Addis Ababa University
(Since 1950)

ADDIS ABABA UNIVERSITY

SCHOOL OF GRADUATE SUTDIES

COLLEGE OF LAW AND GOVERNANCE

STATE REGULATION Vs. SELF-REGULATION OF CORPORATE GOVERNANCE: WHICH ONE WOULD BE APPROPRIATE FOR ETHIOPIA?

A Thesis Submitted in Partial Fulfillment of the Requirements of LL.M. Degree in Business Law

BY: Melese Wondmagegnehu

ADVISOR: Zekarias Kenea'a (Assoc. Prof.)

April, 2015

Contents

Approval Sheet by the Board of Examiners

STATE REGULATION Vs. SELF-REGULATION OF CORPORATE GOVERNANCE: WHICH ONE WOULD BE APPROPRIATE FOR ETHIOPIA?

Approved by Board of Examiners

Zekeos Kinea		05 June 2015
Advisor	Signature	Date
Eskedar Petros		05 June 2015
Examiner	Signature	Date
Tewodros Meheret		June 05, 2015
Examiner	Signature	Date

Plagiarism Declaration

I MELESE WONDMAGEGNEHU BELETE, do hereby declare that the thesis 'STATE REGULATION Vs. SELF-REGULATION OF CORPORATE GOVERNANCE: WHICH ONE WOULD BE APPROPRIATE FOR ETHIOPIA? is my original work and that it has not been submitted for any degree or examination in any other university. Whenever other sources are used or quoted, they have been duly acknowledged.

MELESE WONDMAGEGNEHU BELETE

Signature: .....

Date: ..May 26, 2015.....

This thesis has been submitted for examination with my approval as Advisor.

Zekarias Kenea'a (~~Assoc.~~ Prof.)

Signature .....

Date ..May 26, 2015.....

Place and date of submission: A.A.U.

May 26, 2015

Acknowledgement

I could not imagine writing this paper without the precious assistance of my advisor. I would like to extend my heartfelt gratitude to my advisor Zekarias Kenea'a (Assoc. Prof.) who has minutely read the draft and made very valuable and constructive comments. I am indeed very lucky to work under your supervision!

I would like to thank my family (my wife Emi and my little Queen Blenie) for their patience. They have taken the responsibility of tolerating a very busy and uncaring personality of mine while I was writing this paper.

I also wish to thank Dj., Gech, and Addis for your everlasting love which kept me strong and confident. Dear the 'Makiato Group' at the 'White House' Asrat, Tsega, Mulisa, Yohaness, and Workneh- I am speechless about the unforgettable time that we had.

Finally, I would like to thank all individuals who have restlessly waited the day which heralds the accomplishment of this chapter of my life.

All errors mine.

Acronyms

AACCSA-	Addis Ababa Chamber of Commerce and Sectoral Associations
ECGC-	Ethiopian Corporate Governance Code
EICG-	Ethiopian Institute of Corporate Governance
NBE-	National Bank of Ethiopia
OECD-	Organization for Economic Co-operation and Development
SOX-	Sarbanes-Oxley Act
SROs-	Self-Regulatory Organizations
USAID-	United States Agency for International Development
WTO-	World Trade Organization

Chapter One

1. INTRODUCTION

1.1. Background of the Study

The dominance of companies as central agents in market economies is increasing.[1] As markets become more open and global, businesses become more complex, and doing business as sole proprietor becomes difficult and the contribution of such businesses to the nation's economic growth becomes minimal.[2] Consequently, societies around the world are placing greater reliance on companies as engines of economic growth. In both developed and developing countries, firms organized as companies are the main actors and avenues for large economic activities to take place.[3] A corporation is one of the most successful socio-economic institutions of modern society.[4] In sum, companies contribute to the economic growth and development, which lead to improved standards of living and poverty alleviation, which in turn should lead to more stable political systems.

In addition to their contribution to the economic growth and development of a country, companies are required to assure the generation of returns and the protection of investments of their finance providers – shareholders, banks, or other financial institutions.[5] Such assurances require sound corporate governance practice and proper monitoring of their compliance. Basically, corporate governance concerns the means by which a company assures investors that it has well-performing management in place and that corporate assets provided by investors are being put to appropriate and profitable use.[6]

Corporate governance practices vary across nations and firms, and this variety reflects, among other things, the type and development of the corporate governance regulatory system. Many

---

[1] Jean J. Du Plessis, Anil Hargovan and Mirko Bagaric, **Principles of Contemporary Corporate Governance** Preface, (New York Cambridge University Press, 2nd ed. 2011)

[2] Holly J. Gregory and Marsha E. Simms, **Corporate Governance: What It Is and Why It Matters**, A paper presented at 9th International Anti-Corruption Conference, (Oct. 10-15, 1999), Durban, South Africa 3, Retrieved from http://9iacc.org/papers/day2/ws3/dnld/d2ws3_hjgregorymesimms.pdf Accessed on 12-April-2014.

[3] *Ibid.*

[4] Roger M. Barker, **Corporate Governance, Competition, and political parties, Explaining Corporate Governance changes in Europe** 3, Oxford University Press (2010).

[5] *Ibid.*, p. 68

[6] Ramon Mullerat (ed.), **Corporate social Responsibility: The corporate governance of the 21st Century** 39, The Netherlands, Kluwer law international (2nd ed., 2005).

developing nations with emerging markets have not yet fully developed legal and regulatory systems, enforcement capacities and private sector institutions required to support effective corporate governance.[7] According to Millstein, a renowned governance expert and chairman of the OECD Business Sector Advisory Group on Corporate Governance; "while government provides the *structure* for governance, corporate governance happens *inside* the corporation, and depends on investors, boards and managements".[8]

Different scholars have espoused different theoretical and pragmatic descriptions for the categories and types of regulation of corporate governance. Shailer suggests that regulation of corporate governance can be achieved formally or informally through four primary mechanisms; namely lawmaking (statutory provisions and court-developed common law), stakeholder concentration to increase their monitoring and control capabilities, market discipline, and formal contracting between stakeholders and the company.[9] For Farrar the regulation of corporate governance can be achieved in any of the following three approaches; i.e. hard law, soft law, or hybrid.[10] Some jurisdictions prefer to regulate the corporate governance practices through the black letters of the law which is, according to Farrar, the 'hard law' regulatory model, while some others adopt the 'soft law' regulatory system, which includes voluntary sources of corporate governance standards which companies have the freedom to adopt or not.[11] Apart from these extremist approaches, there is the 'hybrid' regulatory systems which fall somewhere between the two.[12] Zadkovich, however, improved the aforementioned descriptions by characterizing certain corporate governance regulatory practices as 'mandatory' or 'voluntary'.[13]

An ongoing debate on Corporate Governance matters relates to the need for state regulation (a mandatory legal frame work) versus self-regulation (e.g. corporate governance codes). The contemporary trend around the world is moving away from the practice of extensive state

---

[7] Gregory & Simms, *Supra n.* 2, at 6
[8] *Ibid.*, p. 7
[9] Greg Shailer, **An Introduction to Corporate Governance in Australia** 2, New Jersey, Pearson Publisher (2004).
[10] John H. Farrar, *Corporate Governance and the Judges*, 15 BOND L. R., 67 (2003).
[11] *Ibid.*
[12] *Ibid.*
[13] John Zadkovich, *Voluntary Rules and 'Please Explain': A Corporate Governance Quagmire*, 12 DEAKIN L. R, 26 (2007).

intervention of the 'welfare' state and is more in line with the notion of deregulation.[14] Recent trends also suggest a 'new wave' of self-regulation.[15] Self-regulation is viewed as non-legally binding expectations of an elevated standard of behaviour, ethics and responsibility.[16]

The contemporary movements towards regulatory reforms concerning corporate governance have been prompted by different factors mainly;

> ....the growth of small shareholder activism, board control and disclosure of remuneration (leading to controversies concerning perceived excessive senior executives' remuneration), community demand that companies operate their businesses as good citizens, and stakeholders (other than members and employees) expecting their interests to be taken into account in the management of the company.[17]

However, all corporate governance regulatory systems, whether mandatory or voluntary, have their relative strengths and weaknesses and no one regime, of itself, is optimal.[18]

Companies in Ethiopia are regulated by the relevant provisions of the Commercial Code[19], and by specific Proclamations and directives issued regarding financial share companies[20], and other general and specific laws that have bearing on the operations of publicly held companies.[21] From this, one may observe the state's intervention in the regulation of corporate governance in Ethiopia. However, this mode of regulation is in line with an approach known as 'one-size-fits-

---

[14] Ian Bartle and Peter Vass, **Self-Regulation and the Regulatory State: A Survey of Policy and Practice** 1, United Kingdom, The University of Bath (2005).

[15] *Ibid.*

[16] Omarova, (2011). Wall Street As Community Of Fate: Toward Financial Industry Self-Regulation, **University of Pennsylvania Law Review**, Vol. 159, p.423

[17] Zadkovich, *Supra n.* 13, at 25

[18] *Ibid.*, p. 39

[19] Commercial Code of The Empire of Ethiopia, Proclamation no. 166/1960, **Negarit Gazeta**, Extraordinary Issue, No. 3, Addis Ababa, Arts. 347-428. These provisions of the Commercial Code have a bearing on corporate governance. Arts. 347-428 of the Code deal with the management aspects, the board of directors and its mandates, the auditors, the right of share holders, and the general assembly, the different types of meetings, voting processes and voting rights, the right of minority shareholders, auditing and reporting obligations, transparency requirements, and the involvement of the Ministry of Trade and Industry.

[20] Banking Business Proclamation No.592/2008, **Negarit Gazeta**, Addis Ababa; and the directives and procedures for Banking Business issued by the National Bank of Ethiopia. See also Insurance Business Proclamation No. 746/2012, **Negarit Gazeta**, Addis Ababa; and directives and procedures for Insurance Business issued by the NBE.

[21] For instance, Commercial Registration and Business Licensing Proclamation, Proclamation No. 686/2010, **Negarit Gazeta**, Addis Ababa.

all' which is outdated. Some prominent corporate failures in the country[22] also reveal the ineffectiveness of the current regulatory system of corporate governance in the country. Moreover, there are many other factors that urge policy makers for a regulatory reform on the country's corporate governance practice.

Zadkovich characterizes the prevalent regulatory systems in the world are of two types; mandatory and voluntary.[23] However, there are different views as to the appropriateness of these regulatory models. Proponents of the free market economy argue that since enhanced corporate governance practices are desired by and beneficial to investors, firms competing for scarce capital will implement them voluntarily.[24] Hence, they argue, a mandatory regulatory regime for Corporate Governance is unnecessary. On the other hand, others argue that "a voluntary regulatory regime is insufficient, since there is no guarantee that all firms will implement the reforms necessary to provide investors with adequate checks on management and board control".[25] Though Ethiopia has, post 1991, adopted a free market economic policy, its corporate governance regulatory system is in line with the mandatory regime.

Albeit the existing mandatory regulatory regime in Ethiopia, there was an ambitious initiative by the Addis Ababa Chamber of Commerce and Sectoral Associations (hereinafter AACCSA) to introduce a voluntary code of corporate governance in Ethiopia and the Chamber has adopted a code in June 3, 2011. The chamber has also established a non-government, private, and voluntary membership-based Corporate Governance Institute with the view to facilitate the evolution of a dynamic, ethical and responsible business community that complies with both local and international corporate governance standards.

1.2. The Research Problem and Questions

Corporate governance, particularly, of financial companies in Ethiopia is discussed, among the business community and the academia, as being highly regulated by the state through mandatory

---

[22] The debacle of Access Real Estate S.C., Jakaranda Integrated Agro Industry S.C., and Holland Car PLC will be discussed in detail in the coming chapters.

[23] Zadkovich, *Supra n.* 13

[24] Anita Indira Anand, **Voluntary Vs Mandatory Corporate Governance: Towards an Optimal Regulatory Framework** 4, Available at www.law.harvard.edu/.../**Voluntary**%20vs%20**Mandatory**%20**Corporate** Accessed on 16-Apr.-2014.

[25] *Ibid.*

rules of law. Though the regulatory system of the corporate governance of non-financial companies in Ethiopia is mandatory too, there are some prominent corporate failures that would prompt someone to question the appropriateness as well as effectiveness of the regulatory regime. AACCSA is also concerned about the appropriate modes of regulation of corporate governance in Ethiopia. Accordingly, the Chamber has proposed the introduction of a voluntary code of corporate governance in the country. The contemporary view towards the 'one-size-fits-all' framework set by mandatory regimes is equally undesirable in terms of inconvenience and compliance. The country shall cope up with this contemporary trend and it seems that regulatory reform concerning corporate governance is due. The reform should consider key development policy aspects which match with the country's plans for poverty reduction and wealth creation.

It is obvious that effective corporate governance in Ethiopia, which plays a significant role in facilitating the developmental and poverty reduction pursuits of the country, is the call of the day. In order to enhance the effectiveness of the prevalent corporate governance practices in the country, an appropriate regulatory system shall be put in place. Appropriate regulation serves as a means of pressuring firms to adopt effective governance structures and practices.

With the emerging trend in the 'separation of ownership and control' in the publicly held companies of the country, directors and managers are given overwhelming power with little accountability to the dispersed group of shareholders. As a result agency problem will be inevitable among different interest groups. Agency problem is the main cause for the famous corporate failures, like the Access Real Estate S.C., in Ethiopia. Such problem can be reduced by well regulated corporate governance, limiting private benefits and expropriation by controlling owners and directors.

Thus, the underlying exercise of the thesis is revealing the ineffectiveness of the existing corporate governance regulatory system and explores for appropriate regulatory model that support the development of effective corporate governance in Ethiopia. Accordingly, the researcher intends to focus on the following research questions:

A. Why does Ethiopia need to regulate corporate governance?
   - ✓ Why should the Ethiopian State bother to regulate corporate governance of privately owned corporations?

B. What is the existing mode of regulation of corporate governance in Ethiopia and how effective it is?
C. Is there an institutional framework for corporate governance regulation in Ethiopia?
D. What is the role of regulation to enhance good corporate governance in Ethiopia?
E. What are the merits and demerits of self-regulation and state-regulation of corporate governance?
F. What are the lessons that can be drawn from the international experience with respect to regulation of corporate governance?
G. Which mode of regulation of Corporate Governance would be appropriate for Ethiopia? State-regulated or Self-regulated?

1.3. Objective of the Study

The research is triggered by the need to know about the regulation of corporate governance in Ethiopia, its appropriateness and drawbacks, and the way forward for further development. It, accordingly, aims at achieving two equally important objectives. First, it aims at contributing to the domain of knowledge about the regulation of corporate governance of the country. Second, it, in light of the research background, problems, and questions stated above, aims at indicating the appropriate and optimal form of corporate governance regulation for the country and the need, areas and nature of further reform in order to put in place a system of good corporate governance in Ethiopia.

1.4. Significance of the study

In general, the research is of paramount importance to both the pursuit of knowledge and the identification of the reform measures on the regulation of corporate governance in Ethiopia. Though there have been some works concerning 'corporate governance in Ethiopia', this research takes the issue a step further with a particular emphasis on the manner of its regulation. As a result, it is believed that it will have significant contribution as it stimulates thoughts among policy makers and the academia.

1.5. Research Methodology

The research emphasizes on the investigation of the appropriate mode of regulation of corporate governance in Ethiopia based on the relevant laws and institutional practices. To this end, the optimal research approach will be a qualitative research method. The study prefers the qualitative research approach because the data required will be collected through In-depth interviews and based on the reasons, justifications or logical arguments, and analysis of the existing legal frameworks, various literatures, and countries' experiences. The question format used in in-depth interviews will be open-ended and the data format will be textual.

1.6. Scope of the Study

The research is mainly limited to the regulation of corporate governance in Ethiopia. The issues raised in the research are those which are directly related to the regulation of corporate governance. The research deals with corporate governance in general in order to lay the conceptual foundation leading to the heart of the study. The regulatory alternatives for corporate governance will be addressed by the research with an objective to suggest the optimal regulatory alternative for Ethiopia. An effort is also exerted to explore the domestic practice on the mode of corporate governance regulation through interviews with Officials of the relevant organs and reference to relevant minutes of AACCSA. Therefore, much of the study focuses on the attempt to find out the appropriate regulatory regime for Ethiopia.

1.7. Limitation of the Study

Though it has been over two years since "The Ethiopian Code for Corporate Governance" is adopted by AACCSA, there was no specific organ established to oversee the creation of awareness as well as the implementation of the Corporate Governance Code by companies in the country. It was only recently (Oct., 2013) that AACCSA took the initiative of establishing the 'Institute of Corporate Governance' with a primary goal *inter alia* to edit and have the Ethiopian Corporate Governance Code published. However, because the institute is at its infant stage, absence of practical experiences will be a challenge to this research. Moreover, according to the study conducted by USAID in 2007, the Ministry of Trade did not undertake an ongoing

supervision over companies.[26] This will be another limitation on the research against accessing practical evidences on the achievement and failures of the current mode of Corporate Governance Regulation in the country.

1.8. Organization of the Study

This research is organized in to six chapters. The second chapter deals with the conceptual underpinnings of Corporate Governance in general. The chapter also discusses definitional issues, the necessity for Corporate Governance, the highlights of core principles, the prominent approaches of Corporate Governance, and the correlation between Good Corporate Governance and firm performance. The third chapter is concerned with the regulatory aspect of Corporate Governance. It addresses the international regulatory dilemma, the different types of Corporate Governance regulation, the legal framework for the new wave of regulation (i.e. Self-regulation), the merits and demerits of state and self-regulation, and the experiences of selected jurisdictions. The fourth chapter focuses on the Ethiopian Corporate Governance regulation milieu. It discusses the current legal and institutional framework of corporate governance regulation of the financial and non-financial sectors, distinctively, in the country. The fifth chapter discusses the way forward and analyses the appropriateness of those universally accepted regulatory alternatives for Ethiopia. Furthermore, the chapter emphasizes the existing debates on the optimal regulatory model for Ethiopia. The new wave of regulatory regime as introduced by the newly issued Corporate Governance Code and the newly established organ for Corporate Governance, i.e. the Ethiopian Institute of Corporate Governance, is also discussed under this chapter. The sixth chapter, as a final chapter, puts the findings of the research and makes some recommendations based on the study results.

[26] Booz, Allen, Hamilton Inc., **Ethiopia Commercial Law& Institutional Reform And Trade Diagnostic** 21, USAID (2007)

Chapter Two

2. Corporate Governance in general

Corporate governance is conventionally considered as a solution to the issues that arise between owners and managers of corporations as a result of separation of ownership and control.[27] In a company where shareholders are not controlling the day-to-day activities of the company managers might become "satisfiers" rather than "maximizers," that is, they tend to play it safe and seek an acceptable level of growth because they are more concerned with perpetuating their own existence than with maximizing the value of the firm to its shareholders.[28] The design of mechanisms for effective corporate control to make managers act in the best interest of shareholders has been a major concern in relation to separation of ownership and control. Corporate governance is, thus, devised as a mechanism necessary to ensure proper actions on behalf of owners of a corporation.[29]

Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Investors will feel safe and encouraged to spend their capital in a business whose corporate governance is relatively effective. This means, the effectiveness of corporate governance positively affects the performance of a company.[30] Many argued that "businesses that have prospered and remained prosperous are those that have found ways to govern their affairs effectively".[31]

Corporate governance, unknown some years ago, is of universal concern nowadays. The world has witnessed a number of astonishing corporate failures that caused corporate governance systems to evolve over centuries.[32] As the International Finance Corporation notes;

> Each of those corporate failures, often occurring as a result of incompetence or outright fraud, was swiftly met by new governance frameworks, most notably the many national corporate governance codes, the Sarbanes-Oxley Act in the U.S., and the current trend

---

[27] International Finance Corporation, **Corporate Governance Manual** 19 (Hanoi, Vietnam, BACSON2nd ed. 2010)
[28] CORPORATE GOVERNANCE: THE INTERSECTION OF PUBLIC AND PRIVATE REFORM 18 (Eric Hontz & Aleksander Shkolnikov eds., 2009).
[29] *Ibid.*
[30] John Colley et al., **What Is Corporate Governance?** 3, New York, McGraw-Hill Companies (2005).
[31] *Ibid.*
[32] IFC, *Supra n.* 27, at 10.

towards imposing stricter regulatory oversight on banking and financial activities in various countries.[33]

2.1.Definitional Issues

Corporate governance is a nebulous concept. There is no single definition of corporate governance that can be applied to all situations and jurisdictions. Corporate governance is considered by many scholars as an indefinable term, something – like love and happiness – of which we know the essential nature, but for which words do not provide an accurate description.[34] There are innumerable definitions of corporate governance in the vast amount of literature available on the subject, yet definitions vary from each other, and this often leads to confusion.

The Cadbury Report (1992) of the United Kingdom and the South African King Report (1994) take the lead in the history of attempts to define "corporate governance", defining it as 'the system by which companies are directed and controlled'.[35] This definition seems to be not particularly helpful to understand the hazy concept of corporate governance. Contemporary definitions of corporate governance found in various literatures differ based on their focus in defining "corporate governance". Some define it based on the internal aspect of corporate governance while others define from its external aspect. For a genuine understanding, a discussion on the definitional issues will be in place from the structural/framework and conceptual perspective.

2.1.1. Defining "Corporate Governance"

As mentioned above, the term "Corporate Governance" is one that does not lend itself to a single, specific or narrow definition. While some literatures focused on the internal aspect of corporate governance, others defined it from the external perspective of a company. To start with, definitions that focus on the company itself, i.e. an internal perspective, consider corporate governance as internal means by which corporations are operated and controlled.[36]

---

[33] *Ibid.*
[34] Du Plessis et al., *Supra n.* 1, at 3
[35] *Ibid.*
[36] IFC, *Supra n.* 27, at 7

In other words, corporate governance is all about the relationship between shareholders and management which consists in the former providing capital to the latter to achieve a return on their investment.[37] The Vietnamese Corporate Governance Manual, which was commissioned by the International Finance Corporation (IFC), describes the internal aspect of corporate governance in the following manner;

> ...Managers are responsible to provide shareholders with financial and operational reports on a regular basis and in a transparent manner. Shareholders also elect a supervisory body, often referred to as the Board of Directors or Supervisory Board, to represent their interests. This body essentially provides strategic direction to, and control over, the company's managers. Managers are accountable to this supervisory body, which in turn is accountable to shareholders through the General Meeting of Shareholders (GMS).[38]

As Gregory & Simms note, "while government provides the structure for governance, corporate governance happens inside the corporation, and depends on investors, boards and managements".[39] The traditional wisdom regarding shareholders primacy is in line with defining the term "Corporate Governance" from the internal perspective. However, the shareholders primacy model began to be challenged and shareholders dominance has begun to be questioned.[40] Contemporary corporate scholars take in to account outsiders' interests that are also at stake; for example, those of creditors, potential investors, consumers and the public or community at large (so-called stakeholders).[41] Thus, the term "Corporate Governance" has began to be expressed in terms of these other interests.

It is fairly generally accepted that even if, in the strict legal sense, corporations remain directly accountable only to shareholders, the development of loyal and stakeholder inclusive relationships will become one of the most important determinants of commercial viability and business success.[42] The recognition of outsiders' interest is morally and ethically just and has a

---

[37] *Ibid.*, p. 6
[38] *Ibid.*, p.7
[39] Gregory and Simms, *Supra n.* 2
[40] Du Plessis et al., *Supra n.* 1, at 7
[41] David G. Yosifon, (2014). *The Law of Corporate Purpose*, 10 BERKELEY BUS. L. J. 192 (2014).
[42] Du Plessis et al., *Supra n.* 1, at 7

multifaceted advantage for a firm that aspires to establish a good business, be competitive in the market, and viable.[43]

Definitions that are based on the external aspect of corporate governance, therefore, concentrate on relationships between the company and its stakeholders.[44] According to Freeman's history of the term "Stakeholders", "...the term was meant to generalize the notion of stockholder as the only group to whom management need be responsive. Thus, the term "stakeholders" was originally defined as "those groups without whose support the organization would cease to exist".[45] Accordingly, in its original usage, the term 'stakeholder' refers to those in whom the firm has a stake for its survival, i.e. investors who provided the capital, and customers.[46]

In the course of history, the original usage of the term "stakeholders" has encountered a radical shift. Stakeholders have begun to be identified commonly as "...any group or individual who can affect or is affected by the achievement of the organization's objectives".[47] Accordingly, the term "stakeholders" may include employees, creditors, suppliers, consumers, regulatory bodies and state agencies, and the local community in which a company operates.[48] Some commentators also include consideration of the environment as an important entry on the list of stakeholders.[49]

The most realistic approach to corporate governance is the so-called inclusive approach – to view all stakeholders as part of the corporate governance definition.[50] If one takes into consideration recent developments, corporate governance could be defined as follows:

> The system of regulating and overseeing corporate conduct and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities) who can be affected by the corporation's conduct, in order to ensure

---

[43] *Ibid.*
[44] *Ibid.*, p.8
[45] Edward R. Freeman, **strategic planning: a stakeholder approach** 31, London, Pitman Publishing (1984).
[46] Elaine Sternberg, **The stakeholder Concept: A Mistaken Doctrine, Foundation for Business Responsibilities** 13, United Kingdom, University of Leeds (2001).
[47] Freeman, *Supra n.* 45, at 46
[48] Edward R. Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25 C. M. REV. 89(1983).
[49] *Ibid.*
[50] Du Plessis et al., *Supra n.* 1, at 10

responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation.[51]

Stakeholders and shareholders' interests are not mutually exclusive, however. As Gregory & Simms explain,

> Corporations do not succeed by consistently neglecting the expectations of employees, customers, suppliers, creditors, and local communities, but neither do corporations attract needed capital from equity markets if they fail to meet shareholders' expectations of a competitive return. A key aspect of corporate governance is ensuring the flow of external capital to firms.[52]

The definition by Bob Garratt is also worth mentioning as it emphasizes the contemporary understanding of the notion. He defines corporate governance as "the appropriate board structures, processes and values to cope with the rapidly changing demands of both shareholders and stakeholders in and around their enterprises".[53]

Notably, the OECD recognizes corporate governance as a set of relationships between the management, board, shareholders of a company and other stakeholders. Since it is an accepted definition by most of the countries in the world including the multilateral organizations like the World Bank Group, the United Nations, the Basel Committee for Banking Supervision, the International Organization of Securities Commission (IOSCO), the Asian Development Bank, and the Islamic Financial Services[54], this study will also focus on OECD's definition of corporate governance;

> Corporate governance is defined as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through

---

[51] *Ibid.*

[52] Gregory & Simms, *Supra n.* 2, at 3

[53] Bob Garratt, **Thin on top : why corporate governance matters and how to measure and improve board performance** 12, London, Nicholas Brealey Publishing (2003).

[54] Bhavik M. Panchasara, **An empirical study on Corporate Governance in Indian Banking Sector** 7 (PHD thesis), Saurashtra University, (2012). Retrieved from http://etheses.saurashtrauniversity.edu. Accessed on 19-Jul.-2014.

which the company objectives are set and the means of attaining those objectives and monitoring performance.[55]

The various definitions and approaches to corporate governance, generally, suggest that the purpose of corporate governance is to reduce deviance by corporations where deviance is defined as any actions by management or directors that are at odds with the legitimate, investment-backed expectations of investors.[56]

2.1.2. Defining the Framework

According to the World Bank, both the internal and external mechanisms make up the structure of corporate governance.[57] The internal architecture is considered as the traditional structure of corporate governance that addresses the relationship among shareholders, between shareholders and the board of directors, and between the board and managers.[58] Within a company, corporate governance provides the tools that directors need to ensure efficiency, accountability, and sound decision-making. Reporting in general, accounting & financial reporting in particular is among the important tools used in corporate governance practices.

Among other things, strengthened reporting requirements demand improved accounting procedures and stronger internal control systems, which in turn provide managers and directors the tools they need to control expenditure and gauge revenue.[59] Managers can be held more accountable for the decisions they make and the performance that results by increasing the transparency, quality, and regularity of financial reporting.[60] If such corporate governance framework is implemented properly, poor performances or activities that divert company resources into non-profitable activity can be quickly identified and remedied.[61]

---

[55] Organisation for Economic Co-operation and Development, **OECD Principles of Corporate Governance** 11, France, OECD Publications (2004).

[56] Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350 (2004).

[57] The World Bank, **Report on the Observance of Standards and Codes (ROSC): Corporate Governance** (2009).. Retrieved from www.**worldbank**.org/ifa/rosc_cg. Accessed on 11-Mar.-2014.

[58] Magdi R. Iskander & Nadereh Chamlou, **Corporate Governance: A Framework for Implementation Overview** 6, The World Bank (2000). Retrieved from www.worldbank.org/html/fpd/privatesector/cg. Accessed on 14-Apr.-2014.

[59] Hontz and Shkolnikov (eds.), *Supra n.* 28, at 20

[60] *Ibid.*

[61] *Ibid.*

The external institutions are composed of private actors (i.e. stakeholders and reputational agents[62]) and the regulatory mechanisms (i.e. standards, laws and regulations, and the financial sector).[63] Broadly speaking, both the private side and the regulatory side make up what can be called as an institutional framework where corporate governance is implemented. The development of an inter-related web of the private institutions, regulations and rights that underpin the four basic values of corporate governance (transparency, accountability, fairness, and responsibility) influence the corporate governance regulation and enforcement.[64] In other words, this institutional framework affects corporate governance mechanisms and its enforcement.

Developed and emerging economies have differences in corporate governance issues, particularly of which is the issue of external institutions. According to Philip Armstrong, while developed markets have well established and functioning external institutions, institutions in emerging markets are weak.[65] However, commentators like Shkolnikov and Wilson emphasize on the value of strong internal corporate governance practices. Shkolnikov and Wilson explain that,

> It should be noted that even in systems that possess weak external institutions, strong internal corporate governance provides value for companies and is worth pursuing as end in itself. Academic research has indicated that investors in high-risk emerging markets with poor public governance will pay a higher premium to invest in well-governed companies that offer improved financial information as well as better protection for minority shareholders.[66]

The inter-relationship between internal company practices and the external institutions in which companies operate has not always been recognized. In the absence of an advanced inter-related web of the internal company practices and the external institutions, the profound benefits of good internal corporate governance become tenuous.[67] However, if there is a well functioning inter-

---

[62] Reputational agents refer to private sector agents, self-regulating bodies, the media, and civic society that reduce information asymmetry and improve the monitoring of firms.
[63] Iskander and Chamlou, *Supra n.* 58, at 5
[64] Hontz and Shkolnikov (eds.), *Supra n.* 28, at 22
[65] *Ibid.*, p. 36
[66] *Ibid.*, p. 23
[67] *Ibid.*

relationship of the internal company practices and the external institutions, its benefits have "far-reaching impact, increasing investor confidence and providing for the business the legal basis needed to take risk and to grow".[68]

The significance of the inter-relationship between the internal company practices and the external institutions won attention very recently. Many efforts to strengthen corporate governance in emerging markets in the past have focused on the building up of internal company practices.[69] However, as Shkolnikov and Wilson note "it has become evident over the last decade, that internal company practices are inseparable from the environment in which these companies operate".[70] For countries where the external institutions, like Stock exchanges and securities markets, do not exist or are weak, corporate governance provides an avenue for bringing institutional reform issues to the forefront and to begin addressing them.[71]

Generally, there is no single model of corporate governance framework. The trend is, rather, the internal and external architectures explained above have come together in different ways to create a range of corporate governance systems that reflect specific market structures, legal systems, traditions, regulations, and cultural and societal values.[72] "Recently, many countries and firms have updated their systems of corporate governance to reflect a broader and more inclusive concept of corporate responsibility that includes stakeholders".[73]

2.2. The Significance of Corporate Governance

The corporation is one of the most successful socio-economic institutions of modern society.[74] In both developed and developing nations, a growing proportion of economic activity takes place in firms organized as corporations.[75] Firms serve to mobilize and coordinate the use of capital in the generation of economic growth.[76] The importance of corporate governance, hence, lies in its implications for corporate behavior and the role played by a corporation in modern society.

---

[68] *Ibid.*
[69] *Ibid.*, p. 21
[70] *Ibid.*
[71] *Ibid.*, p. 23
[72] Iskander and Chamlou, *Supra n.* 58, at 9-10
[73] *Ibid.*
[74] Barker, *Supra n.* 4
[75] Gregory and Simms, *Supra n.* 2
[76] Barker, *Supra n.* 4, at 3

Apart from the salient features[77] of the corporate institutional form, firms can be organized in a variety of ways in terms of authority and power structure (i.e., the governance).[78]

According to the wordings of Panchasara "corporate governance is about commitment to values and ethical business conduct."[79] He further states that corporate governance improves public understanding of the structure, activities and policies of the firm through a timely and accurate disclosure of information regarding the financial situation, performance, ownership and governance of the company.[80] A firm with a well-established and developed corporate governance system is able to attract investors and enhance the trust and confidence of the stakeholders.[81]

The genesis of corporate governance lies in either of the two types of drivers of corporate governance reform. One set of drivers is associated with corporate failures and scams.[82] This set of drivers suggests a reactive approach to corporate governance reform.[83] That mean, firms are forced to investigate their corporate governance practices and take remedial actions. A more proactive set of drivers has much to do with companies' and countries' search for investment, the need to improve competitiveness, and gaining access to regional and international markets.[84] According to Shkolnikov and Wilson, both types of factors have been responsible for increased attention being paid to corporate governance over the past decade.[85]

In the evolution of corporate governance systems, the first set of drivers plays a great role. The development and refinement of corporate governance standards has often followed the occurrence of corporate governance failures.[86] The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in

---

[77] Separate legal personality, limited liability, shared ownership by investors, a board structure, and transferable shares – are salient in firms around the world
[78] Barker, *Supra n.* 4
[79] Panchasara, *Supra n.* 54, at 5
[80] *Ibid.*
[81] *Ibid.*
[82] Hontz and Shkolnikov (eds.), *Supra n.* 28, at 12
[83] *Ibid.*
[84] *Ibid.*
[85] *Ibid.*
[86] United Nations Conference on Trade and Development, **Corporate Governance in the Wake of the Financial Crisis: Selected international views** 80, Geneva, United Nations Publication (2010).

England.[87] Similarly, much of the securities law in the United States was put in place following the stock market crash of 1929.[88] There has been no shortage of other crises, such as the secondary banking crisis of the 1970s in the United Kingdom and the U.S. savings and loan debacle of the 1980s.[89] The history of corporate governance has also been punctuated by a series of well-known company failures: the Maxwell Group raid on the pension fund of the Mirror Group of newspapers, the collapse of the Bank of Credit and Commerce International and Barings Bank.[90] Each crisis or major corporate failure, often occurring as a result of incompetence, outright fraud, and abusive practices was swiftly met by new and improved system of corporate governance, most notably the many national corporate governance codes.[91]

In order to avert the situation and balance the promotion of firms with greater accountability, developed countries have reformed their corporate governance framework and established a complex mosaic of laws, regulations, institutions, and implementation capacity.[92] Consequently, the newly developed corporate governance framework stimulates "the systematic enforcement of laws and regulations which has created a culture of compliance that has shaped business culture and the management ethos of firms, spurring them to improve as a means of attracting human and financial resources on the best possible terms".[93]

We may appreciate the significance of a robust corporate governance arrangement if we take in to account the repercussions of the systemic failure of corporate governance in East Asia (especially in Indonesia, South Korea and Thailand).[94] The corporate failure that have stemmed from weak legal and regulatory systems, inconsistent accounting and auditing standards, poor banking practices, thin and unregulated capital markets, ineffective oversight by corporate boards of directors, and little regard for the rights of minority shareholders exacerbate the macroeconomic crises in East Asia.[95] More recently, high profile scandals, financial crises and/or

---

[87] IFC, *Supra n.* 27
[88] *Ibid.*
[89] *Ibid.*
[90] *Ibid.*
[91] *Ibid.*
[92] Iskander and Chamlou, *Supra n.* 58, at 1
[93] *Ibid.*
[94] IFC, *Supra n.* 27
[95] Iskander and Chamlou, *Supra n.* 58, at 2

institutional failures in Russia, Asia and the United States have brought corporate governance issues to the frontline in developing countries, transitional economies, and emerging markets.[96]

These incidents illustrate that the lack of a robust corporate governance system enables insiders, whether they be company managers, company directors or public officials, to ransack companies at the expense of shareholders, creditors and other stakeholders (employees, suppliers, the general public, and so forth).[97] Yet, in today's globalized economy, companies and countries with weak corporate governance systems are likely to suffer serious consequences above and beyond financial scandals and crises.[98] What is increasingly clear is that how corporations are governed-commonly referred to as corporate governance- largely determines the fate of individual companies and entire economies in the age of globalization.[99]

At the age of globalization, where competition is fierce, developing and transition economies need a healthy and competitive corporate sector that is fundamental for sustained and shared growth—sustained in that it withstands economic shocks, shared in that it delivers benefits to all of the society.[100] In order to overcome the fierce competition and capital fluctuation, firms need levels of capital that exceed traditional funding sources.[101] Failure to attract adequate levels of capital threatens the very existence of individual firms and can have dire consequences for entire economies. As stated by the World Bank Group succinctly, "it is this growing need to access financial resources, domestic and foreign, and to harness the power of the private sector for economic and social progress that has brought corporate governance into prominence over the world".[102]

Before committing any funds, individual investors, banks, and other financial institutions base their decisions not only on a company's outlook, but they also require evidence that companies are run according to sound business practices that minimize the possibilities for corruption and

---

[96] The Center for International Private Enterprise, **Instituting Corporate Governance in Developing, Emerging and Transitional Economies** 2, (2002). Retrieved from http://www.cipe.org Accessed on 19-Feb.-2014.
[97] *Ibid.*
[98] *Ibid.*
[99] *Ibid.*
[100] Iskander and Chamlou, *Supra n.* 58, at 2
[101] CIPE, *Supra n.* 96
[102] Iskander and Chamlou, *Supra n.* 58, at 2

mismanagement.[103] In other words, investors and financiers seek out companies that have sound corporate governance structures and practices. As stated by the Center for International Private Enterprise,

> Corporate governance is the body of "rules of the game" by which companies are managed internally and supervised by boards of directors, in order to protect the interests and financial stake of shareholders who may be located thousands of miles away and far removed from the management of the firm. Just as good government requires transparency so that the people can effectively judge whether their interests are being served, corporations must also act in a democratic and transparent manner so that their owners can make educated decisions about their investments.[104]

Countries tend to realize that good governance of corporations is a source of competitive advantage and critical to economic and social progress.

By helping countries to attract investment, facilitating institutional reform, reducing opportunities for corruption, increasing competitiveness, and promoting minority shareholders rights protection, corporate governance helps to build a foundation for economic growth, job creation, and private sector-led poverty alleviation.[105] In addition to attracting investment, improving competitiveness, and managing risks, corporate governance is fundamental to changing the relationship between business and state in many emerging markets.[106] By injecting transparency into the equation, corporate governance facilitates an open exchange between the private sector and the government.[107]

Generally, corporate governance helps companies and economies to attract investment and improves economic performance and competitiveness in several ways. First, corporate governance attacks fraudulent business transactions, by demanding transparency in accounting and auditing procedures, and in purchasing practices.[108] Second, corporate governance procedures improve the management of the firm by helping firm managers and boards to develop a sound company strategy, and by ensuring that mergers and acquisitions are undertaken for

---

[103] CIPE, *Supra n.* 96, at 2-3
[104] *Ibid.*, p. 3
[105] Hontz and Shkolnikov (eds.), *Supra n.* 28, at 12
[106] *Ibid.*
[107] *Ibid.*
[108] CIPE, *Supra n.* 96, at 3

sound business reasons.[109] This, in turn, assures investors and lenders that the firm is a well-functioning institution and motivates them to confidently commit their funds. Thirdly, corporate governance may serve as a means of attracting small investors and raise the levels of capital required for a firm that strived to be competitive and viable. A robust corporate governance system provides protection for minority shareholders and encourages a widely dispersed ownership structure in the firm.[110]

2.3. Core principles of Corporate Governance

As noted above, the term "Corporate Governance" remains one that does not lend itself to a single, specific or narrow definition. In 2008, Justice Owen made the following comments in The Bell Group Ltd v Westpac Banking Corporation:

> Directors are in control of the assets of a corporation but they do not own those assets. They control the assets on behalf of the corporation and, through the corporation, others having an interest in the wellbeing of the entity. There are no hard and fast rules that constitute 'corporate governance'. But there are some basic underlying principles that help to explain the guidelines and legal principles that have developed over time and now dictate how a director is expected to carry out her or his responsibilities.[111]

According to the report by the OECD Business Sector Advisory Group on corporate governance, the regulation of corporate governance is likely to be most effective in attracting capital if focused on four essential areas: fairness, transparency, accountability and responsibility.[112] The Business Sector Advisory Group has also recommended that the OECD promote and further articulate the "core standards" of corporate governance based on these four essentials.[113]

Although the OECD principles are intended to be non-binding, they provide thoughtful guidance for policy makers, investors, corporations and other stakeholders worldwide and become an influential benchmark in the design of national level corporate governance codes and

---

[109] *Ibid.*
[110] *Ibid.*, p. 4
[111] Du Plessis et al., *Supra n.* 1, at 5
[112] Gregory and Simms, *Supra n.*2, at 7
[113] *Ibid.*

regulation.[114] They, generally, are viewed as representing the moral consensus of the international community on the core standards of corporate governance. Many national corporate governance codes have been developed based on these OECD Principles.[115] According to Barker "the primary objective of the OECD Principles is to outline the key components of a corporate governance regime that protects the interests of non-insiders in general, although the overwhelming focus is on minority shareholders".[116]

It will be worthwhile to discuss the OECD principles of corporate governance as they are built on the four core values. To start with fairness, on which two of the principles are built, dictates that effective corporate governance should protect the property rights of shareholders, including the rights of minority and foreign shareholders, and ensure secure methods of ownership, registration and free transferability of shares.[117] The principle of fairness also holds that the corporate governance framework should ensure the participatory rights of shareholders on key corporate decisions.[118]

With respect to the core value of transparency, the OECD stipulated a principle recognizing that in a corporate setting, the focus should be on the timely and proactive disclosure of the performance of the firm to investors and shareholders, particularly its financial and operational status, as well as information about corporate objectives and material foreseeable risk factors.[119] Such disclosure can be voluntary or mandatory depending on the market and legal environment within which companies operate.[120]

The other principle which recognizes a corporate governance framework that held directors to be in a fiduciary relationship to shareholders and to the company, and that they owe duties of loyalty and care, is built on the core value of accountability.[121] The OECD has also emphasized on a corporate governance framework which encourages firms to act responsibly and ethically,

---

[114] Barker, Supra n. 4, at 8
[115] IFC, *Supra n.* 27, at 58
[116] Barker, *Supra n.* 4, at 8-9
[117] Gregory and Simms, *Supra n.* 2, at 8
[118] Iskander and Chamlou, *Supra n.* 58, at 11
[119] Hontz and Shkolnikov (eds.), *Supra n.* 28, at 16
[120] *Ibid.*
[121] Gregory and Simms, *supra n.* 2, at 8-9

with special consideration of the interests of stakeholders.[122] This principle is consistent with the core value of responsibility that dictates a corporate governance framework which ensures corporate compliance with the laws and regulations that reflect the respective society's values.[123] These principles of corporate governance articulated by the OECD require both regulation and private sector initiative, i.e. private codes of conduct and voluntary behavior, for implementation.[124]

2.4. Approaches in Corporate Governance

According to Sundaram and Inkpen "governing the corporation requires purposeful activity. All purposeful activity, in turn, requires goals".[125] That means, corporate governance is a tool that facilitates the achievement of a corporate goal. However, debates surrounding the appropriate corporate objective that is going to be achieved through sound corporate governance framework are unfinished yet. There are different views among Scholars and courts over the purposes of the corporation.[126]

Corporate law scholars are at odds on the fundamental question of what the purpose of corporate law should be.[127] Many in the field take it as given that the responsibility of corporate boards is supposed to be profit maximization for shareholders and pursuing other interests is neither the obligation nor the right of directors.[128] On the other hand, some authors underline, governance, unlike management, in a firm has an outward orientation: it concerns the direction of the business rather than its running *per se*.[129] Accordingly, an important component of governance, in addition to providing strategic direction of the business and supervising the executive organ, is providing accountability to legitimate interests.[130] Yosifon notes that "some of the field's most accomplished academics contend that the law allows directors to steer the corporate ship towards

---

[122] *Ibid.*, p. 10
[123] Hontz and Shkolnikov (eds.), *Supra n.* 28, at 16
[124] Gregory and Simms, *Supra n.* 2, at 10-11
[125] Sundaram and Inkpen, *Supra n.* 56
[126] *Ibid.*
[127] Yosifon, *Supra n.* 41, at 183
[128] *Ibid.*
[129] Rilka O. Dragneva & William B. Simons, *Corporate Governance Revisited: Can The Stakeholder Paradigm A Way Out Of "Vulture" Capitalism In Eastern Europe?*, 27 C. & E. Eur. L. R., 95 (2001).
[130] *Ibid.*

the service of non-shareholding stakeholders, including employees, consumers, and the public generally, even when shareholders interests are in tension with such pursuits".[131]

Scholars who are convinced that the law requires shareholder primacy in firm governance tend to also insist that such a governance norm is desirable.[132] On the other hand, scholars who claim that the law allows for a broader corporate agenda tend to argue that directors' attention to non-shareholders concerns is a good thing.[133] The writer's view is that shareholder primacy is indeed the law under the Ethiopian context too. However, corporate governance reforms that would impose broader responsibilities on corporate boards are the needs of the time.

Generally, the current perspectives on corporate governance have been prominently categorized into two contrasting approaches: the traditional approach (shareholding) and the modern approach (stakeholding).[134] Hereunder, these two paradigms will be discussed briefly.

2.4.1. The Traditional Approach

The ruling by the Michigan State Supreme Court in Dodge vs. Ford Motor Company in 1919 is considered as the event that led to the clearest articulation of the primacy of shareholders value maximization.[135] Henry Ford wanted to invest Ford Motor Company's considerable retained earnings in the company rather than distribute it to shareholders.[136] The Dodge brothers, minority shareholders in Ford Motor Company, brought suit against Ford, alleging that his intention to benefit employees and consumers was at the expense of shareholders.[137] In its ruling, the Michigan court agreed with the Dodge brothers and held that "the business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end."[138]

---

[131] Yosifon, *Supra n.* 41, at 183
[132] *Ibid.*, p. 184
[133] *Ibid.*
[134] Steve Letza, Xiuping Sun, and James Kirkbride, *Shareholding Versus Stakeholding: a critical review of corporate Governance*, 12 C. GOV. ALL. DIG. 242 (2004).
[135] Du Plessis et al., *Supra n.* 1, at 6
[136] *Ibid.*
[137] *Ibid.*
[138] *Ibid.*

The beginning of twentieth Century is marked by the convergence of corporate law all over the world as a result of the widespread acceptance of a shareholder-centered ideology of corporate law among international businesses, governments, and legal elites.[139] The dominant view of the time was that corporate law should principally strive to increase long term shareholders value.[140] This emergent consensus has already profoundly affected corporate governance practices throughout the world and its influence increasingly conditions the reform of corporate law.[141]

The basic premise underlying the shareholders primacy model is that shareholders are the residual owners of the company, and as such, their legal rights are determined by the principles governing the possession, use, and transfer of private property.[142] This model, and the legal principles upon which it rests, have led to the fundamental notion that it is the responsibility of corporate managers to protect the interests of shareholders.[143] Commentators who advocate for this model argue that other corporate constituencies, such as creditors, employees, suppliers, and customers should have their interest protected by contractual and regulatory means rather than through participation in corporate governance.[144]

In the shareholding perspective, a basic issue in corporate governance is whether or not shareholders' interest can be effectively protected under the current institutional arrangements.[145] Since shareholders have to delegate control to a few directors and managers to run the company on behalf of all shareholders, there is a potential risk that directors and managers may serve their own interests at the expense of all the shareholders.[146] This problem has become wider and more serious since the early 20th century, as the separation of ownership and control increased the power of professional managers and left them free to pursue their own interests.[147]

---

[139] Henry Hansmann & Reinier Kraakman, **Toward A Single Model of Corporate Law** 56, New York, Oxford University Press (2002).
[140] *Ibid.*
[141] *Ibid.*
[142] Richard C. Baker & Bertrand P. Quéré, **Accountability, Corporate Governance and the Role of the State** 23. Retrieved from apira2010.econ.usyd.edu.au Accessed on 11-March-2014.
[143] *Ibid.*
[144] Hansmann and Kraakman, *Supra n.* 139, at 57
[145] Letza et al., *Supra n.* 134, at 247
[146] *Ibid.*
[147] *Ibid.*, p. 248

Some nations emphasize the primacy of ownership and property rights, and focus on the corporate objective on returning a profit to shareholders over the long term.[148] According to this view, employees, suppliers and other creditors have contractual claims on the company.[149] United States, Canada and the United Kingdom are proponents of shareholders primacy model of corporate governance.[150]

This traditional model of corporate governance, largely dependent on the concept of protecting shareholders interests, have been ineffective in addressing public demands for financial stability, employment, health and worker safety, product safety, environmental protection, immigration, unfair tariffs, and so forth.[151] Thus, Some nations in continental Europe -- particularly Germany , France and the Netherlands --and countries in Asia adopted a modern approach of corporate governance that focus on the need to satisfy societal expectations and, in particular, the interests of employees and other stakeholders.[152]

2.4.2. The Modern Approach

One of the most important 20th century transition has been the moving away from the traditional model of corporate governance and the perception of its role as serving exclusively the profit interest of shareholders, to that of including (or at least accounting for) wider constituencies with diverse stakes in corporate life.[153] The stakeholder notion of corporate governance says that there are other groups to whom the corporation is responsible in addition to shareholders: those groups who have a stake in the actions of the corporation.[154]

In the wake of the 1929 stock market crash and the Great Depression, scholars reevaluated the shareholders value maximization viewpoint.[155] The most widely recognized arguments are attributed to Dodd, who argues that if the corporation can be viewed as an entity that is separate

---

[148] Gregory and Simms, *Supra n.* 2
[149] *Ibid.*
[150] *Ibid.*
[151] Baker and Quéré, *Supra n.* 142, at 21-22
[152] Gregory and Simms, *Supra n.* 2
[153] Dragneva and Simons, *Supra n.* 129, at 110
[154] Freeman and Reed, *Supra n.* 48
[155] Sundaram and Inkpen, *Supra n.* 56, at 351

from its shareholders, then it has citizenship responsibilities.[156] Sundaram and Inkpen explain the role of board of directors "not to be restricted to that of carrying out its shareholder responsibilities, but rather would be that of a trustee with citizenship responsibilities on behalf of all constituencies, even if it meant a reduction in shareholder value".[157]

The stakeholder concept of corporate governance starts from the recognition of the "stakes" that various constituents have in a company.[158] There are different definitions, some of them extremely broad, as to who the company's stakeholders are. Shareholders and investors, employees and managers, customers and suppliers, and local communities are often described as "primary" stakeholders, whereas government and regulators, civic and social groups, competitors, media and academia, as "secondary" ones.[159]

The general message of the stakeholder paradigm is that the proper purpose of corporate governance requires considering the different, sometimes competing, interests of the various constituencies of a company.[160] The corporate governance framework should recognize the stakeholders' contribution as a valuable resource for building competitive and profitable companies rather than exclusively focusing on the often short-term profit interest of shareholders.[161] The governance framework should acknowledge that the interests of the corporation are served by recognizing the interests of stakeholders and their contribution to the long-term success of the corporation. Therefore, it is in the interest of the company to stimulate productive co-operation with the stakeholders, establish a governance framework to acknowledge the existence of these interests and recognize their importance for the long-term success of the company.[162]

Though both shareholders and stakeholders perspectives claim superiority of their models respectively, however, the interests involved therein are not mutually exclusive.[163] Corporations do not succeed by consistently neglecting the expectations of employees, customers, suppliers,

---

[156] *Ibid.*
[157] *Ibid.*
[158] Dragneva and Simons, *Supra n.* 129, at 96
[159] Freeman and Reed, *Supra n.* 48
[160] Dragneva and Simons, *Supra n.* 129, at 96
[161] *Ibid.*
[162] *Ibid.*
[163] Letza et al., *Supra n.* 134, at 257

creditors, and local communities, but neither do corporations attract the needed capital from equity markets if they fail to meet shareholders' expectations of a competitive return.[164] In reality too, a dynamic shift is observed with both models becoming increasingly mutually attractive all over the world.[165]

2.5. The correlation between Good CG and Firm Performance

Anita Indra Anand, a corporate law commentator, argues that "a latent assumption in the academic literature is that there is a causal relationship between corporate governance and firm performance".[166] However, U.S. and recent Canadian researchers conclude that the relationship between good corporate governance and firm performance is elusive.[167] Anand has contended this position arguing that "while there is no causal link between good governance and firm performance, there is evidence of a positive correlation between good corporate governance and firm performance".[168]

There are varying perspectives on what constitutes good practice in corporate governance, and whether good corporate governance is indeed important to the company and actually adds value or 'makes a difference'. Evidence of the significance of good practice in corporate governance comes from the OECD Principles of Corporate Governance. The OECD found out that corporate governance was a key element in improving economic efficiency and growth, as well as in enhancing investor confidence.[169] It also pointed out that companies with a good corporate governance record were often able to borrow larger sums and on more favourable terms than those that had poor records or operated in non-transparent markets.[170]

The OECD further notes that:

> Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system,

---

[164] Gregory and Simms, *Supra n.* 2
[165] IFC, *Supra n.* 27, at 257
[166] Anand, *Supra n.* 24, at 34
[167] *Ibid.*, p. 35
[168] *Ibid.*
[169] The OECD, *Supra n.* 55
[170] *Ibid.*

within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.[171]

Enhanced corporate governance improves the system of accountability, decision making, and ensures compliance with applicable laws, standards, rules, rights, and duties of all interested parties.[172] As a result, it increases operational efficiency and stimulates firm performance.[173] Instituting higher governance standards has perceived benefits to investors. Obviously, investing in a company entails a risk of loss on the funded capital. Heightened governance practices inevitably reduce the risk of loss by improving firm performance. Investors are actually willing to finance, with large amount of money, companies they perceive as having good corporate governance.[174] Firms with good corporate governance are perceived as investor friendly, providing greater confidence in their ability to generate returns without violating shareholders' rights.[175]

Good corporate governance is based on the principles of accessibility, accuracy, completeness, efficiency, timeliness and transparency of information at all levels.[176] It requires good corporate citizenship which respond to the broader concerns of their stakeholder community, and operate in a responsible and transparent fashion.[177] A good system of corporate governance, thus, will facilitate the resolution of corporate conflicts between different interest groups and enable companies to avoid costly litigation.[178]

Many commentators argue that good corporate governance contributes towards combating corruption, which remains one of the greatest threats to development around the world.[179]

---

[171] *Ibid.*
[172] IFC, *Supra n.* 27, at 18
[173] *Ibid.*
[174] Loizos Heracleous, *Does Singapore Need A Code of Best Practice In Corporate Governance?*, **SIN. MANAG. REV.**
[175] IFC, *Supra n.* 27, at 19
[176] *Ibid.*
[177] Hontz and Shkolnikov (eds), *Supra n.* 28, at 23
[178] IFC, *Supra n.* 27, at 19
[179] Hontz and Shkolnikov (eds), *Supra n.* 28, at 8

Simply put, By improving transparency, internal controls, and reporting, good corporate governance makes bribes harder to give and harder to conceal.[180]

Generally, it is important to emphasize that there is global acknowledgment of the benefits of good corporate governance for firms. Many academics and practitioners, international organizations and advocacy groups, investors and company leaders strongly believe that good corporate governance leads to tangible benefits and positively affects the company's performance and outcomes.[181] Most, if not all, contemporary corporate governance reports, guidelines, commentaries and legislative packages strongly emphasize that there is a link between sound corporate governance practices and success within the corporation and throughout the economy.[182]

---

[180] *Ibid.*

[181] IFC, **Practical Guide to Corporate Governance: Experiences from the Latin American Companies Circle** 170, Pennsylvania (2009). Available at www.ifc.org/corporategovernance Accessed on 19-Sep.-2014.

[182] Du Plessis et al., *Supra n.* 1, at 159

Chapter Three

3. The Regulatory Alternatives of Corporate Governance

The term regulation is used in a wide range of disciplines, from politics and economics to sociology, psychology and history.[183] The explanation by Deakin and Cook of the University of Cambridge stated in their research paper is the most appropriate for this study. It reads;

> ...the term 'regulation' may be taken to refer to the control of corporate and commercial activities through a system of norms and rules which may be promulgated either by governmental agencies (including legislatures and courts) or by private actors, or by a combination of the two. The direct involvement of the state is not a necessary condition for the existence of regulation in this sense, since rules may be derived from the activities of industry associations, professional bodies or similarly independent entities.[184]

There are also three broad approaches in understanding 'regulation' in the context of corporate governance. First, regulation is a system backed by government-determined legal rules and by mechanisms for monitoring and enforcement.[185] Secondly, regulation, in a more comprehensive manner, includes any form of deliberate state intervention in the business activity of firms.[186] Thirdly, broadly speaking, from whatever source it is, regulation includes all mechanisms of social or economic influence.[187]

For the purpose of this research, the third approach is the appropriate one in understanding the forthcoming discussions on 'regulation'. That is, all mechanisms affecting behavior, whether these are state-based or from other sources, is deemed regulatory.[188] Accordingly, "regulation may be carried out not merely by state institutions but by a host of other bodies, including corporations, self-regulators, professional or trade bodies, and voluntary organizations."[189]

---

[183] *Ibid.*, p. 157
[184] Paper prepared by the ERSC Centre for Business Research, cited in Du Plessis et al., *Supra n.* 1, at 157
[185] Du Plessis et al., *Supra n.* 1, at 158
[186] *Ibid.*
[187] Robert Baldwin and Martin Cave, **Understanding Regulation: Theory, Strategy, and Practice** 3, Oxford University Press Inc., New York (2nd ed, 2012).
[188] *Ibid.*
[189] *Ibid.*

The impact of regulations on the economy depends on the nature of the regulation and how efficiently and effectively it is implemented.[190] While regulations impose costs on firms, causing them to shift resources away from other activities to achieve compliance, these costs are often justified as a means of improving social welfare.[191] Regulations, especially if they are performance based, may also induce innovations that benefit consumers, producers and society.[192] In some instances, regulations may even increase competitiveness by improving the quality of products and services and giving firms that produce these products and services a first-mover advantage.[193]

The traditional legal regime for any regulated activity is a scheme of rules that prescribes certain behavior, supported by penalties to which those who break the law are subjected.[194] Anand notes that "this model, which supposes that the primary incentive for compliance is fear of the consequences of non-compliance, can be termed as a 'command-and-control' structure".[195] However, the recent developments in the regulation of corporate governance pioneer a contemporary and an alternative regime of regulation, i.e. voluntary regulation.

The impetus for recent corporate governance regulatory reforms has been prompted by a series of corporate collapses around the world and the perceived need to restore confidence in the market.[196] As a result, financial objectives are expressed to be the driving factor underpinning contemporary corporate governance regulation.[197] The immediate section is intended to discuss this point further.

3.1. Why should Corporate Governance be regulated?

Before a detailed discussion on the need for corporate governance regulation, considering the rationale for the regulation will be worthwhile. The importance of corporate governance has been well established in recent years. As a result of the existence of a 'separation of ownership and

---

[190] Daniel Castro, **Benefits and Limitations of Industry Self-Regulation for Online Behavioral Advertising** 1, Washington, The Information Technology & Innovation Foundation (2011).
[191] *Ibid.*
[192] *Ibid.*, p. 2
[193] *Ibid.*
[194] Anand, *Supra n.* 24, at 7.
[195] *Ibid.*
[196] Hontz and Shkolnikov (eds), *Supra n.* 28, at 42
[197] *Ibid.*

control' in the contemporary public corporations, agency problem is inevitable among different interest groups.[198] Directors and managers are given overwhelming power with little accountability to the dispersed group of shareholders.[199] Thus, well regulated corporate governance can reduce such agency problems between managers and shareholders, limiting private benefits and expropriation by controlling owners.[200]

In other words, regulation of a corporation's internal arrangements has been considered vital to ensure that directors and executives do not abuse their power for personal gain.[201] Governance rules and regulations around the world aim at minimizing the abuse of shareholders' interests by top management.[202] Better corporate governance also means better monitoring of management, which can translate into higher company performance.[203] Regulation, thus, is an effective system used in improving governance practices and preventing collapse and associated problems of firms.[204]

Economists refer to the divergence between ownership and control in the corporation as 'agency problem', and similarly suggest that external incentives, like regulation, be implemented in order to fix this problem.[205] According to Lipton and Herzberg, regulation of corporate governance is based entirely on the presumption that directors and managers of modern corporations need to be kept accountable.[206] They emphasize that:

> ...The development of increased interest in corporate governance reflects higher expectations by the public and investment community that greater efforts be made by ... companies to develop structures and procedures so as to ensure management is effective and

---

[198] Du Plessis et al., *Supra n.* 1, at 460
[199] *Ibid.*, p. 461
[200] Valentina G. Bruno & Stijin Claessens, **Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?** 1, (2007). Retrieved from www.ifc.org/.../Bruno%252C%2BClaessens%2B-%2B**Corporate**%2B**Gov** Accessed on 11-Mar.-2014.
[201] Du Plessis et al., *Supra n.* 1, at 461
[202] *Ibid.*
[203] Bruno and Claessens, *Supra n.* 200
[204] Du Plessis et al., *Supra n.* 1, at 461
[205] Marcel Kahan, The Limited Significance of Norms for Corporate Governance, 149 UNIV. P. L. REV. 1877–8 (2001).
[206] Lipton and Herzberg as cited in du Plessis et al., *Supra n.* 1, at 461-2

acts in the interests of shareholders and adopts appropriate standards of corporate behaviour.[207]

Regulatory pressure may encourage firms to use greater levels of monitoring, similar to a "best practices" approach.[208] Essentially, regulation and governance may work together to ensure an effective governance structure. As noted here, regulation serves as a means of pressuring firms to adopt effective governance structures. Joskow *et al.* note that regulation increases the visibility of corporate governance through enhanced public scrutiny and provides a set of instruments (price and allowable cost decisions) to penalize firms perceived to have poor governance structures.[209] Accordingly, regulation of corporate governance is a prominent system in a good corporate governance model.

Regulation of corporate governance also encourages the board of directors to discharge their conformance role effectively. The literature on management and managerial strategy makes a distinction between two primary roles of the board, namely a 'performance role' and a 'conformance role'.[210] According to Tricker, the conformance role of the board includes "judging, questioning and supervising executive management; and a watchdog, confidant and safety-valve role".[211] Bob Garratt sees accountability of the board as including for quality of thinking, high ethical standards and values, to obey the law and to treat stakeholders in a consistent way; and as part of the board's conformance task, Garratt considers supervision of management conformance to key performance indicators, cash flow, budgets and projects.[212] The board is indeed the centre of the enterprise, i.e. "business brain" or central processor unit (CPU), monitoring and coping with the results of the external and internal processes of the whole enterprise'.[213]

---

[207] *Ibid.*

[208] David A. Becher and Melissa B. Frye, **Does regulation substitute or complement governance?** 1, (2008). Retrieved from fic.wharton.upenn.edu/fic/papers/08/0816 Accessed on 11-March-2014.

[209] Paul Joskow et al., **Regulatory Constraints on CEO Compensation** 2, Brookings Papers: Microeconomics (1993).. Retrieved fromwww.**brookings**.edu/~/media/projects/.../1993a_bpeamicro_joskow Accessed on Accessed on 5-Aug.-2014.

[210] Robert I. Tricker, **International Corporate Governance: Text Readings and Cases** 149, New York: Prentice Hall (1994).

[211] *Ibid.*

[212] Garratt, *Supra n.* 53, at 155

[213] *Ibid.*, p. 114

The overriding objective guiding contemporary corporate governance regulation, and more specifically the shift towards more formal rules, is a desire to restore confidence in the market by ensuring that corporations and their participants adhere to good governance practices.[214] In other words, the rationale for the reforms is that without prescriptive regulation in this area, directors and managers would naturally depart from standards of corporate governance best practice, due to a preference for more self-interested transactions and arrangements.[215]

The stewardship theorists, however, advocate that in the great majority of cases, directors, managers and others in positions of power within the corporation will have personal incentives to do what is best for the corporation and its stakeholders, without the need for additional incentives in the nature of formal rules and principles.[216] Accordingly, the longstanding foundation upon which the regulation of corporate governance rests, i.e. formal rules, becomes questionable.

The interest in norms is now being felt in corporate law. By "norms" it is intended, here, to refer to a sense of right and wrong, a sense of duty and responsibility that directors and managers internalize and enforce on themselves simply because it is the right thing to do.[217] One could think of this in terms of a self-enforced obligation to act in the best interests of the corporation and its shareholders.[218] As quoted by Paredes, Chief Justice Veasey opined that "...Self-governance works for the most part because of the sensitivity of directors to do what is right, what is professional, what is honorable, and what is profitable".[219] Norms began as the predominant form by which internal arrangements and management in companies developed, and over time a commonality in the norms operating from company to company could be discovered, setting in place an early standard of corporate governance best practice.[220]

Further supporting view is that norms are just as capable as formal rules of satisfying the objectives of contemporary corporate governance regulation, and capable of operating as a self-

---

[214] Obodo Chimere, *Globalization and Corporate Governance Challenges In Nigeria: A Regulatory And Institutional Perspective*, 4 AFR. J. SOC. SCI. 52 (2014).
[215] Du Plessis et al., *Supra n.* 1, at 456
[216] Troy A. Paredes, A Systems Approach to Corporate Governance Reform: Why Importing U .S. Corporate Law Isn't the Answer, 45 W. & M. L. REV. 1089 (2004).
[217] *Ibid.*, at 1087
[218] *Ibid.*, p. 1088
[219] *Ibid.*,
[220] Du Plessis, *Supra n.* 1, at 454

contained source of regulation independent of external legal rules encouraging compliance through the threat of sanctions.[221] In other words, having a formal approach to corporate governance regulation is not necessary to achieve and maintain sound corporate governance practices, and indeed is not the appropriate regulatory approach.[222]

3.2. Types of Corporate Governance regulations

In terms of types of regulation two main pillars namely state regulation (hard/ mandatory regulation) and self-regulation (soft/ voluntary regulation) have to be distinguished. Regulators face the challenge of choosing between hard or soft regulation of corporate governance practices. In both approaches the regulator defines a set of rules that may affect the governance behavior of firms.[223] However, while the hard approach defines the set of rules to be legally-binding, the soft approach allows firms to comply with these rules or explain why they do not.[224]

Most regimes exhibit characteristics of both soft and hard regulation. Free marketers, of course, dismiss the notion of mandatory corporate governance, arguing that if mandatory corporate governance practices were beneficial and desired by investors, firms competing for scarce capital would implement them voluntarily.[225] On the other hand, others who advocate for investors' welfare argue that an enabling regime is insufficient, since there is no guarantee that all firms will implement the reforms necessary to provide investors with adequate checks on agency problems.[226] Accordingly, this view favours mandatory corporate governance as necessary to protect investors.

According to John Coffee, in many jurisdictions norms and statutory rules of corporate governance regulation reinforce each other and appear closely associated.[227] Legal rules and social norms thus have a way of melting into each other without a sharp, clear line defining

---

[221] John C. Coffee, *Do Norms Matter? A Cross-Country Evaluation*, 149 UNIV. PENN. L. REV. 2171 (2001).
[222] Edward B. Rock & Michael L. Wachter, *Norms and Corporate Law*, 149 UNIV. PENN. L. REV. 1608 (2001).
[223] Marc S. Rapp et al., **Is Soft Regulation of Corporate Governance Efficient From a Shareholders' Perspective?** 1, (2013).. Available at www.bath.ac.uk/management/news_events/.../**pdf**/SchmidThomas Accessed on 11-March-2014.
[224] *Ibid.*
[225] Anita I. Anand, *An Analysis of Enabling Vs. Mandatory Corporate Governance Structures Post Sarbanes-Oxley*, 31 DELAWARE J. CORP. L. 230 (2006).
[226] *Ibid.*
[227] Coffee, *Supra n.* 221, at 2155-2156

where the law ends and the norms begin.[228] Investors realize that they are protected by both, and hence an unexplained departure from a prevailing governance practice might elicit a market penalty.[229]

3.2.1. State regulation

John Farrar uses the term 'hard law' to refer to the 'traditional black-letter law' or a statute enacted by a legislator.[230] In other words, the 'hard law' is a regulatory approach that is backed by a legislative action. The state intervenes through such mandatory laws and takes pro-active or corrective measures on the corporate governance practices of firms.[231] Despite the promulgation of codes of corporate governance, financial crises have continued into the 21st century, thereby leading to more interventions by the State in order to re-establish economic stability.[232] The role of the State in corporate governance is not a recent phenomenon. Rather it has been present and evolved from at least the 16th century.[233]

With the advent of neo-liberalism in the United States in 1980s, many companies were deregulated.[234] This trend towards neo-liberalism continued through the 1990s and 2000s.[235] Many of the formerly regulated companies in the United States (e.g. banking, electricity, airlines, and telecommunications) were no longer held accountable to the State.[236] This deregulation led to financial crises that rendered intervention and regulation by the State necessary.[237]

As noted above, mandatory corporate governance regulation can be seen as a way of signaling to the market that the concerns of investors are taken seriously, thereby helping to rebuild investor confidence.[238] Therefore, it can be maintained that the imposition of

---

[228] *Ibid.*
[229] *Ibid*
[230] Farrar, *Supra n.* 10, p. 65
[231] *Ibid.*
[232] Baker and Quéré, *Supra n.* 142, at 19
[233] *Ibid.*, p. 20
[234] *Ibid.*, p. 21
[235] *Ibid.*
[236] *Ibid.*
[237] *Ibid.*
[238] Deirdre Ahern, **Replacing 'Comply or Explain' with Legally Binding Corporate Governance Codes: An Appropriate Regulatory Response?** 12, (2010). Available at **regulation**.upf.edu/dublin-10-papers/5A3.**pdf** Accessed on 10-Oct.-2014.

legislatively-backed corporate governance standards is an appropriate response to the financial crises and market failures.[239]

Furthermore, the implementation of company laws, i.e. mandatory laws, to control large corporate enterprises not only facilitates the objective of making companies more accountable to shareholders, it also corresponds to social requirements for greater accountability and transparency.[240] Therefore, it is necessary for the State to promote economic stability through prudential regulation of corporate activity and to adopt a stakeholder approach to corporate governance which will hopefully lead to a better allocation of value added across a broad spectrum of interest groups of a company.[241]

Some commentators, however, note that government regulation of corporate governance constitutes a much more intractable problem.[242] Mandatory regulation is counterproductive by its very nature, insofar as it interferes with shareholders' decision in organizing their own corporations in their own ways.[243] Hence, the natural question to follow is that: If it is in the interest of firms to provide adequate protection to shareholders, why mandatory rules, which have such counterproductive effect?

3.2.2. Self-regulation

Self-regulation can be defined as "a regulatory process whereby an industry-level organization (such as a trade association or a professional society), or firm-level organization, as opposed to governmental, sets and enforces rules and standards relating to the conduct of firms in the industry."[244] Businesses use self-regulation to decrease risks to consumers, increase public trust, and combat negative public perceptions.[245] Most of these activities occur through self-regulatory

---

[239] *Ibid.*
[240] Anand, *Supra n.* 225, at 15-16
[241] Baker and Quéré, *Supra n.* 142, at 27
[242] Elaine Sternberg,. **Establishing a market for corporate control** 4, Adam Smith Institute (2012).
[243] *Ibid.*
[244] Anil K. Gupta & Lawrence J. Lad, *Industry Self-Regulation: An Economic, Organizational, and Political Analysis*, 8 ACA. MAN. REV. 417 (1983).
[245] Cary Coglianese et al., **The Role of Government in Corporate Governance** 9, Regulatory Policy Program Report RPP-08, Cambridge, John F. Kennedy School of Government, Harvard University (2004).

organizations (SROs).[246] SROs are the non-governmental organizations formed by the private sector to set standards, monitor for compliance, and enforce their rules.[247]

Companies may choose self-regulation for any of the following three reasons: First, self-regulation may be devised in response to both the absence of government regulation and the threat of excessive government regulation.[248] Second, self-regulation may be implemented in response to catastrophic events, for example to set safety guidelines.[249] Third, Self-regulation may even be adopted by companies that are tightly-regulated and aimed at establishing industry standards or best practices.[250]

In the wake of corporate scandals there have been increasing calls for more effective regulation of corporate behaviour in general and the actions of company directors in particular.[251] In response to that, various laws on issues of corporate governance have been passed in many countries around the world.[252] In addition, in recent years there has been a strong trend towards the adoption of 'soft law' or 'soft regulation' in the form of codes of corporate governance.[253]

The OECD Business Sector Advisory Group on corporate governance stresses that mandatory regulatory measures, though necessary, are not sufficient to raise standards.[254] Indeed, the strengthening of corporate governance standards has been advanced by many corporate leaders who recognize that prospering in the long term requires balancing business objectives with society's concerns.[255] Such companies have gone far beyond the structures of law by adopting voluntary measures that improve the quality of disclosure, ensure that directors discharge their fiduciary responsibilities, and increase the commitment of managers to running companies transparently to maximize value but with due regard for stakeholders' interests.[256] Nowadays,

---

[246] *Ibid.*
[247] *Ibid.*
[248] Castro, *Supra n.* 190, at 3
[249] *Ibid.*
[250] *Ibid.*
[251] David Seidl, Paul Sanderson and John Roberts, **Applying 'Comply-Or-Explain': Conformance With Codes of Corporate Governance in the Uk and Germany** 3, working paper, University of Cambridge, Centre for Business Research (2009).
[252] *Ibid.*
[253] *Ibid.*
[254] Iskander and Chamlou, *Supra n.* 58, at 12
[255] *Ibid.*
[256] *Ibid.*

there is a universal consensus that such behavior enhances the reputation and value of companies.

As mentioned hereinabove, the universal trend is that self-regulatory organizations (SROs) are the responsible organs for the introduction as well as enforcement of self-regulation. SROs often will enforce self-regulation for the entire industry, not just for their members.[257] The power of SROs ranges from receiving complaints on noncompliance (from consumers, regulators or other businesses) to the investigation process.[258] At This juncture, the natural question that comes to our mind will be what if a company is found to be noncompliant? Noncompliance will trigger the process of enforcement. According to the explanation by Castro:

> ...the enforcement process begins with the aim of resolving the issue by turning bad actors into good actors. In other words, the action by SROs is not meant to be punitive in nature. The other important feature of such enforcement is that part of the process is kept confidential in order to prevent businesses from using the process to lodge complaints against competitors. However, if a business is unwilling and non-cooperative to resolve a noncompliance, then the issue is made public by alerting consumers and the media.[259]

There are two lines of arguments based on the role of the government in the regime of self-regulation. One line of argument is that, since firms have incentives to adopt healthy governance practices voluntarily, the state should take advantage of these incentives to create a governance regime that is less costly for firms and still protects investors.[260] If firms are prepared to adopt more comprehensive corporate governance practices voluntarily, and we have seen that they have incentives to do so, then implementing a legal regime that compels them to adopt such practices is unnecessary.[261] The other line of argument is that self-regulation can achieve greater compliance with public objectives but has limited effectiveness without pressure by formal

---

[257] Castro, *Supra n.* 190, at 5
[258] *Ibid.*
[259] *Ibid.*
[260] Anand, *Supra n.* 24, at 26
[261] *Ibid.*

regulatory bodies.[262] Corporate self-regulation has gained overwhelming attention as it emerges as a complement to, if not a substitute for, formal governmental regulation.[263]

The second line of argument, i.e. self-regulation to be backed by governmental regulation, has paved the way for the introduction of different forms of self-regulation. These variants of self-regulation include enforced self-regulation where by the state regulates using rules crafted by firms, or co-regulation, which refers to a tripartite regulatory process of industry associations and individual firms crafting voluntary standards, which the state oversees.[264] Thus, to be effective, self-regulation needs to be properly integrated into the overall regulatory frame work.

Generally speaking, voluntary practices lie at one end of the self-regulation spectrum where monitoring and enforcement by firms is weak; at the other end lie practices monitored by self-regulatory bodies with enforcement Powers.[265] These categories of self-regulation are termed as 'soft' and 'hybrid' regulation respectively.

3.2.2.1. Soft Law

Soft law involves the purely voluntary, i.e. no formal sanctions arise from non-compliance, codes and guidelines articulating benchmarks for what is considered best practice in corporate governance. It also includes scholarly and trade writings (in the form of books, reports and articles) that have had some role in influencing companies to shape their internal arrangements and management to achieve best practice.[266]

Corporate governance objectives can be formulated in soft laws, like voluntary codes and standards, which do not have the status of law or regulation.[267] Such codes play an important role in improving corporate governance arrangements.[268] Codes of good governance increase transparency and as a consequence put managers under external pressure to establish governance

---

[262] Dennis Bogusz, **Corporate Governance or Corporate Governments? Voluntary Firm Practices on Paths to Regulation** 7, (PHD Thesis), Columbia University, (2011). Available at http://academiccommons.columbia.edu/catalog/ac%3A131555 Accessed on 23-Oct.-2014.
[263] Amiram Gill, *Corporate Governance as Social Responsibility*, 26 BER. J. INT. L. 466 (2008).
[264] Bogusz, *Supra n.* 262
[265] *Ibid.*
[266] Zadkovich, *Supra n.* 13, at 30
[267] OECD, *Supra n.* 55, at 30
[268] *Ibid.*

structures that allow them to comply with the code.[269] These codes allow firms to choose individual governance structures and simultaneously provide a framework to make these individual governance structures transparent to investors.[270]

3.2.2.2. Hybrid

The old dichotomy between self-regulation and state regulation had not been helpful in developing more effective systems of corporate regulation as legal scholars have been advocating for some time.[271] As noted above, the contemporary argument on corporate governance regulation is in favour of enforced self-regulation. This 'Hybrid' system of corporate governance regulation has been described as a type of 'enforced self-regulation'.[272] It consists of a collection of non-binding guidelines (often referred to as a code) together with a formal and mandatory requirement for standardized public reporting of firms about whether they comply with each of the guidelines (or not, and if so, why not).[273]

Such kind of regulatory system do not require a 'one size fits all' nor a 'tick a box' approach to corporate governance. Instead, they state aspirations of best practice for optimizing performance and accountability in the interest of shareholders and the broader economy.[274] If a company considers that a principle is inappropriate to its particular circumstances, it has the flexibility to decide whether or not to adopt it.[275] That choice is, however, tempered by the requirement to 'explain if not, why not' which operate under a 'comply or explain' regime.[276]

3.3. Merits and demerits of the two regulatory models

There has been an ongoing debate on international level about the desired extent of regulation for corporate governance. The wide range of opinions stretches from promoting legislative measures to avoiding any kind of regulation – even a self-regulatory code of conduct. The particular considerations central to the choice of an optimal regulatory framework is an analysis of costs

---

[269] Marc S. Rapp, Thomas Schmid, and Michael Wolff, **Hard or Soft Regulation of Corporate Governance?** 2. Available at www.ccfr.org.cn/cicf2012/papers/20120131034312.pdf Accessed on 11-Nov.-2014.
[270] *Ibid.*, p. 24
[271] Roman Tomasic (Prof.), *Company Law Modernization and Corporate Governance In The Uk— Some Recent Issues And Debates*, 1 VIC. L. SCH. J. 46 (2011).
[272] Zadkovich,, *Supra n.* 13, at 28
[273] Rapp et. al., *Supra n.* 223, at 2
[274] Zadkovich,, *Supra n.* 13, at 29
[275] *Ibid.*
[276] *Ibid.*

and benefits.[277] If the costs of a mandatory corporate governance regime outweigh its benefits, then, arguably, such regime should not be in place.[278] Specifically, the cost analysis can be completed by weighing the level of expected compliance against the aggregate costs of each type of regime.[279]

However, both of these regulatory systems are not free from weaknesses. The issue is how should they be structured to maximize their advantages and minimize the disadvantages? Subsequent sub-sections are dedicated to the discussions on the merits and demerits of state and self regulation of corporate governance. In doing so, five interrelated points of reference, i.e. minimum standards, compliance levels, costs to investors, costs to firms, and flexibility will be used.

3.3.1. Merits and demerits of state regulation

State regulation of corporate governance is considered as the traditional legal regime which is a scheme of rules that prescribes certain behavior, supported by penalties to which those who break the law are subjected. To start with its *merits*, it allows the state to establish minimum standards to which market participants must adhere.[280] For a state that accords primary importance to investor protection, enacting and implementing corporate governance legislation will ensure the achievement of its objective by compelling market participants to comply.[281]

The other advantage of state regulation of corporate governance is that the compliance level of companies is so high. As noted above, a state regulation is mandatory and backed by penalties for non-compliance. Thus, compliance will be especially high if the penalties for non-compliance are onerous.[282] There are, of course, some other factors in addition to the penalty that affect the compliance level of such regime. As Anand notes:

> ...if the regime has been in place for a number of years, and market participants are aware of the "rules of the game," including punishments in the case of breach, the regime exhibits

---

[277] Anand, *Supra n.* 24, at 34
[278] *Ibid.*
[279] *Ibid.*
[280] *Ibid.*, p. 8
[281] Rafael La Porta et al., **What Works in Securities Laws?** 12-13, (2004). Available at http://post.economics.harvard.edu/faculty/shleifer/papers/securities-final.pdf Accessed on 15-May-2014.
[282] Anand, *Supra n.* 225, at 239

consistency. Because of this broad-ranging compliance, the legal regime also has certain predictability. The well-founded assumption is that once the regime is implemented, the number of actors who deviate from the regime will be much smaller than the number of actors who comply. Thus, rates of compliance over time in a mandatory regime are both consistent and predictable.[283]

State regulation is also advantageous for uninformed investors. That means it decreases the cost of becoming an informed investor.[284] As mentioned hereinabove, mandatory legislations that aimed at protecting the interest of investors are the main tools in state regulation. Mandatory rules of company laws relate to the process of incorporation, the level of shareholders approval that must be reached for an ordinary or special resolution to be passed, and the authority of agents to contract on behalf of the firm.[285] Particularly, mandatory rules relating to disclosure stand as a shield for uninformed investors against the information asymmetries to which they are subject.[286]

Though state regulation has the above advantages, it is not free from weaknesses too. Because of the serious nature of state regulation, legislations need to be precise, need to define the prescribed action or omission and normally operate on a 'one size fits all' basis, which involves heavy regulation of companies and does not give companies much opportunity to implement practices that are best for the company.[287] This in turn inhibits the degree of flexibility in the way companies adopt and adapt governance practices that best suits their particular circumstances and affects the improvement of standards of corporate governance.[288]

While State regulation is cost-effective for investors, it occasions unnecessary costs for the state and, of course, for the firm.[289] In implementing a governance regime, the state will bear policy design cost, implementation costs and enforcement costs, including costs of monitoring the

---

[283] Anand, *Supra n.* 24, at 9
[284] Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COL. L. REV. 1549 (1989).
[285] Anand, *Supra n.* 24, at 11
[286] *Ibid.*
[287] Keith Johnstone & Will Chalk, What sanctions are necessary?, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE 169, (Ken Rushton ed., 2008).
[288] Bryan Nicholson (Sir), The role of the regulator, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE 101, (Ken Rushton ed., 2008).
[289] Anand, *Supra n.* 225, at 245, 250

market for abuses.[290] It is not only the state that suffers from costs of such regulation. Firms themselves have also to incur costs that arise from monitoring and assessing their own practices (e.g., conducting internal control reviews), implementing new governance structures, producing disclosure and reports, and, distributing disclosure.[291]

Some commentators even argue that fear of the penalties for non-compliance may not be a genuine incentive for the high level of compliance because firms may simply ignore the law and absorb the costs of non-compliance.[292] According to Anand,

> If the firm is performing well, investors will be pleased with the stock price, and deviations from corporate governance standards will likely be of secondary importance to them. Unless the penalty is strict, such as an order to cease trading in the firm's stock, non-compliance is a real option for firms that are performing well.[293]

Such regulatory model is also criticized for not taking advantage of firms' incentives to adopt healthy governance practices voluntarily, and it does not allow firms' flexibility in choosing governance practices that accord with their size, board structure etc.[294] Firms have limited choice regarding the content of rules and the means of compliance. That is, through mandatory rules of company laws, the state establishes not only the objective to be achieved but also the means to achieve the objective which has the potential to downgrade the attractiveness of a nation for business and investment.[295]

As noted above, even under a state regulation, firms may choose to absorb the costs of their non-compliance rather than complying with the law. Such non-compliance renders such regulatory system ineffective and raises questions about the incentive, i.e. fear of penalty, underlying that regime. A noteworthy explanation by Anand emphasizes that "of course, a firm's decision to absorb the costs of non-compliance will relate to the type of penalties that occur on breach, as

---

[290] *Ibid.*
[291] *Ibid.*
[292] Anand, *Supra n.* 24, at 14
[293] *Ibid.*, p. 14-15
[294] Nicholson, *Supra n.* 288
[295] Johnstone and Chalk, *Supra n.* 287, at 154

well as to the extent to which those penalties are enforced. If legal penalties are low or enforcement is expected to be lax, then noncompliance is a viable option".[296]

Therefore, this drives someone to rethink whether corporate governance regulation should be based on a state regulation or there could be a preferred structure of corporate governance regulation.

3.3.2. Merits and demerits of self-regulation

Self-regulation offers a number of potential advantages in the realm of corporate regulation. The first and most important advantage of such regime is flexibility. This regime does not subject companies to the same kinds of procedural and due process hurdles that state regulation does.[297] Capital markets are populated by business entities of different sizes and types which will prefer governance regimes that suit their own individual characteristics than a 'one-size-fits-all' regime.[298] Flexibility in the design of a firm's corporate governance practices is important and needs to be considered in terms of what is meaningful in light of the size of the firm, its stage of development, the sector in which the firm operates and the complexity of the business it runs.[299]

Flexibility will allow firms to adopt governance practices dictated by investor demand, and perhaps pressure from their competitors, rather than by prescribed legal rules.[300] This justifies why regulatory regimes must focus not only on investor protection but also on the efficiency that can be achieved by regulation that is cost-effective.[301] Thus, flexibility in a corporate governance regime is important for both firms and regulators, both of whom have an interest in a regime which is cost-effective.[302]

The other advantage of self-regulation in corporate governance is proximity; meaning that self-regulatory organizations (SROs) are, by definition, closer to the firm being regulated.[303]

---

[296] Anand, *Supra n.* 24, at 17
[297] Coglianese et al., *Supra n.* 245, at 6
[298] *Ibid.* p. 15
[299] *Ibid.*, p. 16
[300] Nolan Haskovec, **Codes of Corporate Governance** 16, A working paper, Millstein Center for Corporate Governance and Performance (2012).
[301] Anand et al., *Supra n.* 24, at 16
[302] *Ibid.*
[303] Coglianese *et al.*, *Supra n.* 245, at 6

According to Coglianese *et al.*, "this proximity means that self-regulatory organizations will generally have more detailed and current information about the industry, something that is especially helpful in rapidly changing sectors".[304]

Self-regulation is also considered as a better regulatory model in generating a higher level of compliance.[305] The high level of compliance in state regulation is conditioned on the existence of onerous penalties for non-compliance. Whereas the high rate of compliance in self-regulation is voluntary and conditioned on other factors different from fear of sanctions. One of the factors is the participation of firms in the adoption and development of self-regulatory rules. The greater the involvement of industry in setting the rules, the more those rules may appear reasonable to individual firms.[306] This regime is also the best avenue to generate rules that solve regulatory problems in ways more sensitive to industry practices and constraints, and hence it may be easier for firms to comply with them.[307]

The other factor for the possibility of high compliance level in self-regulation is peer pressure from firms within an industry to adopt heightened governance practice.[308] Peer pressure is a market-driven incentive for firms to act voluntarily with the idea that they have to adopt the existing practice because their competitors are doing so.[309] As more and more firms adopt and comply corporate governance practices over time, these voluntary practices become the norm among a majority of firms.[310]

Self-regulation is advantageous in minimizing the cost of the firm as well as the state. The cost of enforcement and market surveillance in such regime will not be as high as in state regulation.[311] However, where there is a mandatory disclosure requirement, it is true that the regulator would still have a role and incur enforcement costs in ensuring that firms are making

---

[304] *Ibid.*
[305] *Ibid.*
[306] *Ibid.*
[307] *Ibid.*
[308] Anand, *Supra n.* 225, at 240
[309] *Ibid.*, p. 241
[310] Anand, *Supra n.* 24, at 10
[311] *Ibid.*, p. 14

full, true and plain disclosure of all material facts in respect of certain documents such as the prospectus.[312]

Although self-regulation has these important advantages, it also has some noteworthy drawbacks. The first one relates to the cost to investors. Under purely voluntary governance system, there is less certainty for investors that the firm is indeed complying with the guidelines.[313] This is because the flexibility in self-regulation allows companies to set their own terms of reference. This makes it difficult for investors to assess the relative strength of a company's governance practices and to make comparison between different companies' governance practices.[314] Consequently, the investor incurs more costs for each company s/he assesses in order to learn about the governance regime that each individual company has adopted.[315]

The other disadvantage of self-regulation is the Inadequacy of Sanctions. The greater flexibility afforded to self-regulatory organizations also means they may have the discretion to mete out only modest sanctions against serious violators.[316] Moreover, Coglianese *et al.* argue that flexibility may also make it more likely that compliance with rules will be insufficiently monitored.[317] In other words, if company's interests are at variance with society's interests, then enforcement by self-regulators might be less than optimal for the overall good of the society.[318]

3.4. Instruments of self-regulation

3.4.1. Code of corporate governance

Codes of corporate governance are documents which state the principle, rules and procedures for making strategic decisions and prescribe the frameworks for governing corporations and

---

[312] Nicholson, *Supra n.* 288, at 106
[313] Anand, *Supra n.* 24, at 12
[314] *Ibid.*
[315] *Ibid.*
[316] Coglianese *et al.*, *Supra n.* 245, at 7
[317] *Ibid.*
[318] Gregory F. Maassen, Frans A. J. van den Bosch, and Henk Volberda, *The importance of disclosure in corporate governance self-regulation across Europe: A review of the Winter Report and the EU Action Plan*, 1 INT. J. DISC. & GOV.151 (2003).

achieving corporate objectives.[319] Codes of corporate governance are a set of best practice recommendations regarding the behavior and structure of the board of directors. They are instruments to tackle problems of transparency, accountability and conflicts of interest between management, investors and wider groups of stakeholders.[320] Monitoring and enforcement of compliance with code provisions is left to the capital market. That is, the decision of investors to fund a company is determined by a company's compliance with the standards of 'good corporate behaviour'.[321]

The commonly used and straightforward definition of code of corporate governance is "a non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations".[322] Aguilera and Cuervo-Cazurra consider the codes of good governance as:

> ...a set of 'best practice' recommendations regarding the behaviour and structure of the board of directors of a firm ... designed to address deficiencies in the corporate governance system by recommending a comprehensive set of norms on the role and composition of the board of directors, relationship with shareholders and top management, auditing and information disclosure, and selection, remuneration, and dismissal of directors and top managers.[323]

The first widely recognized national code of corporate governance was developed in the United Kingdom that arose from the report of the Cadbury Committee, under the leadership of Sir Adrian Cadbury, set up in 1992 by the London Stock Exchange and the UK Financial Reporting Council.[324] The Cadbury Code as a mode of regulation for the corporate sector was subsequently imitated in many countries throughout the world. According to the online index of codes available through the European Corporate Governance Institute, as of 2012, there are almost 90

---

[319] Ayodele A. Adekoya, *Corporate Governance Reforms in Nigeria: Challenges and Suggested Solutions*, 6 J. BUS. SYS., GOV. & ETH. 41 (2011).
[320] Susanne Lu¨tz, Dagmar Eberle, and Dorothee Lauter, *Varieties of private self-regulation in European capitalism: corporate governance codes in the UK and Germany*, 9 SOCIO-ECO. REV. 332 (2011).
[321] *Ibid.*, p. 333
[322] Seidl et al., *Supra n.* 251
[323] Ruth V. Aguilera and Alvaro Cuervo-Cazurra, *Codes of good governance worldwide, what is the trigger?* 25 ORG. STUD. 419-420 (2004).
[324] Maassen et al., *Supra n.* 318, at 148

countries with codes of corporate governance, with many countries having multiple codes.[325] Most of these codes focus on the role of the Supervisory Board or Board of Directors in a company.[326]

Apart from these national initiatives there are also some transnational initiatives like the 'OECD Principles of Corporate Governance', which are not so much directed at companies as such, but are primarily meant as guidelines for legislative and regulatory initiatives in both OECD and non OECD countries.[327] Thus, the 'OECD Principles of Corporate Governance' is considered as the first influential international code which was produced by an Organization for Economic Co-operation and Development (OECD) in 1999 following recommendations of a business advisory committee led by Ira Millstein.[328]

The code of corporate governance is not mandatory but prescriptive for an improved culture of good corporate governance.[329] It has generally been intended to be flexible and principles-based. The general aim of the code of corporate governance is to enhance systems and standards of governance in companies. Enhanced corporate governance will facilitate in improving efficiency and competitiveness in the business sector.[330] It will also bolster confidence in the capital market and the confidence of the society generally, in the way in which businesses function.[331] In contrast to statutory law which imposes minimum standards, codes aim at improving corporate behaviour by introducing heightened standards through best practices.[332] In other words, it may serve to either supplement or go beyond any minimum governance regulations to which the company may already be subjected.

In furtherance of the understanding of the purpose of codes of corporate governance, exploring some additional literatures would be worthwhile. Haskovec explains the aim of codes of

---

[325] Haskovec, *Supra n.* 300, at 12
[326] IFC, *Supra n.* 27, at 57.
[327] Seidl *et al.*, *Supra n.* 245
[328] Maassen *et al.*, *Supra n.* 318
[329] Private Sector Federation, **Guiding Code of Corporate Governance** 3, Rwanda, (2008). Available at www.psf.org.rw Accessed on 11-Mar.-2014.
[330] *Ibid.*
[331] *Ibid.*
[332] Sridhar R. Arcot and Valentina G. Bruno, **One size does not fit all, after all: Evidence from Corporate Governance** 5, (2006). Available at siteresources.worldbank.org/INTFR/.../Valentina_Bruno_Feb_8.**pdf** Accessed on 2-May-2014.

corporate governance as it is intended to specifically guide behavior where the law is ambiguous or where a higher level of behavioural prescription is needed than can be provided for in company legislation.[333] It aims to improve the general quality of corporate governance practices by defining best practices of corporate governance and specific steps that organizations can take to improve corporate governance.[334] The Code, thereby, begins to raise the quality and level of corporate governance to be expected from organizations; in some areas the Code specifies more stringent practices than is required by the company law, but it should be emphasized that these additional requirements are in keeping with international best practices.[335]

There are potent arguments on the need for the introduction of a code of corporate governance. Those arguing for not introducing a code of corporate governance point to the high ethical standards already upheld by most corporations.[336] They also opined that introducing a code will be redundancy to the already existing controls on corporate behavior as encoded in documents such as company law.[337] Moreover, they argue that codes can impose cumbersome requirements on companies to comply, without any proven effects on performance.[338]

On the other hand, proponents forward three main reasons for which the introduction of a code would be beneficial for corporations and the economy of a nation as a whole. First, global investors will increasingly be using the existence of codes of best practices as one important yardstick to judge the quality of corporate governance in a country, and how serious that country is about improving its corporate governance practices.[339] The noticeable effect of globalization is that any single country cannot plausibly choose to isolate itself from global markets and trends without suffering severe economic and social consequences.

Secondly, as noted hereinabove, a code of best practices in corporate governance would contain clear guidelines for directors as to what the best practices are and what they should do to attain

---

[333] Haskovec, *Supra n.* 300, at 8
[334] *Ibid.*
[335] *Ibid.*
[336] Heracleous, *Supra n.* 174
[337] *Ibid.*
[338] *Ibid.*
[339] Haskovec, *Supra n.* 300, at 11

them. Thus, directors will not be in difficulty to improve their current practices accordingly.[340] Thirdly, proponents point out that a code of corporate governance grant benefits that legislation cannot. Such codes are flexible, since they are procedurally lax, amenable to the characteristics of each company, and they can be altered much faster than legislation to respond to changing conditions.[341] Heracleous emphasizes further that codes of corporate governance are "more user-friendly than legislation, in the sense that directors can read and understand codes in just a few minutes, but would require a lot of time, strong motivation, and specialist knowledge to read and understand a company law".[342]

Notwithstanding all their benefits, it is important to note that codes of best practices are not panacea. They form part of a larger whole of institutional arrangements, laws, company and industry codes of ethics, and most importantly, personal morality.[343] However, they do have an important part to play in improving practice by making people aware of what the best practices are, and inducing them to follow these practices.[344]

3.4.2. The 'comply-or-explain' principle- a flexible framework

Compliance is, of course, the determining factor in regulation of whatever model, either state or self regulation. However, compliance may not be always the best option for regulatees due to two different reasons. The obvious one is that they may be prevented from conforming for reasons beyond their control.[345] The other reason is that they may determine that the principle underpinning a particular rule or guidance on best practice will, in their case, be best served by non-compliance.[346] This use of discretion to determine conformance or non-conformance, known as the 'Comply-or-explain' principle, can be invaluable, not only for regulatees, but also for regulators.[347]

---

[340] David Jackson, The role of the Company Secretary, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE 74, (Ken Rushton ed., 2008).
[341] Ian MacNeil & Xiao Li, *"Comply or Explain": market discipline and non-compliance with the Combined Code*, 14 J. CORP. GOV. 493 (2006).
[342] Heracleous, *Supra n.* 174, at 61
[343] *Ibid.*, 62
[344] *Ibid.*
[345] Paul Sanderson et al., **Flexible or not? The comply-or-explain principle in UK and German corporate governance** 4, (2010). Available at regulation.upf.edu/dublin-10-papers/4A2.**pdf** Accessed on 4-March-2014.
[346] *Ibid.*
[347] *Ibid.*

However, regulators are concerned about how the decision not to conform is made. That is, regulators need to make sure that the decision is not made for narrow self-interest reasons that conflict with the principle underpinning the discretionary rule.[348] In the wordings of Montagnon, "regulators' natural desire is to sleep easy in their beds at night, secure in the knowledge that they will not be awakened by scandal in the morning".[349] Thus, regulators need to monitor and have to make a determination on whether the regulatees' decision not to comply is indeed genuine and their deviation is consistent with the regulatory objective.[350] In doing so, regulators will depend on the explanation made by the regulatees.

That is why it is said that in a 'comply or explain' framework, the key word is "explanation", not "compliance". If we want full compliance, we should better regulate a given sector in the law, not in a voluntary code.[351] Strenger *et al.* note that "explanations should serve a twofold role: (i) convince the market that a given practice is sound, even if not in line with a code's recommendations; and (ii) make sure the board takes the governance of its company into full consideration".[352] Therefore, compliance statement serves the essential scope of informing the market on a number of non-financial issues, which are crucial in understanding how a company is directed and on how controls are implemented.[353]

The comply-or-explain approach was an innovation in corporate governance regulation introduced for the first time in 1992 by the Cadbury Report.[354] According to Sir Adrian Cadbury, the "comply or explain" approach is preferable to statutory measures because it does not commit companies to a 'one-size-fits-all' approach and thus diminishes the risk of complying with the letter, rather than the spirit of the Code.[355] It is mandatory for companies to state in their annual

---

[348] *Ibid.*, p. 5
[349] Peter Montagnon, The role of the shareholder, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE 83, (Ken Rushton ed., 2008).
[350] Sanderson et al., *Supra n.* 345, at 5
[351] Gian P. Cigna, Southern Europe: Regional Perspectives and Key Considerations, in KEY CORPORATE GOVERNANCE ISSUES IN EMERGING MARKETS: THEORY AND PRACTICAL EXECUTION 57, (Christian Strenger et al., 2012).
[352] *Ibid.*
[353] *Ibid.*
[354] Arcot and Bruno, *Supra n.* 332
[355] *Ibid.*

reports whether they comply with the Code and to identify and give reasons for any areas of non-compliance in light of their own particular circumstances.[356]

It will be worthwhile to consider the preamble of the Combined Code of UK which provides the 'comply-or-explain' principle. It reads;

> If a company chooses not to comply with one or more provisions of the Code, it must give shareholders a careful and clear explanation which shareholders should evaluate on its merits. In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates and contribute to good governance.[357]

Hence, if a company deems it preferable to set aside a specific provision of the code, it may do so provided that it states its reasons. According to Wymeersch, this is the "explain" alternative.[358] If a company prefers to comply, codes introduce significant flexibility in the system, and allow a company to take account of the myriad of individual situations.[359] Therefore, codes are incentives for companies to grow towards better governance practices, without having to revolutionize their internal structures and procedures.[360]

In providing an explanation, the company should aim to illustrate how its actual practices are consistent with the principle to which the particular provision relates, contribute to good governance and promote delivery of business objectives.[361] It should set out the background, provide a clear rationale for the action it is taking, and describe any mitigating actions taken to address any additional risk and maintain conformity with the relevant principle.[362] Where

---

[356] *Ibid.*

[357] Financial Reporting council, **The Combined Code on Corporate Governance** 5, (2008). Available at http://www.ecgi.org/ Accessed on Accessed on 5-Sep.-2014.

[358] Eddy Wymeersch, **Corporate governance codes and their implementation** 60, Belgian Banking, Finance and Insurance Commission, (2006).

[359] *Ibid.*

[360] *Ibid.*

[361] Financial Reporting Council, **The UK Corporate Governance Code** 4, (2012). Available at http://www.ecgi.org/ Accessed on 11-Mar.-2014.

[362] *Ibid.*

deviation from a particular provision is intended to be limited in time, the explanation should indicate when the company expects to conform to the provision.[363]

Companies that choose not to comply with the code but provide a robust explanation for such divergence are generally considered by the market to have complied with the code.[364] It is then up to stakeholders such as investors to determine whether the explanation is persuasive.[365] As Haskovec opines, "investors' judgment may affect the way they vote, engage, or buy and sell the company's shares. Companies that fail to supply an explanation, or that offer little by way of justification for a deviation, may be considered to have failed to comply with the code".[366]

3.4.2.1. Incentives for Code compliance

Before we consider the incentives for code compliance, let us look at the incentives for the adoption of a code. Firms have significant incentives to adopt a governance reform. These incentives include the competition for scarce capital and the threat of mandatory regulation.[367] To start with the first incentive, in the competition for scarce capital, firms will seek to attract investors, and, since investors generally value good corporate governance, firms have a major incentive to adopt enhanced governance practices.[368] In other words, firms have a strong incentive to institute corporate governance practices voluntarily in order to prevent investors from devaluing the firm. The consequence of devaluation is that investors will take their money elsewhere; especially if other firms are readily adopting these best corporate governance practices.

With respect to the other incentive for adopting a code voluntarily is perhaps a firm's desire to pre-empt government regulation by adopting certain practices in advance of a legal rule compelling them to do so.[369] If firms have advance warning that legislative change may occur,

---

[363] *Ibid.*
[364] Haskovec, *Supra n.* 300, at 11
[365] *Ibid.*
[366] *Ibid.*
[367] Anita Anand et al., **Voluntary vs. Mandatory Corporate Governance Regulation: Theory and Evidence** 3, (2005). Available at www.law.harvard.edu/ Accessed on 13-Mar.-2014.
[368] Anand, *Supra n.* 225, at 236
[369] Haskovec, *Supra n.* 300, at 19

they will commit to a certain level of self-regulation so that subsequent regulatory initiatives may be weakened or made unnecessary.[370]

However, a voluntary adoption of a code of corporate governance is not an achievement by itself. What matters most is voluntary compliance with the code. Proponents of soft law argue that our innate desire to conform to social norms produces genuine compliance.[371] Moreover, there are numerous instruments and techniques that support the voluntary compliance of codes of corporate governance.[372] Among others, market pressure and the fear of reputational damage often suffice for firms to adhere to the code voluntarily.[373]

As noted hereinabove, codes of good governance with a principle of 'comply-or-explain' increase transparency and as a consequence put managers under external pressure to establish governance structures that allow them to comply with the code. Through the requirement of disclosure, the codes expose a company and its board to justification, external criticism and most importantly to market assessment.[374] Nowadays, the media has become more concerned with the disclosure statements of firms and regularly expose blatant governance practices.[375] Thus, board members will voluntarily adhere to good governance practices and comply with the code in order to protect their reputation as well as capital of the firm.[376]

The other noteworthy point which the writer does not want to disregard is the incentive for disclosure. The desire to prevent investors from devaluing the firm provides an important incentive to disclose information voluntarily.[377] According to the "no news is bad news" hypothesis, firms may believe that if they withhold information, investors are likely to conclude that the information is bad news.[378] Anand emphasizes that "withholding information increases market "noise" because of the range of possible interpretations of the information. As a result, the expected cost of investors' discounting the value of the firm is so high that the manager is

---

[370] *Ibid.*
[371] Sanderson *et al.*, *Supra n.* 345
[372] Wymeersch, *Supra n.* 358, at 61
[373] *Ibid.*
[374] Montagnon, *Supra n.* 349, at 82
[375] *Ibid.*, p. 83
[376] Charles Mayo, Directors' duties, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE 120, (Ken Rushton ed., 2008).
[377] Anand, *Supra n.* 24, at 22
[378] Robert E. Verrecchia, *Discretionary Disclosure*, J. ACC. & ECO. 5, 180 (1983).

better served by making disclosure".[379] Thus, while disclosure assists in preventing devaluation of the firm by the market or investors, the threat of devaluation in turn provides an important incentive for voluntary disclosure that motivates code compliance.

3.4.3. Disclosure Alternatives

The term "disclosure," as used here, refers to both financial and non-financial information, including information relating to the firm's governance structure. From the company's point of view, disclosure can be a cost-effective means of satisfying investors' demand to know the exposure of the company to risks arising from its business activities, social and environmental conduct.[380] A clear pre-requisite for corporate self-regulatory codes to be effective is disclosure.[381] The general purpose of disclosure is to provide the market with more information to enable investors to assess governance along with other criteria in their purchase, sell, hold and voting decisions. Providing information on which sound investment decision can be made is the goal of all disclosure requirements so as to reduce uncertainties and understand as much as possible the values of the company as can be inferred from its reports.[382]

Corporate governance disclosure is a fundamental theme of the corporate regulatory system, which encompasses providing 'governance' information to the market in a variety of ways. Hence, disclosure of information can be a powerful regulatory tool in corporate governance.[383] In other words, disclosure can sometimes provide a more efficient regulatory tool than substantive regulation through more or less detailed rules.[384] It enhances accountability for the company's governance and transparency on the "true and fair" view of the state of affairs of the company.[385] As said above, disclosure requirement creates an incentive to comply with best practices, and

---

[379] *Ibid.*

[380] David Graham and Ngaire Woods, *Making Corporate Self-Regulation Effective in Developing Countries*, 34 W. DEV. J. 873 (2006).

[381] *Ibid.*, p. 877

[382] Chima M. Damagum and Emmanuel I. Chima, *The Impact of Corporate Governance on Voluntary Information Disclosures of Quoted Firms in Nigeria: An Empirical Analysis*, 4 R. J. FIN. & ACC. 168 (2013).

[383] Maassen *et al.*, *Supra n.* 318, at 148

[384] Madan L. Bhasin, *Voluntary Corporate Governance Disclosures: Evidence From A Developing Country* , 9 F. EAST J. PSY. & BUS. 11 (2012).

[385] Maassen *et al.*, *Supra n.* 318, at 148

allows shareholders and stakeholders to take necessary actions. It creates a lighter regulatory environment and allows for greater flexibility and adaptability.[386]

Companies are unlikely to disclose in any meaningful way unless their reporting is mandated by the government.[387] This is because a voluntary system of disclosure would likely disfavours companies that comply with disclosure requirement than rival companies which did not. Consequently, the disfavoured companies would suffer as competitor companies and regulators may use the disclosed information to their own advantage.[388] However, the vast majority of codes call on companies to provide greater disclosure, on voluntarily basis, of corporate governance practices, including in some instances, disclosure about the extent of compliance with a particular code.[389] Discussions on the two modes of disclosure, i.e. voluntary and mandatory disclosure, are provided hereafter.

3.4.3.1. Voluntary Disclosure

Voluntary disclosure includes information in the annual reports which are in excess of mandatory disclosure requirements and relates to freedom of managers to disclose such in the annual reports without any compulsion.[390] Even in the absence of mandatory requirement of disclosure, firms may be motivated to disclose information concerning their governance voluntarily. As noted above, firms' desire to deter investors from devaluing them provides an important incentive to disclose information voluntarily. The absence of any information about a firm invites a range of possible interpretations. There is a possibility to interpret the absence of any news about a firm as bad news. Thus, a voluntary disclosure helps firms to avoid such range of possible interpretations and assist investors to value firms.

Voluntary disclosure is regarded as an external mechanism for the control of the leaders, the protection of shareholders, and the minimization of the agency costs resulting from the asymmetry of information between insiders and outsiders. Though, no doubt, firms recognize

---

[386] Bhasin, *Supra n.* 384
[387] Graham and Woods, *Supra n.* 380, at 876
[388] *Ibid.*, p. 877
[389] Holly J. Gregory and Robert T. Simmelkjaer, **Comparative Study Of Corporate Governance Codes Relevant to the European Union And Its Member States** 68, Weil, Gotshal & Manges LLP (2002).
[390] Damagum and Chima, *Supra n.* 382, at 166

that they can benefit from making voluntary disclosures about corporate governance, the disclosure costs create disincentives.

Voluntary disclosures can also create competitive disadvantages for the firm. Firms will be reluctant to disclose information from which their competitors can benefit.[391] If a firm's rivals can use voluntary disclosure to become more competitive, the benefits of the disclosure are reduced and a firm will not be motivated to disclose voluntarily. The disincentives will be stronger if a firm has bad news relating to its governance practices to report than if it has positive information.[392] But even if a firm has good news relating to its governance, it may be reluctant to disclose it since enhanced transparency will leave firms open to potential criticism by the market for the structure that it has chosen.[393]

Therefore, firms will assess the costs and benefits of possible disclosures and will voluntarily disclose information that is likely to result in the highest net benefit to the firms.[394] As a result, the credibility of voluntary disclosure will be questioned. That is, the board is likely to make self-serving voluntary disclosures, revealing only information that reflects positively on them.[395] They may refrain from disclosing information relating to poor firm performance and may attempt to convince the market that adopting a particular practice is not in the company's or shareholders' best interest.[396] Hence, given the disincentives and drawbacks of a voluntary disclosure, it seems necessary to consider the potential usefulness of a mandatory disclosure regime in the corporate governance context.

3.4.3.2. Mandatory Disclosure

Mandatory disclosures are those statutorily required to be disclosed by companies. For companies to disclose in any meaningful way, their reporting should be mandated by the government. Mandatory disclosure recognizes that the market alone is not sufficient to encourage voluntary action. There is a need to devise a mechanism that can attack the classic

---

[391] Robert E. Verrecchia, Essays on disclosure, 32 J. ACC. & ECO. 182 (2001).
[392] Ronald A. Dye, *Disclosure of Non-proprietary Information*, 23 J. ACC. R. 129 (1985).
[393] Bhasin, *Supra n.* 384
[394] Haskovec, *Supra n.* 300, at 17
[395] Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 485 (2007).
[396] *Ibid.*

problem of information asymmetry between the investor and the issuer.[397] It is mandatory disclosure that serves to reduce the adverse impact of information asymmetry in the capital markets.[398] It enables investors to determine whether the price of the security is fair and whether the issuer is credible.[399] Furthermore, it ensures that information will be conveyed to investors in a standardized manner by controlling other variables, such as the time, place, and manner of the disclosure.[400]

In addition to solving the credibility problem, mandatory disclosure is perhaps the most important aspect of corporate governance reform as it provides transparency and thereby avoids the exploitation of uninformed investors.[401] Mandatory disclosure also enhances compliance with the codes of best practices. If a firm knows that the market is watching its corporate governance practices, it will have a greater incentive to comply with the voluntary guidelines that investors deem desirable.[402] Moreover, it encourages competition amongst firms to adopt codes of best practices which investors value most.

Several codes of corporate governance rely on a mandatory disclosure requirement to encourage compliance, usually through linkage of the code to listing rules of stock exchanges and the requirement of "comply or explain".[403] Listed companies are required to disclose whether they comply with the specified code or explain any deviations. The disclosure requirement on a "comply or explain" basis is a means of encouraging adoption of specific corporate governance practices.[404] Many companies may consider compliance except as to those few points on which they believe they have strong justification for deviation.[405]

---

[397] S.P. Kothari et al., *The Effect of Disclosures by Management, Analysts, and Business Press on Cost of Capital, Return Volatility, and Analyst Forecasts: A Study Using Content Analysis*, 84 THE ACC. REV. 1645 (2009).
[398] *Ibid.*
[399] Manne, *Supra n.* 395, at 488-489
[400] Frank H. Easterbrook and Daniel R., *Fischel, Mandatory Disclosure and the Protection of Investors*, 70 VIR. L. REV. 700 (1984).
[401] *Ibid.*, p. 694
[402] Anand, *Supra n.* 225, at 248
[403] Gregory and Simmelkjaer, *Supra n.* 389, at 69
[404] *Ibid.*
[405] *Ibid.*

The Cadbury Report was the first code to suggest disclosure on a "comply or explain" basis as a means of encouraging companies to follow best practice recommendations.[406] The London Stock Exchange required listed companies to include a statement of compliance with the Cadbury Code of Best Practice in annual reports and accounts.[407] The company's statement must be reviewed by the auditors before publication as it relates to certain provisions of the Combined Code.[408]

3.5. International experiences

Under this sub-chapter, some international experiences will be considered in order to understand the contemporary trend in corporate governance regulation. The selected experiences herein below are basically from two categories, i.e. from developed and developing markets. The US, UK, and Germany are with developed markets as well as taken as revolutionaries in corporate governance reforms. They also influence corporate governance reforms of other nations. The Republic of South Africa and Nigeria are among the developing markets in Africa but role models in corporate governance reform.[409]

A. The United States

There are still some who wrongly believe that corporate governance was an invention of the Cadbury Report.[410] It is also noteworthy that the Cadbury Report dealt only with a limited area of corporate governance, namely 'Financial Aspects of Corporate Governance'.[411] For the first time, it was the American Law Institute's *Principles of Corporate Governance,* published in 1982, that set out the theories of shareholders primacy and profit maximization in expressing 'the objective and conduct of a corporation'.[412]

---

[406] MacNeil and Li, *Supra n.* 341, at 486
[407] Seidl et al., *Supra n.* 251, at 10
[408] Gregory and Simmelkjaer, *Supra n.* 389, at 70
[409] Isimkah Ibuakah, Key Issues and Challenges for Corporate Governance Reform in Nigeria, in KEY CORPORATE GOVERNANCE ISSUES IN EMERGING MARKETS: THEORY AND PRACTICAL EXECUTION 14-17, A Conference Book, Germany, Center for Corporate Governance, (Christian Strenger et al., 2012). See also Evelynne Change, Corporate Governance Reform In Africa: Key Considerations, in KEY CORPORATE GOVERNANCE ISSUES IN EMERGING MARKETS: THEORY AND PRACTICAL EXECUTION 26, 33, A Conference Book, Germany, Center for Corporate Governance (Christian Strenger et al., 2012).
[410] Du Plessis et al., *Supra n.* 1, at 300
[411] *Ibid.*
[412] *Ibid.*, p. 301

The passing of the (Sarbanes-Oxley Act) SOX should be seen against the backdrop of several huge corporate failures in the USA. These collapses, in particular Enron and WorldCom, caused serious concern and became such a political issue that the United States government of the day (the Bush Administration) saw no option but to act quickly and radically.[413] Because these corporate failures stemmed from lax accounting and corporate governance practices, 'corporate responsibility' became an important political issue in the United States, for the first time.[414] In late July of 2002, Congress passed the Sarbanes-Oxley Act (SOX), which is indeed a blunt statutory instrument, with heavy civil and criminal sanctions for contraventions.[415]

The United States' approach was, from the passing of SOX, based on a prescriptive, rule-based legal approach to governance, while the UK approach is still based on a non-prescriptive, principles based, and self-regulatory approach.[416] The principle underlying SOX is 'comply or else'. In other words, as seen above, there are legal sanctions for non-compliance that could lead to people being convicted of crimes and being sent to jail for long periods or huge fines imposed for non-compliance.[417]

The criticism on SOX is that the corporate failures had occurred despite the existence of such a draconian piece of legislation.[418] In addition, it has been pointed out that the compliance or agency cost of SOX far outweighs its efficiency. It has, for instance, been said that the "total cost to the American economy of complying with SOX is considered to amount to more than the total write-off of Enron, WorldCom and Tyco combined".[419] As Duncan Niederauer, chief executive officer (CEO) of the New York Stock Exchange, stated the regulatory framework in the USA is under strain and requires reform.[420] According to Niederauer, one of the core principles that

---

[413] John W. Cioffi, *Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany*, 7 GER. L. J. 547 (2005).

[414] Lyman Johnson, **Law And The History of Corporate Responsibility** 21, Minneapolis, University of St. Thomas, Center for Ethical Business Cultures (2011).

[415] Gregory Jackson, **Understanding Corporate Governance in the United States: An Historical and Theoretical Reassessment** 39, (2010). Available at www.boeckler.de Accessed on 30-Oct.-2014.

[416] Nicholson, *Supra n.* 288, at 100 and 107-8

[417] **King Report on Governance for South Africa** 7, Institute of Directors(2009). Available at http://african.ipapercms.dk/IOD/KINGIII/kingiiireport/ Accessed on 20.-July-2014.

[418] *Ibid.*, p. 9

[419] *Ibid.*, p. 7

[420] Du Plessis et al., *Supra n.* 1, at 309

should guide modern and proactive regulatory reform is that "a new regulatory system must stress smarter regulation, not overregulation".[421]

The current U.S. corporate governance regime is composed of both the SOX and stock exchange (SEC) requirements for listed companies.[422] Though it is true that they have elements that take the "if not, why not" approach of the Australian regime, the mandatory elements in these structures are extensive.[423] The majority of elements of SOX, in conjunction with the elements of the New York Stock Exchange (NYSE) Rules (approved by SEC in 2003), certainly warrant referring to the U.S. regime as mandatory.[424]

A worth mentioning point here is that the U.S. mandatory regime is clearly not the structure that most countries have adopted.[425] Out of the 28 countries examined by Anand, 12 countries had a completely voluntary governance regime, 14 countries had a partially mandatory regime and only two had a mandatory structure (the U.S. and Pakistan).[426] As Anand opined:

> ...at least one reason for this regulatory difference among countries is that the mandatory regime occasions unnecessary costs; it does not take advantage of firms' incentives to adopt healthy governance practices voluntarily, and it does not allow firms flexibility in choosing governance practices that accord with their size, board structure etc.[427]

B. The UK

In the wake of various corporate scandals and widespread dissatisfaction with lax governance and abuse of auditing and reporting standards that allegedly had made these scandals possible, a committee, chaired by Sir Adrian Cadbury, was set up by the Financial Reporting Council, the London Stock Exchange (LSE) and the accountancy profession in order to address the financial aspects of corporate governance.[428] At the heart of the committee's recommendations was a

---

[421] *Ibid.*
[422] Anand, *Supra n.* 24, at 31
[423] *Ibid.*, p. 32
[424] *Ibid.*
[425] *Ibid.*, p. 34
[426] *Ibid.*, p. 48. The countries examined by Anand are only countries that had released a Code (or Draft Code) post the enactment of Sarbanes-Oxley Act.
[427] *Ibid.*, p.34
[428] Du Plessis et al., *Supra n.* 1, at 312

Code of Best Practice, designed to achieve high standards of corporate behaviour.[429] The committee believed that had a Code of Best Practice been in existence, a number of unexpected company failures and frauds, which had occurred in the UK, could have been avoided.[430]

As mentioned many times in this thesis, the 1992 Cadbury Code is the best known of the pioneer corporate governance codes and the one that set the pattern for many subsequent efforts. The code system was a response to the Maxwell and Polly Peck scandals of that period and used to protect UK companies and their shareholders from the impact of subsequent crises of the stock market at the end of the 1990s.[431]

The Financial Reporting Council (FRC) is the UK's independent regulator for corporate reporting and governance.[432] It has ultimate responsibility for maintaining and updating the UK Corporate Governance Code.[433] The FRC is still considered to be a better form of self-regulation and market-driven regulation of corporate governance than a full-on regulatory regime following SOX in the USA.[434]

The U.K.'s corporate governance regime is a partially voluntary system under the Combined Code.[435] Voluntary compliance with the Combined Code is ensured through the Listing Rules of the London Stock Exchange, which require that as a general rule listed public companies must comply with the Code or explain why they are not complying – the so-called principle of 'comply or explain'.[436]

C. Germany

Germany's corporate governance system relied traditionally on mandatory statutory rules rather than on instruments of corporate self-regulation.[437] However, the picture has changed over the past ten years due to the globalization of the world's economies and the increasing influence of

[429] *Ibid.*, p. 313
[430] *Ibid.*
[431] Montagnon, *Supra n.* 349, at 81
[432] Haskovec, *Supra n.* 300, at 12
[433] *Ibid.*
[434] Du Plessis et al., *Supra n.* 1, at 315
[435] Anand, *Supra n.* 24, at 29
[436] *Ibid.*, p. 30
[437] Lutz-Christian Wolff, *Self-governance German style: comply or explain ...but, if you explain we will make you comply*, 1 THE COR. GOV. L. R. 376 (2005).

the Anglo-American corporate governance culture.[438] Consequently, starting from the mid-nineties of the last century several initiatives have been launched on various levels in order to introduce instruments of corporate self-regulation in Germany.[439] This development culminated in the introduction of the German Corporate Governance Code (Cromme Code) in February 2002.[440] The introduction of the German Code was widely welcomed as a step to improve the German corporate governance system.

The German Corporate Governance Code, like others, is meant to establish standards of good corporate governance. It applies to listed companies, but recommends for non-listed companies to observe its stipulations as well.[441] The stipulations of the German Code are divided into three categories: (1) provisions which only repeat the law as it is currently in force and which are therefore only of a declaratory nature, (2) recommendations, and (3) "soft" suggestions, which may or may not be followed without any consequences.[442] In relation to the recommendations, which are regarded as the core of the German Code, a "comply-or-explain approach"" is adopted.[443]

The German corporate governance system offers a distinct pattern of regulation, which differs significantly from its Anglo-American counter parts in many ways. These include the involvement of employees in the company's strategic decision-making process ("co-determination"), primacy is given to stakeholder-value principle, the two-tier board system- i.e., distinguishing between management board and supervisory board.[444]

D. The Republic of South Africa

Among emerging markets worldwide, South Africa stands out as a particularly interesting case in which to investigate how processes of corporate governance reform unfold. South Africa is Africa's largest and most sophisticated economy and its financial institutional structures are

---

[438] *Ibid.*
[439] *Ibid.*
[440] Marc Goergen et al., *Recent developments in German corporate governance*, 28 INT. REV. L. & ECO. 198 (2008).
[441] Wolff, *Supra n.* 437, at 377
[442] *Ibid.*
[443] *Ibid.*
[444] Goergen et al., *Supra n.* 440, at 176

advanced as compared to other emerging markets. It has set a good example for implementing corporate governance codes in developing markets – though its successes may not be easily replicable.[445]

In 1993, the Institute of Directors established a committee with the additional sponsorship of the leading business organizations and named as chair Mervyn King, a businessman, lawyer, and former judge.[446] The committee was charged to study and make recommendations regarding South Africa's corporate governance.[447] Hence, in 1994, the committee has come up with the King I report which incorporates recommendations to promote the highest standards of corporate governance in South Africa.[448]

The scope of the 1994 King I report went far beyond the financial and regulatory aspects of corporate governance to include social, ethical and environmental best practice.[449] Since corporate governance is an evolving process, the King II Code of Corporate Practices and Conduct was introduced in 2002.[450] It has raised the stakes for businesses in areas such as health and safety, environmental impact, corporate social investment (CSI), diversity and the development of human capital.[451] The introduction of King III in early 2009 raised the bar on governance yet further and addressed a wide range of issues.

The philosophy of the King III code revolves around leadership, sustainability, and corporate citizenship.[452] Responsible leaders direct company strategies and operations with a view to achieving sustainable economic, social, and environmental performance.[453] The code is not designed on a "comply or else" basis, nor on a "comply or explain" basis, but on an "apply or explain" basis.[454] This provides boards with the freedom to apply the recommendation

---

[445] Hontz and Shkolnikov (eds), *Supra n.* 28, at 38
[446] Haskovec, *Supra n.* 300, at 15
[447] *Ibid.*
[448] Spencer Stuart consultancy firm, (2009). **Board Governance in South Africa**, p. 2. Available at https://www.spencerstuart.com/.../**PDF**%20Files/Research%20and%20Insi... Accessed on 30-Oct.-2014.
[449] *Ibid.*
[450] *Ibid.*
[451] *Ibid.*
[452] King Report, *Supra. n.* 417, at 12
[453] *Ibid.*, p. 13
[454] UNCTAD, *Supra n.* 86, at 27

differently, or apply another practice, if they consider that to be in the best interest of the organization, but then they must explain the departure from the recommendation.[455]

For Mervyn King, the 'comply or else' regime of, for example, the US Sarbanes-Oxley (SOX) Act does not work, because then you get mindless compliance, i.e. a 'tick off' compliance.[456] For instance, engineering firms that had to comply with SOX had to hire accountants and lawyers rather than engineers, simply because of the fear of criminal prosecution.[457] There should be civil remedies instead, like a name-and-shame game, but the ultimate sanction is the marketplace and the ultimate compliance officers are a company's stakeholders.[458]

King III code adopts two models of corporate governance: "stakeholder inclusive" and "enlightened shareholders". The "stakeholders inclusive" model dictates the board of directors to consider the legitimate interests and expectations of stakeholders, on the basis that this is in the best interests of the company.[459] Whereas In an "enlightened shareholder" model these interests and expectations would only be considered if they were in the interest of the shareholders.[460] A worth noting point here is that the code recommends integration of economic, social, and environmental reporting, recording how the company's business has impacted positively and negatively on the community, and how it intends to enhance those positive aspects and eradicate or ameliorate the negative aspects in the year ahead.[461]

E. Nigeria

Over the years, investors and depositors in numerous companies in Nigeria have encountered untold hardship and loss due to weak corporate governance practices, regulation and implementation.[462] Though there were laws and corporate governance codes for ensuring good corporate governance in Nigeria, its legal enforcement and regulatory framework were weakened

---

[455] *Ibid.*
[456] King Report, *Supra. n.* 417
[457] *Ibid.*
[458] *Ibid.*, p. 8
[459] Thomas Gstraunthaler, *Corporate Governance In South Africa: The Introduction Of King Iii And Reporting Practices*, 7 J. COR. O. & CON. 149 (2010).
[460] *Ibid.*
[461] *Ibid.*, p. 148
[462] Chimere, *Supra n.* 214, at 50

and made inefficient by different challenges.[463] Notwithstanding the socio-political, economic and cultural factors which create the dismal corporate governance environment in the country, institutionalized corruption has been widely accepted as the bane of poor corporate governance in Nigeria.[464]

Moreover, in the face of the recent global economic crises, Nigeria boldly admitted that it is not immune to the global economic meltdown.[465] Chimere makes a note that:

> The global financial crisis left the Nigerian economy with dwindling government revenues, a weakened banking sector, a devalued currency, crash of the stock market among other tales of economic woes and thus, undermined confidence in the financial sector. Nigeria's experience of the recession triggered the review of the regulations of some corporation laws and promulgation of corporate governance Codes. [466]

As mentioned above, prior to the introduction of the new code of corporate governance by the Central Bank of Nigeria (CBN), there were in existence disparate codes of corporate governance regulating the activities of companies, banks in particular, in Nigeria but as admitted by the CBN these codes were manifestly ineffective and inadequate.[467] Thus, in general, the corporate governance situation in Nigeria does not represent a complete lack or absence of structures, legislations and regulations rather, the ineffectiveness of the legislations and structures to effectively ensure compliance and enforcement entail poor corporate governance practices.[468]

As in most developed countries, Nigeria has adopted a combination of mandatory and voluntary regulatory mechanism.[469] In 2001, the Atedo Peterside committee set up by the Securities and Exchange Commission (SEC), identified weaknesses in the current corporate governance practices and developed a Code of Best Practice for Public Companies in Nigeria in 2003.[470] The

---

[463] Adekoya, *Supra n.* 319, at 42
[464] *Ibid.*
[465] Chimere, *Supra n.* 214, at 52
[466] *Ibid.*
[467] Adekoya, *Supra n.* 319, at 40
[468] *Ibid.*
[469] Chimere, *Supra n.* 214, at 51
[470] Benjamin J. Inyang, *Nurturing Corporate Governance System: The Emerging Trends in Nigeria*, 4 J. BUS. SYS., GOV. & ETH. 5 (2009).

code is voluntary and is designed to entrench good business practices and standards which promote corporate transparency and accountability, economic growth and social development.[471]

Mandatory corporate governance provisions, relating to banks in particular, are contained in the Companies and Allied Matters Act (CAMA) 1990, the Banks and Other Financial Institutions Act (BOFIA) 1991, the Investments and Securities Act 1999, the Securities and Exchange Commission (SECA) 1988, etc.[472] It is a credit to Nigeria that these extant laws and codes reflect some of the OECD and Basel III principles.

Like in Ethiopia, the CBN is the apex regulatory institution in the banking industry while the SEC is the apex regulatory organ of the capital market. The CBN promotes monetary stability and a sound financial system, acts as banker and financial adviser to the Federal Government as well as bank of last resort to other banks.[473] The powers of the CBN include the regulation and supervision of the operations of banks and application of sanctions against defaulting banks and the revocation of licenses, where necessary.[474] The other typical similarity with the National bank of Ethiopia (NBE) is that the CBN has been very insistent on standards particularly regarding persons who are appointed Chairmen, members of the board of directors and top management of banks.[475]

The Corporate Affairs Commission (CAC) is also another corporate governance regulator which maintains register of companies in all the states of the federation and undertakes investigations into the affairs of any company if the interests of shareholders and the public so demand.[476] However, there is apparent general weakness in the enforcement mechanism of the CAC, due essentially to corrupt practices and poor record management. Okike, cited by Inyang, notes that "in practice, the role of the CAC has remained perfunctory and ineffective as some companies and even auditors are known to have flouted company legislation without being punished".[477]

---

[471] *Ibid.*
[472] *Ibid.*, p. 6
[473] *Ibid.*, p. 8
[474] *Ibid.*
[475] *Ibid.*
[476] *Ibid.*, p. 7
[477] *Ibid.*

Chapter Four

4. Corporate governance regulation In Ethiopia

4.1. Corporate governance in Ethiopia: an overview

It is hard to overstate the role of business in helping to bring about social transformation in Ethiopia. Since the Ethiopian Millennium, the government has declared the coming years to be the 'renaissance' of the country. Hence, it is incumbent upon every business to play its part towards the achievement of the 'renaissance' of Ethiopia and be seen as contributing towards the transformation process. The issue is whether there is such responsible, robust, and competitive business community in the country. Of course, corporate governance practice in the country would be one of the determining factors to have the desired kind of economy the community aspires for.

The significance of company law in market economies in encouraging privately owned businesses to flourish goes without saying. A carefully crafted company law in a transition economy, like Ethiopia, sets forth clear and objective rules for a company's ongoing internal governance which attracts new investments for the nation.[478] The current company law of Ethiopia is part of its Commercial Code, which has remained unchanged for over five decades since its enactment in 1960. In cognizance of contemporary business developments, the current government has been working to come up with the updated version of the Code, though it has not succeeded yet.

Corporate governance, in a way, is a set of mechanisms through which outsider investors protect themselves against expropriations by insiders and management.[479] It also provides the framework for the balance of power with which the company is directed, managed, supervised and held accountable.[480] In other words, the basis of corporate governance is not restricted to how

[478] Booz, Allen, Hamilton Inc., *Supra n.* 26, at 18
[479] Chimere, *Supra n.* 214, p. 51
[480] *Ibid.*

companies are directed and managed, but includes how to ensure and promote accountability and transparency to all stakeholders.[481]

It has been widely acknowledged that good corporate governance helps most developing countries and emerging markets to attract domestic and foreign direct investments, build their markets competitiveness, restore investor confidence, promote economic growth and boost national development. Like many company laws, the Ethiopian company law contains important provisions on corporate governance. Arts. 347-428 of the Commercial Code are the relevant provisions that have bearing on corporate governance.[482] The study conducted under the auspices of the USAID has also identified Arts. 325 and 333 of the Commercial Code as relevant to corporate governance.[483] These provisions, of course, have most relevance on share companies while they have very limited application on other forms of business organizations. This might be because of the size and ownership structure of share companies.

Though, in principle, all firms need some governance principles to conduct a successful business, size and ownership structure are the determining factors to set in place a comprehensive governance principles as well as complex governance institutions.[484] Hence, governance institutions, for large and small firms, and for single or multiple ownerships differ.[485] Alemayehu notes that "in smaller firms, with concentrated or sole ownership, the principal governance issues concern the implicit or explicit contracts that the owners have with traders and suppliers, with employees having firm specific skills, and with banks and other financial institutions".[486] Since one way or another, owners are directly involved in the management of small firms, there is no strong need for complex legal protection.[487]

---

[481] *Ibid.*, p. 52

[482] See Private Sector Development (PSD) Hub, **Recommendations And Position Paper of The Business Community on The Revision of The Commercial Code of Ethiopia** 28, Addis Ababa Chamber of Commerce & Sectoral Associations, (2008).. The Team of national experts recommends that the title of Chapter 4 of the 1960 Commercial Code needs to be changed to "Company Governance".

[483] See Booz, Allen, Hamilton Inc., *Supra n.* 26, at 20

[484] Alemayehu Geda, **The Road to Private Sector Led Economic Growth** 98, Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, (2009).

[485] *Ibid.*

[486] *Ibid.*

[487] *Ibid.*

With the downfall of the Durge Regime, which had suspended the formation of share companies, and the declaration of market economy in 1991, share companies started to be formed by selling shares to the wider public and thereby started creating bigger shareholding base.[488] As a result, the issue of corporate governance in Ethiopia is becoming complex.[489] The emergence of publicly held share companies introduces several thousand shareholders who have no control over the company.[490] As the size of a firm increases, the day-to-day control and overall management tasks are left in the hands of few non-owners, i.e. managers.[491] The division between dispersed owners and managers makes governance issues more complicated and creates an agency problem.[492]

The issue of agency costs arising from the principal–agent relationship between the owners and managers within a firm has been central to the modern theories of corporate governance.[493] In the absence of regulatory safeguards, managers may seek to exploit their position of control against the interest of shareholders.[494] There is thus, a need for a carefully designed law on corporate governance which will protect the interest of shareholders and thereby create conducive environment for the flow of capital.[495] With the emergence of separation between ownership and control in the Ethiopian share companies, the pertinent provisions of the Commercial Code (Arts. 325, 333, 347-428) are important to address the agency problem.

However, many commentators argue that the relevant provisions of the 1960 Commercial Code are inadequate to address complex governance issues and they are contrary to current international best practices too.[496] According to the study conducted by Booz|Allen|Hamilton Inc., under the auspices of USAID, the current law contains corporate governance provisions that are contrary to international best practices, facilitate insider minority control, and seriously

---

[488] Fekadu Petros, *Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications*, 4 MIZAN LAW REV. 13 (2010).
[489] *Ibid.*, p. 2
[490] *Ibid.*
[491] Alemayehu, *Supra n.* 484
[492] *Ibid.*, p. 99
[493] Barker, *Supra n.* 4, at 34
[494] *Ibid.*, p. 38
[495] Fekadu, *Supra n.* 488, at 28
[496] See Booz, Allen, Hamilton Inc., *Supra n.* 26, at 19. Look at also Hussein Ahmed, *Overview Of Corporate Governance In Ethiopia: The Role, Composition And Remuneration of Boards of Directors In Share Companies*, 6 MIZAN LAW REV. 46 (2012).. See also Fekadu, *Supra n.* 488, at 2.

discourage new investment by hindering transparency in governance.[497] The study identified the following provisions as defective and odd to international best practices;

> permitting a share company to issue bearer shares (Article 325—this is inadvisable because anonymous bearer shares can lead to hidden ownership and tax evasion); permitting a share company to impose restrictions on free transfer of its shares (Article 333—this is not appropriate, at least in widely held companies, because it prevents share liquidity), and permitting a share company to limit the number of votes which shareholders may exercise at shareholders meetings (Article 408—this is counter to the "one share one vote" principle which assures control in proportion to investment).[498]

4.2. Corporate Governance regulation in Ethiopia

It is undeniable that formulating and establishing appropriate and effective regulatory framework is a prerequisite for good corporate governance in Ethiopia. The existence of good corporate governance framework within the country will not only foster market integrity. It also builds investor confidence and improves economic efficiency and development. The legal and regulatory framework of the Ethiopian company law provisions lag far behind from the new market developments and concerns of complex corporate governance issues. The government of Ethiopia has already recognized the inadequacy of the entire Commercial Code and committed to draft a new one.[499] Hence, formulating an appropriate and efficient company law that reflects the modern business realities and accommodates the demands of different market players in the country is crucial.

The emerging separation of ownership and control in Ethiopian share companies necessitates a robust and effective regulatory framework. It is important to ensure that the activities of corporate executives are under constant and vigorous public scrutiny, because those activities are crucial not only to the firm, but to the economic well-being of the nation too.[500] As Chimere explains "the idea is that managers serve as specialists who use their expertise to increase the value of the firm while the actual owners are passive investors who are diversified, supply large

---

[497] Booz, Allen, Hamilton Inc., *Supra n.* 26, at 20

[498] *Ibid.*

[499] Though the revision process of the 1960 Commercial Code has been hoped to be completed by early 2007, it has not been realized yet.

[500] Chimere, *Supra n.* 214, at 53

amount of capital, and seek gains from increases in the value of the business".[501] Thus, unless their activity is properly supervised and regulated, corporate executives' misconduct will cause the distress and collapse of firms.

The corporate governance regulatory regime in Ethiopia can be discussed from two perspectives; from the financial sector and non-financial sector perspectives. This is because, though the Commercial Code provides the common regulatory framework for the two sectors, there are legal as well as institutional regulatory regimes specific to the financial sector. Moreover, the degree and probability of corporate failures, as a result of corporate governance problems, is different in the two sectors. Hence, the forthcoming sections consider the existing regulatory setting in Ethiopia, with respect to the financial companies and non-financial companies, distinctively.

4.2.1. The current regulatory landscape

4.2.1.1. With respect to financial Companies

Good corporate governance practices are essential for the effectiveness, competitiveness and soundness of financial institutions. The need for a competent financial sector is important to stimulate and support economic growth through efficient resource allocation. Corporate governance of financial companies in developing economies, like Ethiopia, is of even greater importance given particularly, the dominant position of banks as providers of fund.[502] Thus the performance of financial companies is affected by good corporate governance practices and policies.[503] The robustness of the corporate governance of financial companies may have an impact on non-financial companies in particular and on the macro economy in general. For this reason, this sector is normally a very heavily regulated one in Ethiopia. Even countries that intervene little in other sectors tend to impose extensive regulations on the financial industry, particularly on banking.[504]

---

[501] *Ibid.*

[502] Luc Laeven, *Corporate Governance: What's Special about Banks?*, 5 THE ANN. REV. FIN. ECO. 66 (2013).

[503] Vasil Cocris & Maria C. Ungureanu, **Why Are Banks Special? An Approach from The Corporate Governance Perspective** 57, (2007). Available at anale.feaa.uaic.ro/.../08_Cocris_V._Ungureanu_MC_-_Why_are_banks_ Accessed on 11-Mar.-2014.

[504] Ross Levine, **The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence** 3, World Bank Policy Research Working Paper 3404 (2004).

As banks are important components of any financial system, the Ethiopian financial sector is dominated by the banking sector.[505] The efficiency and competitiveness of banking system defines the strength of any economy.[506] The existence of sound corporate governance regulatory framework will enhance the efficiency and competitiveness of banks. The special nature of banking requires not only a broader view of corporate governance, but also government intervention in order to control the opportunistic behavior of bank management.[507]

Ensuring better corporate governance of financial institutions is increasingly recognized as a pre-condition for a country's development. Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the financial system, which are critical to the proper functioning of the financial sector and economy as a whole.[508] The corporate governance of the financial sector in Ethiopia has been regulated with its own unique regulatory feature for the reasons to be discussed hereunder.

4.2.1.1.1. Why Corporate Governance regulation of the financial sector is unique?

The corporate governance of the financial sectors is characterized by a complex framework as it encompasses a wide range of stakeholders including not only shareholders but also depositors, creditors, suppliers, employees, and regulatory bodies.[509] These large numbers of stakeholders, whose economic well-being depends on the health of the financial industry, depend on appropriate regulatory practices and supervision.[510] Supervisors and regulators of a financial sector play significant roles for the existence of a healthy financial system in a country.[511] A key aspect of their function is to create and promote standards and norms, and procedures for risk management, which protect consumers and investors from financial abuse and misconduct.[512]

---

[505] Wondaferahu Mulugeta, **The Structure and Development of Ethiopia's Financial Sector** 3, Andhra University (2010).

[506] *Ibid.*

[507] T.G. Arun and J. D. Turner, **Corporate Governance of Banks in Developing Economies: Concepts and Issues**, p. 5. Available at www.seed.manchester.ac.uk/medialibrary/IDPM/.../depp_wp02.pdf Accessed on 18-June-2014.

[508] Basel Committee on Banking Supervision, **Principles for enhancing corporate governance** 5, (2010). Available at www.bis.org/publ/bcbs176.pdf. Accessed on 20-Feb.-2014

[509] Kenneth Spong and Richard J. Sullivan, *Corporate Governance and Bank Performance*, J. ECO. LIT., 1 (2007).

[510] Kern Alexander, **Corporate Governance And Banking Regulation** 6, Working Paper 17, Cambridge Endowment for Research in Finance (2004).

[511] *Ibid.*

[512] *Ibid.*

Accordingly, regulators and supervisors need to ensure that financial institutions are based on strong governance structures.[513]

Financial firms, particularly banks, are generally more opaque than non-financial firms, and evidences suggest that informational asymmetries are larger in financial sectors than in others.[514] These unique features of banks necessitate strict government regulation through bank supervisors and a range of banking laws and regulations.[515] The multifaceted and sensitive role that banks play in the national economy normally draws government's attention to intervene through heavy regulation and is demonstrated by the almost universal practice of states in providing, in many cases, a government safety net to compensate depositors when banks fail.[516] That is, the unique nature of banking firms requires the legal protection of depositors equally as that of shareholders.

Generally, as a result of its unique features, the regulatory landscape of the financial sector in Ethiopia is different from that of the non-financial sector. Alem has identified some of the unique features of the financial sector, the banking industry in particular, which necessitates a particular type of regulatory regime. The unique features include:[517]

- Unlike normal business entities which are funded mainly through shareholders' funds; a bank's business involves funds raised mainly through deposits. The business of raising public deposits places greater fiduciary responsibilities on the institution and its managers, since depositors' funds need to be safeguarded in a special way.
- Banks are the agents of the payments system where they facilitate payments domestically and internationally, through various instruments such as bank accounts, fund transfers, credit cards, etc.
- Banks are able to undertake all such business operations as a result of public trust and faith in the stability and soundness of the banks in particular and the system in general. The

---

[513] *Ibid.*

[514] Pablo De Andres and Eleuterio Vallelado, *Corporate Governance in Banking: the Role of Board of Directors*, 32 J. BAN. & FIN. 2571 (2008).

[515] Maria-Eleni K. Agoraki et al., *The effect of board size and composition on bank efficiency*, 23 EUR. J. L & ECO. 4 (2007).

[516] Alexander, *Supra n.* 510

[517] Alem Gebremedhin, **A Study On The Application Of Corporate Governance Principles In The Ethiopian Private Commercial Banks (The Case Of Lion International Bank)** 19-20, Addis Ababa University, (Unpublished MA thesis), (2011).. See also Gustavo Visentini, *Corporate Governance: The Case of Banking*, BANCA NAZIONALE DEL LAVORO Q. REV. 170-179 (1997).

history on bank failures in many countries indicates that loss of public confidence in banks could be contagious and could easily lead to systemic banking crisis situations.

Consequently, the financial sector is heavily regulated and supervised in every country around the globe.[518] Thus, Ethiopia is not unique in establishing a particular corporate governance system for the financial companies.

4.2.1.1.2. The legal framework

The traditional approach of corporate governance in the financial sector often involved the regulator or bank supervisor relying on statutory authority to devise governance standards promoting the interests of shareholders, depositors and other stakeholders.[519] In a similar fashion the National Bank of Ethiopia (NBE hereinafter), as a regulator and supervisor of the financial sector in Ethiopia, is working to set in place a directive[520] that prescribes governance standards for companies in the financial industry. The Commercial Code is, of course, the existing legal framework of corporate governance applicable to the financial sector as well. However, there are specific legal frameworks for specific sub-sectors, like, the Banking Business Proclamation No. 592/2008, the Insurance Business Proclamation No. 746/2012 and the Microfinance Business Proclamation No. 626/2009.

Some commentators, however, have criticized the existing legal framework as inadequate to regulate the corporate governance of the financial sector in Ethiopia. To mention some, Fekadu argued that the Banking Business Proclamation focuses on financial regulation, which is "just one aspect of governance and does not give sufficient solution to the problems minority investors face in these companies".[521] He further emphasized that the legal framework "instead, pays attention to the protection of depositors and the maintenance of a sound monetary system".[522]

Gebeyaw has also criticized the Ethiopian corporate governance regulatory framework as contrary to the universally accepted OECD principles which apparently adopt the "enlightened

---

[518] Maria-Cristina Ungureanu, *Banks: Regulation and Corporate Governance Framework*, 5 J. OWNERSHIP & CONTROL 2 (2008).

[519] Alexander, *Supra n.* 510, at 4

[520] The NBE has made available, on its official website, the final draft of a directive titled "Corporate Governance for Banks/Insurers/Micro Finance Institutions, **Directives No. ---/2014**". The directive is expected to enter in to force in the near future.

[521] Fekadu, *Supra n.* 488, at 28

[522] *Ibid.*

shareholders value" approach.[523] Such approach recommends corporate governance frameworks to focus on areas of shared shareholders and stakeholders concerns recognizing that shareholders could not achieve wealth through disregard.[524] According to Gebeyaw, the OECD principles particularly emphasized the advantage of employees' participation in company's corporate governance process to enhance the latter's performances.[525] In contrast to such principles, the Ethiopian National Bank Directive unequivocally prohibited bank employees from being represented in the board.[526] Such clear stipulations enable someone to reasonably infer that "the policy objective of Ethiopian banking corporate governance framework declines to address the interests and roles of stakeholders in the corporate governance of the company."[527] Gebeyaw further recommends that "at least the Directive should allow companies to determine whether or not employees are allowed to be represented on boards. Conversely, such clear prohibition will have disincentive for employees to apply their human capitals in the banking companies."[528]

Though the NBE has been empowered to issue directives that prescribe corporate governance standards in detail[529], it has failed to come up with an enforceable directive until the writing of this thesis.[530] If the directive enters in to force promptly, it may overhaul the existing deficiencies of the regulatory framework and establish sound corporate governance practices. The provisions of the draft directive range from director's duties and responsibilities and shareholders' rights and remedies, which determine the relationship between directors, management and shareholders, to the financial and non-financial disclosure provisions, which are intended to ensure that a company's governance practices are characterized by transparency and accountability.

---

[523] Gebeyaw Simachew, **A Critical Analysis of the Ethiopian Commercial Code in Light of OECD Principles of Corporate Governance Framework** 32, (PHD dissertation), University of London, (2011/12).. Available at http://sas-space.sas.ac.uk/4733/ Accessed on 10-Nov.-2014.

[524] Virginia H. Ho, *Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 THE J. COR. L. 62 (2010).

[525] Gebeyaw, *Supra n.* 523

[526] See Art. 5 of Licensing and Supervisions of Banking Business, Limits on Boards Remunerations and Number of Employees Who Set on Bank Board, **Directive No. SBB/49/2011**. Available at http://www.nbe.gov.et/pdf/directives/bankingbusiness/sbb-49-11.pdf Accessed on 10-Nov.-2014.

[527] Gebeyaw, *Supra n.* 523, at 33

[528] *Ibid.*

[529] Art. 14/4/c of the Banking Business Proclamation 592/2008, Art. 15/4/c of Insurance Business Proclamation No. 746/2012, and Art. 11/4 of Microfinance Business Proclamation No. 626/2009.

[530] Though the draft of the corporate governance directive is available on the NBE's official website as a **final** draft, the writer is informally told by the legal department that it is made available still for comment. The writer is denied a formal access of information from the Bank Supervision Directorate for the reason of workload.

4.2.1.1.3. The institutional framework

Due to its unique features, discussed hereinabove, the corporate governance of the financial sector is a highly and strictly regulated matter in Ethiopia. The NBE, as a Central Bank, is the supervising and regulatory organ of the financial sector in Ethiopia. Like in Ethiopia, in many countries around the globe, concerns over the moral hazard that might result from the emergency assistance and the potential costs of financial instability in turn led Central Banks to take a closer interest in the behaviour of individual financial firms.[531]

The purpose of the NBE is to maintain monetary stability and foster a sound financial system in the country.[532] Sound regulation on the implementation of corporate governance practices in the financial sector clearly facilitates the achievement of the NBE's goal. To this end, the legislator has empowered the NBE with various regulatory and supervisory powers over financial companies. Thus, the NBE is the responsible organ to ensure the adoption and implementation of good corporate governance practices in the financial companies.

Among others, the NBE has the power to prescribe the requirements for eligibility of bank/insurance directors, managers, and to reject the appointment of those nominees who do not satisfy its criteria; to ensure that the companies have prepared and publicized proper financial statements and they are adequately disclosed to the public; to regulate transactions that could give rise to possible conflict of interest; to regulate the rights of shareholders and the amount of shares they can hold, and to regulate risk management in the companies.[533] Moreover, the legislator further strengthens the powers of the NBE, by empowering it to supervise compliance of rules by the companies through onsite and off-site supervision mechanisms and to impose various sanctions on a non-complying company.[534]

Based on the finding of the inspection, the NBE is further empowered to take corrective measures on companies that have failed to comply with the relevant laws and directives, or with the terms and conditions of their licenses, or have engaged in fraudulent practices, or have

---

[531] Ungureanu, *Supra n.* 518, at 7

[532] The National Bank of Ethiopia Establishment (as Amended) proclamation, Procl. No. 591/2008, **Negarit Gazeta**, 14th Year, No. 50, Addis Ababa, Art. 4

[533] See at Arts. 10-11, 14-15, 18-19, 22, 28 of the Banking Business Proclamation and See also Arts. 11-12, 15-16, 19-24, 33, 42,45 of Insurance Business Proclamation.

[534] See at Arts. 29-31 of the Banking Business Proclamation and See also Arts. 34-36 of Insurance Business Proclamation.

weaknesses in their corporate governance.[535] The recent case of Nib International Bank S.C. is noteworthy here. The NBE has appointed inspectors to investigate the complaint of some board members and shareholders of the Nib bank. On March 10/2014, the NBE issued a report entitled: "Special Investigation Report on Nib International Bank S.C." and gave instructions to the Board to take corrective measures. The complainants, however, are distressed by the failure of the NBE to take appropriate measures itself.[536]

It is noteworthy here to consider the arguments for and against strong government regulation, i.e. regulation by the Central Bank, of corporate governance in the financial sector. Those who favor government regulation argue that shareholders and depositors cannot exert enough control over management, due to the complex and opaque environment in which financial companies operate.[537] Differences in the operation of financial and nonfinancial firms have led many to view regulatory oversight of the industry as a critical element of governance of financial firms.[538] In addition, regulation by the Central Bank "would facilitate direct access to pertinent information and readily available knowledge of the condition and performance of banks".[539] This in turn, can help the Central Bank identify and respond to the emergence of a potential systemic problem in a timely manner.[540]

Others disfavor government regulation arguing that corporate governance regulatory policies that facilitate private sector regulation improve financial firms' performance. Such kind of approach endorses the International Association of Insurance Supervisors' (IAIS) core principles and standards as well as Basel's II pillar on market discipline and a more limited role for the government that focuses on information disclosure.[541] It is also argued that the concentration of regulatory and supervisory power in the Central Bank might lead to potential abuse in the performance of such functions.[542]

---

[535] See at Art. 31 of Banking business proc. and Art. 36 of Insurance business proc.
[536] The writer invokes this single case to highlight the practice of the NBE's regulatory role and not to discuss the case in detail. For further information on the case look at **Reporter Newspaper**, Vol. *20*(1500), Vol. *20*(1510), Vol. *20*(1512).
[537] Cocris And Ungureanu, *Supra n.* 503, at 63
[538] *Ibid.*
[539] Ungureanu, *Supra n.* 518, at 8
[540] *Ibid.*
[541] Cocris And Ungureanu, *Supra n.* 503, at 63
[542] Ungureanu, *Supra n.* 518, at 9

Unlike many jurisdictions, Ethiopian financial companies' corporate governance is characterized by the absence of an organized stock exchange. On the other hand, stock exchange[543] plays an important role in the protection of investors by mitigating the agency costs of companies with dispersed ownership structure. Asnakech opined that establishing an organized stock market and furnishing it with a robust legislative framework could help the share buying public.[544] She further emphasized that "such an institutional framework also enhances confidence in the *financial* industry and makes the business of buying and selling shares easier, profitable, and predictable" (*emphasis added*).[545]

In many jurisdictions, stock exchanges are self-regulatory organs that undertake the task of adopting and executing codes of corporate governance. They encourage the implementation of good corporate governance through the requirement of 'listing'. Listing is a regulatory process through which the securities of a public company can become eligible to be traded in a regulated stock exchange.[546] That means if a company wants its securities to be traded in a stock exchange, it must be listed.[547] Listing also avoids the problem of information asymmetry which is prevalent in the financial companies.

Therefore, one key institution that is missing in Ethiopia is a stock exchange. This void is a serious deficiency, and makes corporate governance reforms more difficult than they already are. Given the emerging separation of ownership and control in publicly held share companies, like banks and insurance companies, and the dispersed ownership pattern, the introduction of stock exchange in Ethiopia seems to be of a paramount importance.

---

[543] A stock exchange is any organization set up for the purpose of providing a trading platform, where buyers and sellers can meet to transact in securities. See Kahsay Mulu, **Introducing Regulated Stock Markets In Ethiopia: Relevance To The Banking Sector Development And Role In Investors' Protection** 81, Addis Ababa University, unpublished LLM Thesis, (2011).

[544] Asnakech Getnet, *Revisiting the Ethiopian Bank Corporate Governance system: A Glimpse of the Operation of Private Banks*, 1 LAW, SOCIAL JUSTICE & GLOBAL DEV. J. 10 (2013).

[545] *Ibid.*

[546] Kahsay, *Supra n.* 543

[547] Page Nigel (ed), **A guide to listing on the London Stock Exchange** 17, London, White Page Ltd, (2010). The most common listing requirements may include, *inter alia*, disclosure of financial and nonfinancial information, the financial data to be audited by recognized professional accountants, the company must be a publicly held company, payment of a listing fee etc.

4.2.1.2. With respect to non-financial Companies

4.2.1.2.1. The legal framework

As noted above, the company law, incorporated in the 1960 Commercial Code, has provisions that dealt with corporate governance issues of both financial and non-financial companies. However, company law provisions of the Commercial Code pertinent to corporate governance of non-financial companies are not supplemented by other legislations, including voluntary codes and listing standards. There is, only, the Commercial Registration and Business Licensing Proclamation which has attempted to overhaul the deficiencies of company law provisions of the Commercial Code.[548]

The writer believes that the discussions hereinbefore have established that the need for good corporate governance stems from the desire to protect investors from the expropriation of their asset by controlling shareholders or managers.[549] The diversion of investors' asset by the management is caused by the information asymmetry which potentially exists in publicly held companies whose ownership structure is dispersed. However, the importance of good corporate governance extends beyond solving the principal-agent problem. A robust corporate governance legal framework shall also effectively protect minority shareholders from the dominance of block-holders.[550]

In order to measure the effectiveness of a company law in protecting minority shareholders, scholars such as La Porta, Lopez-de-Silanes, Shleifer, and Vishny have developed a shareholder rights index –called "anti-director rights index". The index includes six different types of

---

[548] Interview with Ato Nuredin Mohammed, Advisor, State Minister for trade practice and regulatory sector, on 8th Dec., 2014. Nuredin has explained that Art. 12 of the Commercial Registration and Business Licensing Proclamation No. 686/2010 is aimed at filling the lacuna of the company law in the Commercial Code.

[549] Rafael La Porta et al., *Investor protection and corporate governance*, 58 J. FIN. ECO. 4 (2000). Expropriation can take a variety of forms. In some instances, controlling shareholders and managers simply steal the profits. In other instances, they sell the output, the assets, or the additional securities in the firm they control to another firm they own at below market prices. In still other instances, expropriation takes the form of diversion of corporate opportunities from the firm, installing possibly unqualified family members in managerial positions, or overpaying executives.

[550] *Ibid.*

shareholders rights.[551] The index is also adopted by states which are members of the OECD since it is in conformity with the OECD Principles on Corporate Governance.[552]

The Ethiopian Commercial Code meets only two of the six criteria from La Porta et al. index. The first right provided by the Commercial Code in compatible to La Porta et al.'s index is the minimum percentage required for shareholders to call general meetings, i.e. 10% of the capital, (Art. 391(2)). The other is the pre-emptive right of shareholders to buy newly issued shares in proportion to their shareholding (Arts. 345(4) and 470(1)).

The most important protections of minority shareholders are lacking in the Ethiopian legal framework. These are: the derivative suit mechanism i.e., the legally recognized right of shareholders to sue directors or third parties on behalf of the company, Cumulative voting or proportional representation of minorities on boards of directors (because Art. 352 of the Commercial Code is not clear)[553], the right to proxy voting by mail (Arts. 398(1) and 402 of the Commercial Code does not allow proxy voting by mail), and shareholders are required to deposit their shares during shareholders meetings (Art. 396/1). Hence, Fekadu notes that "given that the protections lacking under the Code are the most important ones that can minimize minority shareholder exploitation by managers and/or block holders, it can be said that the law is inadequate in shareholders protection".[554]

---

[551] *Ibid.*, p. 10. The "antidirector rights index" is a summary measure of shareholder protection. This index includes the right to proxy voting by mail; Absence of the obligation provided by law compelling shareholders to deposit their shares prior to shareholders' meeting; Cumulative voting or proportional representation of minorities on board of directors; Legally recognized right of shareholders to sue directors or to challenge the decisions of shareholder meetings in court; The minimum percentage of share capital that entitles a shareholder to call ordinary general meeting is less than or equal to 10 percent; and Shareholders have pre-emptive rights when new shares are issued that can be waived only by a shareholder vote.

[552] Kahsay, *Supra n.* 543, at 78

[553] See Fekadu, *Supra n.* 488, at 19. According to Fekadu Art. 352 of the Commercial Code is not sufficiently clear. It is ambiguous what the phrase "…legal status…" in the provision particularly refers to. Fekadu inquires whether the law intends to refer to the class of shareholders under Articles 335, 336 and 337. He further notes:

> *Art. 352 of the Commercial Code* seems to require a situation where shareholders are divided into several groups with each shareholder having some internal bond by which to identify with its group and vote in concert. However, this cannot be envisaged in share companies with thousands of shareholders. Though the notion will be easier to comprehend in a closely held company, it will be less useful in the dispersed ownership model. (*emphasis added*)

[554] *Ibid.*, p. 21

The current legal framework is also criticized for stipulating some provisions that potentially hamper the effort of building investors' confidence.[555] Generally, all these deficiencies in the corporate governance legal framework will have potential impacts on investors' investment decisions in the country. This in turn not only creates loss of investors' confidence in the existing Ethiopian informal capital markets but also results in market inefficiency, raises the cost of capitals and inefficient use of scarce resources in the country.[556]

4.2.1.2.2. The institutional framework

Though there is a wide consensus that effective investors' and shareholders' protection relies on a combination of internal and external controls, some argue that good corporate governance will be best guaranteed by external institutions having regulatory oversight over the companies.[557] In some jurisdictions regulatory institutions are endowed with a wide range of functions including the setting of accounting standards, auditing standards, and the establishment of a combined code of corporate governance.[558]

The existing Ethiopian company law bestows regulatory and supervisory powers solely on the Ministry of Trade. Though very limited, the Ministry has the following regulatory powers over companies. These include registering newly established companies and receiving companies' reports (Arts. 90, 323 and 447); regulating share transfers between holding companies (Art. 344); reducing boards' remuneration upon the application of shareholders owning not less than 10% of the share capitals of the company (Art. 353(7)); and ordering investigation of companies' scandals based on its initiation or the petition of shareholders (Arts. 381-387).

However, the existing Ethiopian company law has failed to confer sufficient powers on the Ministry for regulating public companies from their incorporation throughout their operations.[559]

---

[555] Look at Arts. 325, 333, 408 of the Com. C. and see also the discussion hereinabove at section 4.1

[556] Gebeyaw, *Supra n.* 523, at 23

[557] Inam Wilson, *Regulatory and Institutional Challenges of Corporate Governance In Nigeria Post Banking Consolidation*,12 NIGERIAN ECO. SUM. GR. (NESG) ECO. IND. 6 (2006).

[558] Baker and Quéré, *Supra n.* 142, at 19

[559] The study of USAID uncover that "there is no ongoing company regulation or monitoring such as is provided in other countries by bodies such as securities commissions, stock exchanges and similar agencies, or by investor groups. There is, however, regulation of private banks by the National Bank, which oversees their financial statements and conditions, among other things" See at Booz, Allen, Hamilton Inc., *Supra n.* 26, at 21. Moreover, though different sources have indicated that over 700 Share Companies are registered in different sectors in Ethiopia, no one, including the Ministry, is able to determine their existing operational status. This is because of

As a result, the Ministry is busy in dealing with corporate crises than preventing the potential risk of failures by taking corrective measures over fraudulent practices.[560] The Ministry admits its weakness to have conducted an ongoing supervision of the affairs of non-financial companies and claims that the promulgation of the Commercial Registration and Business Licensing Proclamation No. 686/2010 has been helpful at filling such gaps.[561]

The Ministry also lacks sufficient powers to regulate the adoption as well as implementation of sound corporate governance principles by publicly held companies. Gebeyaw noted that, unlike the NBE, the Ministry's supervisory roles are almost omitted from the provisions of the existing company law in the Commercial Code.[562] He further emphasized that "even after the finding of the investigation of companies' scandals, there is no provision that allows the Ministry to take appropriate *measures* on failed company" (*emphasis added*).[563] Accordingly, the institutional framework for the regulation of corporate governance of non-financial companies in Ethiopia is considered as inefficient to protect investors and to avoid market inefficiencies.

Recently, there was a determination by the government to establish a corporate governance regulatory organ.[564]Ministry of Trade had also reaffirmed that the regulator will be established at a directorate status and to enter in to operation by September, 2014. However, subsequently, the Ministry has announced that the establishment of the directorate is delayed temporarily.[565] Due to lack of such organ in the country, investors are discouraged and are not confident enough to

---

the absence of an ongoing supervision and regulation. See **Reporter news paper**, (26- Oct.-2014), Vol. 20, Issue no. 1512, p. 2.

560 The Ministry has been dealing with many cases at the time the writer has conducted the interview. Ato Nuredin has mentioned, among others, the Access Real Estate (the prominent case handled by the interviewee himself) and Jacaranda Integrated Agro-Industry S.C.

561 Interview with Ato Nuredin, *Supra n.* 548. Ato Nuredin explains that for lack of an ongoing regulation, for instance, the Ministry was unable to discover the actual amount of capital and number of shareholders that Access Real Estate has. The only information that the Ministry has, before it intervene due to the debacle, is that the company has five share holders (including the founder Ermias T. Amelga) and a capital worth of 50,000 Br. However, the company has increased the number of its shareholders to over 600 and the capital to 40 million Br. without the knowledge of the Ministry.

562 Gebeyaw, *Supra n.* 523, at 24

563 *Ibid.* As discussed above, the banking business and Insurance business Proclamations have overhauled this deficiency of the company law. Look at Art. 31 of Banking business proc. and Art. 36 of Insurance business proc.

564 **Reporter news paper**, (26-Oct.-2014), Vol. 20, Issue no. 1512, p. 2. See also **Reporter news paper**, (29-Oct.-2014), Vol. 20, Issue no. 1513, p. 4.

565 *Ibid.* Ato Nuredin also hopes the establishment of the directorate in the meanwhile and strongly believes that the Ministry will become efficient to set the current corporate governance landscape in order.

fund newly established share companies. This, in turn, hampers new investments not to flourish in the country which ultimately affects the national economy at large.

Though AACCSA has established a Corporate Governance Institute, it is not empowered to have a self-regulatory role. The Institute is still at its infant stage and aims basically at stimulating the business community to endorse the Ethiopian Corporate Governance Code (ECGC) by creating awareness on good corporate governance.[566] Since compliance with the ECGC is voluntarily, the Institute's role is simply to facilitate the adoption of the code at least by its member companies initially. Of course, discussions are in progress to determine in what form the Institute should be established independently in the coming two years.[567]

4.3. Disclosure– as a regulatory tool

As noted earlier, disclosure and transparency are the central facets of corporate governance. A timely disclosure of all relevant and accurate information that reflects the "true and fair view" of the company's financial position and its internal structure is among the pillars of corporate governance.[568] Asnakech has also opined that "the corporate governance framework should ensure that timely and accurate disclosure is made on all important matters regarding the corporation, including the financial situation, performance, ownership and governance of the company".[569] It has been argued that lack of transparency arising from inadequate disclosure allowed significant problems to build up in publicly held companies.

To maintain an efficient governance system in the financial sector, establishing sound disclosure and transparency requirements by NBE is worthwhile. Accordingly, each Commercial Bank, Micro-Financing Institution and Insurance Company in Ethiopia is duty bound to send to the NBE a duly signed balance sheet; profit and loss statement.[570] Thus, the NBE has implemented a

---

[566] Interview with W/ro Tsion Admassu, Manager of the Ethiopian Institute of Corporate Governance, on 5th Dec., 2014.

[567] *Ibid.* The Institute is temporarily established under the auspices of AACCSA. The writer logically infers from the interview with W/ro Tsion that ones the ECGC is adopted by, at least, publicly held companies and the Institute is stabilized, the later may be able to focus on one of its objectives, i.e. to investigate and publish the state of a company's compliance with the ECGC.

[568] Gebeyaw, *Supra n.* 523, at 34

[569] Asnakech, *Supra n.* 544, at 16

[570] See at Art. 28/ 1 of Banking business proclamation, and Arts. 33/1 of Insurance business proclamation, and Art. 15 of Micro-Financing Business Proclamation

mandatory disclosure as an effective regulatory tool over the corporate governance practices of financial companies.

Moreover, the legislations on banking and insurance business are notable for establishing an effective protection for investors as well as shareholders through mandatory legal regime of disclosure.[571] In practice too, there are efforts made by financial companies to publicize their financial position through news papers.[572] Generally, by enhancing companies' transparency, a strong corporate governance disclosure enables investors to make informed decisions and shareholders to monitor boards' stewardship towards the company and themselves.

On the other hand, the legal framework of the disclosure requirements for non-financial companies is insufficient and defective. The financial disclosure requirements provided under Arts. 419(1), 446, 447 and 448 of the Commercial Code failed to comply with international financial reporting standards and best practices.[573] The financial reports required by these provisions only cover balance sheets and profit and loss accounts. They neglected other important components of financial reports (companies' cash flows and income statements, and any equity changes, recognized gains or losses statement).[574] Moreover, company law provisions of the Commercial Code had loopholes to require auditors to apply established accounting and auditing rules and standards.[575] Unless the audit is conducted and the report is prepared based on established accounting and auditing rules and standards, it is hardly possible to expect that financial statements truly and fairly represent a company's financial position and performance.

With respect to the non financial disclosures, the Commercial Code provisions missed the basic elements of disclosure standards. These includes, companies' ownership structure and voting rights, related parties' transactions, companies' objectives and potential risk factors, corporate

---

[571] See at Art. 28/2/ & /3/ of Banking business proclamation, and Arts. 33/2/ & /3/ of Insurance business proclamation

[572] See for instance **Reporter News paper**, (29-Oct.-2014), Vol. 20, Issue no. 1513, p. 4, **Reporter Newspaper**, (Nov. 5,2014), Vol. 20, Issue no. 1515, p. 5. None of the reports, however, did have annexed the auditors' report as required by the law.

[573] OECD, *Supra n.* 55, Principle V (B & C).

[574] Reports on Observance of Standards and Codes Ethiopia (ROSC), (2007). Commissioned Report. Available at http://www.worldbank.org/ifa/rosc_aa_ethiopia.pdf Accessed on 19-Mar.-2014.

[575] Hussein Ahmed, *Reforming Corporate Governance in Ethiopia: Appraisal of Competing Approaches*, 3 ORO. L. J. 193 (2014).

governance structures, procedures and policies and how they are implemented.[576] Thus, the current legal framework of Ethiopia is characterized as inefficient to minimize information asymmetry between investors and non-financial companies.

Moreover, the methods of disclosure prescribed in Art. 392 of the Commercial Code are inadequate and in terms of cost effectiveness they are burdensome to a company. Correspondingly, the means of accessing company's information provided under Arts. 392(3), 406, 417, 422 and 427 of the Commercial Code are expensive for shareholders. The law may solve this accessibility problem by requiring companies to publish full and material information on the company's website, public media and send to each shareholder via e-mail.

At the current state of corporate disclosure, unveiling the "vast corporate governance malpractices" that are assumed to exist in the country is almost impossible.[577] Thus, there should be minimum disclosure standards and requirements that are not burdensome to companies or endanger their competitiveness in markets.

Generally, in the Ethiopian corporate governance framework context, the main regulatory tool is neglected. The existing company law provisions of the Commercial Code failed to clearly articulate the minimum standards of companies' disclosure of all relevant and reliable financial and non financial information timely and regularly. In addition, there are no other mandatory or voluntary disclosure standards, except for financial companies, in the country. Therefore, disclosure and transparency, which is a fundamental theme of the corporate regulatory system is at its rudimentary stage in Ethiopia.[578]

---

[576] See OECD, *Supra n.* 55, Principle V ((A/2-8))
[577] Fekadu, *Supra n.* 488, at 2
[578] Asnakech, *Supra n.* 544, at 16

Chapter Five

5.1. The way forward– Towards an optimal Corporate Governance regulatory framework for Ethiopia

Currently, as noted above, the trend is a tendency towards the separation of ownership and control in the Ethiopian publicly held companies. Given this prevalent situation, there is a need to be cautious so that shareholders may not subjected to exploitation in the hands of corporate directors, managers, or block holders. There are also some known corporate debacles, like the Access Real Estate S.C., Holland Car Plc, Jacaranda Integrated Agro-industry S.C. etc. that have resulted from poor corporate governance regulation in the country. The agency problems that could occur between dispersed shareholders and managers and/or block holders of share companies and the renowned and other potential corporate crisis in Ethiopia, therefore, necessitate good corporate governance laws and institutions.

There is an impressive level of interest and commitment to the development of good corporate governance in the country by the Government, by business associations, AACCSA, and by the leading actors of the business community. This can be inferred from the unfinished effort of the government to revise the Commercial Code and the establishment of a Corporate Governance Institute under the auspices of AACCSA. A code of corporate governance is also introduced by AACCSA and the effort of persuading companies to adopt it continued.[579] The issue is which mode of regulation would solve the existing as well as potential problems of corporate governance in Ethiopia?

There are a number of choices that need to be made to develop an optimal corporate governance regulatory regime in Ethiopia. Among the available choices, the following sections will discuss whether the appropriate corporate governance approach for Ethiopia is shareholders primacy, stakeholders primacy, or enlightened shareholders value and whether the appropriate regulatory model is state regulation or self-regulation.

[579] Interview with W/ro Tsion, *Supra n.* 566

5.2. Alternative models of Corporate Governance for Ethiopia: Shareholders primacy, Stakeholders primacy, or Enlightened shareholder value

As discussed earlier, corporate governance framework integrates internal governance of a company and external regulations of governance of a company. Both internal and external governance frameworks intended to ensure the effective functioning of companies in the creations of wealth by minimizing agency costs. To attain these corporate objectives, there are ongoing debates by legal scholars and policy makers in shaping the structure of corporate governance framework and the roles of companies. These debates are shareholders primacy on the one hand and stakeholders primacy approach on the other hand.

The proponents of shareholder primacy approach advocates that the board is responsible solely for maximizing shareholders' profit by disregarding the interests of stakeholders.[580] The proponents of stakeholder primacy, on the other hand, contend that the board should direct the company not only for the interests of shareholders but also for the interests of various stakeholders.[581] This approach recognizes that the governance of a company shall consider stakeholders that play influential role for the success of the company.

However, through time, these two contending approaches converged into another theory called an "enlightened shareholders value" approach. According to this latter approach, for the long term profit maximization of shareholders and sustainability of the company, the decisions of the board should align the interest of shareholders profit maximization with the interest of stakeholders.[582] The OECD Principles apparently takes the position of the "enlightened shareholders value" approach.[583]

The existing Ethiopian company law provisions of the Commercial Code, ostensibly, adopted the traditional shareholders primacy approach of corporate governance. As a result, they entirely disregarded the interests of stakeholders, i.e. employees, suppliers, customers, the community,

---

[580] Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 H. L. REV. 1049 (1931).
[581] Merrick E. Dodd, *For Whom Are Corporate Managers Trustee?*, 45 H. L. REV. 1145, 1149 (1932).
[582] Ho, *Supra n.* 524
[583] OECD, *Supra n.* 55, Principle IV.

the environment and the regulators.[584] The only exception in this regard is that there are some provisions that recognize the interest of creditors of the company.[585]

The policy objective of Ethiopian corporate governance framework is also clear from the legal framework of the financial sector. For instance, bank employees are unequivocally prohibited from being represented in boards.[586] From this, it is reasonable to infer that the country's corporate governance framework declines to address the interests and roles of stakeholders in the corporate governance of the company. This is apparently in contradiction with the contemporary approach which is adopted by the OECD principle IV.

Since Ethiopian companies are unsophisticated, labour intensive, and lacks credit access, addressing stakeholders' interests and promoting their active cooperation with the company will be essential for the long term shareholders' profit maximization and companies' financial sustainability. In addition, it is obvious that malpractices by company managers are not only detrimental to stakeholders and the company but also have potential risk to an overall financial soundness and economic developments of the country.

The corporate governance approaches discussed herein above, have been tested around the world and as Hussein notes: "Ethiopia cannot afford the luxury of searching for another …system *or developing a fourth one*" (*emphasis added*).[587] At this age of globalization, Ethiopia could not isolate herself from the wave of novel developments around the globe. Hence, as a developing country, it would be appropriate for policy makers of Ethiopia to consider the existing approaches of corporate governance.

If Ethiopia needs to attract new investments, it should adjust its corporate governance framework in conformity with international best practices. A corporate governance framework is perceived as investor friendly, if it enables firms' to provide greater confidence in their ability to generate returns without violating shareholders' rights.[588] A robust corporate governance framework shall minimize the problem of agency cost as well as guarantee return to the investor by enhancing the

[584] See at Arts. 362, 363 and 364 of the 1960 Commercial Code.
[585] See at Arts. 366/1, 436, 437, 438 of the 1960 Commercial Code
[586] See Art. 5 Directive No. SBB/49/2011, *Supra n.* 526
[587] Hussein, *Supra n.* 575, at 200.
[588] IFC, *Supra n.* 27, at 19

participation of stakeholders in the wealth creation process of the company.[589] Thus, policy makers in Ethiopia have to consider all these factors and act wisely in reforming the corporate governance framework of the country.

5.3. The debate on the mode of Corporate Governance regulation: State Vs Self-regulation

Previous discussions have unveiled the loopholes in the legal, institutional, and regulatory frameworks of the corporate governance regime of Ethiopia. Regardless of the uncovered cases, some astonishing corporate crises that took place in Ethiopia due to poor corporate governance regulation have also been mentioned hereinbefore. The natural question that may be raised here, thus, is that what model of corporate governance regulation will be appropriate for Ethiopia to overhaul the current deficiency of the corporate governance regime.

The debate on the appropriate form of regulation in the Ethiopian context is unfinished yet. While some corporate commentators, like Hussein, advocate for the adoption of mandatory or state regulation, others, like Alemayehu, propose a voluntary code of corporate governance. Though the voluntary approach had many advocates and even seemed to be in the dominance, Ethiopia should not leap to either of the approaches without evaluating different factors, including her individual needs and circumstances.[590]

Those who advocate for state or mandatory regulation criticize the voluntary system of corporate governance as unreliable system to effectively control corporate frauds in the context of emerging separation of ownership and control in Ethiopian share companies.[591] Hussein opined that Ethiopia lacks markets, like tough stock markets, which can play strong disciplinary roles for companies unwilling to apply principles of good corporate governance voluntarily.[592] Countries with self-regulation of corporate governance are characterized by strong securities

---

[589] *Ibid.*

[590] Hussein, *Supra n.* 575, at 201. In addition to her local realities and individual needs, Ethiopia should consider the benefits and costs of adopting state regulation or self-regulation.

[591] *Ibid.*, p. 204. Also Interview with Ato Nuredin, *Supra n.* 548. According to Nuredin, the regulation of the Ministry of Trade remains loosely not to hamper the booming of share companies in the country. Accordingly, the regulation of corporate governance was, almost, left to the respective companies themselves which ended at chaos.

[592] *Ibid.*, p. 205

markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control constitutes the ultimate disciplinary mechanism on management.[593]

Proponents of mandatory regulation further emphasized that it is difficult to assume voluntary compliance with principles and best practices of corporate governance by companies where the culture of competition is week.[594] This can be illustrated by the existence of malpractices in banks that is "evidenced by their former top executives being criminally prosecuted, regardless of tight regulation by the NBE".[595] Recently, there has also been instability in NIB International Bank, where the NBE has intervened and undertook investigation of the case.[596] The opponents of voluntary regulation infer from this that it is difficult to regulate and control "financial frauds in companies by employing a soft law".[597] Accordingly, Hussein advocates that the government should "adopt principles of good corporate governance in a legislation which binds all companies and appropriate penalties should be imposed on those companies which fail to comply with the law".[598]

On the other hand, there are scholars who argue that:

> Taking into consideration the present stage of corporate governance in the country, and the diversity of the dominant forms of business associations in the country, it is suggested that a realistic approach would be to introduce corporate governance as a voluntary framework.[599]

Accordingly, a voluntary code of corporate governance that introduces "best practices" is the appropriate model for Ethiopia. The road map study for private sector development recommends that the Ethiopian Code of Corporate Governance be developed to such an extent that it includes standards for the relationship of the company with stakeholders and the society in general.[600]

The state or mandatory regulation of corporate governance is criticized as it operates on a 'one size fits all' basis, which involves heavy regulation of companies and does not give companies

---

[593] John D. Coffee, The Rise of Dispersed Ownership: The Role of law and State in the Separation of Ownership and Control, 111 THE Y. L. J. 3 (2001).
[594] Hussein, *Supra n.* 575, at 205
[595] *Ibid.*
[596] See at **Reporter Newspaper**, Vol. *20*(1500), Vol. *20*(1510), Vol. *20*(1512).
[597] Hussein, *Supra n.* 575, at 205
[598] *Ibid.*
[599] Alemayehu, *Supra n.* 484, at 111
[600] *Ibid.*, p. 113

much opportunity to implement practices that best fit their contexts.[601] In other words, it does not allow firms' flexibility in choosing governance practices that accord with their size, board structure etc.

Companies may choose self-regulation in response to both the absence of government regulation and the threat of excessive government regulation.[602] The Ethiopian regulatory landscape is characterized by a tight regulation of financial companies and loose regulation of non-financial companies. Inefficient or over regulation raises production costs for businesses without any corresponding benefits and these costs are ultimately borne by consumers.[603] Thus, the introduction of self-regulation in Ethiopia is important to complement the existing regulatory regime by imposing supplemental rules to govern the behavior of firms.

Self-regulation is mostly undertaken by self-regulatory organizations (SROs), such as the North American Electric Reliability Corporation (NERC) in the U.S.[604] There is an emerging trend to establish an SRO in Ethiopia. The establishment of the Ethiopian Institute of Corporate Governance (EICG hereinafter), as SRO, and the adoption of the code of corporate governance by AACCSA is a clear indication of the business community's interest in self-regulatory system. Since SROs use a participatory process to design regulations from the bottom up, they are more effective than government agencies at rulemaking.[605]

State regulation also imposes costs on firms, causing them to shift resources away from other activities to achieve compliance.[606] Such impact of state regulation will be severe for companies that are formed in developing countries, like Ethiopia, where resource is already scarce. The flexibility in self-regulation, however, minimizes the burden of companies with respect to compliance.[607]

---

[601] Johnstone and Chalk, *Supra n.* 287, at 169
[602] Castro, *Supra n.* 190, at 3
[603] *Ibid.*, p. 5
[604] *Ibid.*,p. 3
[605] When businesses come together to develop rules, those involved are likely to have a higher degree of technical and industry expertise than an outside law maker and government regulator.
[606] Castro, *Supra n.* 190, at 1
[607] Flexibility in self-regulation is to mean that they are procedurally lax, i.e. it does not subject companies to the same kinds of procedural and due process hurdles that state regulation does; and it is amenable to the characteristics of each company .

Corporate scholars who advocate for mandatory regulation in Ethiopia invoke the U.S. experience. It is argued that "voluntary code of corporate governance is proved to be a failing mechanism even in the U.S. where vibrant markets play crucial disciplinary roles...and as a result, the Congress had to adopt a mandatory code of corporate governance that culminated in the Sarbanes-Oxley Act of 2002".[608]

However, as noted in Chapter three above, the U.S. mandatory regime is clearly not the structure that most countries have adopted. The study conducted by Anand revealed that out of the 28 countries examined, 12 countries had a completely voluntary governance regime, 14 countries had a partially mandatory regime and only two had a mandatory structure (the U.S. and Pakistan). In other words, many countries are moving away from the mandatory system of corporate governance regulation for ample of reasons.[609] Thus, the policy makers of Ethiopia have to consider such contemporary trend in adopting the optimal regulatory regime.

Generally, in establishing the optimum corporate governance regime in Ethiopia a distinction shall be made between the financial and non-financial sectors. This is because, as it is noted above, no single corporate governance structure is appropriate for all industry sectors, and that the application of governance models to a particular industry sector should take in to account the institutional dynamics of that specific industry. Adams and Mehran also argue for an industry-specific approach to corporate governance because of the systematic differences between corporate governance relevant variables of the financial and non-financial firms.[610]

In seeking the optimum between state regulation and self-regulation for financial firms in Ethiopia, there may appear the choice between the trust in the capital market's ability to discipline such firms, i.e. the "invisible hand of the market", or a total lack thereof.[611] Ethiopia, however, lacks an organized capital market that can play such disciplinary role. This justifies a

---

[608] Hussein, *Supra n.* 575, p. 206-207

[609] According to Anand, mandatory regime occasions unnecessary costs; it does not take advantage of firms' incentives to adopt healthy governance practices voluntarily, and it does not allow firms flexibility in choosing governance practices that accord with their size, board structure etc. See Anand, *Supra n.* 24, at *34*

[610] Renee Adams and Hamid Mehran, *Is Corporate Governance Different for Bank Holding Companies?*, 9 FRBNY ECO. POLICY REV. 135 (2003).

[611] Monika Marcinkowska, *Regulation and self-regulation in banking: in search of optimum*, 44 BANK I KREDYT 137 (2013).

corporate governance system which is fully controlled by regulators and institutional supervision of financial firms in Ethiopia.

Moreover, it has been discussed hereinbefore that corporate governance of the financial sector is unique based on its special attributes, i.e. greater opacity and susceptibility to systemic risk. Because of the greater opacity of financial firms, it is extremely difficult for outsiders to value the assets of such firms and, consequently, market mechanisms cannot adequately control insiders; that are managers and shareholders.[612] According to Marcinkowska, "both empirical studies and theoretical analyses agree that the financial sector needs more efficient regulatory supervision to strengthen its corporate governance".[613] The state regulation of the financial sector in Ethiopia will make the threat of systemic crisis less probable. That is, state regulation primarily aimed at reducing systemic risk (i.e. make the system safe and credible) and protect consumers, particularly depositors. The regulatory intervention of the government to improve governance in the financial sector may also minimize opacity; thereby enhance the flow of information and protect investors from information asymmetry.

On the other hand, the writer believes that self-regulation is the optimal corporate governance regulatory regime for non-financial companies in Ethiopia. To this end a code of corporate governance should be introduced for non-financial companies but with generous flexibilities. That is, the Code shall permit companies to comply only with principles and standards they deem complementary in their contexts. However, the regulatory framework should be designed cautiously not to encourage deviations from the principles and standards under the guise of flexibility. Despite the incentives to comply with the code of corporate governance voluntarily[614], policy makers have to determine the appropriate self-regulatory model to ensure either compliance or genuine deviation.

---

[612] Andrea Polo, Corporate governance of banks: the current state of the debate 3, MPRA (2007). Available at http://mpra.ub.uni-muenchen.de/2325/ Accessed on 11-Mar.-2014.

[613] Marcinkowska, *Supra n.* 611, at 120

[614] As noted in Chapter three, incentives like innate desire to conform with social norms, market pressure, and the fear of reputational damage may force companies to adhere to codes of corporate governance voluntarily.

5.3.1. The choice among self-regulatory models

It has been noted that the recommendation of the road map study for private sector development is that the Code of Corporate Governance of Ethiopia should be voluntary. However, international experiences as well as the study by Anand evidenced that the contemporary argument on corporate governance regulation is in favour of 'enforced self-regulation'. This modality of regulation is designed to balance the flexibility in self-regulatory regime.

An enforced self-regulation is a 'hybrid' or 'partially mandatory' type of regulation that consists the non-binding guidelines (often referred to as a code) together with a formal and mandatory requirement for standardized public reporting of firms as to whether they comply with each of the guidelines (or not, and if so, why not).[615] In other words, an effective self-regulatory regime is the one that is supplemented by a mandatory structure of disclosure operated under the "comply-or-explain" principle.

The Ethiopian corporate governance regime is characterized by an age old 'one size fits all' approach and the rampant information asymmetry between investors and firms. Thus, an optimal regime for Ethiopia, where the disciplinary role of the market is insignificant[616], would be one that recognizes investors' need for protection, on the one hand, and firms' need for flexibility, on the other. An enforced self-regulation or the partially mandatory regime, thus, meets both of these concerns. That is, the code of corporate governance, which allows flexibility for companies, should be enforced by the requirement of mandatory disclosure to minimize the problem of information asymmetry.

It has been made clear in the previous discussions that disclosure under a "comply-or-explain" principle is mandatory in the sense that companies are required to disclose either their compliance with the Code or explain their deviations. A partially mandatory regime recognizes that though, compliance is the determining factor in corporate governance regulation, it may not be always the best option for regulatees due to different reasons. Such flexibility to deviate, however, is tempered by the requirement to 'explain if not, why not' which operate under a 'comply or explain' regime.

---

[615] Rapp et al., *Supra n.* 223
[616] Hussein, *Supra n.* 575, at 205

As discussed earlier, monitoring and enforcement of compliance with code provisions, in many jurisdictions, is left to the capital market. Through the requirement of disclosure, capital markets put companies under constant and vigorous public scrutiny. Based on a company's disclosure, it is up to stakeholders, such as investors, to determine whether the explanation is persuasive. That is, the decision of investors to fund a company is determined by a company's compliance with the standards of 'good corporate behaviour'. No company needs to be undervalued by investors failing to comply or to provide a robust explanation for its deviation. Regardless the absence of organized capital markets in Ethiopia, the existing informal capital market may play the role of gauging the explanation tendered by companies. Moreover, it is the objective of the EICG to investigate and publish the state of companies' compliance with the ECGC.

The position of AACCSA and its members is also in favour of a partially mandatory regulatory regime. The chamber and its members have identified the following, among others, as important characteristics of good corporate governance;[617]

- Preference for self-regulatory approaches to corporate governance matters, ahead of heavy-handed government-mandated intervention; and
- Transparency in corporate governance arrangements, including ongoing disclosure of material information, especially financial information, to markets and to shareholders.

The Ethiopian Code for Corporate Governance, which is adopted by AACCSA, has also incorporated the principle of "comply or explain" for companies listed or acting at capital markets.[618] Hence, this indicates that sooner or later, capital market must be put in place in Ethiopia.

5.4. A code of corporate governance as instrument of self-regulation in Ethiopia

The rationale behind the introduction of instruments of self-regulation, such as codes of best corporate governance practices, should be that corporate governance-related decision-making powers are delegated at the corporate level.[619] Such delegation makes sense where decisions made at the corporate level can more appropriately take into account company specifics which

---

[617] Addis Ababa Chamber of Commerce & Sectoral Association, (2012). Addis Business, **External Relations and Media Department Monthly News Paper**, Vol. *11*(4), p. 6

[618] AACCSA, (2011). **The Ethiopian Code for Corporate Governance**, Principle 1(1.3).

[619] Chee L. Keong (ed.), **Corporate Governance in the United Kingdom, in Corporate Governance – An Asian Pacific Critique** 341, 368, Sweet & Maxwell Asia (2002).

generally applicable laws may not be able to address.[620] Instruments of self-regulation, therefore, allow for flexibility when it comes to the installation of corporate governance structures.

The various discussions held at different workshops organized by AACCSA and the study conducted by the same revealed that there are concerns that stimulate appetites for a corporate governance code in Ethiopia.[621] In the discussions held by the Chamber with the then Ministry of Industry and Trade, now Ministry of Trade, it has been indicated that the fact that the private sector prepared and endorsed a code of corporate governance to govern itself is something the government considers as a matter of great importance and would support it.[622]

Accordingly, the private sector development centre of AACCSA has undertaken the study of the relevance of good corporate governance in businesses and made it available to local companies to look into it from the perspective of the real situation on the ground in the country and comment on it.[623] Such effort of the Chamber has culminated in the endorsement of the code by over 200 companies.

5.4.1. An overview of The Ethiopian Corporate Governance Code: challenges and prospects

The preparation of a Code of corporate governance may take various forms, like multi-stakeholder authorship (UK), single-stakeholder authorship (France), or public authority authorship (Germany, The Netherlands).[624] The adoption of the Ethiopian Corporate Governance Code (ECGC) through an interactive and participatory process by the Stakeholders of the Ethiopian Business Community - private companies and corporations, state owned enterprises, government institutions, professional organizations, and the academia[625] shows that it belongs to the multi-stakeholder authorship model. Such authorship model permits the ECGC to consider multi-stakeholder interests and enables the participants to provide additional corporate

---

[620] Lutz-Christian Wolff, *Making Perfect Corporate Governance Rules: Mission Impossible?*, 7 COR. GOV. IN. 19 (2004).

[621] See at AACCSA, (2014). **Addis Business, External Relations and Media Department Monthly News Paper,** Vol. *12*(7), p. 6. See also AACCSA, *Supra n.* 34

[622] AACCSA, (2013). Addis Business, **External Relations and Media Department Monthly News Paper**, Vol. *11*(5), p. 4.

[623] *Ibid.*

[624] Haskovec, *Supra n.* 300, at 9.

[625] AACCSA, *Supra n.* 618, Preface, p. 4.

governance considerations that would be above and beyond the current legal or legislative requirements.

AACCSA has opened a new chapter in the Ethiopian corporate governance history through the adoption of the ECGC.[626] The ECGC has introduced standards of good corporate governance in Ethiopia in a detailed and comprehensive manner. It has adopted best principles and practices regarding boards of directors, rights of shareholders and corporate disclosure and transparency. It is also a pioneering document in the field of corporate governance of the country in adopting the 'enlightened shareholders value' approach. It has clearly articulated principles and standards regarding corporate social responsibility and the right of stakeholders.

It has been widely acknowledged that good corporate governance helps most developing countries and emerging markets to attract domestic and foreign direct investments, build their market competitiveness, restore investor confidence, promote economic growth and boost national development. The objectives of the ECGC are compatible with these generally accepted goals of good corporate governance. As stipulated in the preface, the ECGC has taken in to account the development policy and strategy of the country regarding poverty reduction and wealth creation, which are the main objectives of the Growth and Transformation Plan (GTP).[627]

Though it has been over three years since its adoption, the Code has not entered in to force yet. The writer has identified, from his interview with the manager of the EICG, certain reasons that inhibit the Code's enforcement. According to the manager, the Institute has been updating the Code and, at the same time, creating awareness among the business community in the past years.[628] Moreover, lesser number of member companies (only seventy) have signed the declaration to adopt and implement the Code and the Institute's re-establishment as an

---

[626] The ECGC is adopted by a non-governmental organ, i.e. AACCSA, and mainly applicable on companies that endorse it and are members to the Ethiopian Institute of Corporate Governance. Regardless, the Code is named as "Ethiopian Corporate Governance Code" which seems as adopted by the Federal government having a nationwide application. Thus, notwithstanding the importance of making all efforts to assure the endorsement and implementation of the Code by all companies in the country, the nomenclature needs to be modified.

[627] See at The FDRE Ministry of Finance and Economic Development, **Growth and Transformation Plan 2010/11-2014/15**, Vol. *1*(Main text), (2010).

[628] Interview with W/ro Tsion, *Supra n.* 566

independent organ is not determined yet.[629] The forthcoming sections will further address some potential challenges and prospects in the enforcement of the ECGC.

5.4.1.1. Prospects

The corporate governance codes are best enforced by professional bodies in collaboration with government institutions and the stock market regulators.[630] The existence of stock markets serves as a disciplining instrument not only through its regulatory role but also indirectly by facilitating exit for minority shareholders from underperforming or oppressing companies. They will also serve as market organizers (companies share liquidity), information distributors (between investors and issuers), standard setters (setting the listing standards for companies), and as regulators (regulating their members based on stated standards).[631]

In a country where publicly held companies are booming, the government cannot remain reluctant resisting the pressures for the introduction of stock markets. It is clear that the reluctance of the government encourages the transaction of shares informally. This shows that the market is far ahead from the government. Thus, the need for the development of stock markets in Ethiopia is gaining momentum. Many researches are conducted and recommend the urgent introduction of stock market in the country. It is also an issue that attracts the attention of the academia and the government too.

Principle 1(1.3) of the ECGC also indicates the role of stock markets in the self-regulatory regime. Thus, the introduction of stock markets in Ethiopia will be a good opportunity for an effective enforcement of the ECGC. Many stock markets in the world make compliance with corporate governance codes as a listing requirement. Since such listing requirement is aimed at ensuring the protection of investors, establishing a stock market that adopt this standard will be logical and important for Ethiopia.

The growing trend in the separation of ownership and control in publicly held companies in Ethiopia is also another opportunity for the ECGC to be adopted and enforced widely. As noted

---

[629] *Ibid.* According to W/ro Tsion, the Statute that established the Institute stipulates that the later should be reestablished as an independent organ within three years. A year has already gone and two years are left to determine the appropriate form of organization for the Institute to be legally registered.

[630] Adekoya, *Supra n.* 319, at 3

[631] *Ibid.*

earlier, a dispersed ownership structure possibly causes agency cost and endangers the interest of investors. A company which strives to attract investors and to build a sustainable growth that benefits shareholders in the long term, undoubtedly, will adopt the ECGC which promotes good corporate governance and minimizes agency cost.

Though the ECGC was endorsed by over 200 companies, only 70 companies have signed the declaration and effected payment of membership.[632] Regardless of the lesser number of the existing signatories, W/ro Tsion confirms that they are receiving many requests to sign the declaration and adopt the code. Accordingly, she is confident enough that the code will be adopted and enforced by, almost, all publicly held companies in the country.

The discussions hereinbefore reveals that Ethiopia has encountered various corporate crises caused by major failures in corporate governance practices, lack of investors and consumer protection, inadequate disclosure and transparency legal frameworks, critical gaps in the regulatory framework, and uneven supervision and enforcement. As a result, the Ministry of Trade engaged in a hectic activity of dealing with the cases of those companies post crisis. This situation will alarm both the government and publicly held companies to look for a mechanism which provides the tools that would ensure good corporate governance and avoid post crisis trauma. The ECGC is the available self-regulatory framework to which the government and companies already extend their interest.[633]

Therefore, there is an impressive motivation among the government, the leading actors of the business community, business associations, and AACCSA to reform the existing corporate governance regulatory regime. All these are keen on the development of and adherence to corporate governance principles. They are interested to participate and contribute to the development and application of good corporate governance in the country. Hence, this is a wonderful prospect which the ECGC would avail.

The other opportunity for the adoption and enforcement of the ECGC is that Ethiopia's accession to the WTO. It has been said that the Ethiopian government shall lay the groundwork, among

[632] Interview with W/ro Tsion, *Supra n.*566

[633] As discussed earlier, two hundred companies have endorsed the ECGC and many others are requesting to sign the declaration to adopt and implement the Code. The government has also encouraged the effort of the private sector to prepare and endorse a code of corporate governance to govern itself.

others enhancing competitiveness, for the WTO accession. The adoption and enforcement of good corporate governance principles provides an incentive for the Ethiopian private sector to become more competitive. Ethiopia's accession to the WTO, thus, will be a catalyst for change, encouraging companies to adopt the ECGC and strengthen their role in the economy.

5.4.1.2. Challenges

According to W/ro Tsion, the EICG is working towards the creation of awareness on the aims and concepts of corporate governance and stimulating companies to adopt the ECGC. However, the wide-spread adoption of the ECGC may not necessarily guarantee that the companies are committing themselves to the principles of the Code. For one reason, there is no mechanism established to oversee whether the companies conform to the principles of the Code. For the other reason, there is no organ, like stock markets, mandated to supervise the observance of the Code. Thus, unless the EICG is independently established with the power of supervising the implementation of the Code, its effort towards stimulating companies to adopt the Code will be futile.

Some SROs, such as the North American Electric Reliability Corporation (NERC) and the Financial Industry Regulatory Authority (FINRA), operate with endorsement by government.[634] The NERC, which is responsible for establishing and enforcing standards for the electric power grid, is certified by the Federal Energy Regulatory Commission and the FINRA, which regulates the securities industry in the United States, operates with oversight from the Securities and Exchange Commission (SEC).[635] Unlike, the EICG have no kind of endorsement by government organs, like the Ministry of Trade, and even it is not yet a legally registered independent SRO.

Staff's instability within the EICG is also another challenge for the prompt adoption and implementation of the ECGC. The writer has visited the Institute, almost six months after his first appearance, hoping that he will find out an impressive progress in the implementation of the Code and overall operation of the Institute. However, the staff of the Institute, including, the manager have been changed and the existing staff claim that many tasks with regard to the implementation of the Code are not finalized as the Institute is a newly established one.[636] It is

[634] Castro, *Supra n.* 190, at 3
[635] *Ibid.*
[636] However, it has been, almost, a year since the EICG is established.

obvious that it takes time for new staff to familiarize themselves with their new post and to accomplish tasks that were on the table.

The other challenge for the wide-ranged adoption and implementation of the ECGC is the prevalent weak culture of competition among companies. In other words, companies in Ethiopia have little interest for the attributes of a corporate governance code, i.e. an enhanced accountability and transparency which excel competitiveness. Thus, the prevalent culture of competition may be a disincentive for companies to adopt and implement the ECGC. Moreover, regardless of an ongoing effort of the EICG to create awareness, the level of knowledge on the concept of corporate governance among companies is still low. This obviously threatens the wide adoption and implementation of the ECGC.

Chapter Six

6. Conclusion and Recommendations

6.1. Conclusion

At the age of globalization, where competition is fierce, developing and transition economies need a healthy and competitive corporate sector that is fundamental for sustained and shared growth—sustained in that it withstands economic shocks, shared in that it delivers benefits to all of the society. In order to overcome the fierce competition and capital fluctuation, firms need levels of capital that exceed traditional funding sources. That is, companies need to attract investors and increase their capital bases.

Investors would feel safe and encouraged to spend their capital in a business whose corporate governance is relatively effective. This means, the effectiveness of corporate governance positively affects the performance of a company. A firm with a well-established and developed corporate governance system is able to attract investors and enhance the trust and confidence of the stakeholders.

Corporate governance is also conventionally considered as a solution to the issues that arise between owners and managers of corporations as a result of separation of ownership and control. Agency problem is inevitable among different interest groups in the contemporary public companies where separation of ownership and control is prevalent. Directors and managers of publicly held companies are given overwhelming power with little accountability to the dispersed groups of shareholders. Thus, well-regulated corporate governance can reduce such agency problems between managers and shareholders, limiting private benefits and expropriation by controlling insiders.

Regulation, thus, is an effective system used in improving governance practices and preventing collapses and associated problems of firms. Regulatory pressure may encourage firms to use greater levels of monitoring, similar to "best practices" approach. The overriding objective guiding contemporary corporate governance regulation is a desire to restore confidence on the market by ensuring that firms and their participants adhere to good governance practices.

The Ethiopian regulatory landscape is characterized by a tight regulation of financial companies and loose regulation of non-financial companies. Inadequate regulation or over regulation raises production costs for businesses without any corresponding benefits and these costs are ultimately borne by consumers. The emerging separation of ownership and control in Ethiopian share companies necessitates a robust and effective regulatory framework.

The corporate governance regulatory regime in Ethiopia can be discussed from two perspectives; from the financial and non-financial sector perspectives. The corporate governance regulation of the financial sector in Ethiopia has its own unique features. It is characterized by a complex framework as it encompasses a wide range of stakeholders including not only shareholders but also depositors, creditors, suppliers, employees, and regulatory bodies. These large numbers of stakeholders, whose economic well-being depends on the health of the financial industry, depend on appropriate regulatory practices and supervision.

The unique features of the financial sector necessitate strict government regulation through bank supervisors and a range of banking laws and regulations. Some commentators, however, have criticized the existing legal framework as inadequate to regulate the corporate governance of the financial sector in Ethiopia. They argued that the Banking Business Proclamation focuses on financial regulation, which is just one aspect of governance and does not give sufficient solution to the problems that minority investors face in these companies. The legal framework of the financial sector, instead, pays attention to the protection of depositors and the maintenance of a sound monetary system.

The corporate governance framework of the financial sector declines to address the interests and roles of stakeholders in the corporate governance of the company. In contrast to international principles, the Ethiopian National Bank Directive unequivocally prohibited bank employees from being represented in the board. The OECD principles, for instance, particularly emphasized the advantage of employees' participation in company's corporate governance process to enhance the latter's performances. In addition, unlike many jurisdictions, Ethiopian financial companies' corporate governance is characterized by the absence of an organized stock exchange. Stock exchange plays an important role in the protection of investors by mitigating the agency costs of companies with dispersed ownership structure.

The robustness of the corporate governance of financial companies may have an impact on non-financial companies in particular and on the macro economy in general. Due to this reason, this sector is normally very heavily regulated in Ethiopia. Even countries that intervene little in other sectors tend to impose extensive regulations on the financial industry, particularly on banking. Such a draconian regulation is justified by the difficulty for shareholders and depositors to exert enough control over management, due to the complex and opaque environment in which financial companies operate.

Notwithstanding the specific corporate governance framework of the financial sector, the 1960 Commercial Code of Ethiopia has relevant provisions (Arts. 325, 333, 347-428) that are important to address the agency problem in publicly held companies (both financial and non-financial). However, many commentators argue that these provisions of the 1960 Commercial Code are inadequate to address complex governance issues and they are contrary to current international best practices too. The study conducted by Booz|Allen|Hamilton Inc., under the auspices of USAID, has identified Arts. 325, 333, and 408 of the Commercial Code as defective and contrary to the international best practices.

The corporate governance provisions of the Ethiopian Commercial Code meet only two of the six criteria from La Porta *et al.*'s shareholder rights index –called "anti-director rights index". Given that, the shareholders protections lacking under the Ethiopian Commercial Code are the most important ones that can minimize minority shareholders exploitation by managers and/or block holders, it can be said that the law is inadequate in shareholders protection. The government of Ethiopia has already recognized the inadequacy of the entire Commercial Code and committed to draft a new one. However, the draft revised Commercial Code did not introduce any change on those provisions of the 1960 Commercial Code that are considered as contrary to La Porta *et al.*'s shareholder rights index.

The existing Ethiopian company law bestows regulatory and supervisory powers, with regard to non-financial companies, solely on the Ministry of Trade. However, the law has failed to confer sufficient powers on the Ministry for regulating non-financial companies from their incorporation throughout their operation. As a result, the Ministry is busy in dealing with corporate crises instead of preventing the potential risk of failures by taking corrective measures

over fraudulent practices. Moreover, though the Ministry is empowered to order investigation of companies' scandals (Arts. 381-387), there is no provision that prescribes the measures to be taken, by the Ministry, on failed companies. Accordingly, the institutional framework for the regulation of corporate governance of non-financial companies in Ethiopia is considered as inadequate and inefficient to protect investors and to avoid market inefficiencies.

Contemporary perspectives on corporate governance have been prominently categorized into two contrasting approaches: the traditional approach (shareholders) and the modern approach (stakeholders). In the shareholders approach, a basic issue in corporate governance is whether or not shareholders' interest can be effectively protected under the existing institutional arrangements. The stakeholders approach of corporate governance, on the other hand, underscores that there are other groups to whom a company is responsible in addition to shareholders: those groups who have a stake in the company.

The existing Ethiopian company law provisions of the Commercial Code, ostensibly, adopted the traditional shareholders primacy approach of corporate governance. As a result, they entirely disregarded the interests of stakeholders, i.e. employees, suppliers, customers, the community, the environment and the regulators. The only exception in this regard is that there are some provisions that recognize the interest of creditors of the company. It is obvious that malpractices by company managers are not only detrimental to shareholders and the company but would also be potential risks to stakeholders and the overall financial soundness, and economic developments of the country.

As noted above, the existing corporate governance regulation in Ethiopia is mandatory, i.e. a regulatory approach which is backed by a legislative action. The state intervenes through such mandatory laws and takes pro-active or corrective measures on corporate governance practices of firms. However, the OECD Business Sector Advisory Group on corporate governance stresses that mandatory regulatory measures, though necessary, are not sufficient to raise standards.

The debate on the appropriate form of corporate governance regulation in the Ethiopian context is unfinished yet. While some corporate governance commentators advocate for the adoption of mandatory or state regulation, others propose a voluntary code of corporate governance. The

state or mandatory regulation of corporate governance is criticized as it operates on a 'one size fits all' basis, which involves heavy regulation of companies and does not give companies opportunities to implement practices that best fit their respective specific contexts.

The contemporary trend around the globe is also moving away from mandatory corporate governance regulation. The study conducted by Anand revealed that out of the 28 countries examined, 12 countries had a completely voluntary governance regime, 14 countries had a partially mandatory regime and only two had a mandatory structure (the U.S. and Pakistan). Hence, international experiences as well as the study by Anand evidenced that the contemporary argument on corporate governance regulation is in favour of 'enforced self-regulation' or 'hybrid' regulation. Such regulatory model recognizes investors' need for protection, on the one hand, and firms' need for flexibility, on the other.

Codes of corporate governance are instruments of self-regulation which consist of a collection of non-binding guidelines together with a formal and mandatory requirement for standardized public reporting of firms about whether they comply with each of the guidelines (or not, and if not, why not). In contrast to statutory law which imposes minimum standards, codes aim at improving corporate behaviour by introducing heightened standards through best practices. In other words, it may serve to either supplement or go beyond any minimum governance regulations to which the company may already be subjected. Moreover, codes of good governance increase transparency and as a consequence put managers under external pressure to establish governance structures that allow them to comply with the code.

This paper has identified that Ethiopia has encountered various corporate crises caused by major failures in corporate governance practices, lack of investors and consumers' protection, inadequate disclosure and transparency legal frameworks, critical gaps in the regulatory framework, and uneven supervision and enforcement. As a result, the Ministry of Trade is engaged in a hectic activity of dealing with the cases of those companies post crisis. This situation seems to be alarming to both the government and publicly held companies to look for a mechanism which provides the tools that would ensure good corporate governance and avoid post crisis trauma.

In addition, the Ethiopian corporate governance regime is characterized by an outdated 'one size fits all' approach and the rampant information asymmetry between investors and firms. Thus, an optimal regime for Ethiopia, where the disciplinary role of the market is insignificant, would be one that recognizes investors' need for protection, on the one hand, and firms' need for flexibility, on the other.

AACCSA has issued "The Ethiopian Corporate Governance Code" and established the EICG with a responsibility to facilitate the adoption and implementation of the code by the business community. The discussions held by the Chamber with the then Ministry of Industry and Trade, now Ministry of Trade, revealed that the fact that the private sector prepared and endorsed a code of corporate governance to govern itself is something the government considers as a matter of great importance and would support it. Recently also, President Dr. Mulatu Teshome, in his speech at the inaugural ceremony of the ECGC, has confirmed that the government is interested in such self-regulatory regime and committed to work for its realization.[637] Accordingly, these are indications that tempt the writer to believe that the government is optimist for the introduction and implementation of self-regulation of corporate governance in the non-financial sector.

Though it has been over three years since ECGC is adopted, it has not entered in to force yet. Moreover, the EICG is still at its infant stage and aims basically at stimulating the business community to endorse the ECGC by creating awareness on good corporate governance. Though investigating and publishing the state of companies' compliance with the Code is among the objectives of the EICG, it is not clearly empowered with a self-regulatory role. If self-regulation of corporate governance needs to be effective, there has to be an organ which is entrusted with supervisory powers and that can keep the government away from regular intervention. EICG, as SRO, is the responsible organ for the introduction as well as enforcement of self-regulation in Ethiopia.

[637] **Reporter Newspaper**, (15-Feb.-2015), Vol. 20, Issue no. 1544, p. 12.

6.2. Recommendations

Based on the research findings, the following points are recommended to be considered by the concerned organs.

1. The legal framework of the financial sector needs to be revised to provide sufficient protection of shareholders in general and that of minority shareholders in particular. As the corporate governance framework gives attention to depositors and the maintenance of a sound monetary system in the country, an equivalent concern for the protection of minority shareholders should be put in place.
2. The directive that prohibits bank employees from being represented in the board needs to be amended in line with international principles. Employees' participation in company's corporate governance process plays significant role to enhance the company's performances. Prohibition of such participation will have disincentive for employees to apply their unreserved human capitals in the banking companies.
3. An organized stock market backed by a robust legislative framework needs to be established. The existence of an organized stock market could strengthen the institutional framework of the Ethiopian corporate governance regulation. It plays an important role in the protection of investors by mitigating the agency costs of companies with dispersed ownership structure. It also enhances investors' confidence and makes the business of buying and selling shares easier, profitable, and predictable.
4. Though the government is committed to revise the defective provisions of the Commercial Code, the existing draft revised code has failed to introduce any change on those provisions of the 1960 Commercial Code that are considered as contrary to international best practices and La Porta *et al.*'s shareholder rights index.[638] Hence, the revised code needs to reconsider those provisions which are relevant to the protection of shareholders' rights in line with international best practices and La Porta *et al*'s shareholder rights index.

Look at Arts. 325, 333, 352, 396/1, 398/1, 402, and 408 of **The revised Commercial Code of The Federal mocratic Republic of Ethiopia**, (Draft Version). Except Art. 402, the other provisions are the verbatim copy of existing Commercial Code of the 1960. The amendment under Art. 402, even, does not entitle shareholders to xy voting through mail; rather it has introduced sub-art. 2 which stipulates the possibility for the authority of resentation vested in proxy with regard to an ordinary meeting to have effect also with regard to an extraordinary eting held in 15 days.

5. Ministry of Trade, the corporate governance regulator of non-financial companies, needs to be endowed with sufficient powers of ongoing supervision. Unlike the NBE, the Ministry has no an on-site or off-site supervisory powers over the ongoing corporate governance practices of non-financial companies which resulted in the renowned debacles in the country. Moreover, the establishment of the regulatory directorate under the auspices of the Ministry should be realized promptly. The regulatory directorate may enable the Ministry to closely oversee the corporate governance practices of non-financial companies and to take pro-active measures on any potential failures.
6. The draft revised Commercial Code needs to include provisions that prescribe the measures to be taken, by the Ministry, on failed companies based on investigations of companies' scandals and the findings of such investigations. Otherwise, empowering the Ministry to order investigation of companies' scandals without the power to take measures would be futile.
7. The legal frameworks of corporate governance of the country need to adopt the contemporary 'enlightened shareholder value' approach. Since Ethiopian companies are unsophisticated, labour intensive, and lack credit access, addressing stakeholders' interests and promoting their active cooperation with the company will be essential for the long term shareholders' profit maximization and companies' financial sustainability. It has been discussed in this paper that an 'enlightened shareholder value' approach recommends corporate governance frameworks to focus on areas of shared stakeholder and shareholder concerns recognizing that shareholders could not achieve wealth through disregard.
8. The appropriate corporate governance regulatory model for Ethiopia needs to be different for the financial and non-financial sectors. This paper recommends that the optimal corporate governance regulatory model for the non-financial sector is an enforced self-regulation or a hybrid regulatory regime which recognizes investors' need for protection, on the one hand, and firms' need for flexibility on the other.

The writer strongly believes that the existing mandatory corporate governance regulation of the financial sector should be maintained in Ethiopia. State regulation is the optimal regime for the financial sector in Ethiopia to ensure that the financial institutions are based on strong governance structures, and thereby create a healthy financial system in

the country. Of course, in order to overhaul the existing legal and regulatory loopholes, cautious reforms need to be undertaken.

9. A tireless effort shall be made by EICG to stimulate the endorsement and implementation of the ECGC by all non-financial companies in Ethiopia. As an instrument of enforced self-regulation or hybrid regulation, the Code should be enforced by the requirement of mandatory disclosure to minimize the problem of information asymmetry. However, principle 1.3 of the Code, which adopted the principle of "comply or explain", needs to be amended as to prescribe the application of the principle to all companies. That is, it should not be limited to companies acting at capital markets or listed for public trade of their shares.
10. The EICG needs to be empowered with self-regulatory powers for the development of good corporate governance among non-financial companies. It has been said that Ethiopia lacks an organized stock market, which can play strong disciplinary roles for companies unwilling to apply principles of good corporate governance voluntarily. The available institutional framework is the EICG that is established with an objective, *inter alia*, to investigate and publish the state of companies' compliance with the Ethiopian Corporate Governance Code. Thus, what the Institute needs to effectively supervise companies' compliance with the Code is that endorsement by the government. Moreover, EICG needs to determine its independent establishment promptly and organize itself with a functional, robust, and accountable structure that can keep the state away from regular intervention in the self-regulatory regime.

BIBLOGRAPHY

Books

- Baldwin, Robert, and Cave, Martine, **Understanding Regulation: Theory, Strategy, and Practice**, 2nd ed., Oxford University Press Inc., New York, 2012.
- Barker, M. Roger. **Corporate Governance, Competition, and political parties, Explaining Corporate Governance changes in Europe**, Oxford University Press. 2010.
- Bartle, I. and Vass, P. **Self-Regulation and the Regulatory State: A Survey of Policy and Practice**, The University of Bath, 2005.
- Booz, Allen, Hamilton Inc. **Ethiopia Commercial Law& Institutional Reform and Trade Diagnostic**, USAID, 2007.
- Castro, Daniel. **Benefits and Limitations of Industry Self-Regulation for Online Behavioral Advertising**, Washington, The Information Technology & Innovation Foundation, 2011.
- Change, Evelynne, Corporate Governance Reform In Africa: Key Considerations, in KEY CORPORATE GOVERNANCE ISSUES IN EMERGING MARKETS: THEORY AND PRACTICAL EXECUTION, A Conference Book, Germany, Center for Corporate Governance (Christian Strenger et al., 2012).
- Cigna P. Gian, Southern Europe: Regional Perspectives and Key Considerations, in KEY CORPORATE GOVERNANCE ISSUES IN EMERGING MARKETS: THEORY AND PRACTICAL EXECUTION, (Christian Strenger et al., 2012).
- Coglianese, Cary et al., **The Role of Government in Corporate Governance**, Regulatory Policy Program Report RPP-08, Cambridge, John F. Kennedy School of Government, Harvard University (2004).
- Colley, John et al., **What Is Corporate Governance?**, New York, McGraw-Hill Companies, 2005.
- Du Plessis, J. Jacques, Hargovan, A., and Bagaric, M. **Principles of Contemporary Corporate Governance** (2nd edition), Cambridge University Press, 2011.
- Freeman, R. Edward. **Strategic planning: a stakeholder approach**, London, Pitman Publishing, 1984.

- Garratt, Bob. **Thin on top : why corporate governance matters and how to measure and improve board performance,** Nicholas Brealey Publishing, 2003.
- Gregory, H. J., Simmelkjaer, R. T. **Comparative Study of Corporate Governance Codes Relevant to the European Union and Its Member States**, Weil, Gotshal & Manges LLP, 2002.
- Hansmann, H. and Kraakman, R. **Toward A Single Model of Corporate Law**, New York, Oxford University Press, 2002.
- Hontz, E. and Shkolnikov, A. (eds.). **Corporate Governance: The Intersection of Public and Private Reform**, Center for International Private Enterprise, 2009.
- Ibuakah, Isimkah, Key Issues and Challenges for Corporate Governance Reform in Nigeria, in KEY CORPORATE GOVERNANCE ISSUES IN EMERGING MARKETS: THEORY AND PRACTICAL EXECUTION, A Conference Book, Germany, Center for Corporate Governance, (Christian Strenger et al., 2012).
- Jackson, David, The role of the Company Secretary, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE, (Ken Rushton ed., 2008).
- Johnson, Lyman. **Law And The History of Corporate Responsibility,** Minneapolis, University of St. Thomas, Center for Ethical Business Cultures, 2011.
- Johnstone, Keith & Chalk, Will, What sanctions are necessary?, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE, (Ken Rushton ed., 2008).
- Keong, L. Chee (ed.). **Corporate Governance in the United Kingdom, in Corporate Governance – An Asian Pacific Critique**, Sweet & Maxwell Asia, 2002.
- Mayo, Charles, Directors' duties, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE 120, (Ken Rushton ed., 2008).
- Montagnon, Peter, The role of the shareholder, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE, (Ken Rushton ed., 2008).
- Mullerat, Ramon (ed.). **Corporate social Responsibility: The corporate governance of the 21st Century**, Kluwer law international, 2005.
- Nicholson, Bryan (Sir), The role of the regulator, in THE BUSINESS CASE FOR CORPORATE GOVERNANCE, (Ken Rushton ed., 2008).

- Nigel, Page (ed). **A guide to listing on the London Stock Exchange**, London, White Page Ltd., 2010.
- Shailer, Greg. **An Introduction to Corporate Governance in Australia**, New Jersey, Pearson Publisher, 2004.
- Sternberg, Elaine. **Establishing a market for corporate control**, Adam Smith Institute, 2012.
- Sternberg, Elaine. **The stakeholder Concept: A Mistaken Doctrine, Foundation for Business Responsibilities**, University of Leeds, 2001.
- Tricker, I. Robert. **International Corporate Governance: Text Readings and Cases**, New York: Prentice Hall, 1994.
- Wymeersch, Eddy. **Corporate governance codes and their implementation**, Belgian Banking, Finance and Insurance Commission, 2006.

Journals

- Adams, Renée and Mehran, Hamid. Is Corporate Governance Different for Bank Holding Companies?, **FRBNY Economic Policy Review**, Vol. *9*(1), 2003.
- Adekoya, A. Ayodele. Corporate Governance Reforms in Nigeria: Challenges and Suggested Solutions, **Journal of Business Systems, Governance and Ethics**, Vol. *6*(1), 2011.
- Aguilera, V. R., and Cuervo-Cazurra, A. Codes of good governance worldwide, what is the trigger? **Organisation Studies**, Vol. *25*(3), 2004.
- Anand, I. Anita. An Analysis of Enabling Vs. Mandatory Corporate Governance Structures Post Sarbanes-Oxley, **Delaware Journal of Corporate Law**, Vol. *31*. 2006.
- Asnakech, Getnet. Revisiting the Ethiopian Bank Corporate Governance system: A Glimpse of the Operation of Private Banks, **Law, Social Justice & Global Development Journal**, Vol. *1*(LGD), 2013.
- Berle, A. Adolf. Corporate Powers as Powers in Trust, **Harvard Law Review**, Vol. *44*(7), 1931.

- Chimere, Obodo. Globalization and Corporate Governance Challenges In Nigeria: A Regulatory And Institutional Perspective, **African Journal of Social Sciences**, Vol. *4*(2), 2014.
- Cioffi, W. John. Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany, **German Law Journal**, Vol. *7* (06), 2006.
- Coffee, C. John. Do Norms Matter? A Cross-Country Evaluation, **University of Pennsylvania Law Review**, Vol. *149*(2151), 2001.
- Coffee, D. John. The Rise of Dispersed Ownership: The Role of law and State in the Separation of Ownership and Control, **The Yale Law Journal**, Vol. *111*(1), 2001.
- Damagum, M. Chima and Chima, I. Emmanuel. The Impact of Corporate Governance on Voluntary Information Disclosures of Quoted Firms in Nigeria: An Empirical Analysis, **Research Journal of Finance and Accounting**, Vol. *4*(13). 2013.
- De Andres, Pablo and Vallelado, Eleuterio. Corporate Governance in Banking: the Role of Board of Directors, **Journal of Banking and Finance**, Vol. *32*, 2008.
- Dodd, E. Merrick, Jr. For Whom Are Corporate Managers Trustee?, **Harvard Law Review**, Vol. *45*(7), 1932.
- Dr. Bhasin, L. Madan. Voluntary Corporate Governance Disclosures: Evidence from A Developing Country, **Far East Journal of Psychology and Business**, Vol. *9*(2). 2012.
- Dragneva, O. Rilka. and Simons, B. William. Corporate Governance Revisited: Can The Stakeholder Paradigm A Way Out of "Vulture" Capitalism In Eastern Europe?, **Central and East European Law Review**, Vol. 27 No. 1, Kluwer Academic Publishers. 2001.
- Dye, A. Ronald. Disclosure of Non-proprietary Information, **Journal of Accounting Research**, Vol. *23*(1), 1985.
- Easterbrook, H. Frank, and Fischel, R. Daniel. Mandatory Disclosure and the Protection of Investors, **Virginia Law Review**, *70*(669), 1984.
- Farrar, H. John. Corporate Governance and the Judges, **Bond Law Review**, Vol. 15, Issue 1, 2003.
- Fekadu, Petros. Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implications, **Mizan Law Rev.**, Vol. *4*(1), 2010.

- Freeman, R. Edward and Reed, L. David. Stockholders and Stakeholders: A New Perspective on Corporate Governance, **California Management Review**, Vol. XXV, No. 3, University of California, 1983.
- Gill, Amiram. Corporate Governance as Social Responsibility, **Berkeley Journal of International Law**, Vol. *26*(2), 2008.
- Glaeser, E., Johnson, S., and Shleifer, A. Coase versus the Coasians. **Quarterly Journal of Economics,** Vol. *116*(3). 2001.
- Goergen, Marc et al., Recent developments in German corporate governance, **International Review of Law and Economics**, Vol. *28*(3). 2008.
- Gordon, N. Jeffrey. The Mandatory Structure of Corporate Law, **Colum. L. Rev.**, Vol. *89*. 1989.
- Graham, D., and Woods, N. Making Corporate Self-Regulation Effective in Developing Countries, **World Development journal**, Vol. *34*(5), 2006.
- Gstraunthaler, Thomas. Corporate Governance In South Africa: The Introduction Of King Iii And Reporting Practices, **Journal of Corporate Ownership & Control**, Vol. *7*(3)., 2010.
- Gupta, K. Anil, and Lad, J. Lawrence. Industry Self-Regulation: An Economic, Organizational, and Political Analysis, **The Academy of Management Review**, Vol. *8*(*3*), 1983.
- Heracleous, Loizos. Does Singapore Need A Code of Best Practice in Corporate Governance?, **Singapore Management review**, National University of Singapore, (n.d.).
- Ho, H. Virginia. Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide, **The Journal of Corporation Law**, Vol. *36*(1). 2010.
- Hussein, Ahmed. Overview of Corporate Governance In Ethiopia: The Role, Composition And Remuneration of Boards of Directors In Share Companies, **Mizan Law Rev.**, Vol. *6*(1), 2012.
- Hussein, Ahmed. Reforming Corporate Governance in Ethiopia: Appraisal of Competing Approaches, **Oromia Law Journal**, Vol. *3*(1), 2014.

- Inyang, J. Benjamin. Nurturing Corporate Governance System: The Emerging Trends in Nigeria, **Journal of Business Systems, Governance and Ethics**, Vol. *4*(2), 2009.
- Kahan, Marcel. The Limited Significance of Norms for Corporate Governance, **University of Pennsylvania Law Review**, Vol. *149*(1869), 2001.
- Kothari, S. P. et al., The Effect of Disclosures by Management, Analysts, and Business Press on Cost of Capital, Return Volatility, and Analyst Forecasts: A Study Using Content Analysis, **The Accounting Review**, Vol. *84*(5), 2009.
- La Porta, Rafael et al., Investor protection and corporate governance, **Journal of Financial Economics**, Vol. *58,* 2000.
- Laeven, Luc. Corporate Governance: What's Special about Banks?, **The Annual Review of Financial Economics**, Vol. *5,* 2013.
- Letza, S., Sun, X., and Kirkbride, J. Shareholding Versus Stakeholding: a critical review of corporate Governance, **Corporate Governance Alliance Digest,** Vol. 12 No. 3, Blackwell Publishing Ltd., 2004.
- Lu¨tz, S., Eberle, D., and Lauter, D. Varieties of private self-regulation in European capitalism: corporate governance codes in the UK and Germany, **Socio-Economic Review**, Vol. 9., 2011.
- Maassen, F. G., Van den Bosch, A. J., and Volberda, H. The importance of disclosure in corporate governance self-regulation across Europe: A review of the Winter Report and the EU Action Plan, **International Journal of Disclosure and Governance,** Vol. *1*(2), 2003.
- MacNeil, Iain, and Li, Xiao. "Comply or Explain": market discipline and non-compliance with the Combined Code, **Journal of Corporate Governance**, Vol. *14*(5), 2006.
- Manne, A. Geoffrey. The Hydraulic Theory of Disclosure Regulation and other Costs of Disclosure, **Alabama Law Review**, Vol. *58*(3), 2007.
- Marcinkowska, Monika. Regulation and self-regulation in banking: in search of optimum, **Bank i Kredyt**, Vol. *44*(2), 2013.
- Omarova, T. Saule. Wall Street as Community of Fate: Toward Financial Industry Self-Regulation, **University of Pennsylvania Law Review**, Vol. 159, 2011.

- Paredes, A. Troy. A Systems Approach to Corporate Governance Reform: Why Importing U .S. Corporate Law Isn't the Answer, **William & Mary Law Review**, Vol. *45*(3). 2004.
- Prof. Dr. Wolff, Lutz-Christian. Self-governance German style: comply or explain ...But, if you explain we will make you comply, **The Corporate Governance Law Review**, Vol. *1*(3), 2005.
- Prof. Tomasic, Roman. Company Law Modernization and Corporate Governance in The Uk— Some Recent Issues And Debates, **Victoria Law School Journal**, Vol. *1*, 2011.
- Rock, B. Edward and Wachter, L. Michael. Norms and Corporate Law, **University of Pennsylvania Law Review**, Vol. *149*(1607), 2001.
- Spong Kenneth and Sullivan, J. Richard. Corporate Governance and Bank Performance, **Journal of Economics Literature**, No. G21, G34, 2007.
- Agoraki, K. Maria-Eleni et al., The effect of board size and composition on bank efficiency, **European Journal of Law and Economics**, Vol. *23*(1), 2007.
- Sundaram, K. Anant, and Inkpen, C. Andrew. The Corporate Objective Revisited, **Organization Science,** Vol. *15*(3), 2004.
- Ungureanu, Maria-Cristina. Banks: Regulation and Corporate Governance Framework, **Journal of Ownership & Control**, Vol. *5*(2), 2008.
- Verrecchia, E. Robert. Discretionary Disclosure, **Journal of Accounting and Economics**, Vol. *5,* 1983.
- Verrecchia, E. Robert. Essays on disclosure, **Journal of Accounting and Economics**, Vol. *32,* 2001.
- Visentini, Gustavo. Corporate Governance: The Case of Banking, **Banca Nazionale Del Lavoro Quarterly Review**, Special Issue, 1997.
- Wilson, Inam. Regulatory and Institutional Challenges of Corporate Governance In Nigeria Post Banking Consolidation, **Nigerian Economic Summit Group (NESG) Economic Indicators**, Vol. *12*(2), 2006.
- Wolff, Lutz-Christian. Making Perfect Corporate Governance Rules: Mission Impossible?, **Corporate Governance International**, Vol. *7*(3), 2004.
- Yosifon, G. David. The Law of Corporate Purpose, **Berkeley Business Law Journal,** Volume *10*(2), 2014.

- Zadkovich, John. Voluntary Rules And 'Please Explain': A Corporate Governance Quagmire, **Deakin Law Review,** Volume *12*(2), 2007.

Working papers and Others

- Alem, Gebremedhin. **A Study On The Application Of Corporate Governance Principles In The Ethiopian Private Commercial Banks (The Case Of Lion International Bank)**, Addis Ababa University, (Unpublished MA thesis), 2011.
- Alexander, Kern. **Corporate Governance and Banking Regulation,** Working Paper 17, Cambridge Endowment for Research in Finance, 2004.
- Bogusz, Dennis. **Corporate Governance or Corporate Governments? Voluntary Firm Practices on Paths to Regulation**, (PHD Thesis), Columbia University, 2011. Available at http://academiccommons.columbia.edu/catalog/ac%3A131555 Accessed on 23-Oct.-2014.
- Dr. Alemayehu, Geda. **The Road to Private Sector Led Economic Growth,** (A strategy document), Addis Ababa, Ethiopia Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectoral Associations, 2009.
- Gebeyaw, Simachew. **A Critical Analysis of the Ethiopian Commercial Code in Light of OECD Principles of Corporate Governance Framework**, (PHD dissertation), University of London, 2011/12. Available at http://sas-space.sas.ac.uk/4733/ Accessed on 10-Nov.-2014.
- Gregory, J. Holly and Simms, E. Marsha. **Corporate Governance: What It Is and Why It Matters**, A paper presented at 9th International Anti-Corruption Conference, 10-15 October 1999, Durban, South Africa. Available at http://9iacc.org/papers/day2/ws3/dnld/d2ws3_hjgregorymesimms.pdf Accessed on 12-April-2014.
- Haskovec, Nolan. **Codes of Corporate Governance**, A working paper, Millstein Center for Corporate Governance and Performance, 2012.
- International Finance Corporation. **Corporate Governance Manual** (2nd ed.), Hanoi, Vietnam, BACSON. 2010.

- International Finance Corporation. **Practical Guide to Corporate Governance: Experiences from the Latin American Companies Circle**, Pennsylvania, 2009. Available at www.ifc.org/corporategovernance Accessed on 19-Sep.-2014.
- Joskow, Paul et al., **Regulatory Constraints on CEO Compensation**, Brookings Papers: Microeconomics, 1993. Available at www.**brookings**.edu/~/media/projects/.../1993a_bpeamicro_joskow Accessed on 5-Aug.-2014.
- Kahsay, Mulu. **Introducing Regulated Stock Markets In Ethiopia: Relevance To The Banking Sector Development And Role In Investors' Protection**, Addis Ababa University, Unpublished LLM Thesis, 2011.
- Levine, Ross. **The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence**. World Bank Policy Research Working Paper 3404, 2004.
- Organisation for Economic Co-operation and Development. **OECD Principles of Corporate Governance**, Paris, 2004.
- Panchasara, M. Bhavik. **An empirical study on Corporate Governance in Indian Banking Sector** (PHD thesis), Saurashtra University, 2012. Available at http://etheses.saurashtrauniversity.edu Accessed on 19-Jul.-2014,
- Private Sector Development (PSD) Hub. **Recommendations And Position Paper of The Business Community on The Revision of The Commercial Code of Ethiopia**, Addis Ababa Chamber of Commerce & Sectoral Associations, 2008.
- Seidl, D., Sanderson, P., and Roberts, J. **Applying 'Comply-Or-Explain': Conformance with Codes of Corporate Governance In The Uk And Germany**, Working paper, University of Cambridge, Centre for Business Research, 2009.
- The FDRE Ministry of Finance and Economic Development. **Growth and Transformation Plan 2010/11-2014/15**, Vol. *1*(Main text), 2010.
- United Nations Conference on Trade and Development (UNCTAD). **Corporate Governance in the Wake of the Financial Crisis: Selected international views**, United Nations, 2010.
- Wondaferahu, Mulugeta. **The Structure and Development of Ethiopia's Financial Sector**, Andhra University, 2010.

Internet Sources

- Ahern, Deirdre. **Replacing 'Comply or Explain' with Legally Binding Corporate Governance Codes: An Appropriate Regulatory Response?,** 2010. Available at **regulation**.upf.edu/dublin-10-papers/5A3.**pdf** Accessed on 10-Oct.-2014.
- Anita Anand et al., **Voluntary vs. Mandatory Corporate Governance Regulation: Theory and Evidence**, 2005. Available at www.law.harvard.edu/ Accessed on 13-Mar.-2014.
- Anand, I. Anita. **Voluntary Vs Mandatory Corporate Governance: Towards An Optimal Regulatory Framework,** (n.d.). Available at www.law.harvard.edu/.../**Voluntary%20vs%20Mandatory%20Corporate** Accessed on 16-Apr.-2014.
- Arcot, R. Sridhar and Bruno, G. Valentina. **One size does not fit all, after all: Evidence from Corporate Governance,** 2006. Available at siteresources.worldbank.org/INTFR/.../Valentina_Bruno_Feb_8.**pdf** Accessed on 2-May-2014.
- Arun, T.G. and Turner, J. D. **Corporate Governance of Banks in Developing Economies: Concepts and Issues,** (n.d.). Available at www.seed.manchester.ac.uk/medialibrary/IDPM/.../depp_wp02.**pdf** Accessed on 18-June-2014.
- Baker, C. Richard and Quéré, P. Bertrand., **Accountability, Corporate Governance and the Role of the State**, (n.d.). Available at apira2010.econ.usyd.edu.au Accessed on 11-Mar.-2014.
- Basel Committee on Banking Supervision. **Principles for enhancing corporate governance**, 2010. Available at www.bis.org/publ/bcbs176.pdf. Accessed on 20-Feb.-2014.
- Becher, A. David and Frye, B. Melissa. **Does regulation substitute or complement governance?**, 2008. Available at fic.wharton.upenn.edu/fic/papers/08/0816 Accessed on 11-March-2014.
- Bruno, G. Valentina and Claessens, Stijn. **Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?,** 2007. Available at

www.ifc.org/.../Bruno%252C%2BClaessens%2B-%2BCorporate%2BGov Accessed on 11-Mar.-2014.

- Cocriş, Vasile and Ungureanu, C. Maria. **Why Are Banks Special? An Approach from The Corporate Governance Perspective**. 2007. Available at anale.feaa.uaic.ro/.../08_Cocris_V,_Ungureanu_MC_-_Why_are_banks_ Accessed on 11-Mar.-2014.
- Financial Reporting council. **The Combined Code on Corporate Governance**, 2008. Available at http://www.ecgi.org/ Accessed on 5-Sep.-2014.
- Financial Reporting Council. **The UK Corporate Governance Code**, 2012. Available at http://www.ecgi.org/ Accessed on 11-Mar.-2014.
- Iskander R. Magdi and Chamlou, Nadereh. **Corporate Governance: A Framework for Implementation overview**, The World Bank, 2000. Available at www.worldbank.org/html/fpd/privatesector/cg. Accessed on 14-Apr.-2014.
- Jackson, Gregory. **Understanding Corporate Governance in the United States: An Historical and Theoretical Reassessment**, 2010. Available at www.boeckler.de Accessed on 30-Oct.-2014.
- **King Report on Governance for South Africa**. Institute of Directors. 2009. Available at http:// african.ipapercms.dk/IOD/KINGIII/kingiiireport/ Accessed on 20.-July-2014.
- La Porta, Rafael et al., **What Works in Securities Laws?,** 2004. Available at http://post.economics.harvard.edu/faculty/shleifer/papers/securities-final.pdf Accessed on 15-May-2014.
- Polo, Andrea. Corporate governance of banks: the current state of the debate, MPRA, 2007. Available at http://mpra.ub.uni-muenchen.de/2325/ Accessed on 11-Mar.-2014.
- Private Sector Federation. **Guiding Code of Corporate Governance**, Rwanda, 2008. Available at www.psf.org.rw Accessed on 11-Mar.-2014.
- Rapp, S. Marc et al., **Hard or Soft Regulation of Corporate Governance?,** (n.d.). Available at www.ccfr.org.cn/cicf2012/papers/20120131034312.pdf Accessed on 11-Nov.-2014
- Rapp, S. Marc et al., **Is Soft Regulation of Corporate Governance Efficient From a Shareholders' Perspective?,** 2013. Available at

www.bath.ac.uk/management/news_events/.../**pdf**/SchmidThomas. Accessed on 11-Mar.-2014.

- Reports on Observance of Standards and Codes (ROSC) Ethiopia. Commissioned Report. 2007. Available at http://www.worldbank.org/ifa/rosc_aa_ethiopia.pdf Accessed on 19-Mar.-2014.
- Sanderson, Paul et al., **Flexible or not? The comply-or-explain principle in UK and German corporate governance**, 2010. Available at regulation.upf.edu/dublin-10-papers/4A2.**pdf** Accessed on 4-Mar.-2014.
- Spencer Stuart consultancy firm. **Board Governance in South Africa**, 2009, Available at https://www.spencerstuart.com/.../**PDF**%20Files/Research%20and%20Insi... Accessed on 30-Oct.-2014.
- The Center for International Private Enterprise. **Instituting Corporate Governance In Developing, Emerging and Transitional Economies**, 2002. Available at http://www.cipe.org Accessed on 19. Feb.-2014.
- The World Bank. **Report on the Observance of Standards and Codes (ROSC): Corporate Governance**, 2009. Available at www.**worldbank**.org/ifa/rosc_cg. Accessed on 11-Mar.-2014.

Laws

- Addis Ababa Chamber of Commerce and Sectoral Association, (2011). **The Ethiopian Code for Corporate Governance.**
- Banking Business Proclamation No.592/2008, **Negarit Gazeta**, 14th year, No. 57, Addis Ababa.
- Commercial Code of The Empire of Ethiopia, Proclamation no. 166/1960, **Negarit Gazeta**, Extraordinary Issue, No. 3, Addis Ababa.
- Corporate Governance for Banks/Insurers/Micro Finance Institutions, **Directives No. --/2014**, Draft Version. Available at www.nbe.gov.et Accessed on 10-Nov.-2014.
- Commercial Registration and Business Licensing Proclamation, Proclamation No. 686/2010, **Negarit Gazeta**, 16th year, No. 42, Addis Ababa.

- Insurance Business Proclamation No. 746/2012, **Negarit Gazeta**, 18th year, No. 57, Addis Ababa.
- Licensing and Supervisions of Banking Business, Limits on Boards Remunerations and Number of Employees Who Set on Bank Board, **Directive No. SBB/49/2011**. Available at http://www.nbe.gov.et/pdf/directives/bankingbusiness/sbb-49-11.pdf Accessed on 10-Nov.-2014.
- Micro-Financing Business Proclamation No. 626/2009, **Negarit Gazeta**, 15th Year, No. 33, Addis Ababa.
- The National Bank of Ethiopia Establishment (as Amended) proclamation, Procl. No. 591/2008, **Negarit Gazeta**, 14th Year, No. 50, Addis Ababa.
- **The revised Commercial Code of The Federal Democratic Republic of Ethiopia,** (Draft Version).

Newspaper Articles

- Addis Ababa Chamber of Commerce & Sectoral Association, (2012). **Addis Business, External Relations and Media Department Monthly News Paper**, Vol. *11*(4).
- Addis Ababa Chamber of Commerce & Sectoral Association, (2013). **Addis Business, External Relations and Media Department Monthly News Paper**, Vol. *11*(5)
- Addis Ababa Chamber of Commerce & Sectoral Association, (2014). **Addis Business, External Relations and Media Department Monthly News Paper,** Vol. *12*(7).
- Editorial, **the Reporter**, Vol. *20* Issue No. 1512, Published Weekly by Media and Communications Center Plc., Sunday 26-Oct.-2014.
- Dawit, Taye. Wogagen Bank earns 413.8 Mill. Br. before tax, **the Reporter**, Vol. *20* Issue No. 1515, Published Weekly by Media and Communications Center Plc., Wednesday 5-Nov.-2014.
- Dawit, Tay. The Corporate Governance Code and the business community, **the Reporter**, Vol. *20* Issue No. 1544, Published Weekly by Media and Communications Center Plc., Sunday 15-Feb.-2015.

- Letter from Nib International Bank board Members, **the Reporter**, Vol. *20* Issue No. 1500, Published Weekly by Media and Communications Center Plc., Sunday 17-Aug.-2014.
- Letter from Nib International Bank board Members, **the Reporter**, Vol. *20* Issue No. 1510, Published Weekly by Media and Communications Center Plc., Sunday 19-Oct.-2014.
- Yohannes, Anberbir. The establishment of the regulatory agency is extended, **the Reporter**, Vol. *20* Issue No. 1513, Published Weekly by Media and Communications Center Plc., Wednesday 29-Oct.-2014.

Interviews

- Interview with Ato Nuredin Mohammed, Advisor, State Minister for trade practice and regulatory sector, on 8th Dec., 2014.
- Interview with W/ro Tsion Admassu, Manager of the Ethiopian Institute of Corporate Governance, on 5th Dec., 2014.