suggested with the aim at enhancing the level of corporate governance in South Africa.

Thesis structure:

This study commences with Chapter 2 by providing a general background to corporate governance, its objectives and explaining why it is relevant. In Chapter 3, certain international corporate governance models are analysed, with reference to market governance, bank governance as well as holding company governance. Chapter 4 provides an overview of the extent to which the previously discussed governance mechanisms exist in South Africa, as well as an evaluation of the potential to incorporate certain aspects of the monitoring mechanisms into the existing governance framework. Chapter 5 suggests an alternative form of monitoring for South African corporations, i.e. monitoring by large institutional investors.

2. OBJECTIVES OF CORPORATE GOVERNANCE

2.1 Corporate governance defined

The term, corporate governance, is often defined as the formal system of accountability by senior management to the shareholders. A more expansive definition includes the entire set of legal rules, relations and behaviours that constitute the system by which a company is controlled and directed in a given society.

The Cadbury Committee Report: Financial Aspects of Corporate Governance (Cadbury Report) (1992) defines corporate governance as

“the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meeting”
(paragraph 2.5).

The Cadbury Committee was set up, in the United Kingdom, specifically to consider the financial aspects of corporate governance. These aspects included the way boards set financial policy and oversee its implementation, the use of financial controls as well as the process whereby boards report to the shareholders on the activities and progress of the company (Cadbury Report, 1992).

Subsequently, the Hampel committee was established in 1995 to review the recommendations of the Cadbury committee in respect of corporate

governance and noted that the Cadbury Committee's definition of corporate governance places the directors of the company at the centre of any decision on corporate governance. The report also links corporate governance to the role of the shareholders who must appoint the directors and concludes that the Cadbury Committee's definition is restrictive because it excludes many activities involved in managing a company, which may be vital to the success of the business (Hampel Report, 1998).

The Hampel Report (1998) further states that the overriding objective of listed companies is the preservation and greatest enhancement, over time, of their shareholders' investment. It also refers to the stakeholder view of corporate governance, that "...a company must develop relationships relevant to its success. These will depend on the nature of the company's business; but they will include those with employees, customers, suppliers, credit providers, local communities and governments" (paragraph 1.16). This recognises that directors can pursue the objective of successfully enhancing shareholder value, in the long term, only by developing and sustaining the various stakeholder relationships.

The King committee in South Africa supports the wider definition of corporate governance and recognises the importance of corporate governance in addressing the needs of different stakeholders including shareholders, employees, bankers, suppliers, customers, environmentalists and the community (King Report, 1994). The second King Report (2002) expands on this inclusive approach by stating that a company's stakeholders need to be considered when developing the strategies to achieve the company's goals. It also stresses the importance of mutually beneficial relationships between the company and its stakeholders in creating sustained business success and long-term growth in shareholder value.

From the various definitions, it can be deduced that corporate governance includes the systems and structures which govern the relationships between

the management of a firm and its various stakeholders. This chapter will outline the objectives and relevance of inclusive governance in a corporate context.

The stakeholder view of corporate governance incorporates a wide range of stakeholders that is affected by the rules and relationships that comprise a corporate governance system. The review of various corporate governance systems in Chapter 3 will, however, mainly focus on the systems that support one of these stakeholder relationships, namely, management (or controlling parties') accountability to shareholders.

2.2 The objectives of corporate governance

As outlined in the Cadbury Report (1992), the basic principle which underpins corporate governance in the UK, is that managers should be free to drive their companies forward, exercising that freedom within a framework of effective accountability. A framework of accountability provides the necessary checks and balances and is one that can facilitate action when a leader uses his/her power in an abusive or irresponsible manner. The committee's statement, however, recognises the important role of quality leadership by indicating that freedom of leadership style should be permitted. The successful turnaround of a business, or the establishment of a company's long-term profitability, can often be attributed to exceptional leadership. On the other hand, numerous corporate failures can be the consequence of the extended reign of a powerful leader who is not supported by an effective system of essential checks and balances. A system promoting management accountability seems to be an essential component of an effective governance system.

Following the first King Report (1994), the second King Report (2002) provides a useful summary of the objectives of corporate governance, including its seven primary characteristics, which can be summarised as follows:

- Discipline – senior management must adhere to recognised behaviour
- Transparency – outsiders must be able to analyse a company's actions
- Independence – potential conflicts of interest should be minimised
- Accountability – individuals and groups must be held accountable for their decisions
- Responsibility – the board must be responsible to all stakeholders
- Fairness – companies must have balanced systems, taking in to account those who have an interest in the company
- Social responsibility – companies must be aware of and respond to social issues

In Chapter 3, the discussion on various corporate governance systems will include a review of the effectiveness of these systems in meeting these objectives, as reported in literature.

2.3 The background to corporate governance

The problem associated with corporate governance originated with the separation of joint ownership and control of the stock in a company. This separation can lead to a deviation from the goal of maximizing shareholder value because the controlling powers (executive management) could value their own well-being above that of the owners (shareholders) of the business. The potential misappropriation of the firm's funds, or abuse of power by management, creates need for ongoing reform in corporate governance. However, there seems to be little consensus as to how far reaching corporate governance arrangements should extend. The vastly differing corporate governance models outlined below, reflect the both narrow and broad definitions of corporate governance provided in section 2.1.

The principal-agent model

The principal-agent model assumes that markets provide the most effective restraints on managerial behaviour. Shareholders are viewed as the owners of the corporation and by exercising their voting rights, they should commit corporate resources to optimising shareholder value (Keasey, et al, 1997: 3). It contends that external intervention, for example, costs incurred in aligning managerial behaviour with the shareholders' interests, represent distortions of effective market systems and should therefore be eliminated or minimized. Initiatives like executive stock options, or leveraged management buy-outs, will occur spontaneously if they are viewed as improvements to the current system. It is argued that improvements in corporate governance will be implemented without compulsion when they will increase a company's profitability and, therefore, also its value.

As previously noted, the separation of ownership and control may allow managers to deviate from the value-maximizing objective. According to Jensen and Meckling (1976), the cost of such behaviour is already discounted in the equity value when an owner-manager sells stakes to outsiders. The fact that owner-managers sell equity in this manner, indicates that the benefits of having a professional management function outweigh the cost of the separation of ownership and control. This relationship, or contract, between management (board of directors) and the owners (shareholders), leaves no room on the corporate board for any additional obligations to other stakeholders.

The principal-agent model echoes the narrow definition of corporate governance, namely the formal system of accountability of management to shareholders.

The stakeholder model

The stakeholder model expands the definition of a firm's objective beyond simply maximizing shareholders' wealth. The stakeholder model recognises that the well-being of other stakeholders associated with the firm, particularly employees, suppliers and customers, is important to a firm's long-term success.

The model rests on the principle that the ethical treatment of employees, suppliers, and customers establishes long-term, trusting relationships between the firm and its stakeholders thereby supporting further profitable investments and contracts (Keasey, et al, 1997: 9). These strong internal and external relationships can also provide a firm with competitive advantage.

The stakeholder model is in line with the wider definition of corporate governance that recognises a firm's responsibility and accountability towards the various stakeholders that play a key role in its long-term success.

The analysis of governance systems in Chapter 3 will again deal with these various approaches, as Anglo-American governance systems tend to support the principal-agent model, while the German and Japanese systems incorporate the stakeholder model.

2.4 The relevance of corporate governance

Although corporate governance is now a familiar topic, it was not the case before the 1990s and, internationally, the debate surrounding corporate governance has intensified. Some of the main reasons for this heightened awareness of this issue are outlined below:

2.4.1 Director mismanagement and fraud

Even though there are ample restraints on managerial behaviour such as the appointment of independent non-executive board members, the internal and external audit process and the market for corporate control, management is still left with considerable discretion in the application of corporate assets. Notwithstanding apparently high corporate governance standards, incidents of mismanagement and fraud by directors frequently occur. Recent examples of such incidents in South Africa reported on in the popular press include Leisurenet, Regal Treasury Bank and Unifer².

Leisurenet was declared insolvent in October 2000, with debts amounting to R681 million. The directors of the company neglected to reflect the true financial situation of the company in its 1999 annual report and a subsequent change in accounting policy showed significant drop in the 1999 results from a profit of R221 million to a loss of R60 million. The joint Chief Executive Officers of Leisurenet were later prosecuted; charges included fraudulent dealings that constituted a violation of the Companies Act (No. 61 of 1973) because they had direct or indirect interests in transactions which were in conflict with their fiduciary responsibility in Leisurenet. In addition, they were charged with income tax and value added tax (VAT) fraud.

Following this, in June 2001, Regal Treasury Bank (Regal) was placed in curatorship, following unusually large-scale withdrawals by depositors. Regal's annual report for 2000 contained incorrect and incomplete information, creating incorrect perceptions among investors. In the 2000 financial year, the Chief Executive Officer's (CEO) total remuneration amounted to R17 million, including benefits, none which had been approved by the board, or disclosed in the annual financial statements. Adequate levels of non-executive representation at board level seem to have been absent, allowing the running of the company to be dominated by the CEO.

² Source: www.news24.com (refer to section 7 for further reference)

The third case, Unifer, a listed micro-loan company, collapsed in January 2002, when it became apparent that provisions had to be made for significant bad debt because of irrecoverable loans. Absa (the second largest bank in South Africa) which held the majority stake in Unifer, lost a quarter of its share value as a result of Unifer's troubles, which can be attributed to mismanagement and poor internal control systems. The approval terms of, and procedures for advances were not properly controlled, while the systems for collecting and administering outstanding debts had serious deficiencies.

These examples clearly illustrate the need for improved governance standards.

2.4.2 Corporate failure

In addition to management failure, the broader economic environment can influence corporate governance. Given the general downturn in the global stock markets following the terrorist attacks on the World Trade Centre in New York on 11 September 2001, it has become difficult for companies to create shareholder value and the recent spate of profit warnings by large market players illustrates that this pressure seems to be increasing.

One of the large South African banks, Saambou Bank was placed under curatorship in February 2002, because of serious liquidity problems following an abnormal outflow of funds out of the bank, and consequently many investors and clients incurred losses. The losses that stakeholders suffer when large corporations fail, reinforces the importance of improving mechanisms of corporate governance in order to protect them.

2.4.3 Globalisation

The market for products and services, as well as capital, has expanded during the past decades to incorporate the entire globe. Sound systems of governance are, therefore, becoming increasingly important for attracting

foreign investment, or for establishing a company as a competitive, global supplier of products or services. This has been highlighted by the President of the World Bank, Jim Wolfensohn, who is quoted in the second King Report, as follows: "The proper governance of companies will become as crucial to the world economy as the proper governing of countries" (King Report, 2002, Introduction and background, paragraph 7.2).

2.4.4 Changes in the employment market

During troubled times, restructuring or downsizing workforces are often used as cost-cutting measures often implemented to improve profitability. This has intensified labour and political action against apparently unsympathetic companies, as well as increased demand by employees for greater involvement in the decision-making and the governance procedures in companies.

2.4.5 Executive remuneration

Executive remuneration is a well-researched topic and a considerable number of studies have explored the relationship between CEO compensation and company performance. Most of these studies follow the principal-agent paradigm in which CEO compensation should serve as a mechanism for aligning managers' incentives with the interests of shareholders. A positive relationship between CEO compensation and company performance would therefore fit the agency theory (Barkema & Comez-Mejia, 1998; Cohen & Uliana, 1990). Researchers, however, often find a weak, or statistically insignificant relationship between pay and performance (Jensen & Murphy, 1990; Kerr & Bettis, 1987). Other factors such as market forces, a firm's strategy (e.g. its product diversity and international diversity), demand instability, industry complexity and regulation, as well as the national tax system seem to influence the structure of executive compensation (Barkema & Comez-Mejia, 1998).

The extent of the influence of executive remuneration packages may be questionable, as the benefit thereof to stakeholders is not immediately evident from firm performance. A recent example illustrating this, is the case of the former South African Airways CEO, Coleman Andrews³, who earned R232 million during his two-and-a-half years with the company, with a further R243 million paid to consultants, among whom the biggest service provider was a company of which Andrews was a founder member. Even though he took certain positive steps to turn the company around, the extent of his remuneration is difficult to justify in relation to stakeholder benefit.

The world-wide phenomenon of high executive compensation, regardless of how well shareholder funds are governed, clearly calls for corporate governance reform, which incorporates sound approval mechanisms or structures (e.g. via remuneration committees) as well as greater transparency (proper disclosure).

The above examples provide some insight as to why corporate governance is still a topic for intense debate, both locally and internationally. It is apparent that while the factors influencing corporate governance, discussed above, remain relevant, current systems of governance should be under continuous scrutiny for weaknesses and that corporate governance reforms should be instituted where shortcomings are evident.

This chapter outlined the objectives of corporate governance. Although covering a wide spectrum of aspects, it reiterates that a sound system of governance should promote management accountability to stakeholders, enhance the transparency of the company's affairs and in general, limit opportunities for management to abuse its power.

³ Source: www.news24.com (refer to section 7 for further reference)

3 SYSTEMS OF GOVERNANCE

Chapter 3 provides an analytical overview of different corporate governance systems. It will attempt to establish how well these systems meet the objectives of corporate governance, as stated in Chapter 2 and will form the base of further analysis in subsequent chapters.

No governance system can be understood without looking at the salient features of the society in which it was shaped. Governance systems can, therefore, be viewed as products of historical events, legal, market and economic structures, as well as political forces. The following analysis of various systems will address aspects like the features of the typical corporation, ownership and control thereof, the legal framework and market structure in which it operates, as well as the general investment perspective (long-term ownership versus short-term investors).

3.1 Market governance

3.1.1 The typical corporation: ownership and control thereof

Corporate governance in the United States (US) and the United Kingdom (UK) developed through the emergence of joint stock companies and public stock exchanges. In the late 19th century, companies required substantial amounts of capital in order to support technological development. As they were no longer able to fund capital from internal resources or debt financing, they sought capital from investors who bought shares in their companies. Shareholders were the owners of the corporations, while a professional management team took charge of running the business. This process resulted in the typical Anglo-American or Berle-Means corporation (Berle & Means, 1932). A distinct feature of this type of corporation, is diffused shareholding among a number of stockholders, with management firmly in control of the operations. This structure is based on the principle that the owners (shareholders) appoint agents (directors) to manage the business,

with the directors providing annual feedback in respect of their fiduciary duties. The directors, therefore, can delegate their powers and obligations to management, but they cannot abdicate them, creating accountability links between management and the directors, and directors and shareholders. The board of directors is therefore one of the key elements in a typical corporation's governance structure and the board's functions, to a large extent determines the effectiveness of the system of accountability to shareholders.

In the US and UK, numerous statutes and codes rule the composition and functioning of boards. Some of these include:

- The Company Act 1985 (UK)
- In the US there is no Federal Companies Act; companies incorporate under the laws of the state of their choice. The main features relating to board selection and regulation according to US law are similar to the UK Company Act (Charkham, 1994: 182).
- Stock Exchange and Takeover Panel Codes (UK)
- Regulations of the various stock exchanges in the US (American, New York and Nasdaq).
- Guidelines and documents e.g. the report and recommendations of the Blue Ribbon Committee (1999) on improving the effectiveness of Corporate Audit Committees, the New York Stock Exchange and the National Association of Securities Dealers.

A board's composition plays an important role in its ability to monitor the running of the business effectively. Both in the US and UK, boards function under a single-tier board system, which does not include employee representation and it is common for outside directors (non-executive directors in the UK) to constitute a significant portion of the board. This practice is believed to improve independent oversight of management and for the same purpose, separating the functions of chairman and CEO is widely advocated. Where the CEO is also chairman of the board, he is, in fact, monitoring his own executive performance. As stated by the Cadbury Code:

“There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive it is essential that there should be a strong independent element on the board, with a recognised senior member.”

(1992, par 1.2)

It is common for boards to appoint committees to assist them in fulfilling their duties. The list of committees can be quite long, but the most important ones include:

- **Audit committees:** The main duties of audit committees include appointment of the auditors, reviewing the scope and results of external and internal audits, reviewing the adequacy of the companies' accounting policies and practices, as well as reviewing the effectiveness and integrity of the systems of financial control (Charkham, 1994: 191). In the Cadbury Report (1992) and Blue Ribbon Report (1999), extensive recommendations are made regarding the composition and functioning of audit committees.
- **Remuneration committees:** The purpose of this type of committee is to formulate the company's remuneration policy and establish guidelines in such a way that management and shareholders' interests are reconciled. In recent years, top executive remuneration has attracted much public interest, particularly when raises were not matched by increased profit performance. The solution lies in the effective functioning of a remuneration committee that usually consists of non-executive directors who can take an objective view on the competing interests of executive management and shareholders.
- **Executive committees:** Their major role includes dealing with general management issues arising between board meetings. The nature of

functions of such committees dictates that executive directors must actively participate in these.

Institutional investors (including pension and mutual funds, insurance companies and trust companies) collectively own large stakes of the US and UK equity markets. In the UK, institutional shareholding increased from approximately 30% in 1963, to 62% in 1993 (Keasey, et al, 1997: 19), and nearly half of the total US equity market is held by institutions (Scott, 1998). A large portion of this growth, in the UK, is attributable to indirect equity investments by individuals who use pension funds and life insurance as long-term savings vehicles. Pension funds, in particular, are popular vehicles for individual investors' assets due to the tax benefits currently accruing to pension contributions and benefits (Keasey, et al, 1997: 20). Pension funds are the largest form of institutional investor in the UK and hold UK shares for over half the value of their portfolios of assets.

Even though institutions collectively own large stakes of the equity market, the shares held by individual institutions are generally low when measured against the market capitalization of companies. A further ownership feature of the US and UK stock market, is the widespread diffusion of shares among numerous, individual shareholders.

3.1.2 Governance mechanisms

In the US and UK, a key principle underpinning governance is the principle of one-share-one-vote; effectively, ownership of shares entitles the holder to an equivalent and proportional right of control. The wide diffusion of shares, however, also means that voting rights are widely distributed, resulting in actual control being vested in the hands of a professional management team tasked with optimising shareholder wealth. The CEO leads the team, usually in a dominant position, relative to the other board members.

This separation of ownership (shareholders) and control (management) leaves room for management to deviate from meeting the shareholders' objectives, because the allocation of company funds is left to management's discretion, which clearly gives rise to a potential conflict of interests. As a consequence, the corporate governance systems in typical Anglo-American corporations are designed to minimise this potential conflict. Market related corporate governance mechanisms directed at aligning management's behaviour with shareholders' objectives may include market action, the market for corporate control and leveraged buy outs, each of which is discussed below:

3.1.2.1 Market action

An effective and liquid external market for equity exists in both the US and UK. These markets provide shareholders with an unrestricted and low-cost option to exit the market (sell their shares) when they are dissatisfied with a company's performance. Theoretically, if enough shareholders take the same action, the share price will drop. This collective action is a clear message to management that changes, congruent with the shareholders' objectives, are necessary.

3.1.2.2 The market for corporate control

Given the dispersed small shareholdings of the typical Anglo-American corporation and the high costs to the company, associated with collective action, the exit option normally dominates voice (right to vote). A further deterrent to collective action is the so-called free-rider problem where individual investors pay the price of remedial intervention, while other shareholders benefit from such action. Although the role of the shareholder voice, in this instance seems to be limited, it remains an important source of power.

Among the various issues that shareholders might vote on, the right to vote on takeover bids, is the one issue that forms the centre of most discussions.

Since Manne (1965), the market for corporate control hypothesis has held that the ability of shareholders to vote for a managerial team's control, which offers them the greatest increase in shareholder wealth, represents the single most important constraint on managerial behaviour. The fact that any company can, at any time, be a potential takeover target, is an effective and ongoing governance control for all companies that ought to sharpen the focus of current management teams.

The total value of takeovers in the US and UK, reflects the active market for corporate control and indicates its relevance as a mechanism for corporate governance. In the US, takeover value rose from \$12 billion in 1975 to \$268 billion in 1988 and in the UK, mergers and takeovers peaked during 1988 at a total value of £16.87 billion (937 completed transactions). Even though the value of these transactions has dropped in both the US and UK, to less than \$100 billion and £10.2 billion, respectively, in 1991, takeovers remain a powerful governance mechanism (Charkham, 1994: 215).

Evidence supporting the notion that takeovers address governance problems, include the fact that takeovers typically result in an increase of the combined value of both the target and acquiring firms, indicating that profits are expected to increase subsequent to the takeover (Jensen & Ruback, 1983). Poorly performing firms are also often the targets for takeovers (Palepu, 1986) and are associated with the replacement of management once the takeover succeeds (Martin & McConnell, 1991). Takeovers are regarded as a key mechanism for corporate governance in the US and UK, in that they can effectively control managerial behaviour.

3.1.2.3 Leveraged buy outs (LBOs)

A leveraged buy out (LBO) generally involves a new group of investors, which usually includes management, specialised buyout firms, banks and public debt holders, and which buys the shares from the company's current shareholders (Jensen, 1989a: 1989b). In LBOs, managers generally have an

increased equity stake in the firm, with the buy-out firm typically effectively controlling the business. The transaction is financed through loans (extensive debt) and this, together with the personal sureties that management must provide in respect of this debt ensure that its behaviour is aligned with the goals of the other stakeholders.

Available evidence indicates that LBOs result in efficient organisations. Kaplan (1989) found evidence from a sample of LBOs, that subsequently went public, that these businesses do increase their profits and are effective in both promoting management accountability to stakeholders (specifically other capital providers), as well as increasing shareholder wealth, thereby enhancing the level of governance.

3.1.3 Legal and regulatory framework

A country's legal framework significantly influences the features of its corporate governance systems. Examples may include the various statutes regulating ownership and control rights, e.g. by limiting the amount of equity that certain institutions own, the regulation of voting mechanisms as well as merger and acquisition activities.

In the US, the political sentiment discouraging concentrated financial power has contributed to the low concentration of certain forms of institutional ownership in that country. Some of the regulations that influence the ownership structure include:

- The Glass-Steagall Act of 1933, which prohibits banks from underwriting stock or affiliating with investment banks that underwrite stock.
- The Bank Holding Company Act of 1956 that restricts bank holding companies from owning large shareholdings in companies not closely related to banking (Charkham, 1994: 196-197).
- In 1906 life insurers were banned to own equity and the 1940 Investment Company Act required mutual funds to hold diversified portfolios with

penalties if a representative of the fund was appointed to the board of the company they invest in.

Regulation of voting mechanisms that have an impact on the market for corporate control include the following:

- In the US the use of multiple classes of stock was limited until the 1980s. The relaxation of the restrictions led to considerable growth in the issuance of dual class shares as a management protection mechanism during the 1980s active market for takeovers.
- Until 1986, the New York stock exchange prohibited the use of dual class share arrangements, a rule that was established in 1926.
- In Britain, the Companies Act was amended in 1948 to prohibit the issuance of non-voting shares.

Legal restrictions in the US and UK prohibit group formation – a system that affects control in the hands of a minority shareholder or group of shareholders.

- The Public Utility Holding Company Act of 1935 banned pyramid holding companies; once a common feature in the American utilities industry.
- Dividends flowing between separate legal entities within the US are taxable, constituting a further deterrent for the formation of holding companies.
- In Britain, the London Stock Exchange prohibits the listing of a company whose main asset is the controlling shareholding in another listed company.

In the US, the basic laws governing company structure are the State laws. There can be significant differences between the various States, opening the possibility for companies to incorporate in the State of their choice – probably where the governance regulations are most favourable to their circumstances. The Securities and Exchange Commission (SEC) also regulates many

processes affecting the governance of corporations. Examples of governance aspects not regulated by state laws, but by the SEC include:

- Rules on the disclosure of executive remuneration. Disclosure requirement includes a detailed breakdown of annual and long-term compensation into its various components, performance graphs comparing the cumulative shareholders' returns to the return on a broad index such as the Standard & Poor's 500 Stock Index, as well as reports from compensation committees explaining the factors considered in determining executive compensation (Charkham, 1994: 185-186). These rules are aimed at greater transparency for shareholders.
- Shareholder approval of employee stock option plans (Charkham, 1994: 174 – 175).
- Disclosure by persons who agree to take collective action if they together hold more than 5% of the company's shares.

In the UK, the Take-over Panel (TOP), established in 1968, regulates takeovers. The TOP serves as both legislator and court, and promulgated the TOP Code, which has had a significant effect on the takeover process. Generally, the underlying themes of the code are those of transparency, timeliness, as well as equal and fair treatment of the shareholders concerned (Charkham, 1994: 306 – 307).

3.1.4 Market structure

Well-developed and liquid external capital markets are essential components of a market driven corporate governance model. From the statistics detailed below, it is evident that both the US and UK markets show these characteristics.

Stock exchanges in America⁴:

- In December 2001, there were a total of 7 598 companies listed on the American Stock Exchange, the New York Stock Exchange and the Nasdaq, with a total market capitalisation of \$14 717 billion.
- The money raised on these stock exchanges from initial public offerings in the year 2001, amounted to \$44,3 billion (2000: \$112,5 billion), representing 101 (2000: 451) new offerings.
- 795 billion shares were traded on these stock exchanges in 2001, amounting to a total value of \$1 559 billion.

London Stock Exchange (LSE)⁵:

- On 31 December 2001, there were 2 891 companies (UK and international) listed on the LSE, with a total market capitalisation of £4 115 billion.
- For the year 2001, 304 new companies listed on the LSE, raising capital of £196 billion.
- The number of equity shares traded totalled 1 803 billion, with an equity turnover value of £5 581 billion.

The liquid markets stimulate market-related corporate governance actions and provide shareholders with unlimited scope for selling their shares at fairly low costs when dissatisfied with their investment.

3.1.5 The long-term versus short-term perspective

As already indicated, institutions hold and manage significant stakes in the US and UK equity markets. The ability to activate certain governance mechanisms e.g. appointing the board of directors or voting on takeover issues depends, to a large extent, on whether shareholders, including institutions, exercise the ownership rights inherent in the shares. The

⁴ Source: <http://www.marketdata.nasdaq.com>

⁵ Source: <http://www.londonstockexchange.com> (quarterly fact file)

objectives and perspectives of institutions will therefore influence the effectiveness of those governance mechanisms that depend on the active pursuit of ownership rights.

Charkham (1994: 283) argues that institutions often view shares as commodities that can be readily traded in an active market. From this point of view, institutions see themselves as fund managers with a concomitant need for freedom to move funds around in order to maximize the returns for the beneficiaries of those funds (institutions). Contrary to the short-term investors' view, institutions may act as the owners of a corporation and therefore take on the responsibility of shareholders, as defined in the Companies Act. This longer-term ownership perspective assumes the monitoring of a company's management and when necessary, accepts the cost of intervention in order to increase investment returns. This dual role of institutional investors, as both shareholder and investor, results in a conflicting situation: from the investor's perspective investment performance is measured over short term horizons, forcing them to focus more on short term profit maximization, while the shareholder view is orientated towards the longer-term. Should a single institution take costly action to intervene in company management policy, returns will be lower than their competitors', which at least in the short term, will be detrimental to their beneficiaries and may result in the loss of clients.

The substantial institutional stakes in the US and UK markets, means that they cannot divest from companies on a large scale. This supports the long-term investors' perspective and calls for collective action to improve the standard of corporate governance. In the Cadbury Report (1992), institutions are urged to take on the role of large shareholders and to monitor the management of the company on behalf of the small shareholders.

Macey (1998) argues in favour of the investors' perspective that institutional investors should focus on reducing their cost as well as eliminating firm-

specific risk by constructing balanced portfolios of shares. Both these strategies are inconsistent with a long-term perspective of monitoring. Macey's argument is based on the modern portfolio theory of diversification that eliminates firm-specific risk. According to the Capital Asset Pricing Model, investors are only compensated for bearing non-diversifiable risks. Gaining benefit from long-term relationship investments, coupled with ongoing interceptive actions, seem to fly in the face of these theories.

A phenomenon that supports the investor's objective rather than that of the owner, is indexed matching, where investors buy all the shares in a given index and the funds are weighted identically to the index, itself. This passive form of institutional fund-management, will in some cases, encourage managers to take a longer-term perspective, but will not necessarily lead to increased intervention because fund managers will be driven by investment performance against an index (Charkham, 1994: 209, 283; Keasey, et al, 1997: 24). Again, the problem arises that intervention results in increased management costs for an individual fund manager, with potential benefit for the non-intervening index-matched funds.

From the above discussion, it is clear that active participation in the corporate governance of a corporation calls on investors to take a longer-term view of their investments and therefore requires them to exercise the ownership rights to which they are entitled. Indexed matching, or passive portfolio management, reduces the need for shareholders to actively monitor the companies they invest in.

3.1.6 Criticism

Among the market governance mechanisms mentioned in 3.1.2, takeovers feature most prominently. Criticisms of the effectiveness of takeovers as a governance mechanism include the following:

- Takeovers are expensive, increasing the likelihood that only significant performance failures will be addressed. Apart from the cost of a takeover,

the bidder may need to pay the target firm's shareholders a price related to the expected increase in profits from his management. Should the bidder fail to do this, the current shareholders will often be reluctant to sell their shares, as they would become more valuable after a successful takeover.

- Takeovers can increase the bidding agency's costs if it pays an inflated price for an acquisition to achieve the private benefits of control (Shleifer & Vishny, 1988). Acquisitions are not necessarily used for disciplinary purposes, but can also provide the bidder's management with the means of increasing their empires or diversifying current operations. Jensen (1993) indicates that of the hostile takeover activity in the 1980s in the US, only a small portion had disciplinary intentions.
- The anti-takeover legislation that contributed to the decline of the 1980s takeover wave shows that using the takeover as a mechanism for corporate governance is vulnerable to political opposition or interference. (Jensen, 1993).

3.2 Bank governance: the German governance system

3.2.1 The typical corporation: ownership and control thereof

The most common framework for companies in German industry is the incorporated company, specifically, the following two types:

- Gesellschaft mit beschränkte Haftung (GmbH) or company with limited liability;
- Aktiengesellschaft (AG) or share company (Charkham, 1994: 15).

The number of listed companies in Germany is relatively low. At the end of 1992 only 664 out of the 3 219 AGs were listed, while AGs accounted for only about 20% of business turnover at that time. Market activity is dominated by a few large AGs and in 1991, a mere 50 companies accounted for more than 85% of domestic share trades (Keasey, et al, 1997: 235). It is evident that, in Germany, the stock market plays a far less significant role in facilitating corporate control, than in the US or UK. A key characteristic of the numerous non-listed firms is highly concentrated ownership with a close correlation

between owners and managers. As a result, the scope for principal-agent conflicts, a feature of the Anglo-American company, is more limited. This is typical of the German entrepreneurial culture, which is known for its aversion to both public disclosure requirements and sharing control with outsiders.

In Germany, non-financial enterprises hold the largest stake of issued equities (39% in 1993). Concentrated ownership, in the form of large block-holdings is a common feature of German business. The holdings of pension funds and insurance companies are relatively insignificant – approximately 15%, jointly, in 1993 and is due to the fact that two-thirds of employees' pension contributions can be retained within the company and utilised as a source of internal finance (Keasey, et al, 1997: 245).

The importance of stakeholders, particularly employees and customers, relative to shareholders can be illustrated by the accounting policy adopted by German companies. While the UK accounts should reflect a true and fair view of the company's affairs, the German audit approach, which is entrenched by legislation, is based on commercial prudence (Charkham, 1994: 31). Risks are generally provided for in the balance sheet as reserves for difficult financial times. This clearly indicates that the continuity of the business is more highly rated than communicating profits to shareholders.

3.2.2 Governance mechanisms

Low reliance on capital markets means that the German governance system is significantly different from that of the Anglo-American model. Actions like hostile takeovers, or shareholder activism by large institutions, are not key features in this market, and the corporate governance system is greatly influenced the by the two-tier board structure and the distinctive role of banks in Germany.

3.2.2.1 Bank influence

German banks have, in a number of areas, close relationships with industrial companies. In the early days of industrialisation, businesses turned to the banks for long-term financing. In turn, the banks realised the long-term nature of their lending and perceived the need to build relationships with their customers. This, consequently, improved information flow from company to bank, which is essential to the banks in understanding their customers and the industries in which they operate (Charkham, 1994: 36). To secure long-term relationships with clients, banks extend their lending services together with a range of further services, including management consultancy.

Apart from providing debt financing, banks are also important shareholders in listed equities and, in 1993, held 14% of issued stock (Keasey, et al, 1997: 236). Many of their holdings were acquired from companies, which could only settle their debt with an offer of equity (shareholding) in the business.

Private and corporate investors generally deposit their shares with the banks, which are authorised to perform the work of shareholders, on a professional basis. Consequently, the banks' influence through proxy voting has a far more significant impact than their direct holdings. Banks are obliged, by law to give shareholders advice and to consult them about voting instructions. They will therefore send their views on how to vote to shareholders and in the absence of a different instruction from the shareholder, will exercise proxy votes accordingly (Charkham, 1994: 38). Exercising voting rights means that banks profoundly influence the composition of executive bodies, managing boards, as well as supervisory boards in German corporations. This is illustrated by the fact that, on average, banks collectively represent more than 83% of all votes, present at meetings, with the three big banks accounting for 45% of the votes present (Keasey, et al, 1997: 237).

This combination of long-term lending, direct ownership and proxy voting rights, reflects the strong relationship between companies and banks, and

accompanied by intimate knowledge of customers' businesses, give banks the authority to influence the company's management.

3.2.2.2 Two-tier board structure

The German corporation operates under a two-tier board system, comprising a lower, executive board of managers, and an upper, non-executive supervisory board. For firms with between 500 and 2 000 employees, a two-tier board system with one-third employee representation is compulsory. Firms with more than 2 000 employees have a similar structure, but 50% of the representatives are selected by shareholders, and the other 50% by employees and trade unions. The chairman of the supervisory board has a casting vote and will always be a shareholder representative (Charkham, 1994: 18).

This system originated during the industrialisation of Germany, during the second half of the 19th century. It has already been noted that in the absence of well-developed stock markets, the banks supplied the large amounts of capital required for industrial growth, resulting in close relationships with their clients, and board membership. In 1884, the supervisory board was made compulsory and further legislation, in 1937, formalized the separation between the executive responsibilities of the managing board and the control function of the supervisory board (Keasey, et al, 1997: 243).

The purpose of the two-tier system is to put management supervision in the hands of a committee of shareholders and employee representatives. With the separation of management (control) and ownership, specifically where there is a dominating managing board in control, the functions of the supervisory board become increasingly important. The objective of the supervisory board is to ensure that the interests of the managers coincide with those of the stakeholders in the business. The role of employees, as stakeholders, is enhanced by the fact that two-thirds of their pension fund contributions are retained within the company, as a source of internal

funding. Further benefits from co-determination by employees include improved labour relations and union co-operation.

3.2.3 Legal and regulatory framework

Regulations that impact on the governance mechanisms of a particular country, as already noted when discussing the typical Anglo-American corporations, include those regulating the concentration of ownership, voting mechanisms, or merger and takeover activities. Some of the laws and regulations that apply to German corporations include the following:

- Pension and insurance funds are subject to rules limiting the investment of their assets; of the assets held to cover current obligations, only 20% can be invested in equities and the total stake in any one company is limited to 10% (Charkham, 1994: 27). These regulations, coupled with the retention of pension contributions in companies as a source of working capital, further explains why the German capital market in Germany is less developed than in the UK and US.
- Although it has no significant impact on German banks, the Second Banking Co-ordination Directive (adopted in December 1989) limited a banks' shareholdings in individual companies to 15% of its capital, and the total of such holdings to 60% (Charkham, 1994: 37).
- As discussed in section 3.2.2.2, German law regulates mandatory nature and composition of supervisory boards. The authority and tasks of the supervisory board are also prescribed and include appointments to the executive board, approving dividend payments, approving the company's accounts for a specified period, approval of significant capital expenditure and strategic investments (Charkham, 1994: 22).
- Representation on the supervisory board generally serves as mechanism for the protection of shareholder rights. The decision-making responsibility of the supervisory board is, however, limited and further legal protection of shareholders against negligent executive boards seems lacking: for shareholders to act against management, would require a majority of votes

at a general meeting, or at least 10% of votes to file a court objection (Scott, 1998).

3.2.4 Market structure

As discussed in section 3.2.1, and unlike the US and UK, the market does not play a significant role in facilitating corporate control in Germany. The stock market does not attract large proportions of German savings, nor is the stock market a particularly large source of capital for companies. Although merger activity takes place quite often for normal commercial reasons, hostile takeovers seldom occur. The international trend of greater concentration of market share by major companies has been achieved through merger activity.

3.2.5 The long-term versus short-term perspective

The German system of governance recognises a wider range of stakeholders than just the shareholders and as a result, the longer-term stability and interests of the company remain key focus areas for the business. Because the combined stock holdings of companies and banks are far more significant than the holdings of private shareholders, and as noted in section 3.2.2.1, they have means at their disposal to exercise influence, they understand the business and tend to take a long-term view.

The absence of a constant takeover threat has encouraged this long term view, and German investors are known to prefer slow, steady increases in earnings and major reinvestment in assets and development costs, rather than high distributions (Charkham, 1994: 52).

3.2.6 Criticism

The strong bank influence and supervisory board system that form part of the German corporate governance model are regarded as positive attributes in promoting executive board accountability to shareholders. A number of aspects of the German corporate governance system have, however, been criticized and include the following:

- The effectiveness of the supervisory board has been questioned in the sense that the board is dependent on information provided by the executive board on issues concerning the corporation's current state of affairs and areas of risk.
- A further problem inherent in the German system, is its inability to cope with the increasing globalisation of businesses, coupled with its lack of transparency and disclosure (Keasey, et al, 1997: 248). While international capital markets allow German corporations to select their providers of finance, they will escape their traditional monitors, however, the greater reliance of German corporations on international capital markets might lead to a decline in profitability for banks in monitoring management's performance. Furthermore, increased globalisation may result in a call for changes to accounting and information policies.
- The extent of the house banks' monitoring powers could also be an area of concern. Their independence as objective monitors can be questioned when considering the effective control exercised by the largest banks. Collectively, the five largest universal banks cast between 54% and 64% of votes at their own shareholders' meetings in 1992 (Scott, 1998). Outside shareholders, and/or market forces, seem to have little constraining power over the power of banks, leaving effective monitoring at the discretion of bank managers.

3.3 Bank governance: the Japanese governance system

3.3.1 The typical corporation: ownership and control thereof

There are generally three types of corporations in Japan, namely commercial partnerships, limited partnerships and limited companies. Even though only a small percentage of companies are listed, they account for a substantial proportion of turnover, due to the numerous associated, unlisted companies (Charkham, 1994: 75).

The typical corporation structure or “Keiretsu⁶” consists of a group of companies forming a complex finance and supplier network, which links member companies through cross-shareholdings and customer-supplier relationships. The six largest Keiretsu are Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa and Dai-ichi Kangyo (Keasey, et al, 1997: 181).

The Keiretsu developed from the pre-war Zaibatsu structure. The Zaibatsu comprised a holding company, controlled by the founding family which, in turn, controlled a number of industrial and financial companies, including the major banks (Charkham, 1994: 75). During the US occupation of Japan, in 1945, the Zaibatsu were dissolved and the controlling families’ shareholdings were confiscated and sold off, resulting in a substantial decline in cross-holdings (Berglof & Perotti, 1994). During the 1950s and 1960s, the inter-firm relationships progressively reemerged and in addition, new groups formed around the large city banks. A significant change from the previous Zaibatsu was the substitution of hierarchical holding company control with horizontal co-ordination resulting in cross-company trading and bank lending.

One of the main features of the Keiretsu, noted above, is the extensive cross-holdings of shares among member firms. Even though each individual company normally only has a small equity holding in another member firm, the combined shares of member companies are typically large enough to ensure that the group can control its members.

Holdings by group financial institutions play an important role in most Keiretsu. Typically, the Keiretsu's main bank holds between 2 and 5% (5% being the legal limit) of a member’s equity. In addition to equity stakes, the groups’ banks extend substantial amounts of debt financing to member

⁶ There are two types of Keiretsu in Japan – horizontal and vertical. The vertical Keiretsu consists of a main manufacturer and its affiliated subcontractors. The reference to “Keiretsu” in this section refers to the horizontal structure.

companies. Keiretsu firms further rely heavily on inter-group lending through trade credits (Berglof & Perotti, 1994).

The Keiretsu groups usually include members from a wide range of industries. Because members usually do not compete in the same industry, there are seldom overlaps in terms of the main product lines and consequently, extensive trade relationships exist between virtually all group member companies. Cross holdings of blocks of stock are often viewed by businesses as mechanisms for obtaining new business rather than realising investment return (McDonald, 1998). The mutual trade and finance relationships within a group have implications for the composition and the size of groups. Firms that are likely to be affiliated with the group will include those with the greatest potential to benefit from long-term, cooperative relationships. The addition of a new firm can only be justified if the expected benefits of collaboration outweigh the costs of adding another member to the group. It is also more likely that members that are comparable in size will support inter-group relations, which is not the case with hierarchical relationships (Berglof & Perotti, 1994).

A characteristic of Japanese boards is the low representation of non-executive or outside directors, when compared with the US/UK model. Even though, by law, directors need the support of a third of the shareholders to be selected, Japanese company directors are often full-time employees, or engaged in managing the business (Charkham, 1994: 85). Large corporations are controlled by a management committee, comprising the top layer of directors, which is responsible for decision-making, and the board of directors has a more ceremonial role.

Japanese boards tend to be far bigger than their western counterparts to include the employees who have progressed to the top of the organisation and have been elected to serve on the board in recognition for long and loyal

service. Consequently, Japanese boards tend not to play a significant role in the objective control of the management of an organisation.

The increased focus on corporate governance issues in Japan is, however, beginning to bring about changes in individual corporations. The average board size seems to be declining, for example, Sony, which has reduced its board from 38 directors to 10, of whom three are outsiders and Long-Term Credit Bank reduced its board from 28 to six. It should be noted that companies making these drastic changes are those with substantial global interests – Sony's stock is listed on the London and New York stock exchanges and over 40% of its shares are held by foreign shareholders. It is more difficult for the traditional Japanese corporations to reduce the number of directors because this would exclude a number of career executives from being recognised for loyal service to the company. The number of suitable, independent outside directors is also limited because of the extensive Keiretsu groupings (Goldstein, 1998), and all these factors will effectively limit scope for board reform in the short-term.

A further feature of corporate governance in the Japanese model, is the function of statutory auditors, appointed by the shareholders. In terms of Articles 273-80 of the Commercial Code, the function of statutory auditors is to audit the directors' activities to ensure that business is conducted in accordance with the applicable laws and the company's regulations and in the best interest of the shareholders. Their aim is to prevent any improper activities, which might lead to the company being held liable to any third party. In reality their role is often regarded as a formality, and lacking real substance. In order to fulfil their duties, access to relevant information on important business and financial decisions is required. Support in terms of allowing statutory auditors to attend board meetings and arranging interviews with company presidents seems to be inadequate for this auditing function to fully achieve its purpose (Charkham, 1994: 93).

3.3.2 Governance mechanisms

The main governance structures in Japan are a result of the typical Keiretsu groupings.

3.3.2.1 Mutual monitoring among group firms

As previously mentioned, the Keiretsu is a group of companies operating in different industries, but involving long-term relationships through extensive trade relationships and equity stakes in the various members' companies. The joint controlling stake owned in one firm, by other firms in the group, ensures a mutual commitment to monitoring the management of that firm. With their combined voting rights, the alliance can influence the company's strategy and ensure that management acts to the benefit of stakeholders.

The frequent trading between partners in the group can lead to further monitoring opportunities, because it provides a base for the exchange of financial and production information that can be used for continuous performance evaluation. In order to obviate the problem of members withholding information about an insolvent firm in the group (protecting the failing member's management from settling their trade claim in return), the Keiretsu's main bank often guarantees trade claims. This provides incentives for timely reporting of poor performance and insolvency (Berglof & Perotti, 1994).

Mutual monitoring may be compared with governance arrangements that rely on threat of loss of managerial control. Similar to the takeover market in the US and UK, mutual monitoring poses a real threat to management, in that individuals might be replaced or demoted. In this instance, the internal substitution of management is likely to be more cost effective and less disruptive than corporate control changes enforced by external investors (Berglof & Perotti, 1994).

Furthermore, the intense competition between the various Keiretsu further enforces strict discipline within the group (Berglof & Perotti, 1994).

3.3.2.2 Main bank monitoring

The self-controlled coalition of managers, as described above, may potentially lead to a situation where managers protect each other from outside interference. The absence of an objective monitoring mechanism is clearly not desirable, from a stakeholder and shareholder perspective.

In order to alleviate this potential collusive arrangement, member firms fund themselves extensively through debt financing from the main bank. As principal provider of finance, the main bank becomes the controlling body when a member firm defaults and is relatively well-positioned to obtain information about a member's strategy, performance and management. Debt repayments provide a regular source of interaction and payment default will clearly signal profitability problems. It also often occurs that employees of the main bank are appointed as board members in member-group firms, and incentives seem to be sufficiently strong for main banks to fulfil this monitoring function. As holders of equity and providers of debt financing, they can protect their investments by monitoring and limiting the financial burden involved in the restructuring of a failing member (Kaysey, et al, 1997: 182).

3.3.2.3 Cultural norms of the Keiretsu system

Apart from sharing the Keiretsu name and logo, group members, as already mentioned, interact in many ways: trade relationships, debt, equity holdings, employee exchange networks and group-wide councils. This multi-level interaction has established a sense of cohesion among group members and the intense competition between various Keiretsu further facilitates solidarity between group members. Being part of a Keiretsu group implies adhering to the principles and codes of the group, as well as living up to the expectations of other group members. The Keiretsu structure therefore enforces strict discipline within the group.

3.3.3 Legal and regulatory framework

The legal framework that impacts on governance mechanisms includes the following:

- The Commercial Code, which governs the structure and conduct of companies, including the annual general meetings and the board of directors.
- Legal ownership restrictions that include, as noted above, limiting banks from holding more than 5% of the total equity of a firm and allowing groups of financial institutions to hold up to 40% of the total equity in a firm (Berglof & Perotti, 1994).
- The Japan Pension Fund Association regulates and administers the national pension scheme for employees working at companies with less than 500 employees and released a set of guidelines on exercising shareholder voting rights, in June 1998. These urge pension asset managers to actively oversee the management of corporations and focuses on increasing investment return for pension beneficiaries. Further, the guidelines promote adequate and timely disclosure of information on corporate activities. Through exercising voting rights, pension fund managers can influence the size, function, and composition of corporate boards, as well as both the profit distribution and business strategies (McDonald, 1998).
- The Liberal Democratic Party (LDP) and the influential business group Keidanren (Federation of Economic Organizations) both issued corporate governance proposals emphasising the need to strengthen the audit system and change the rules governing shareholder lawsuits. Both proposals require that a majority of each company's internal auditors be independent, with independent being defined as a person who has never worked for the company, or a subsidiary. This means that retired executives may not be classified as independent, even after a five-year nominal separation from the companies where they worked their entire lives. In addition, auditors who resign in the middle of their terms must now provide reasons for doing so. Where shareholders' interests are

protected through improved audit systems, the restrictions on shareholder lawsuits, however, pose further limitations to investors. In both proposals, it is a requirement that shareholder plaintiffs should have owned stock in the corporation at the time of the incident, giving rise to the suit. Shareholders who bought shares after the incident occurred, but before it became public are left with no legal recourse for losses because of the incident. Companies would further be allowed to indemnify directors in derivative suits. These proposals from Japanese corporations, and their political allies, are clearly set to restrict the number of shareholder suits (Goldstein, 1998).

- The Corporate Governance Forum of Japan (CGFJ) has issued a comprehensive code on the principles of corporate governance. The principles to be adopted in the short-term include improved disclosure to shareholders on information affecting their interests, reducing the number of directors so as to facilitate more effective decision-making and the inclusion of independent, outside directors on boards. The longer-term principles, which will require substantial legal reforms, include independent outsiders comprising the majority on corporate boards, establishment of remuneration and audit committees, as well as separating the roles of chairman and chief executive officer.
- Stock options were first legalised in Japan in 1997 and a number of companies introduced stock option plans for their executives and directors. The weaknesses of the stock market have, however, lead to a decline in the attractiveness of stock options (Goldstein, 1998). Further profit-sharing devices such as bonus systems and stock-holding plans, have been introduced as part of an effort to align profit maximizing for shareholders with maximizing profits for all stakeholders (Report of the CGFJ, 1997).

3.3.4 Market structure

The Japanese stock market is an important source of corporations' external capital. Due to large block holdings (the various Keiretsu cross-holdings,

previously discussed), a high proportion of shares is in stable hands. As a result, trading in the market is unlikely to occur when a hostile bid is made for a particular company. Management therefore pays little attention to any threat of take-over and, as a consequence, the market is not an effective mechanism for disciplining management's behaviour. Willing, or arranged mergers, in the case of failing companies often occur.

3.3.5 The long-term versus short-term perspective

The dominant view in Japan generally seems to favour the long-term preservation and prosperity of companies above maximizing shareholders' value. Japanese companies value employees and customers just as highly as, or even more than their shareholders. This stakeholder approach is in stark contrast from the Anglo-American model that mainly revolves around the shareholder.

The collective monitoring system inherent in the Japanese governance model relies on a long-term, stable ownership structure, which means that structure and relationships within a Keiretsu group are therefore orientated towards the long-term. A consistent ownership structure is supported by the procedures for allocation of voting rights in the event of an equity issue or the sale of shareholdings by a Keiretsu firm (Berglof & Perotti, 1994). The main bank often intervenes when a group member is selling its equity by allocating the share, proportionally among group members.

3.3.6 Criticism

A number of areas of the Japanese governance structures have been criticised and include the following:

- The vested trade and shareholding interests, mean that rules other than normal business principles may apply to under-performing firms, which means that the Keiretsu structure can lead to non-viable firms being kept alive longer than practical (Berglof & Perotti, 1994).

- The recent trend towards loosening the Keiretsu ties may suggest that the structure is not flexible enough to meet the demands of global competition (Berglof & Perotti, 1994).
- According to Coffee (1991) the main Keiretsu bank receives a premium (above market interest rates on loan financing) in return for its monitoring functions. As shareholders should be able to diversify to protect themselves against company-specific losses, they are disadvantaged when above market interest rates are paid on debt financing. The main bank's monitoring commitments to members, therefore, mainly benefit management and protect the bank's interests, at the expense of the outside shareholders.
- In addition, bank intervention is often restricted to the event of a keiretsu member becoming financially distressed, and therefore banks cannot offer an ongoing monitoring mechanism (Coffee, 1991).

3.4 Holding company governance

3.4.1 The typical corporation: ownership and control thereof

The holding company, or pyramid structure, is a corporate arrangement commonly found in countries like Sweden, France, Italy, Belgium, Canada, Korea and South Africa. A holding company is one whose assets contain shares in another company. The holding company, by owning more than 50% of its subsidiary company, can exercise full control over it. A pyramid company can therefore be defined as a company whose only, or main asset, consists of a controlling shareholding in another company, for the express purpose of exercising control. The ultimate ownership of the holding company at the top of the pyramid is usually concentrated, while ownership of the subsidiary companies is more widely diffused among outside shareholders (Barr, et al, 1995).

The concentration of control in the hands of a minority shareholder can be accomplished by introducing various layers of holding companies into the

organisation, thus forming a pyramid structure. The rationale behind employing this structure is often to enable the owner and manager to raise additional financing without compromising control of the operating company. Where the controlling shareholder's holdings have already been reduced to 50%, additional capital cannot be raised without losing total control of the operating company. By transferring its shareholding to a pyramid or holding company, further shares can be issued, thereby diluting the shareholdings in the holding company rather than in the operating company. Once the shareholdings in the holding company decrease to a level of 50%, the underlying equity stake in the operating company would have reduced to 25% (i.e. 50% of 50%). Control over the operating company is, however, maintained as the controlling shareholder holds the majority of votes in the holding company, while the holding company in turn holds the majority of votes in the operating company. By repeating this process and forming yet another holding company, which takes up 50% of the shares in the previous holding company, the main shareholder's equity stake is further diluted to 12,5%, without any effective change in the control of the operating company. This structure illustrates how the distribution of shareholders' voting rights (control) is no longer linked to the underlying equity stakes (Gerson & Barr, 1994).

Through the use of pyramid holding company structures, a shareholder-controlled environment is created in contrast to the management-controlled environment in the US or UK (Kantor, 1998). Unlike in the US or UK, where agency conflict exists between shareholders as owners and management as controllers, the conflict here arises between the controlling minority shareholder and the majority shareholders. Being the controlling shareholder does not necessarily mean owning the rights and dividends of the companies it controls. A South African example where this occurred is when the Oppenheimer family controlled 40% of the value of the JSE Securities Exchange South Africa ("JSE"), but owned only about 8% of the value of the Anglo American Corporation (Kantor, 1998).

The method of raising financing through introducing additional holding companies into the group, can be repeated indefinitely, as long as there are willing buyers of shares who are satisfied with not having effective controlling rights. A key feature influencing the market demand for this type of share issue, is the reputation of the controlling shareholder among the investor community (Barr, et al, 1995). It is easier for successful entrepreneurs with well-established reputations to raise funding, at the right price, in this way, than for company owners that do not have proven track records.

3.4.2 Governance mechanisms

By controlling the ultimate holding company at the top of the pyramid, control over the various operating subsidiaries is automatically obtained. Although it may vary in levels of intensity, the controlling shareholder normally actively participates in the management and strategy of the operating companies. By holding the majority of votes, strong influence is exercised through the appointment of management teams and boards of directors, and the controlling shareholder plays a monitoring role by reviewing the performance of the operating companies' management teams. Through consolidation of the results of the various operating companies, information flow to the holding company is effected, thereby improving the monitoring capabilities of the controlling shareholder. In this structure, replacing under-performing management teams is a relatively easy and inexpensive task to perform, when compared with the extensive procedures of market driven disciplinary actions.

It is also common for holding companies to provide guarantees for the operating companies in a group, thereby decreasing the bankruptcy risk and enabling the operating companies to source external financing at more favourable rates. Guarantees, and often loan financing provided to operating companies, increase the incentive for the holding company to monitor the performance of its operating companies.

The sustainability of the holding company structure is dependent on its ability to protect and grow shareholder value. As the majority of shareholders need to willingly invest in a company, knowing that they will, for all practical purposes, own "voteless" shares, the holding company's governance has to earn investors' confidence. One way of doing this is by producing superior returns for these shareholders.

Barr, et al (1995) evaluated the performance of South African conglomerates in order to determine whether group structures can be justified. They found that the five large mining houses, all pyramid structures, produced average returns for the period 1981 through to 1992 that outperformed the All Share Index and exceeded the CPI by about 550 basis points. They also found that over the period January 1989 to June 1993, the mining houses, without exception, provided significantly higher returns when compared to the returns that an individual investor would have earned, holding the same proportion of listed investments, independent of the holding company. The mining houses seemed to have created shareholder value over and above the value of their listed holdings and thereby proved the pyramid or holding company to be an effective governance system in the context of protecting and increasing shareholder value. Barr, et al identified a number of other characteristics of effective holding company governance, including:

- The higher the reputation of the controlling shareholder, the lower the potential percentage claim to dividends from the operating companies under its control.
- Where the controller's equity stake is well in excess of his remuneration as manager or director, his incentives would be better aligned with those of the outside shareholders, making it more attractive for them to invest in "voteless" shares.

Both these features seem to enhance the standard of corporate governance, thereby supporting the existence of holding company governance.

3.4.3 Legal and regulatory framework

As usual, legal rules and policies often significantly shape corporate governance frameworks. In the US and UK the principle of “one-share-one vote” is strongly promoted and regulations entrenching this include:

- The banning of pyramid holding companies, once a prominent feature in the American utilities industry, in terms of the Public Utility Holding Company Act of 1935.
- Also in the US, the taxation of dividend flows between separate legal entities within a group constrains the formation of holding companies.
- It is contrary to London Stock Exchange regulations to list a company whose main asset is a controlling shareholding in another listed company.

In countries where these regulations do not apply, pyramid group structures may provide a beneficial way of structuring operations, and financing a corporation.

3.4.4 Market structure

Large, diversified groups can exercise control over significant portions of the market. This is specifically true for South Africa where, in 1999, five groups controlled approximately 63% of equity issued on the JSE (measured in terms of market capitalisation) (McGregor, 2000). As a result, market controlled governance mechanisms like hostile takeovers are virtually impossible to execute. Shareholders must depend on the controlling shareholder to align his goals with those of the shareholders and act in their best interests. Among these interests is replacing under-performing executive teams, which, as indicated earlier, is a relatively easy task given the absence of proxy or takeover battles.

3.4.5 The long-term versus short-term perspective

Group structures are generally formed with the purpose of establishing long-term control. As a result, the controlling shareholder usually takes a long-term view on the management and strategy of the corporation. The controlling

owner's active participation in the running of the business, as well as the often significant personal stakes involved, supports a long-term investment approach.

3.4.6 Criticism

One of the reasons why an owner of a business may want to utilise a holding company structure for further share issues, is to finance investments unrelated to the current core business, thereby diversifying his portfolio. Corporate diversification has been strongly criticised in the past, as it often lacks clear focus and compromises shareholder returns. Non-controlling shareholders, therefore, run the risk of reduced returns when investing in diversified groups still effectively controlled by the original owner.

Further potential conflict between the controlling shareholder and other minority shareholders may include excessive benefits paid to the controlling shareholder, as well as a potential succession problem when the controlling owner steps down (Barr, et al, 1995).

In a pyramid structure, there are no guarantees that the controlling shareholder will not abuse his power to the detriment of minority shareholders. The strongest control seems to be the dependence of the controlling shareholder on willing investors, continuing to purchase "voteless" shares. Where the controllers are unable to convince investors that they are unlikely to abuse their powers, they will not be able to attract investors at the right price.

3.5 Conclusion

In Chapter 2, corporate governance was defined as the system whereby companies are directed and controlled in a particular society. As previously stated, corporate governance deals with the agency problem of separating a company's ownership (shareholders) from its control (management). The

objectives of sound governance include providing a system or structure where the necessary checks and controls exist to ensure that the goals of management match those of the shareholders, and other stakeholders. As a firm's financiers represent an important group of stakeholders, the review of various corporate governance systems in this chapter focuses mainly on the governance mechanisms that support the relationships between management and these entities. In this context, corporate governance deals with the question of how to assure financiers that they get an adequate return on their investment.

From the analysis in Chapter 3, it is clear that legal protection of investors, together with some form of concentrated ownership, represent two essential components of a good corporate governance system. Large shareholders, sporadic concentration of owners during a takeover process and significant influence from banks characterise concentrated ownership. In addition, a combination of concentrated ownership and the legal protection of investors both profoundly influence the various governance systems that have been reviewed.

In the US and UK, shareholders are supported through an extensive legal system that protects minority rights, promotes the independent selection of directors, allows for easy transfer of shares and which protects shareholders against any director's breach of fiduciary duties. Extensive bankruptcy protection of companies means that US creditors (including banks) have fewer rights than their German and Japanese counterparts and consequently, there is active public participation in the equities market, concentration of ownership via periodic takeover action or leveraged buyouts, associated with little bank governance.

In Germany, creditors have stronger legal protection than they do in the US and UK, but fewer shareholder rights are evident. As a result, large shareholders and banks form powerful governance structures. Participation

by smaller equity investors that are more reliant on legal protection, therefore, is virtually non-existent. Similarly, in Japan, banks and large long-term shareholders (Keiretsu networks) play an important governance role and because of the prevalence of large, long-term investors in both Germany and Japan, hostile takeovers are rarely encountered.

With holding company governance in certain European countries, Canada, Korea and South Africa, legal protection of investors is less significant. Control is concentrated in the hands of a group of minority shareholders, often a founding family. Insufficient laws or a failure to enforce existing laws often leads to legal protection being insubstantial. In general, there is less reliance on external financing and where external funding is to be sourced, the reputation of the minority controllers and their ability to generate adequate returns become important factors.

A common feature of the corporate governance systems of the US and UK, Germany and Japan is a combination of legal protection of investors' rights and concentrated control, while holding company governance has concentrated control, but less significant investor protection. A combined system of legal protection and concentrated control helps to solve the agency problem and, as a result, ensures access to future external equity and debt funding.

Following the analysis of various international governance systems in this chapter, the next chapter deals with corporate governance structure in South Africa. It will provide an overview of the extent to which the identified governance mechanisms exist within the South African framework.

4 EXISTING GOVERNANCE STRUCTURES IN SOUTH AFRICA

South Africa is classified as an emerging market, and the general investors' perception is that corporate governance standards in emerging markets, lag behind those in the US, UK and continental Europe. This is consistent with the outcome of the 2000 McKinsey Investors Opinion Survey, which indicated that investors are of the opinion that emerging markets are in greater need of reform than in other regions. Given South Africa's emerging market status, there should be a continuous focus on corporate governance reform in order to bring South Africa on a par with international standards.

The South African corporate and market structure shows the characteristics of a control model of governance. It has already been noted that in 1999, the five largest groups listed on the JSE controlled more than 60% of its value (McGregor, 2000). This controlled environment is established via holding or pyramid company structures, as well as through the strong influence of family-owned businesses. The recent trend towards unbundling, as well as changes to the JSE listing requirements prohibiting the listing of pyramid companies, may cause holding company governance to be less effective in the future. These changes in the governance environment, coupled with the perception that emerging markets' governance structures are in need of reform, stress the importance of constantly reviewing corporate governance in South Africa to improve standards. Serious corporate governance failures including those of Unifer, Regal Treasury Bank and LeisureNet, have also increased the intensity of debate surrounding corporate governance reform.

This chapter provides an overview of the extent to which the governance mechanisms, identified in Chapter 3, exist in South Africa. Each section focuses on the unique South African circumstances that influence the suitability of a governance mechanism to the South African context. It is furthermore the intention to identify aspects of corporate governance that can be incorporated in the South African framework, in order to enhance the

current dispensation. Chapter 5 will take this a step further and introduce the possibility of monitoring by large, institutional investors as an alternative form of governance.

4.1 Market governance in South Africa

In order to evaluate the functioning of market governance in South Africa, the components of the market governance model need to be viewed against the background of the South African institutional and corporate environment.

4.1.1 Institutional environment: shareholder structure

Dispersed ownership is a distinct feature of the market model. In contrast to the wide spread shareholding of corporations in the US and UK, a significant number of companies listed on the JSE are tightly controlled, in the sense that a single shareholder coalition holds a majority of the shareholders' votes (refer to section 3.4.4). Control is often established via pyramid holding company structures in which a shareholder, or group of shareholders, can dilute their shareholding below the level of 50% and still maintain control over a majority of the votes. The large number of family-owned businesses further increases the level of control.

In the market model of governance, the regulatory environment encourages shareholder equality and ownership generally translates into equal proportions of control rights (the principle of one-share-one-vote). The shareholders' voting rights enable them to appoint a professional team to manage the business on their behalf. Until recently, one-share-one-vote was neither enforced nor encouraged by the regulatory environment in South Africa. Before the amendments to the JSE listing requirements in 2002, the listing of a company whose main asset consisted of the controlling shareholding in another listed company, was not prohibited. In terms of the latest changes to the JSE listing requirements, pyramid companies may not be listed (JSE listing requirements, section 14.8), nor can shares with

differential voting rights. These rules, however, only apply to new listings and share issues and will not be forced on existing structures. The use of pyramid holding companies in South Africa, can result in the underlying percentage of shareholding being disproportionate to the voting rights. The non taxability of dividend flows between separate group companies in South Africa, in contrast to the US and UK, where such dividend flows are taxable, encourages group formation. Where the regulatory system permits deviation from the one-share-one-vote principle, it is inevitable that mechanisms such as pyramid companies and dual class share arrangements will be applied to create new share issues without sacrificing control.

4.1.2 Institutional environment: capital market liquidity

A key component of the market governance model is an active equity market, including access to equity financing via public offerings. Even though the JSE represents a major source of external finance for South African corporations, its size and activity is small when compared with the London and American stock exchanges. In December 2001, there were 542 companies listed on the JSE, compared to the 2 891 companies listed on the London Stock Exchange and the 7 598 companies listed on the three major American stock exchanges, at that time. South Africa ranked 17th in the world, in terms of market capitalisation at the end of December 2001, but 26th in terms of market liquidity percentage and 22nd in terms of market turnover measured in US dollar value. While only 11 new listings occurred on the JSE for the year 2001, 85 delistings occurred over the same period⁷. The trading volumes of shares on the JSE are significantly lower than on the bigger Anglo-American stock markets. Excluding arbitrage transactions, 60 billion shares were traded on the JSE for the year 2001, with a total value of R606 billion (£36,8 billion⁸). In comparison, the volume of shares traded on the LSE and three major American stock exchanges amounted to 1 803 billion and 795 billion, respectively, while the value of shares traded amounted to £5 581 billion and

⁷ Source: JSE market profile report as at 31 December 2001

⁸ Source: I-Net Bridge 26 March 2002; exchange rate: £1 = R16,45

\$1 559 billion (£1 093 billion⁹) respectively. In order to access international capital, some of the large South African corporations also listed on international stock markets. Shares that were previously traded by foreign investors on the local stock market have now been relocated to foreign exchanges, thereby further decreasing the liquidity of the South African equity market.

Effective market action is dependent on stock markets that will provide shareholders with an unrestricted and low-cost option for exiting from their investments when they are dissatisfied with a company's performance. Without well-developed, active stock markets to support quick and inexpensive selling of shares, shareholders lose their ability to "vote with their feet", utilising market action as a mechanism for disciplining management.

Furthermore, an active takeover market forms one of the basic underlying principles by which the market model operates. The market for corporate control as a governance mechanism relies on the assumption that shareholders can use their votes to effect changes to a management team which is not operating in their best interests. The constant threat of a takeover provides an ongoing governance control with the objective of aligning management's focus with shareholder expectations.

Given the concentrated control environment in South Africa, the threat of hostile takeovers can have little effect on directing management's behaviour. Rather than the permanent fear of being replaced by a different management team through a hostile takeover, the market for new share issues plays a key role in aligning the controllers' goals with those of the other shareholders. As their shares will effectively be "voteless", thereby not providing them with normal ownership rights, investors need to be satisfied that the controllers will not abuse their powers to the detriment of minority shareholders. Failing to do

⁹ Source: I-Net Bridge 26 March 2002; exchange rate: \$1 = £0,701

this, means that controlling shareholders will not be able to issue further shares at the price they desire.

4.1.3 Corporate environment

Corporate structures, like non-executive majority boards, the separation of the chairman and chief executive officer roles, as well as various governance committees, form components of the market model that aim to promote the independent monitoring of management. It has been noted that mechanisms for governing and aligning executive management's performance include remuneration committees and share incentive schemes. These aspects of corporate reform have been incorporated into the South African corporate governance framework, with reasonable success. The 2001 KPMG survey that focused mainly on areas of corporate reform consequently had favourable outcomes in respect of these areas.

4.1.4 Conclusion

It is clear that the institutional framework in South Africa tends to support a control model of governance. Concentrated ownership largely prevails, while equity markets are under-developed and illiquid, resulting in limited takeover action and new share issues. However, within the corporate framework of South Africa, corporate governance has been extensively reformed. The King Report (2002) encourages independence via non-executive majority boards as well as alignment of the board's performance with stakeholder objectives. It also promotes a high level of transparency and accountability. A situation which combines the features of a control governance model, within the institutional context, while market model reform is applied within the corporate context, is evident in South Africa.

4.2 Bank governance in South Africa

As explained in the previous chapter, governance arrangements in Germany and Japan rely more heavily on debt, or bank finance, than on equity finance.

In both Germany and Japan, banks maintain long-term relationships with their customers, or in the Japanese framework, the member firms of the Keiretsu. In Germany, businesses mainly turned to the banks for financing during the industrialisation period, while in Japan, member firms of a Keiretsu primarily source finance from their main bank. Through extensive levels of debt financing, the banks become controlling bodies and are normally well positioned to obtain relevant information about their customers. Banks also often secure board representation, thereby increasing their monitoring capabilities.

The German and Japanese governance structures incorporate specific governance arrangements e.g. board representation and proxy voting on behalf of shareholders. Apart from these mechanisms, the basic governing features accompanying debt finance, stem from the nature of the debt contract through which the borrower obtains funds from the lender, and in return, undertakes to repay the lender in the future. The lender, furthermore, needs to adhere to certain covenants such as maintaining the value of the assets provided as security (collateral) for the finance. If the borrower defaults on a payment, or violates any covenant, the lender has certain rights, such as the ability to take possession of the collateral, or apply for the liquidation of the firm. A key feature of debt is the activation of the lender's control rights when a borrower fails to adhere to the debt contract (Shleifer & Vishny, 1997).

In order to assess the significance of lenders' control rights and their ability to invoke these in a monitoring capacity in South Africa, the extent of debt financing needs to be reviewed. For the purpose of this exercise, the level of financing provided by the six largest banks in South Africa was reviewed¹⁰. Data regarding advances provided by the selected banks were obtained from their 2001 published annual reports. Advances include various types of

¹⁰ Standard Bank, Nedcor, ABSA, Investec, First Rand and BOE.

facilities e.g. loans, overdrafts, mortgage advances, instalment sale and leasing accounts. Collectively, the total advances the six banks provided, amounted to R670 billion. Of this total, R284 billion was lent to individuals. The balance, R386 billion, included advances to listed and private companies, as well as the public sector and institutions. The total JSE market capitalisation of R1770,7 billion¹¹ represents the extent of equity financing of listed corporations, and far exceeded the level of debt financing.

Even though it might vary for individual companies, this indicates that in general, equity represents the main source of finance for listed corporations, which are less dependent on debt financing. As a consequence, the potential for South African banks to act as monitors of corporate governance is restricted.

Although banks' equity holdings are regulated, banks in Germany and Japan often extend their monitoring influence through share ownership of their customers' or member firms' equity. The Banks Act (Act No. 94 of 1990) (The Banks Act) regulates banks in South Africa. In terms of these regulations, banks are required to hold liquid assets (thereby excluding equity investments) matching the extent and category of their liabilities (The Banks Act, section 72). Investments in shares are limited to the bank's risk capital (The Banks Act, section 76) and the extent and type of individual investments are also restricted (Regulations relating to Banks, Government Gazette No. 21726, 2000, regulation 34). The review above included an analysis of the extent of equity investments held by South Africa's six largest banks. It showed that the combined investments in listed and unlisted equities, as well as investments in associated companies for the selected banks amounted, on average, to less than 4% of total assets, and listed equities represented approximately 2% of these. Of the six banks, Standard Bank had the highest monetary investment value, R23,5 billion, of which R18 billion related to listed

¹¹ Source: JSE market profile report

equities, translating to 1% of the market capitalisation of the JSE. Standard Bank's R18 billion investment portfolio, furthermore, includes a large number of different equities. These low levels of equity holdings indicate that the potential of banks to extend their monitoring influence via equity holdings is fairly restricted in this country.

In Germany, proxy voting has a far greater monitoring impact than direct equity holdings. Through exercising voting rights, banks can exert major influence over the composition of executive bodies and boards of directors, but in South Africa, this type of proxy voting is not common. Banks, however, do act as nominee companies, providing a facility allowing investors to register their shares in the name of that nominee company. However, the service provided by the nominee companies is limited to certain administrative functions e.g. administration of share certificates and excludes voting on an investor's behalf, or providing guidance in respect of voting issues.

It can be concluded from this review, that the role of South African banks in monitoring corporate governance is limited and the level of debt financing, in general, is lower than the extent of equity financing. Unlike the banks in Germany and Japan, which increase their ability to monitor by way of both equity holdings and proxy voting, South African banks do not have significant equity holdings nor do they act as proxy voters.

4.3 Other features of the German and Japanese governance systems

In addition to bank monitoring, there are a number of other features of the German and Japanese systems, identified in Chapter 3, which are relevant within the South African corporate governance framework.

4.3.1 Two-tier board structure

Chapter 3 outlined that the purpose of the two-tier board system is to provide a committee of shareholders and employees the power and authority to

supervise management. This means that the objectives of the supervisory board are to ensure that management's interests are aligned with those of the stakeholders.

As already noted, there has been significant progress towards reforming corporate governance in South Africa, particularly in respect of the independence and performance of corporate boards, as well as transparency and accountability to shareholders (section 4.1.3, above). The process of reforming the composition and functioning of boards that South African corporations have adopted seems to follow the market model standards. Given investors' preference for the principles of the market governance model, the implementation of the two-tier board concept would, therefore, not generally be viewed as an enhancement of corporate governance standards.

4.3.2 Mutual monitoring

In Japan, the mutual monitoring between members of a Keiretsu group is established via the extensive web of trade relationships and equity holdings, and is coupled with the frequent trading between partners in the group, which provides a base for the continuous flow of information necessary for monitoring performance. Mutual monitoring serves as a governance mechanism in the sense that it constantly threatens management with demotion or replacement.

A similar form of monitoring can be found in the large South African group corporations, where the holding or parent company and its various subsidiaries have a comparable relationship. The controlling shareholder normally plays a key role in appointing management teams and in monitoring the performance and strategy of the subsidiary companies. In group companies, the holding company directors are often members of the boards of subsidiary companies, thereby enhancing the flow of information, up the pyramid, to the holding company. The various governance committees of the

subsidiaries, e.g. the audit and remuneration committees, can often include holding company representation.

Although in a different format, the objective of mutual monitoring is achieved within the group corporations in South Africa.

4.4 Holding company governance in South Africa

Chapter 3 provided an analysis of the holding company governance in the South African context. The effectiveness of holding company governance is illustrated by Barr, et al (1995) who found that large conglomerates increased shareholder wealth by creating value in excess of the value of the listed, individual holdings of the members of the same group.

However, a number of significant unbundling transactions have taken place in South Africa over the past couple of years. Examples include Rembrandt, which scrapped its pyramid structure and listed as two separate entities, VenFin (technology interests) and Remgro (mining, financial and industrial investments), De Beers which unbundled its 35% stake in Anglo American and Pepkor's split into three listed entities after unbundling and delisting its holding company, Peggro. Further unbundlings included Tiger Brands' stake in Astral Foods (its agri-poultry business), Johncom's stake in M-Cell and Iscor's unbundling to separately list its mining operations. This trend supports the transformation of the controlled shareholder environment, as established via pyramid holding company structures, into a more widely dispersed ownership structure, congruent with market model principles. The changes in the requirements for listing on the JSE are further steps towards reforming the current shareholder control environment in South Africa.

Even though the South African shareholder environment is still predominantly a controlled one, it seems to be shifting towards a wider distribution of

ownership rights. An outcome of this trend is the reduced impact of holding company governance in the South African corporate governance framework.

4.5 The enhancement of the South African governance system

This section examines whether certain aspects of the governance systems previously identified can be incorporated into the existing South African framework in order to enhance the standard and quality of corporate governance.

4.5.1 Market governance reform

Similar to many emerging market economies, a South African priority is attracting international equity investment. As the market model of governance is a key feature of Anglo-American corporations, investors generally feel assured by this governance structure. The alignment of corporate governance standards and structures with international norms is necessary for South Africa to become a global player and as a result, corporate reform naturally tends towards the market model (McKinsey, 2001).

The developments in corporate governance in South Africa do, in fact, fit with this trend towards transforming the current dispensation into a market model orientated governance system and has been assisted by the regulatory changes implemented during recent years. Reference has already been made to the changes to both the Companies Act (No. 61 of 1973) and the JSE's listing requirements. The corporate governance guidelines for South Africa, the King Report (1994) and the second King Report (2002), further set the tone and principles for sound governance. The King Report (2002) mainly addresses the internal governing of corporations, specifically boards of directors, auditing and accounting policies and procedures, internal audit, risk management, as well as certain non-financial matters including communication with stakeholders.

It is important to note that the corporate governance system of a country not only consists of the internal guidelines for governing corporations, but that institutional structures, including the shareholder environment and market structure (liquidity and level of development), also comprise a significant component of a country's governance system. It is in these areas that South Africa's ruling governance structures differ most from the market governance model. Unfortunately, these aspects play a major role in promoting investors' confidence. Over half of the respondents in McKinsey's 2001 Emerging Market Survey rated institutional and corporate form as equally important, because they perceive that institutional reform provides a greater level of security for their investments. The institutional aspects that McKinsey considered in its survey also included the enforceability of legal rights, macro-economic stability, as well as the accuracy, timeliness and coverage of financial accounts.

Some of the regulatory changes in South Africa are designed to address institutional reform. The changes to the JSE listing requirements, prohibiting both the listing of new pyramid companies and the issue of shares with differential voting rights, are steps towards relaxing the prevailing control structures. However, as the regulatory changes are not retrospective, it remains a challenge to encourage corporations with existing control structures to reform the shareholder environment. The recent drive by the Accounting Practices Board to align South African Generally Accepted Accounting Practice (SA GAAP) with international standards, as well as the aspects of the King Report (2002) addressing communication with, and reporting to stakeholders, can also be viewed as improvements to the institutional environment. The King Report (2002) has also recommended that there be legal backing for accounting standards. The revised JSE listing requirements also stipulate that all listed companies should prepare their annual financial statements in compliance with GAAP standards. The JSE listing requirements, in general, are intended to promote international investor confidence and increase the quality of information available to investors.

The greatest barrier to market model reform in South Africa remains the illiquid and underdeveloped equity market, when compared with Anglo-American markets. In this context, certain conditions of the amended JSE listing requirements impose further constraints on accessing capital. In the past, companies had to have a pre-tax profit history of R1 million, subscribed capital of R2 million and 300 public shareholders (10% shareholder spread). However, following the amendments, they must have a pre-tax profit history of R8 million, subscribed capital of R25 million and 500 public shareholders (20% shareholder spread).

In terms of the governing of corporations, the King Report (2002) guidelines reflect the market model. Given the structural support of a sound code of corporate governance, the acceptance and implementation of these guidelines by the business community must be the next area of focus.

4.5.2 Bank or debt governance reform

Section 4.2 provided a review of the potential monitoring capabilities of banks in South Africa and included an examination of the extent of debt financing provided by banks, their level of equity holdings, as well as their role in proxy voting. This revealed that equity financing represents a more significant source of funding than bank debt financing for listed companies, and that banks' equity holdings are limited, nor do they act as proxy voters on behalf of shareholders.

As a result, the potential of South African banks to act as monitors, as is the case in Germany or Japan, is limited. The possibility of this role for South African banks has, furthermore, been reduced by the recent failures in the banking industry (Saambou Bank, Regal Treasury Bank, Unifer), outlined in the introduction to this study.

However, the six largest banks in South Africa do collectively provide various forms of debt financing, which amounts to approximately R390 billion, to listed and private corporations, the public sector and other institutions. The potential for banks to contribute to an improved corporate governance environment, in this country, should therefore not be disregarded.

4.5.3 Holding company governance reform

From the previous discussion, it is clear that migration towards a market model of governance would improve investors' confidence and improve the overall standard of governance in South Africa. In addition, the trend in South Africa also seems to reflect reform that will shift governance towards the market model of corporate governance. Movement away from a control shareholder environment is evident from the unbundling transactions, already mentioned, as well as the changes to the JSE listing requirements. The King Report (2002) further endorses governance principles that fit the market model standards. While holding company governance, which has played a key role in the company governance in the past, will continue to do so for as long as company control structures are in place, it is evident that the trend of reform will be towards the market model. Consequently holding company governance will play a less significant role in the South African framework of the future.

4.5.4 The need for alternatives

When viewing the structural framework of corporate governance in South Africa, it would appear that the King Report (2002), the JSE rules and regulations and the Companies Act (No. 61 of 1973) have laid the foundation for corporate governance reform that complies with international market model standards. The acceptance and implementation of these guidelines and regulations is an evolving process that will, over time, enhance the overall quality of corporate governance in South Africa.

The reality that needs to be addressed, is a shareholder environment that is still largely control dominated, as well as illiquid and underdeveloped equity markets, in terms of Anglo-American standards. The significant corporate governance failures of Saambou Bank, Unifer, Regal Treasury Bank and LeisureNet, which have severely dented the image of corporate governance in South Africa, further illustrate that the appropriate guidelines and standards have not been satisfactorily incorporated into the corporate governance framework.

South Africa finds itself in a unique transitory situation where the rules and guidelines have been formulated in a market model context, but where the institutional framework (control shareholder environment; illiquid and underdeveloped equity markets) fails to support full transformation into a market model dispensation. Given these circumstances, the current governance system can only benefit from embracing alternative forms of monitoring that will bring South Africa closer to its goal of meeting international standards for corporate governance.

A mechanism that has been successfully applied in the US to improve the level of governance is monitoring by large institutional investors. In the next chapter, the possibility of using a similar mechanism will be proposed as an alternative form of corporate governance in South Africa.

5 A NEW PERSPECTIVE: MONITORING BY LARGE INSTITUTIONAL INVESTORS

Institutional investors, for example in the US and UK, collectively hold large stakes of the US and UK equity markets. Given the collective size of these holdings, they control a significant portion of the equity market. Through exercising the ownership rights linked to their portfolios, institutional investors have the potential to play a key monitoring role, thus influencing the quality of governance of the companies in which they invest.

This view is shared by various corporate governance reports (Cadbury, 1992, Hampel, 1998, King, 2002) that contain recommendations pertaining, specifically, to institutional investors. These recommendations advocate greater involvement by large institutional investors and aim to encourage them to accept the ownership responsibilities implied by their shareholding.

5.1 Recommendations by corporate governance codes concerning institutional investors

The Cadbury committee incorporated, into its report, the following recommendations from the Institutional Shareholders' Committee in the UK, that:

- institutional investors should encourage regular, systematic contact at senior executive level to exchange views and information on strategy, performance, board membership and management quality;
- institutional investors should make positive use of their voting rights; and
- institutional investors should take a positive interest in the composition of boards of directors (Cadbury Report, 1992: 50).

The Hampel Report on Corporate Governance (1998: 41 - 45) includes the following principles of good corporate governance pertaining to shareholders:

- Shareholder voting: Institutional shareholders should adopt a considered policy on voting the shares that they control;
- Dialogue between companies and investors: Companies and institutional shareholders should each be ready, where practicable, to enter into a dialogue based on the mutual understanding of objectives;
- Evaluation of governance disclosures: When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors and their advisers should give due weight to all relevant factors drawn to their attention;
- The annual general meeting (AGM): Companies should use the AGM to communicate with private investors and encourage their participation.

The King Report (2002: 149 - 151) includes the following guidelines pertaining to institutional investors:

- Institutional investors have an obligation to their policy holders, etc., to ensure that the underlying investments are achieving their full potential through applying effective corporate governance practices;
- Sanctions should be visited upon directors and the management of companies, notably institutional shareholders, who fail to attend shareholders' meetings;
- Institutional bodies, of which the investors are members, are to apply pressure to ensure that appropriate involvement is achieved.

These recommendations of increased institutional investors' involvement aim to enhance the overall standard and quality of a country's corporate governance system. They also underline the potential for institutional investors to become successful monitors, thereby improving the existing governance framework.

5.2 Monitoring mechanisms

The most common and accessible forms of monitoring available to institutional shareholders remain their right and power to vote as shareholders at the Annual General Meeting. While this is the most obvious way for institutions to exercise their power over a company's management, there are a number of other courses of action available to them, in their capacity as relatively large shareholders, and these are dealt with below:

5.2.1 Refusal to participate in rights issues

One course of action available is that an institution can refuse to participate in rights issues when companies attempt to raise additional equity financing on the market (Keasey, et al, 1997: 39). As companies are largely dependent on institutions to support them in a rights issue, this refusal provides institutions with a level of power in these circumstances. Institutions can, for example, make their acceptance of the rights issue conditional on certain governance changes e.g. board replacements.

5.2.2 Adverse public comment

The ability of institutions to make negative public announcements about the firms they invest in poses a constant threat to the management of those companies (Keasey, et al, 1997: 39). However, the problem arises that such announcements might damage the share price and reputation of these companies, thereby negatively affecting institutional investments. Such negative publicity can also discourage further information flow from management to the institutions, thereby hampering future monitoring potential.

5.2.3 Removal of directors via a general meeting

In addition, institutional shareholders can act to replace a company's directors at a general meeting. However, this course of action could be detrimental to a

company's share value and reputation, with consequences similar to those of negative public announcements.

5.2.4 Threat of selling a company's shares

A threat to sell shares in a firm represents a mechanism that need not necessarily be exercised publicly, as with the actions mentioned above. Such a threat may, however, adversely affect the investments of other institutions, resulting in potential criticism or retaliatory action (Keasey, et al, 1997: 40)

5.2.5 Developing long-term relationships

A feature of corporate governance that could be incorporated from the Japanese system is longer-term interaction between institutions and a firm's board and management. Such a strategy could provide a means for institutional shareholders for improving their monitoring capability, but is dependent on the co-operation of management and could imply a substantial investment of time and money.

5.3 Intervention by institutional shareholders: empirical evidence

There are a number of studies designed to obtain empirical evidence about the relationships between shareholder intervention and a firm's performance. Smith (1996) analysed the effects of institutional shareholder activism on shareholder wealth and operating performance. His empirical study was based on the 51 firms targeted by the California Public Employees' Retirement System (CalPERS)¹² over the period 1987 to 1993. Smith found that shareholder wealth increased for firms that adopted the changes proposed by, or made changes resulting in a settlement with, CalPERS (who acted as intervening institution), while shareholder wealth decreased for firms which resisted changes. However, there was no statistically significant

¹² CalPERS represents a large institution that attempts to increase their portfolio returns through governance-related activities. For documented cases refer to Fulman (1998), Hemmerick (1997) and Springsteel (1998).

change in operating performance for the firms that did implement the CalPERS suggestions. Nesbitt (1994) comes to the same conclusion regarding stock price performance for a sample of firms targeted by CalPERS. According to Nesbitt, successful intervention by CalPERS had a long-term favourable effect on the selected firms' share prices.

These results indicate that there are potential benefits that can result from active intervention by institutional investors in the governance of companies, in terms of increased share price performance.

5.4 Potential difficulties arising from intervention by institutional shareholders

A number of aspects can influence an institutional shareholder's decision to actively monitor their investments, as outlined below.

5.4.1 Indexed matching or passive investment by institutions

Impediments to more active intervention by institutional investors include the need to diversify, as well as the growth of indexing (whereby investors own a basket of shares selected to reflect the performance of an index, which represents the market or a sector of the market). With indexed matching, fund managers are usually driven by their portfolio's investment performance against the selected index. This can lead to managers taking a short-term approach to the shares in their portfolios. In terms of this approach, non-performing shares are sold, instead of being retained while incurring costly intervention actions to improve long-term share value, thereby decreasing the return of the portfolio.

5.4.2 The costs of monitoring

Intervention by institutional investors necessitates a significant investment of time and costs, because the process of gathering information, as well as monitoring management may be highly technical in nature and therefore

require a relatively high level of expertise and involvement. Free-riding imposes a further problem for the intervening institution as its effort will also be to the benefit of all the other investors. Collective action, therefore, by a group of institutions provides a solution to the free-riding problem.

5.4.3 Risks of trading

A close relationship between an institutional investor, the board and management of a firm, implies a reasonably extensive level of information exchange. In this way, the institution becomes party to such information that trading of its stake might result in accusations of insider trading.

It is evident, therefore, that institutional shareholders face a number of difficulties when actively participating in the governance of the firms included in their investment portfolios.

5.5 Monitoring by institutional investors as a proposition for South Africa

Institutional investors' current role in governance, coupled with levels of shareholding in the market, will influence their potential for monitoring corporate governance in South Africa.

The various vehicles for long-term savings e.g. insurance or pension funds have a strong presence in the South African economy and is largely the historical result of savings flows into such funds rather than into banks. During the high inflation period of the 1970s, pension and retirement funds preferred investments in equities over bonds or cash investments. Changes in the 1980s, meant that public sector pension funds were no longer restricted in terms of their equity investments, resulting in further flows to the equity market (Kantor, 1998). This shift to equities was also motivated by the returns, well above the inflation rate, achieved in the equity market during that period.

The South African tax legislation is also more favourable for savings via pension or retirement vehicles than bank or unit trust investments. Contributions to pension funds and retirement annuities are tax deductible for personal and company tax purposes (employee and employer contributions). However, funds deposited with banks, or unit trust investments are not tax deductible. Furthermore, until 1996, pension and retirement funds were not liable for tax, thereby stimulating personal savings through these vehicles. The taxability of interest, versus the tax exempt status of dividend income, creates a further disincentive for cash investments. Secondary Tax on Companies (STC), based on all dividends declared by a company, currently charged at a rate of 12,5%, was introduced in 1993, in conjunction with a reduction in the company tax rate. The intention of STC was to encourage companies to adopt a modest dividend distribution policy while reinvesting funds in the corporation. It should therefore not be seen as a withholding tax on shareholders.

Historically, exchange control regulation also contributed to the high savings flow into the pension and retirement industry. In the past, strict exchange control regulations limited international investment options for South African investors and as a result, stimulated flows into domestic equities via pension and retirement fund vehicles. Although exchange control regulations have been relaxed significantly, there are still restrictions pertaining to the level of foreign investments for both institutions and individuals.

For these reasons, the South African insurance companies enjoy a significant share of the long-term savings product market, and also manage a number of retirement funds. According to Kantor (1998), long-term savings vehicles owned up to 90% of the value of the JSE-listed shares. In addition to the policyholders' funds invested in the equity market, the demutualisation of two of the largest life insurance companies in South Africa (Sanlam during 1998

and Old Mutual during 1999), brought a further investment of their shareholders' funds into the equity market.

It should also be noted that due to the limited equity investment opportunities in South Africa and the relatively illiquid stock market, institutional investors are often locked into their investments. This forces the institutional investor to take a longer-term view of its investment, and consequently involve itself in the governing of that particular company.

It is evident that the South African life insurance companies, through investments of their policyholders' and shareholders' funds, and through management of a number of pension funds, exercise control over significant portions of the equity market. However, the reality is that the life insurance companies appoint professional asset managers to manage the various portfolios of funds according to specific investment mandates, whose mandates often include different levels of index matching, with the performance of portfolios measured against these indices. The problems relating to institutional intervention, as outlined in section 5.4, are therefore equally apposite for the South African institutional investor.

A conflict of interest arises for portfolio managers; as investors, they need to decrease the risk of their portfolios, while optimising portfolio returns. However, in their capacity as shareholders they need to exercise their ownership rights, including the right to vote on issues that affect the governing of the firms in which they hold shares.

5.6 Conclusion

South African life insurance companies claimed significant stakes of individual investors' savings flows via long-term savings vehicles, as a result of the historical economic climate and the taxation dispensation. Through investing their policy- and shareholders' funds, as well as by managing various pension

funds, the life insurance companies own significant portions of the JSE. Given the relatively illiquid and inactive state of the equity market, as well as limitations on foreign investment opportunities, institutional investors are often effectively locked into certain investments, with the result that South African institutional investors, especially the large life insurance companies and pension fund administrators, can potentially play a significant monitoring role in the corporate governance framework.

However, there are deterrents to this type of institutional intervention, among which are the costs of monitoring by individual institutions and the absence of structures to stimulate co-ordinated intervention by institutional shareholders.

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6 CONCLUSION

This dissertation aims to identify alternative or improved corporate governance mechanisms that could be incorporated into the current South African governance structure in order to enhance the current dispensation.

For this purpose, various international corporate governance models were analysed. For each model, monitoring mechanisms that restrict management's ability to abuse its power and promote management accountability to stakeholders, were identified.

The market model found in the US and UK, is characterised by widespread shareholding, a regulatory environment that promotes shareholder equality (the principle of one-share-one-vote), as well as active and liquid capital markets. As a result, the monitoring mechanisms tend to be market orientated. The effective and liquid external market for equity provides shareholders with an unrestricted and low-cost option to offload their investment when they are dissatisfied with a company's performance, thereby voting with their feet for a change in management's actions. Shareholders' ability to vote on takeover bids and thereby affecting change in managerial control represents a further significant check on managerial behaviour.

In South Africa, a controlled shareholder environment as well as inactive and illiquid equity markets when compared with the Anglo-American standards are evident. These features prevent the market model mechanisms from playing a greater monitoring role in the South African governance framework. Market model reform in this institutional context will necessitate regulatory and structural changes, thus addressing the restrictive shareholder environment and the status of the equities market. It is unlikely that the influence of market model monitoring mechanisms will increase until such changes are effected.

Further market model mechanisms aimed at promoting the independent monitoring of management include corporate structures such as non-executive majority boards, separation of the chairman and chief executive officer roles as well as the existence of various governance committees. Extensive reform in these areas has already been incorporated into the South African corporate governance framework over the last decade. Examples of such reform include the 1994 and 2002 King Reports, as well as changes to the Companies Act (No. 61 of 1973) and the Banks Act (No. 94 of 1990), designed to improve the level of corporate governance. Notwithstanding these measures, a number of significant corporate failures occurred during this period. Enforcement and acceptance of the guidelines provided by the King Reports seem to be imperative.

The German and Japanese bank governance model relies more heavily on debt financing than on equity financing. Through extensive levels of debt financing, the banks become controlling bodies, often increasing their monitoring capacity by securing positions on their customers' boards. They also often hold their customers' equity. In Germany, proxy voting further extends the banks' influence over the composition of corporate boards and executive bodies.

In South Africa the level of bank debt financing is generally lower than equity financing, thereby limiting banks' ability to become monitors through their debt control rights. Banks neither have significant equity holdings, nor act as proxy voters on behalf of shareholders. The potential for reform in South Africa by way of increased bank monitoring is therefore restricted. The image of banks as potential monitors was furthermore tarnished by recent corporate failures in the banking industry.

The German and Japanese governance models feature further monitoring mechanisms, such as two-tier boards structures (Germany) and mutual monitoring among Keiretsu members (Japan). With the support of regulations

and guidelines like those contained in the King Reports, certain sections of the Companies Act (No. 61 of 1973) and JSE listing requirements, board reform in South Africa reflects the principles of the market model and consequently, implementing a two-tier board structure would not be viewed as an enhancement of South African corporate governance enhancement. In Japan, mutual monitoring between members of a Keiretsu group is established via the extensive web of trade relationships and equity holdings within the group. Within the large South African group corporations where the holding or parent company and their various subsidiaries have a comparable relationship and similar structure, the objectives of mutual monitoring are achieved.

With holding company governance in certain European countries, Canada, Korea, and South Africa, control is concentrated in the hands of a group of minority shareholders, often the family that founded the business. The controlling shareholder strongly influences the appointment of management teams, boards of directors and the company strategy, thereby acting as monitors. The reputations of minority controllers, as well as their ability to generate adequate shareholder returns, play an important role in raising additional equity funding.

Even though studies have illustrated the effectiveness of holding company governance in South Africa (Barr, et al, 1995), a number of factors have caused its impact to wane. The recent, significant unbundling transactions, as well as amendments to the JSE listing requirements to prohibit the listing of pyramid companies, all support transformation of a controlled shareholder environment into a wider, dispersed ownership structure. The trend of reform addresses transformation of the shareholder environment, and reflects market model principles.

In order for South Africa to attract capital globally, the perceived level of governance needs to comply with international standards. The shift towards

market model standards is natural, as investors generally tend to feel more assured by the governance structures applied in the Anglo-American corporations. Regulatory reform in South Africa, over the last decade, has supported transformation into a market model dispensation. However, the continued existence of an institutional framework (control shareholder environment, illiquid and underdeveloped equity markets) that fails to support total reform to the market model, remains a reality that must be addressed. Given these circumstances, the current governance system can only benefit from incorporating alternative forms of monitoring that can help South Africa to comply with international standards.

Monitoring by large institutional investors has improved the level of governance in the US. South Africa's economic history, coupled with the taxation dispensation, has contributed to a strong institutional shareholder environment, dominated by large insurance companies and pension funds. Furthermore, the relatively illiquid and inactive state of the equity market, together with limitations on foreign investment opportunities, mean that institutional investors are largely locked into their investments. In this environment, it is proposed that institutional investors in South Africa should play a more significant monitoring role in corporate governance, by becoming active shareholders and by assuming the ownership responsibilities inherent in the shares under their control. In addition, the development of structures to co-ordinate intervention can be stimulated and would significantly enhance monitoring activities.

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