

THE NEXUS BETWEEN CORPORATE
GOVERNANCE AND CAPITAL MARKETS: WHY
CORPORATE GOVERNANCE IS IMPORTANT TO
CAPITAL MARKET DEVELOPMENT.

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1st CIS/GMC WEST AFRICAN CAPITAL MARKET
CONFERENCE, ACCRA 2014



Outline...



- 1) Introduction – The Nexus
- 2) Key attributes of capital markets
- 3) Corporate governance definition
- 4) Characteristics of well governed entities and consequences of poor corporate governance
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THE NEXUS

Corporate governance and Capital markets reinforce and complement one another. Capital markets benefit when public companies are well governed while the attributes of capital markets promote the proper governance of companies.



Key Attributes of Capital Markets

Transparency

Liquidity

Disclosure

Fairness

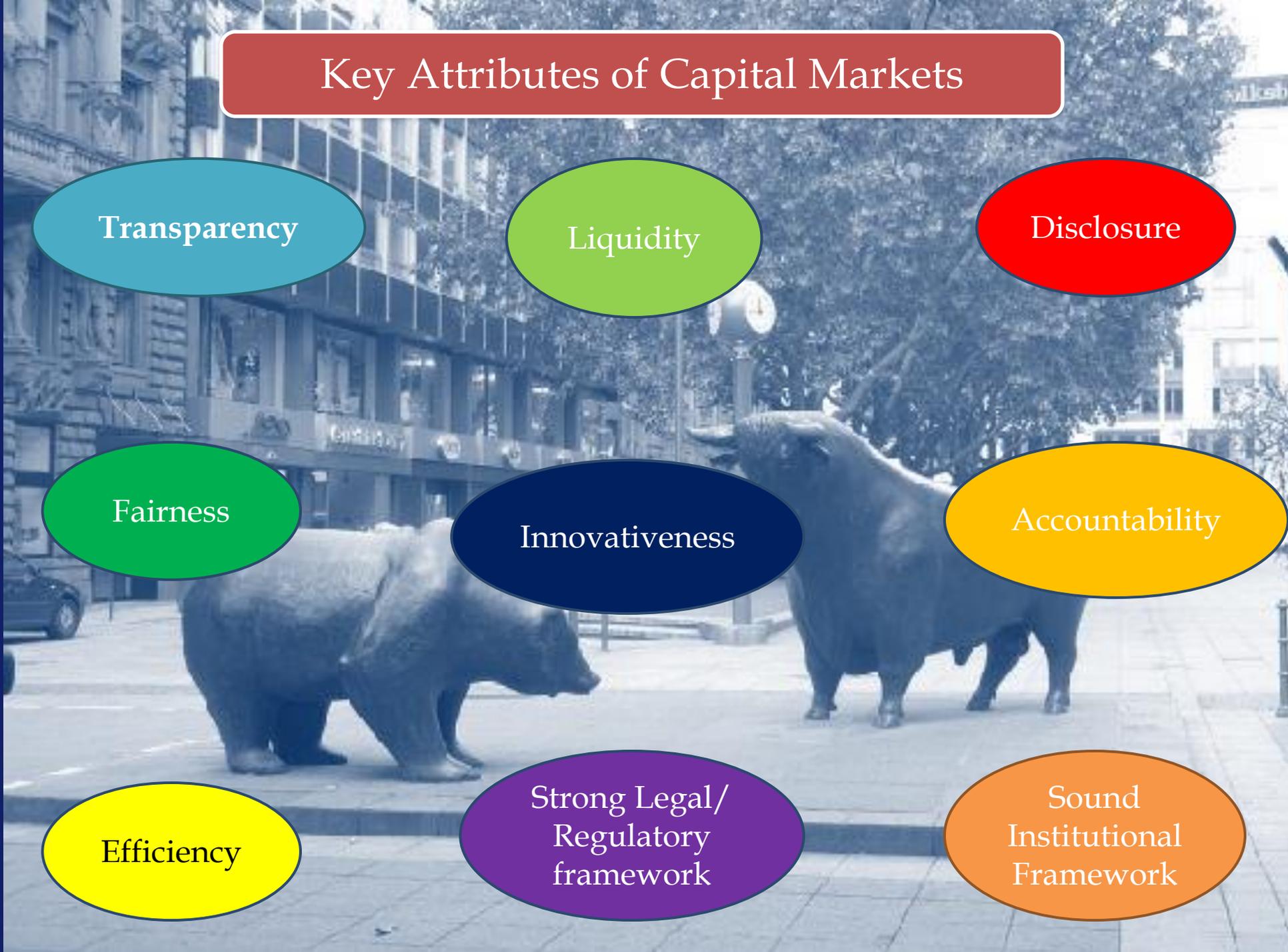
Innovativeness

Accountability

Efficiency

Strong Legal/
Regulatory
framework

Sound
Institutional
Framework



NOTABLE DEFINITIONS OF CORPORATE GOVERNANCE

“The collection of control mechanisms that an organization adopts to prevent or dissuade potentially self interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders”

David Larcker
Brian Tayan

“Corporate Governance matters...” 2011

“Procedures and processes to which an organization is directed and controlled.”

OECD CG Code 2004

“The system by which companies are directed and controlled.”

Cadbury Report 1992

“The process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder values, whilst taking into account the interest of other shareholders...”

Malaysian Code of Corporate Governance 2012





CORPORATE GOVERNANCE: MY VIEW



- Corporate governance is the introduction and adherence to structures, processes and rules to ensure that companies (and indeed other entities) are properly run to the benefit of their owners and invariably to the benefit of the economy. Corporate governance in my view, is about the behaviour of companies and existing controls to shape the behaviour positively. Like human behaviour, corporate behaviour can have positive or negative implications which can be far reaching. And when a company imbibes good corporate governance it will ultimately become a culture of the company.



WHAT HAD THESE COMPANIES IN COMMON?





CONSEQUENCES OF SUCH GOVERNANCE FAILURES



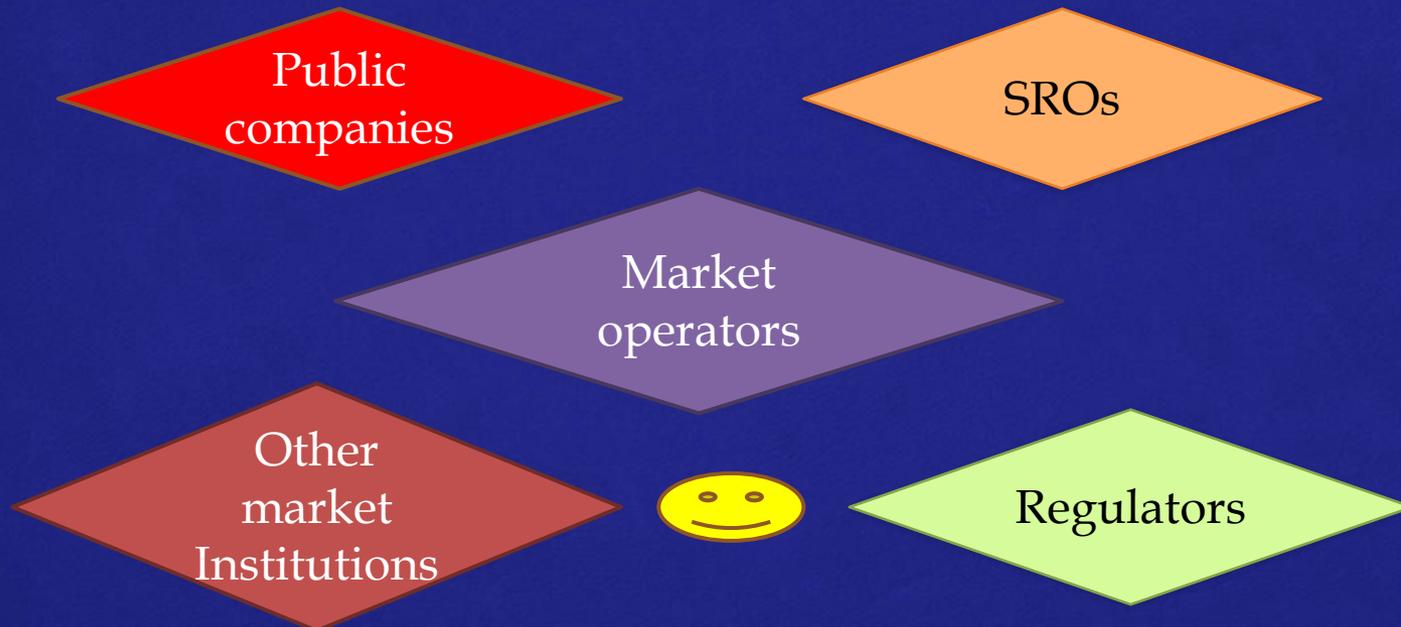
- ❑ Investment loss by shareholders can lead to confidence loss and deter further participation in the capital market and the financial services industry.
- ❑ Job and possible pension loss can be devastating to employees with socio-economic implication.
- ❑ Failure or distress of other companies including creditors and suppliers linked with the failed company.
- ❑ Systemic threat including deposit run on banks, economic slowdown and possible contagion effect on other economies .
- ❑ Pressure on government finances from bail out and other resolution measures of failed institutions.
- ❑ Reputational risk to individuals can be grave e.g. Robert Maxwell, Ken Lay, Ivan Boesky, Michael Milken, Bernard Madoff, Alan Stanford, Jeff Skilling, Bernie Ebbers



CORPORATE GOVERNANCE



- Who should corporate governance apply to in the capital market?



CHARACTERISTICS OF A WELL GOVERNED ENTITY



- ❑ A well governed company will exhibit the following attributes in the conduct of its activities. These attributes are capital market promoting and are indeed fostered by the capital market.
 - ✓ Competence, efficiency and care
 - ✓ Responsibility and accountability
 - ✓ Integrity and honesty
 - ✓ Transparency and financial propriety
 - ✓ Effective risk management and internal controls.
 - ✓ Efficient and effective system of supervision
 - ✓ Adherence to good ethical standards
 - ✓ Adherence to laws, regulations and processes
 - ✓ Equitable treatment of shareholders and respect for their rights.
 - ✓ Effective board of directors
 - ✓ Focus on enhancing shareholders' value





WHY CORPORATE GOVERNANCE IS IMPORTANT TO PUBLIC COMPANIES



- When Companies are properly governed:
 - ✓ Perception improves, they are taken more seriously by stakeholders, investors become more attracted to them which should result in easier access to lower cost capital.
 - ✓ They are likely to be more exposed to a variety of funding sources.
 - ✓ Performance can improve as the company gets better managed and attracts goodwill from stakeholders.
 - ✓ valuation and share performance improves as investors' confidence strengthens . Shareholders consequently benefit.
 - ✓ Good governance serves as a good international branding tool, positions company for international competition giving visibility beyond the domestic market.
 - ✓ They can better weather crisis and difficult business times..





WHY CORPORATE GOVERNANCE IS IMPORTANT TO PUBLIC COMPANIES



□ When companies are well governed:

- ✓ They are likely to attract better and more productive employees which can impact positively on their bottom-line. When companies do well shareholders benefit by way of dividends, bonuses and capital appreciation. Reputation improves and good reputation attracts trust and respect of investors and the public which can translate into enhanced demand for the products or services of the company and boost profit.
- ✓ They are likely to be more enduring and stable which are beneficial to shareholders, capital markets and economies.
- ✓ It can foster harmonious relationship between a company and its stakeholders
- ✓ A poorly governed company which is significant to the capital market or systemically important can pose a significant threat to the stability of the capital market and the economy. Well governed companies therefore reduce risk to themselves, the capital market and the economy.





WHY CORPORATE GOVERNANCE IS IMPORTANT TO PUBLIC COMPANIES



- ❑ When companies are well governed they are less likely to violate laws, regulations and agreements and are therefore not likely to engage in market abuse as internal systems and structures provide appropriate checks and controls against violations by employees. They are generally more responsible corporate citizens.
- ❑ Institutional and high net worth investors, consider governance as an important criterion for investing and may not invest in companies with weak corporate governance. Institutional investors are known to seek high standards of corporate governance from companies in order to invest or retain an investment.





WHY CORPORATE GOVERNANCE IS IMPORTANT TO PUBLIC COMPANIES: SOME SURVEYS



- Corporate governance survey by the International Finance Corporation (IFC) in 2010 found that:
 - ✓ Investors often do not invest in emerging market companies with poor governance
 - ✓ All respondents in the survey said that “governance was part of their pre-investment due diligence on a target firm”
 - ✓ Investors said they would pay more for a better governed firm in an emerging market than they would for a firm that came with some governance gap. Indeed the report stated that more than half of investors surveyed said they would pay at least 10% more for a better governed firm compared to a similar poorly-governed firm in the same emerging market. However, 38% said they would pay 20% more for the shares of such companies.
 - ✓ Investors believe that better firm level governance can make up for country weakness in corporate governance
 - ✓ Lack of transparency is red flag for emerging market investors
 - ✓ See” survey say... Corporate Governance matters to investors in emerging market companies” by Vikramaditya Khanna and Roman Zyla. IFC Publication.



WHY CORPORATE GOVERNANCE IS IMPORTANT TO PUBLIC COMPANIES:

SOME SURVEYS

Mckinsey2002



□ “Even after allowing for the effect of characteristics such as financial performance (measured by return on equity) and size of valuation, we found that companies with better corporate governance did have higher price to book ratio, indicating that investors will pay a premium for shares in a well governed company, By moving from worst to best in corporate governance, companies in our sample can expect, on average to experience roughly a 10 to 12 per cent increase in their market value”

Roberto Newell + Gregory Wilson

Based on a corporate governance and market valuation study in 188 companies in 6 emerging markets



WHY CORPORATE GOVERNANCE IS IMPORTANT TO PUBLIC COMPANIES: SOME SURVEYS



- EIRIS Emerging markets Report 2012 noted that:
Poor corporate Environment, Social and Governance (ESG) disclosure remains the number one challenge to investing in emerging markets with more than 78% of surveyed investors mentioning this. Over 67% of respondent (the highest of all criteria used) apply corporate governance to their emerging market portfolio.
Investor survey on investment in emerging markets and in ESG issues



WHY CORPORATE GOVERNANCE MATTERS TO MARKET OPERATORS



- ❑ Market operators are the link between investors and capital markets. As the “face” of the capital market their behaviour shapes investors’ perception, confidence and integrity of the market.
- ❑ Operators with good corporate governance are usually perceived as credible, earn the trust of investors and attract business which can positively impact performance.
- ❑ They are better positioned to build strong business relationships and synergies with well known and respected institutions.
- ❑ Operators give investment advice and manage investors funds. These activities can be affected by the quality of governance in a firm. A poorly governed firm will be susceptible to poor advice and decisions, engage in front running, insider dealing and other illegal and unethical practices in the market .



WHY CORPORATE GOVERNANCE MATTERS TO MARKET OPERATORS



- ❑ Risks is better identified and managed when good corporate governance exist in a firm
- ❑ Employee activities are better controlled and supervised thus reducing firm wide risk .
- ❑ Good governance promotes professionalism, attracts respect of peers , customers/clients and other stakeholders which can boost business.
- ❑ Promotes efficiency which enhances performance .
- ❑ Firms are less likely to have brush with the law, regulators and clients/customers.
- ❑ Good corporate governance is a good tool for competition.



WHY CORPORATE GOVERNANCE MATTERS TO REGULATORS



- ❑ Good corporate governance builds confidence in a capital market and encourages participation which can improve both primary and secondary market activities.
- ❑ Improves reputation and international standing of a capital market and promotes foreign portfolio investment and listings.
- ❑ Safeguards investors' assets which is vital to investor protection and market integrity .
- ❑ Promotes timely and reliable corporate information disclosure to the investing public; vital for confidence and investment in capital markets.



WHY CORPORATE GOVERNANCE MATTERS TO REGULATORS



- ✓ Can be used as an instrument of investor protection; when there is good corporate governance investors are better protected.
- ✓ Encourages international best practices and as domestic companies compete internationally, international visibility and perception of the capital market would rise.
- ✓ Reduces abuse and enhances professionalism in the market and decreases regulatory pressure on regulators.
- ✓ Failure of regulatory oversight encourages weak corporate governance in regulated entities and undermines the integrity of the market.
- ✓ Reduces systemic risk. Significant governance failures can have devastating effects on markets.



WHY CORPORATE GOVERNANCE MATTERS TO REGULATORS



- ✓ Weak corporate governance can undermine the ability of capital markets to optimally foster capital formation and promote economic development.
- ✓ Weak governance leads to lack of transparency and can encourage unfair trading practices and increase market volatility. Good governance therefore, fosters market stability and development.
- ✓ Resolution of financial crisis can put considerable burden on the resources (financial , manpower etc) of regulators and tax payers.
- ✓ Good corporate governance can serve as an anti-corruption vehicle as companies with good governance usually have effective structures to discourage corrupt practices.
- ✓ Reputational risk to regulators as they often get blamed for major corporate governance failures.
- ✓ Good private sector governance can influence good public sector governance.



CORPORATE GOVERNANCE AND THE ECONOMY



Improved economic growth

Enhanced government revenue

Higher profit, more taxes

Higher profitability

Increased productivity

Improved efficiency , better access to capital

Good Corporate governance

HOW REGULATORS PROMOTE CORPORATE GOVERNANCE



The Brazilian Corporate Governance Example



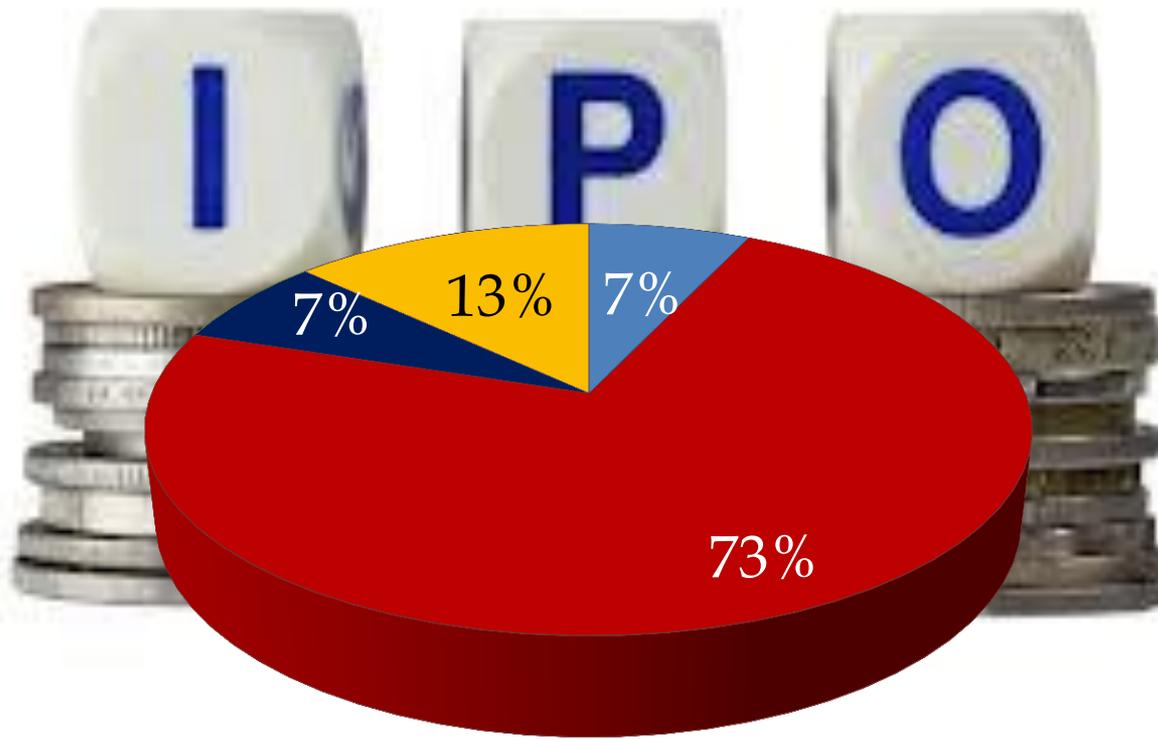
❑ Novo Mercado (New market)

- ✓ The Brazilian capital market was in the 1990s quite inactive with practically no issuance activities and a sluggish secondary market. BOVESPA (the Sao Paulo Stock Exchange) for instance, was said to have lost 46.8% and 38.3% in equity trading and the Stock index respectively between July 1997 and December 2000. The corporate governance and regulatory environment was also weak and obviously impacted on the state of the market (Lee Janice Chin Poh Wah)
- ✓ Concerned, the Exchange in 2000 established a special segment with corporate governance as focus. It has level 1, level 2 and the Novo Mercado which has the most rigorous corporate governance requirements
- ✓ Novo Mercado lists companies which voluntarily subject themselves to stringent corporate governance requirements; higher than standards applicable by law. This is in addition to compliance with existing regulatory requirements.
- ✓ From 1 listing in 2002 companies on the Novo Mercado reached 134 by mid April 2014. Between 2001 and 2007 companies in this segment were said to have made up 81 of the 113 IPOs in Brazil. Bovespa considerably improved.



IPOs by each listing Segment (2004 - May/ 2010)

■ BDR ■ Novo Mercado ■ Level 1 ■ Level 2



Figures from Edna Holanda, The Market's Experience Novo Mercado (New Market) in Brazil



The Brazil Corporate Governance example cont'd....



□ Novo Mercado

- ✓ Considerable visibility has been drawn to the Brazilian capital market which is now ranked one of the best in corporate governance and a leading emerging market
- ✓ Liquidity, IPO activities, listings and overall governance quality of listed companies improved markedly.
- ✓ Both domestic and foreign investments in the market rose.
- ✓ Novo Mercado is now a model and case study in corporate governance .
- ✓ The companies in the Novo Mercado index have been able to set themselves apart in corporate governance and indeed from other companies which have had beneficial effect on them by way of reputation, capital raising etc.
- ✓ According to the World Bank/IFC, the Brazil Corporate Governance Index (CGI) has been less volatile and out performed the IBOVESPA, the market benchmark index since 2001.



CORPORATE GOVERNANCE INFLUENCES

Regulations/rules of Securities Commissions and other relevant agencies(eg central bank)

Securities Law

Corporate Governance Codes

SRO Rules (eg Stock exchange listing and Market rules)

A company's internal governance practices

Company Law



CORPORATE GOVERNANCE STAKEHOLDERS IN THE CAPITAL MARKET



- ✓ Regulators
- ✓ SROs
- ✓ Market operators
- ✓ Auditors
- ✓ Lawyers and other market professionals
- ✓ Analysts
- ✓ Public companies
- ✓ Employees
- ✓ Shareholders and other investors
- ✓ Governments
- ✓ Legislators
- ✓ The press
- ✓ Creditors of public companies
- ✓ Suppliers and customers





Conclusion



- ❑ Investors tend to notice public companies with good corporate governance and will be willing, confident and indeed proud to associate with them. There are several benefits of good corporate governance to a company and the sector in which it operates particularly when it is the financial sector. We saw that there are also benefits to shareholders, domestic and global financial markets and economies as well as customers and suppliers. With the collapse of high profile institutions, the Asian financial crisis in the late 1990's and more recently, the global financial crisis, good corporate governance has become a front burner issue for markets, economies and International Financial Institutions (IFIs).





Conclusion cont..



∞ Today, there are several corporate governance codes by different jurisdictions largely spearheaded by regulators which some accounts have put at over 200. There are also laws such as the US Sarbanes Oxley Act and Australian CLERP 9 which were in response to corporate governance failures. The proliferation of corporate governance codes clearly point at the importance placed on corporate governance in today's corporate and regulatory environment.





Thank You



Q&A