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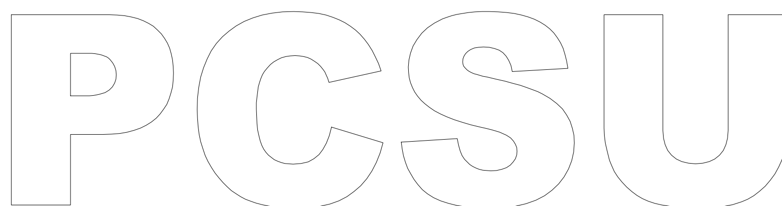

The Corporate Governance Policy Framework in Egypt

Special Study

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EXECUTIVE SUMMARY

Corporate governance issues are at the heart of the problem of economic transition —— how to convince economic actors to act differently, to become more efficient, to look outwards, to search for new opportunities rather than to wait for current problems to go away or to be solved by government. More specifically, *corporate governance refers to the set of rules and incentives by which the management of a company is directed and controlled.* Shareholders are confronted with a basic problem: how can they monitor and control the activities of management? Two basic types of conflict of interest are possible:

- In widely held companies, conflicts of interest exist between management and shareholders. Good corporate governance procedures keep managers accountable.
- In closely held companies, large shareholders can expropriate minority shareholders. Good corporate governance encourages additional investment and lowers the cost of capital.

At a formal level, the corporate governance framework in Egypt seems to work reasonably well: shareholders vote at annual general meetings, Boards of directors meet, many companies are restructuring and preparing for the more competitive market environment to come. However, the need for corporate governance reform remains urgent and although much has already been done, Egypt has some distance to go. Where and how far is indicated by a comparison of its present corporate governance policy framework with emerging international standards.

In recent years a consensus has emerged around the world that shareholder value is the goal of good corporate governance. There is also an emerging consensus that four separate but highly related factors lead to better corporate governance:

1. A strong, clear, and well-enforced **legal framework**, particularly in the protection of shareholder rights. This includes basic shareholder ownership rights and protection, minority shareholder rights, and the basic governance processes and procedures. Enforcement powers are also key.

2. Requirements for greater i**nformation disclosure** leading to greater transparency and allowing shareholders (and other stakeholders) to monitor management activities and to enforce ownership rights. This area also includes the accounting reform and the adoption of international accounting and auditing principles.

3. The adoption of Board practices designed to provide **independent, accountable oversight of managers.** An active and objective Board of Directors is the main line of defense against management abuses, and can respond immediately and flexibly in a way that the regulators and the shareholders cannot. Typical steps to a more active and objective Board:
   - Clarify the corporate objective / mission
   - Define Board responsibilities
   - Encourage Board independence, and define an optimal mix of "Independent", "Executive", and other types of Directors. (Almost all reforming countries recommend some level of independence on the Board, although the definitions of independence can differ).
   - Define ideal Board composition and criteria for Board membership
   - Encourage independent Board leadership (e.g. separate the roles of CEO and Chairman).

- Establish Board committees, if possible with independent Board members as chairmen.

4. **External factors** are also crucial, although were only briefly considered in this Study. The economic and policy environment that surrounds the firm is a basic influence on a Board of directors. In addition, the financial markets play a key role. Successful corporate governance reform will require the creation and strengthening of natural allies. The securities industry is a natural ally in the advocacy of shareholder rights, transparency and accountability.

Legal reform and disclosure have long been recognized as critical to the creation of well-functioning securities markets and strong investor protection. They are often reflected in the securities laws many developed (and many emerging) markets.

What is new about the contemporary governance debate is the strong focus on the Board of Directors. The past five years has witnessed a proliferation of "codes of best practice" designed to improve the ability of corporate directors to hold managements accountable. Over 30 codes have been developed; most deal with internal governance mechanisms (especially the role of Boards). Many codes are voluntary; they help change business values, and help forward-thinking firms eager to tap markets and meet international standards. Other codes are less voluntary, and are linked to stock exchange rules. Listed companies are typically required to disclose whether they follow the code, and to disclose any deviations.

How does Egypt compare to the "world standards"?

The picture of the corporate sector is similar to many countries around the world. Ownership is extremely concentrated; among 40 actively traded companies, only a handful meet the definition of "widely held" used in the literature. This ownership concentration raises fears of minority shareholder expropriation by large shareholders, and puts renewed emphasis on basic legal reform. In addition, Egypt has a large number of stock exchange-listed companies, making stock exchange information disclosure requirements a powerful and wide-reaching tool.

In Egypt the capital market institutions are growing and maturing rapidly, and already providing impetus to improved corporate governance practices.

A basic review of the legal, disclosure and oversight frameworks lead to 19 recommended changes or courses of action, described in Table 1 below. To summarize:

- **Legal and regulatory development.** The basic law supports many basic shareholder rights, and many improvements are on the way (new depository and capital markets laws), although some changes are required to bring the law into compliance with international standards. Harmonization, future enforcement, and court efficiency are the key issues.
- **Information Disclosure.** The new draft Stock Exchange listing rules appear to point Egypt on the right path. The new rules will apparently require a new level of disclosure, including "governance disclosures" (e.g. ownership structures). Enforcing the rules, and fining or delisting the offending firms will make a real difference in the Egyptian business culture. The stock exchange should be supported in its stated goal: to delist firms that do not comply.
- **Management Oversight**. Egypt is in the very early stages of developing Board independence. There is some confusion about the role of the Board vis-à-vis management. Family owners typically play both roles and end up both managing and

monitoring. A code of best practice (rather than legal change) is probably an efficient way to introduce the Oversight concepts.

The study proposes the outline of an initial strategy for reform:

- Create a working group to draft a code of best practice
- Use the opportunity to make changes to draft laws, and the consensus generated by a working group, to draft a world-class company law
- Focus on the role of the State in corporate governance
- Train directors and explore the creation of an "institute of directors"
- Develop monitoring and rating procedures for corporate governance

Table 1:
Summary of Key Recommendations for Corporate Governance Reform in Egypt

1. The draft companies law should be harmonized with the new capital markets and depository laws after their enactment.
2. The draft companies law could include a list of specific responsibilities for the Board of directors. It could also recommend the mandatory creation of audit and other committees of the Board.
3. All parties (the Holding Companies, regulators, the securities industry, and issuers) should encourage rapid conversion of registries and depositing of shares into the MCSD.
4. Careful attention should be paid to companies with relatively large numbers of shareholders not maintained by the MCSD. A review of off-exchange transfer procedures may be worthwhile.
5. Egypt does not comply with one-share/one-vote. Although this is not an OECD requirement, international investors encourage it.
6. To the extent it is not covered in the new Capital Markets Law, insider trading should be made illegal, as part of the executive regulations, and steps should be taken at enforcement.
7. Per the OECD Principles, "Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares."
8. The laws and procedures related to shareholder appeals to the CMA and shareholder arbitration should be reviewed, and lessons learned should be incorporated into the Executive Regulations of the new Capital markets Law. Contractually binding arbitration may be a good solution to the problem of a slow court process.
9. The restrictions on the use of proxies and the blocking of shares required at annual meetings represent an unnecessary burden on shareholders, and are out of line with international standards. A working group should be convened to study the entire question of voting rights, procedures, and proxies, with the final goal of drafting provisions for the new draft company law that will modernize voting procedures and the use of proxies.
10. The working group should also explore mandatory cumulative voting as a way of increasing minority representation on closely held Boards.
11. Imposing a duty of loyalty of another fiduciary duty on controlling shareholders and/or officers of the company is a direct approach to reducing the risk of expropriation of minority shareholders. It should be investigated if these obligations could be inserted into the draft Uniform Companies Law.
12. The laws regulating Board conflicts of interest should be reviewed in the draft law.
13. To the extent not addressed in the new draft Capital Markets Law, takeover regulation should be reviewed to ease the regulatory burden as much as possible.
14. The CMA should be the "relevant administrative authority", the official guarantor of corporate governance in Egypt, and should work hand-in-hand with the Companies department to regulate the activities of joint stock companies.
15. The Ministry of Economy and the CMA should develop a strategy for future development of accounting rules, application of the accounting standards, and improving the training of the accounting profession.
16. The CASE should be supported in a vigorous enforcement of its new listing rules, even if large number of delistings should eventually result. Delisting should only take place once all other alternatives and penalties have been exhausted.
17. The CASE should encourage compliance with all aspects of the new rules, including the crucial data on ownership structure, names of directors, bank relationships, voting rules, etc.
18. The revision to the company law (and any work towards a code of best practice) should include a review of holding company law and practice. This area is a potentially large problem for shareholder rights.
19. Egypt should begin the process of putting together a code of best practice. The Code should specifically address the Management Oversight / Board Structure issues. Shareholder rights and disclosure issues that are raised can be inserted into Law and Listing requirements. Some countries to look at as models are Korea, Brazil, and especially Mexico, whose economies were similar in structure to Egypt. Moving quickly is important because the some of the Best Practice Committee's recommendations could be incorporated in the final version of the new Uniform Companies Law and perhaps even the Capital Markets Law. Moving quickly would also show Egypt's eagerness to embrace foreign investors and the global capital market.

INTRODUCTION

In the past decade many countries have made economic progress by implementing market-based reforms and recognizing the role of the private sector as the engine of growth. The successful package of reforms has typically included disinflationary macroeconomic adjustment, liberalization of trade and capital flows, banking and financial sector reform, public enterprise reform, and (last but by no means least) privatization. Although there has been recent frustration with some aspects of the reform package, especially privatization, the basic consensus remains solid. Many countries around the world including Egypt have benefited from pro-market and pro-growth policies, and have impressive growth rates to show for them.

Over the past several years, corporate governance reform has been added as “the newest pillar of the post-Cold War economic architecture.”[1] In 1998, following the Asian financial crisis and the Russian debt default, the leaders of the G7 nations announced a new focus on corporate behavior and incentives. By mid-1999 the Organization for Economic Cooperation and Development (OECD) adopted a set of basic principles. The international financial institutions (IFIs) all view improved governance practices as a key to spurring prosperity and jobs by strengthening corporations' ability to compete for global capital. In response, over 30 countries (in both emerging and mature markets) have now developed “codes of best practice” or have initiated legal, regulatory and institutional corporate governance reform projects.

Many of our counterparts mentioned that corporate governance reform was new to Egypt, and that this study was in many ways a “first”. In that regard, the study should be considered the first step in both building a body of research and a set of action steps to bring international-standard corporate governance reform to Egypt. Many items are only touched briefly upon because of the fact that on-going reform and technical assistance projects are already deeply involved in addressing those issues. Future Special Studies by the PCSU will take a detailed look at corporate governance development at the company level.

The first part of this paper addresses the question: what is corporate governance? It briefly sets out the essential elements of the concept, and reviews the nature and origin of many corporate governance concerns. The second section summarizes the main features of the emerging international standards in corporate behavior and regulation. The third section reviews the Corporate Governance situation in Egypt, with emphasis on areas of greatest divergence between the new international standards and Egyptian law and practice. The fourth and final section proposes an initial strategy for reform.

This study was prepared in association with the Ministry of Economy and Foreign Trade, as a Special Study by the Privatization Coordination Support Unit, administered by CARANA Corporation. The full terms of reference for this paper are presented as Appendix C.

WHAT IS CORPORATE GOVERNANCE?

At the most basic level, corporate governance is about the relationship of the management of a joint stock company with its owners. Early in a firm's life, its founders/managers may not require any outside capital, or may be able to supply it all themselves. In this case, the interests of management and owners (equity capital) are perfectly aligned. However, as the firm grows, it may require large amounts of both debt and equity capital. As new equity capital is injected, the interests of the owners (shareholders) may begin to diverge from those of the managers. At this point, the shareholders are confronted with a basic problem: how can they monitor and control the activities of management? This problem increases as the company grows, as the number of shareholders increases, as the activities of the firm become more complex, and during the transition to a market economy.

While much is discussed in its name, it is difficult to find a clear, universally accepted, definition of what is meant by corporate governance. For the purposes of this study,

> *Corporate governance refers to the set of rules and incentives by which the management of a company is directed and controlled. Good corporate governance maximizes the profitability and long-term value of the firm for shareholders.*[2]

Corporate governance reform has implications for Boards of State-owned enterprises and smaller companies, as well as large companies listed on an exchange. Indeed, governance is at the heart of the role that all Boards of directors play, so an understanding of what it is about and the issues involved can provide useful insight for policymakers, Board members, managers, analysts, and shareholders alike.

Corporate governance is thus many things to many people. A review of the issues raised in the debate indicates that "corporate governance" casts a wide net, and touches on many of the most fundamental choices remaining in a modern economy. The modern corporate governance debate centers on four key issues, but raises a large number of difficult questions (see Table 2 below).

BASIC FRAMEWORK

Large corporations are typically a dominant force in a market economy. Since its creation over 400 years ago, the limited liability legal form has been fantastically successful. The separation of management and ownership allows for managers and the providers of capital to specialize in what each does best. However, as corporations (especially publicly traded ones) grow, they need to achieve a balance between giving directors and management enough discretion to run the company without undue interference, and making them accountable to shareholders and other corporate stakeholders (workers, banks, creditors, suppliers, customers, and the State).

Good corporate governance bridges the gap between the two sets of interests, and is the result of strong oversight and incentives for management to act in the interest of shareholders. The main benefit of good corporate governance is straightforward: stronger private investment and corporate performance. For the economy as a whole, better corporate governance results in a more efficient corporate sector, and higher levels of economic growth.

Table 2:
Selected Policy Issues falling in the realm of Corporate Governance

Accountability of management to shareholders, based on a balance of power between the Board of directors, management, shareholders, and the auditor.	**Fairness** to minority investors (protection against fraud, self-dealing, or insider wrongdoing).	**Transparency** through the improved disclosure of accurate and timely information on corporate performance.	**Responsibility** of the corporation / joint stock company to obey the law and to act with regard to the needs of other corporate stakeholders (workers, State, customers, etc.).
Key policy issues include:	Key policy issues include:	Key policy issues include:	Key policy issues include:
➢ Monitoring company and management performance ➢ Optimal Board structure (e.g. one-level vs. two-level Boards) ➢ Determining the role of banks and other creditors on the Board of directors ➢ Setting executive compensation packages, including salary, fringe benefits, and options ➢ The role of the auditor ➢ The role and responsibilities of Boards of directors ➢ The composition of the Board of directors ➢ The role of the independent director ➢ The roles and responsibilities of shareholders	➢ Privatization policy ➢ Quality of shareholder recordkeeping infrastructure (capabilities of central depositories and registries to maintain accurate shareholder records) ➢ Protections offered to minority investors in the company and securities laws ➢ Rights of shareholders to participate at Annual General Meetings ➢ Enforcement capabilities of the securities (and other) regulators ➢ Efficiency of the legal system and the courts to handle private lawsuits	➢ Accounting standards and compliance with international accounting standards ➢ The external auditing function and financial disclosure ➢ The role of the internal auditor ➢ The role of the audit committee ➢ Stock exchange listing requirements ➢ Dissemination of information	➢ Compliance with the law (and the prevention of corruption) ➢ Worker participation in company management ➢ The State's role in company management (before, during, and after privatization) ➢ Company communication with stakeholders and the media ➢ Responding to "Shareholder activism"

The four major players in corporate governance are presented in the figure below:[3]

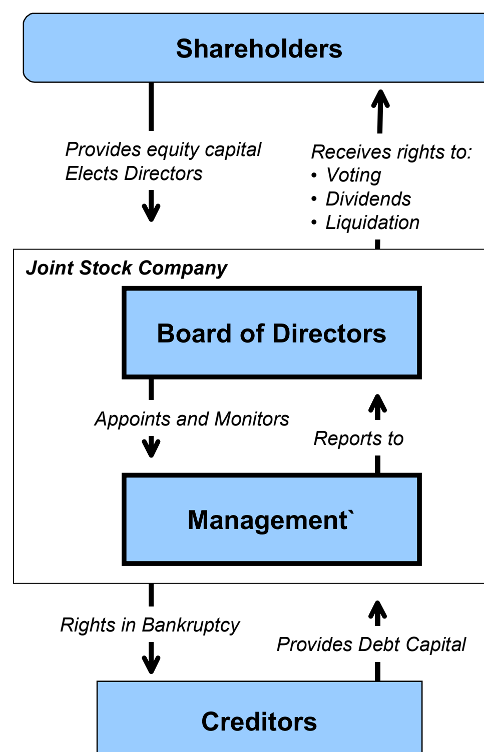
- **Shareholders** provide equity capital in exchange for the rights to profits and increases in corporate value. Share ownership is safeguarded by certain rights: to sell shares, to elect and remove directors and to approve or disapprove fundamental changes, such as mergers or changes in capital structure. In general, shareholders want to maximize the value of the firm's equity and distributions.

- **The Board of directors** is supposed to represent the basic interests of shareholders (and sometimes other interested parties). It selects and replaces management, provides general direction to managers, and reviews management performance. In most countries the Board has responsibility for strategic planning (including mergers and acquisitions), declaring dividends and setting incentives for management. Since the Board may be composed of representatives of shareholders, managers, creditors, workers and other **stakeholders**, its

interests can be mixed. But in many countries the Board has a legal fiduciary duty to shareholders.

– **Management reports to the Board and** has responsibility for day-to-day operations. It is responsible for maximizing corporate profits and shareholder value, but often has other Board-defined objectives (environmental protection, maintaining jobs and so on). Managers are assumed to want to maximize their salaries, benefits and professional reputations.

– **Creditors'** interests focus on maximizing the probability of repayment of debt. In countries where creditors are allowed to have a substantial equity stake, this interest can be balanced by that of maximizing company value.



The interests of these parties often conflict, particularly when things go wrong. The key challenge in these conflicting interests is the so-called "principal-agent problem", that of ensuring that managers (agents) represent the interest of shareholders (principals) in maximizing corporate value.

The conflicts of interest differ depending on the type of company. For widely held companies (i.e. companies with no controlling or "anchor" shareholder, traditionally in countries like the US, UK, Japan, or Taiwan) good corporate governance keeps managers accountable to shareholders. Managers without any oversight may have an interest in executing projects that do not maximize shareholder value. Expropriation might take many forms:

- **Above market wages.** Managers could pay themselves an overly generous salary. This issue is a key "hot-button" in many developed markets, as executive pay packages have spiraled up in recent years.
- **Unprofitable investment projects.** Managers might carry out projects that provide no long-term benefit to shareholders. This might include overly elaborate and expensive headquarters buildings, white-elephant investment projects in a manager's home city, or growing at breakneck speed to build market share without concern for profitability. The

fate of the large chaebols in Korea is a prime example of a lack of corporate governance leading to major shareholder losses.

- **Overly risky financial transactions.** Managers may borrow heavily to promote expansion, without concern for high levels of leverage that will get the company in trouble when market growth slows. As described below, this pattern was prevalent in East Asia and contributed to the "Asian Financial Crisis".
- **Asset Stripping.** Managers could remove assets from the company, without the knowledge of other shareholders. As the managers sell or reposition the assets, the formerly valuable company will become a worthless shell. This failure of corporate governance clearly held back the transition in a number of Central and Eastern European countries in the 1990s.
- **Nepotism.** A well-entrenched Managing Director could appoint his children to all key company positions, leading to incompetent management and future losses, but big potential gains to the manager and his family. The experience of the Korean chaebols is again an indication of the potential dangers of this practice.

There is considerable empirical evidence to suggest that monitoring, control, and accountability improve shareholder value. Many surveys around the world suggest that the positive impact of corporate governance is measurable. A small sample:

- One study correlated the performance of U.S. companies to corporate governance criteria. The result was a argument for corporate governance reform: the more active and independent a Board of directors is, the better the company performs.[4]
- Another study concluded that close monitoring by companies pays big dividends. Companies that were closely monitored and targeted by CalPERS (The California State Pension Fund) significantly under-performed the S&P 500 index in the five years before intervention, and out-performed the index for up to five years after the intervention.[5] Companies outperformed the index by 54.4 percent in the five years following application of pressure from the fund.
- A study by McKinsey concluded there is a 'governance premium' which indicates that shareholders are prepared to pay more for shares in companies which conform with local standards of best practice on corporate governance.[6]
- Other studies have examined the premium for shareholder rights. Non-voting shares tend to trade at a discount, which in some cases is substantial. For example, in the UK in mid-1997, there was an 18.8% premium at one company and a 75% percent premium at another, for the voting as opposed to non-voting stock.[7]

ADDITIONAL CHALLENGES IN EMERGING MARKETS

In most emerging markets shareholders can be further separated into **controlling shareholders** and **minority shareholders**. Most corporations are closely held, often by founding families, who dominate the Board and often occupy key management positions. The majority shareholder often serves as the chief executive officer or chairman of the Board and has the decisive vote in major corporate decisions. The controlling shareholders are thus "insiders" and tend to be indistinct from management. As a result, the key issue is protecting minority shareholders against possible expropriation by controlling/majority shareholders.

Several studies have recently reviewed shareholding patterns around the world. A study of the world's top 27 stock markets finds that in the average market only 36 percent of the largest publicly traded firms are widely held.* This average would be even lower if some

* "Widely held" is defined in this study as no shareholders controlling more than 20 percent of the votes.

advanced markets were excluded (e.g. the UK had 100% of large companies widely held, Japan 90%, and the US 80%).[8]

Family dominance is also very common (see Table 3 below). On average, 30 percent of each market's firms were controlled by a family group. Among smaller companies the share of closely held firms is higher still. The family held the position of CEO or Chairman in more than 68% of these family-controlled firms.[9]

Table 3:
Family Control of Large Publicly Traded Firms around the World

Country	Percent of large companies that are family controlled	Of which: Family involved in management
Argentina	65	62
Australia	5	100
Austria	15	33
Belgium	50	50
Canada	25	100
Denmark	35	57
Finland	10	50
France	20	75
Germany	10	50
Greece	50	60
Hong Kong	70	50
Ireland	10	100
Israel	50	60
Italy	15	100
Japan	5	100
Mexico	100	95
Netherlands	20	50
New Zealand	25	60
Norway	25	80
Portugal	45	44
Singapore	30	67
South Korea	20	75
Spain	15	67
Sweden	45	56
Switzerland	30	100
UK	0	0
US	20	75
Average	**30**	**68.5**

Source: La Porta, Rafael, Florencio Lopez-de-Silanes and Andrei Sheifer "Corporate Ownership Around the World," NBER working paper # 6625, June 1998

Empirical evidence suggests that, in emerging markets, valuations for closely held companies are lower than they otherwise would be because of minority shareholders' fear of expropriation.[10] The discounts can range from 82 percent to nearly 100 percent.[11] In advanced securities markets with stronger protection for outside investors, the discount tends to be smaller but still significant (6 to 20 percent). Such discounts increase the cost of funds, which further weakens insiders' incentive to reduce their ownership stake, creating a vicious circle of insider control. In particular, foreign investors may be much less willing to invest.[*]

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[*] Co;;ncentrated shareholdings should have many benefits. In mature markets, securities analysts generally regard significant share ownership by corporate insiders as a sign of commitment that enhances the firm's value. Ownership concentration eases the job of monitoring and directing corporate management. The empirical evidence suggests that ownership concentration is a two-edged sword, and is distrusted by investors once beyond a certain level.

THE MAIN FEATURES OF THE EMERGING INTERNATIONAL STANDARDS IN CORPORATE GOVERNANCE AND ITS REGULATION

> *Corporate governance - ten years ago the phrase was not used, today it is commonplace. The work of company directors is in the spotlight. The issues are legion: how to improve corporate performance and strategies, how to ensure corporate conformance through executive supervision and accountability, the role of outside directors, audit committees, chairman and CEO, directors' remuneration, German two-tier Boards, Japanese Boards, institutional investor power...*[12]

Many factors are responsible for the creation of well-governed corporations, where management acts in the interests of shareholders to build shareholder value. Active, dynamic, and imaginative managements push companies into new markets, provide new or cheaper services to customers, and reacts swiftly to outside pressures. However, ensuring that management acts in the interest of shareholders (and also that controlling shareholders protect the interests of minority shareholders) generally requires more.

A basic world standard is emerging in corporate governance. The mission of the company under the standard is to build shareholder value. Building and protecting shareholder value comes from a combination of three different (but closely linked) packages of reforms[*]:

- **Basic Legal and Regulatory Framework**. A strong, clear, and well-enforced legal framework is crucial and fundamental, particularly in the protection of shareholder rights. In emerging markets, the legislative framework plays an especially important role, because market pressures and shared values that result in good governance are not fully in place.
- **Information Disclosure**. Requirements for greater Information disclosure lead to greater transparency and allow shareholders (and other stakeholders) to monitor management activities and to enforce ownership rights.
- **Independent Oversight of Management**. The adoption of Board practices designed to provide independent, accountable oversight of managers

Standards for corporate governance are reflected in many countries through "**Codes of Best Practice**". The modern trend of developing corporate governance guidelines and codes of best practice began in the early 1990s in the UK, the US and Canada in response to a perceived lack of effective Board oversight that contributed to poor company performance. The Cadbury Report in the UK, the General Motors Board of Directors Guidelines in the U.S., and the Dey Report in Canada have each proved influential sources for other guideline and code efforts.

Reflecting the emergence of a basic consensus in many areas, the new Codes share many common characteristics:

- Most recommendations of the new codes of best corporate governance practice deal with the creation of internal governance mechanisms, including Boards and Board committees. In countries with a tradition of weak shareholder rights (e.g. Germany, Italy, and Russia) the code concentrates on basic shareholder rights and may be part of corporate law.

[*] This Study also briefly examines the importance of external factors in promoting good corporate governance, especially trade policy and financial markets. However, the policy issues were determined to be outside the Study's scope.

- The guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary. For many forward-thinking firms interested in gaining access to international capital markets, the “reputational effect” of voluntarily following an international-standard code of best practice is vital.
- Other countries use the prodding of law and custom to force change. Often Codes are linked to stock exchange listing rules. Typically, listed companies on the stock exchange are not required to follow the Code recommendations, but they must disclose whether they follow the recommendations in those documents and must provide an explanation concerning divergent practices. Such disclosure requirements exert a significant pressure for compliance.

This report will use the *OECD Principles of Corporate Governance* as the proxy for a new minimum world standard in corporate governance. These principles were developed on the basis of a wide variety of views from a number of different countries, in mature markets. As a result, they represent a basic consensus on corporate governance requirements, and describe existing rules rather than propose radical changes. As a political consensus, they can also be accused of representing the “least common denominator” of good governance. However, for emerging and transition countries, the OECD Principles are an excellent starting point for the examination of a strong framework.

BASIC LEGAL AND REGULATORY FRAMEWORK

In the end, all of the "best practices" in the world will not change everyone's behavior. The rights described in the "best practice" statements reflect values that must be incorporated in the countries' legal and regulatory framework. Reform of the laws that protect investors and lay out basic governance procedure is a necessary but not sufficient condition of any corporate governance reform effort.*

Company, civil, and securities laws provide the foundation of the corporate governance framework. The basic international standard requirements for these laws that relate to the basic shareholder rights required by the *OECD Principles* are presented on the following page. A checklist of basic legal framework issues is presented in appendix A, and is analyzed below for Egypt. The checklist is based on the OECD principles, but goes further to examine many issues that may be specific to emerging markets.

The key incentive to good corporate governance (and to capital markets development) is the solid protection of investor rights under the law. Minority investors are encouraged to commit their capital when there are safeguards against majority owners or management expropriating or misusing their assets.

Basic shareholder rights include the right to:

- Secure ownership registration
- Sell the shares
- Obtain all legally available information (to be reviewed later under disclosure)
- Participate and vote in general shareholder meetings, and elect members of the Board. Voting for all shareholders should be as easy as possible, and all shareholders should be able to cast their votes.
- Obtain all cash flow and liquidation rights due to shareholders.

Some international investors go beyond the OECD Principles to the notion of "one-share / one vote", which discourages multiple classes of common shares. This approach is favored for several reasons:

- One-share / one-vote reduces conflicts of interest among shareholders, and removes incentives for one class to expropriate another;
- It becomes more difficult for small groups of shareholders to dominate the company, through the use of voting caps, pyramid schemes, etc;
- Creating one class of shares and removing voting caps will tend to encourage the takeover market.
- Historically, some countries have favored the introduction of multiple-class shares as a way to reducing foreign control and maintaining a local presence. Local large shareholders hold the shares with voting rights, and small and foreign investors buy only the cash flow rights. Creating a difference in rights may be politically wise in the short-term, but it also represents a withdrawal from "one-share/one-vote".

In the absence of any enforcement, even good laws will tend to be ignored. Thus the strength of the legal and regulatory framework is crucially dependent on the **enforcement capabilities** of the various regulators, the efficiency of the court system, and the existence of any private legal or dispute resolution mechanisms (e.g. arbitration systems).

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* Although the regulations of the stock exchange (especially the listing rules) and the basic accounting standards in place are also legal and regulatory issues, they will be discussed under "information disclosure" below.

Table 4:
Basic Shareholder Rights
OECD Principles of Corporate Governance

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

I. A. Basic shareholder rights include the right to:

1. secure methods of ownership registration;
2. convey or transfer shares;
3. obtain relevant information on the corporation on a timely and regular basis;
4. participate and vote in general shareholder meetings;
5. elect members of the Board; and
6. share in the profits of the corporation.

I. B. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:

1. amendments to the statutes, or articles of incorporation or similar governing documents of the company;
2. the authorization of additional shares; and
3. extraordinary transactions that in effect result in the sale of the company.

I. C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, which govern general shareholder meetings:

- Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.
- Opportunity should be provided for shareholders to ask questions of the Board and to place items on the agenda at general meetings, subject to reasonable limitations.
- Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

I. D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

I. E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

- The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.
- Anti-take-over devices should not be used to shield management from accountability.

I. F. Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

II. A. All shareholders of the same class should be treated equally.

1. Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote.
2. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.
3. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

II. B. Insider trading and abusive self-dealing should be prohibited.

II. C. Members of the Board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

Source: OECD Principles of Corporate Governance

INFORMATION DISCLOSURE

One of the most critical aspects of good corporate governance is disclosure to existing and potential investors of financial and non-financial information that is important to shareholders and new investors. Effective information disclosure is:

- Material;
- Timely;
- Accurate;
- Consistent;
- Comparable to that of other firms;
- Consistent.

Information is a powerful tool:

- Information is often provided by, and for the use of, the "reputational agents" of shareholders, including the securities industry (research departments), attorneys, accountants, and rating agents. The strength of these agents is vital to the ability of shareholders and the market to process the information, and thus to make good governance decisions.
- Boards cannot independently monitor performance when they lack the proper information, including externally audited and accurate financial data. Inadequate disclosure and the lack of fully consolidated financial statements can allow firms to hide debts on the books of affiliates, preventing lenders and shareholders from discovering the firm's real liabilities.
- Good information allows the financial markets to function efficiently, provides the ammunition to existing shareholders worried about company performance, and allows the market to make good judgements about the prospects of the company (and thus create new shareholders).
- A lack of transparency is frequently cited as a major cause of the recent Asia crisis and is often associated with "crony capitalism".
- Information disclosure is often regulated by a company's securities laws, and enforced by the securities regulator and the stock exchange.

The world standard for information disclosure is reflected in the OECD standards, presented below in Table 5. Formal information disclosure is based on "timely and accurate" disclosure of all material information on the company, including financial and non-financial disclosure. Formal reporting is usually made both quarterly and annually, and includes the following items:

- The financial and operating results of the company.
- Company objectives.
- Major share ownership and voting rights.
- Members of the Board and key executives, and their remuneration.
- Material foreseeable risk factors.
- Material issues regarding employees and other stakeholders.
- Governance structures and policies.

The non-financial disclosure requirements reflected in the OECD standards are particularly relevant from the point of view of corporate governance. The last five items could be thought of as "governance disclosures", and are important to truly understanding the ownership and management of a company.

Table 5:
Disclosure and Transparency
OECD Principles of Corporate Governance

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

IV. A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.
2. Company objectives.
3. Major share ownership and voting rights.
4. Members of the Board and key executives, and their remuneration.
5. Material foreseeable risk factors.
6. Material issues regarding employees and other stakeholders.
7. Governance structures and policies.

IV.B. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.

IV.C. An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.

IV. D. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

Source: OECD Principles of Corporate Governance

Financial disclosure: the development of accounting standards

The key to effective financial disclosure is the accounting framework that is used to prepare financial statements. Traditionally, there have been no international standard accounting rules, resulting in rules in many countries that provided little information to outside investors.

Today, accounting in countries with an "equity culture" has evolved to the point where it provides abundant detail about the financial performance of a company, so that external equity investors can regularly make informed judgements about their investments. By contrast, in the "insider" systems that were prevalent in the rest of the world, public accounts presented a less comprehensive picture of the group's financial performance. Key information was distributed among a select group of insiders – management and supervisory Boards and bank creditors. The accounting frameworks in these countries also tended to be tax-driven.

There are two main international standard accounting frameworks to which companies all over the world have been migrating. US Generally Accepted Accounting Principles (US GAAP) is the system required by the US SEC for listed companies, and is considered to be the most investor-friendly choice. International Accounting Standards (IAS) is a direct attempt to create a synthesis of different accounting cultures while ensuring that investors obtain more of the information they require to assess a company's performance. In recent weeks, regulators have announced that an "international accounting standards Board" will be created, and that US GAAP and IAS will gradually merge.

In response to the pressures to change described in previous sections, many large corporations around the world are adopting IAS and US GAAP, and are starting to give more information to the outside world. Daimler-Benz was the first German company to publish its accounts under US GAAP, followed by Deutsche Telekom and dozens of other companies across Europe. Many more companies and financial institutions have moved to embrace IAS, including Deutsche Bank, Bayer, Merck, Roche, Nestlé and ABB.

There is no real choice today for any market (mature or emerging) – countries must adopt international-standard accounting, and companies must embrace the standards, if they want to participate in the market.

Auditing standards

In many countries, the role of the auditor and his independence is also under discussion.

- In the US, UK, and elsewhere, the independence of the auditor may have been compromised by the auditor's conflict of interest when the auditing firm provides other ("consulting") services to the Board.
- In emerging markets, Big 5 auditors were recently accused by the World Bank of tolerating lax standards from affiliates. The International Forum on Accountancy Development (IFAD) has been created to work on this problem and to spread IAS.
- Auditing firms around the world are now being encouraged to adopt the International Federation of Accountants code of professional ethics, especially the measures to promote auditor independence.

INDEPENDENT OVERSIGHT OF MANAGEMENT

So far we have focussed on the legal and disclosure incentives to good corporate governance. These factors have long been recognized as crucial in the creation of liquid securities markets and investor protection, and are often reflected in the securities laws many developed (and many emerging) markets.

What is new about the contemporary governance debate is the strong focus on the Board of Directors. The past five years has witnessed a proliferation of new laws and codes of best practice designed to improve the ability of corporate directors to hold managements accountable. An active and objective Board of directors is the main line of defense against management abuses, and can respond immediately and flexibly in a way that the regulators and the shareholders cannot. Many codes focus on this issue in particular. This global movement emphasizes that Boards have responsibilities separate and apart from management, and describes the practices that best enable directors to carry out these responsibilities.

How does a Board become active and objective? In both developed and developing countries, codes of best practice focus on Boards of directors and "…attempt to describe ways in which Boards should be positioned to provide some form of guidance and oversight to management, and accountability to shareholders and society at large."[13] Turning insular and passive corporate Boards into effective and independent players is a formidable challenge across emerging markets. As we have seen, most large companies in emerging markets are part of conglomerates or financial/industrial groups, and shares are often closely held by founding families.

As with the legal framework and the information disclosure framework, the OECD Principles lay out a basic framework for the best-practice responsibilities of a Board of directors. These responsibilities are presented in the page at the end of this section. The key steps:

1. **Define the corporate objective / mission**

2. **Clearly define Board responsibilities**

3. **Encouraging Board Independence, including:**

- Defining the optimal mix of "Independent", "Executive", and other types of Directors
- Defining criteria for Board membership
- Encouraging independent Board leadership.

4. **Establish Board committees**

Each of these will now be addressed in turn.

Clarify the corporate objective / mission

25 years ago there were many answers to the question: what is the goal of the corporation and thus the mission of the Board of Directors? Today, around the world, the answer is relatively unambiguous: the Board's job is to build shareholder value. The codes of best practice of many countries state that the Board's only mission is to protect and enhance the shareholders' investment, including Australia, Canada, UK, U.S. in mature markets, and Brazil, India, Kyrgyzstan, and Malaysia in emerging markets.

Other countries tend to put more focus on the notion of the "stakeholder", referring to other parties interested in the company's well-being, including creditors, workers, the State, and consumers. Most codes of best practice follow the OECD and insist that "…the rights of stakeholders that are protected by law are respected."[14] However, the primacy of shareholder value as a corporate goal has gained force all over the world.

Define Board responsibilities

In addition, there is a basic international standard in terms of the responsibilities of the Board of Directors. Board responsibilities are "…distinct from management responsibilities."[15] The basic idea is that the Board plans, oversees and evaluates, and management implements. Since it is hard to evaluate yourself, a merger of the Board and management function naturally leads to a lack of oversight. This is a key point, since in many emerging markets the line between management and the Board is very gray and very thin.

Most corporate governance standards around the world that address the issue specify similar Board functions, including:

- strategic planning
- risk identification and management
- selection, oversight and compensation of senior management
- succession planning
- communication with shareholders
- monitoring of internal financial control
- general legal compliance

Encourage Board independence

Perhaps the most contentious issue relates to the composition of the Board of Directors. As shown in Table 6 below, the clear international standard is that the Board should be independent and able to provide objective oversight of the company. Other issues include the criteria of Board membership, training that Board members must receive, the separation of the chief executive and the Chairman of the Board, and recommendations on the establishment of Board committees. The rationale for all recommended standards is the same: "…*some degree of director independence -- or the ability to exercise objective judgment of management's performance -- is important to a Board's ability to exercise objective judgment concerning management performance*."[16]

Table 6:
Independence Requirements in Selected Countries

	Country	Authority	Compliance Requirements	Independence Recommendations	Recommend Separate CEO/Chairman?	Recommended Committees			
						Audit	Renumer.	Nomination	Governance
OECD Counties	Australia	Code (Bosch)	VWDONC	• Majority of Board non-executive • 1/3 is independent	Yes	√	√	√	
	Canada	Code (Dey)	VWDONC	• Majority of non-executive “unrelated” • At least 2 executives	Yes	√	√	√	√
	France	Various	Voluntary	• Majority of independent	No	√	√	√	
	Greece	Voluntary w/ statement		• Majority non-executive • “Certain” non-executives independent	Yes		√		
	Ireland	Listing Rule	VWDONC	• Balance of executive/non-executive • Majority non-executive independent	Yes	√	√	√	
	South Korea	Code	Voluntary	• Majority of non-executive • Minimum ¼ or 3	No	√	√	√	
	Spain	Code (Olivencia)	VWDONC	• “Reasonable” number independent	No	√	√	√	√
	UK	Listing Rule	VWDONC	• Balance of executive/non-executive • Majority non-executive independent	Yes	√	√	√	
	US	Code (Business Roundtable)	Voluntary	• Substantial majority non-executive • “Substantial degree of independence”	No	√	√	√	√
	OECD	Code	Voluntary	• Majority must be independent	No	√	√	√	
Emerging Markets	Brazil	Code (Inst. Of Corp. Gov.)	Voluntary	• Majority should be independent	Yes	√	√	√	
	India	Code (Indian Confederation)	Voluntary	• Large companies should have competent non-executive directors (>50% if Chairman=CEO)	No	√			
	Malaysia	Listing Rule	VWDONC	• Balance of executive/non-executive • 1/3 independent, min. two	Yes	√	√	√	√
	Mexico	Code	Voluntary	• Independent and “patrimonial” directors should represent >40% • Independent > 20%	No	√	√	√	
	South Africa	Code (King Report)	VWDONC	• Balance of executive / non-executive • All non-executive is independent	Yes	√	√		
	Thailand	Listing Rules	Mandatory	• At least 2 independent members	No	√			

Note: Germany, Italy, Russia, Hong Kong, Kyrgyzstan, and Singapore have also produced codes, but they do specifically address Board issues.
VWDONC = Voluntary with disclosure of non-compliance

Sources: *Investor Responsibility Research Center, Global Corporate Governance Codes, Reports, and Legislation, 1999.*
Commonwealth Association for Corporate Governance (CACG) Guidelines 'Principles for corporate Governance in the Commonwealth - Towards global competitiveness and economic accountability'. (Nov. 1999)
Gregory, Holly, of Weil, Gotshal & Manges LLP, *International Comparison of Board Best Practices in Developing and Emerging Markets*.

The optimal mix of "Independent" and "Executive" directors

The notion that independent directors improve the functioning of corporate Boards is almost universally accepted in best practice codes around the world. Table 6 above presents the Board independence requirements of a selected group of countries with available codes of best practice. Independence requirements are "…strongest in the U.S. and Canada, where best practice documents call for a "substantial" majority of the Board to be comprised of independent directors."[17] However, the table shows that the basic principal of independence has been widely accepted.

However, there is less consensus on a precise definition of "independence". Like beauty, independence is to some extent in the eye of the beholder. The general concept is quite clear however. At a minimum, independent directors are "outside directors" and are not executives of the company.

Table 7:
Selected Definitions of Director Independence

Brazil Institute of Corporate Governance	A director is independent if he or she: ♦ has no link to the company besides Board membership and share ownership ♦ receives no compensation from the company other than director remuneration or shareholder dividends; ♦ has never been an employee of the company (or of an affiliate or subsidiary); ♦ provides no services or products to the company (and is not employed by a firm providing major services or products); and ♦ is not a close relative of any officer, manager or controlling shareholder.
Malaysian Code of Best Practice	Directors are independent if they: ♦ are not officers of the company; ♦ are neither related to its officers nor represent concentrated or family holdings of its shares ♦ who, in the view of the company's Board of directors, represent the interests of public shareholders, ♦ and are free of any relationship that would interfere with the exercise of independent judgment."
Mexico Code of Corporate Governance	Independent Directors are persons selected for their abilities, experience and professional recognition, and who at the time of their designation are <u>not</u>: (i) employees or officers of the corporation; (ii) stockholders of the corporation having authority over officers of the corporation; (iii) consultants to the corporation . . . whose incomes depend significantly on such contractual relationships; (iv) clients, suppliers, debtors or creditors of the corporation . . . ; (v) employees of a charitable institution, university or entity that receives significant contributions from the corporation; (vi) the *Director General* or a high-ranking officer on the Board of Directors of another corporation in which the *Director General* or a high-ranking officer of this corporation is/are Directors; or (vii) family to any of the persons mentioned above. Note: Mexico also introduces the notion of "Patrimonial Directors", who are (or represent) significant shareholders (founders).
Combined Code (UK)	Directors who -- apart from their fees and shareholdings -- are independent from management and free from any business or other relationship which could materially interfere with the exercise of independent judgment.
Korea Stock Exchange Listing Rules	Included among the list of persons who do not qualify as "outside directors" are: ♦ controlling shareholders ♦ a spouse or family member of a director who is not an outsider ♦ current or recent officers and employees of the corporation, its affiliates, or of corporations that have "important business relations" with the corporation; ♦ and persons who serve as outside directors on three or more listed companies.

Source: Holly Gregory, Weil, Gotshal & Manges LLP, International Comparison of Board "Best Practices in Developing and Emerging Markets (Revised Nov. 1999).

Define Criteria for Board membership

In many countries there has been concern with other director characteristics (besides independence) which affect the quality of the Board's decisions. Although there is no clear standard, many countries recommend a maximum number of Board seats that any one person can hold. Board members should be able to pay close attention to the issues of the company, and should have time to attend meetings. Other criteria include issues such as experience, personal integrity, and core corporate governance code competency.

Many codes also stress the importance of training for Board members, both in basic governance procedures, and in the business concepts specific to each company.

Encourage Independent Board leadership

Another major area of concern is the relationship between the Chairman of the Board and the Chief Executive. Many guidelines and codes seek to institute independent leadership by recommending a clear division of responsibilities between Chairman and CEO. Independent Board leadership is thought by some to encourage the non-executive directors' ability to work together to provide true oversight of management. As explained by the National Association of Corporate Directors (U.S.), "…the purpose of creating [an independent] leader is not to add another layer of power but ... to ensure organization of, and accountability for, the thoughtful execution of certain critical independent functions" -- such as evaluating the CEO; chairing sessions of the non-executive directors; setting the Board agenda; and leading the Board in responding to crisis.[18]

Table 6 above shows that there is no clear international model on this issue. Eight countries recommend separation of the Chairman and CEO (while typically not requiring it), while eight countries do not even make the recommendation.

If the position is separated, while the CEO can have a significant presence on the Board, the non-executive directors will also have a formal independent leader to look to for authority on the Board. Codes that place less emphasis on the need for a majority of independent directors seem to place more emphasis on the need for separating the role of Chairman and CEO. For example, India explicitly relates the two concepts -- recommending that if the Chairman and CEO (or managing director) are the same person, a greater percentage of non-executive directors is necessary. The Malaysian Report on Corporate Governance similarly emphasizes that "[w]here the roles are combined there should be a strong independent element on the Board." This is in accord with the UK's Cadbury Report, which states that, where the Chairman is also the CEO "it is essential that there should be a strong and independent element on the Board." [19]

Establish Board committees

All of the countries listed in Table 6 above stress the importance of one or more Board committees. Although not specifically addressed in the OECD Principles, it is fairly well accepted that many Board functions are more properly delegated to a committee. Removing these decisions from the full Board and perhaps a powerful Chairman/CEO is seen as necessary to provide full and objective oversight. Key committees include:

- **Audit committees**, to oversee and work with the companies internal and external auditors;
- **Nominating committees**, to recommend or nominate new Directors for approval of the full Board;

- **Remuneration (or compensation) committees**, to provide recommendations on compensation packages for directors.
- **Governance committees**, to put in place and review the company's formal governance rules.

In most cases, it is recommended that that the majority of these Board committees be filled by "independent" or at least "non-executive" members.

Table 8:
The responsibilities of the Board
OECD Principles of Corporate Governance

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the Board, and the Board's accountability to the company and the shareholders.

A. Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

B. Where Board decisions may affect different shareholder groups differently, the Board should treat all shareholders fairly.

C. The Board should ensure compliance with applicable law and take into account the interests of stakeholders.

D. The Board should fulfil certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

3. Reviewing key executive and Board remuneration, and ensuring a formal and transparent Board nomination process.

4. Monitoring and managing potential conflicts of interest of management, Board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

5. Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.

6. Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.

7. Overseeing the process of disclosure and communications.

E. The Board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.

1. Boards should consider assigning a sufficient number of non-executive Board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and Board remuneration.
2. Board members should devote sufficient time to their responsibilities.

F. In order to fulfil their responsibilities, Board members should have access to accurate, relevant and timely information.

Source: OECD Principles of Corporate Governance

Audit committees

The functioning and composition of the audit committee receives significant attention in most guideline and code documents because of the key role it plays in protecting shareholder interests and promoting investor confidence. Audit committees are seen as a tool to reinforce the independence of external auditors and strengthen the auditor's hand when dealing with operational management. In the European Commission's words, "…experience

has shown that, even where audit committees have been set up mainly to meet listing requirements, they have proved their worth and developed into essential committees of Boards of directors."[20]

Nomination, remuneration, and other committees

Many codes address the process by which directors are nominated. The intent is to create a formal and transparent process for appointing new directors. The use of nominating committees is favored in the U.S. and UK as a means of reducing the CEO's influence in choosing the Board that is charged with monitoring his or her performance.[21] The Malaysian Corporate Governance Report expresses a similar view: "[T]he adoption of a formal procedure for appointments to the Board, with a nomination committee making recommendations to the full Board, should be recognized as good practice."[22] At the same time, however -- and as advocated by the King Report (South Africa) -- it is generally agreed that the Board as a whole has the ultimate responsibility for nominating directors.

Remuneration committees are popular in Codes in countries where the level of executive (and director) compensation has received considerable attention. Governance committees are a somewhat newer idea, but are designed to monitor and disclose the company's governance rules and procedures.

EXTERNAL INCENTIVES

In addition to the three factors already discussed (legal framework, disclosure regime, and Board structure), many observers of corporate governance point to the importance of "external factors" in providing discipline to the management of firms.[23] While these factors are obviously important, they are somewhat outside of the scope of this study. However, we will review them briefly.[24]

The economic and policy environment that surrounds the firm is a basic influence on a Board of directors. If the firm is a monopoly or is protected by high trade barriers, the Board will behave differently (and less competitively) than if the firm is subject to intense competition. A firm in a competitive environment will be much more likely to pay attention to its shareholders, so that it can tap the capital markets in the future. Where market discipline is inadequate, corporate sector performance will be weaker, and enterprise energy will be diverted to lobbying, and anti-competitive practices that can undermine economic and financial stability.

Openness to trade

The most powerful incentive to good governance of all is market competition, which encourages efficiency, innovation and consumer welfare. Competition ensures that companies profit not from illegal monopolistic practices but by producing better or lower-priced goods than rivals. In the market for management and skilled workers, competition ensures that companies offer opportunities and incentives to attract top-notch staff.

Increased openness to foreign trade has caused a revolution in the way many companies are governed and managed around the world. One recent example is Mexico: before NAFTA ten years ago, its industries were assumed to be uncompetitive at home. Today, Mexico is the world's eighth biggest exporter, and its companies are dynamic, flexible, and moving away from the "hacienda capitalist" form of family control.[25]

Financial markets

The key to successful corporate governance reform will be the creation and strengthening of natural allies. The securities industry is a natural ally in the advocacy of shareholder protection, transparency and accountability. In fact, an independent securities industry may be the only industry in a transition environment that has a profit and business growth incentive to support these values and to support their adoption into law and their enforcement.

The influence of the financial markets is thus inexorably intertwined with corporate governance:

- **Financial and capital market competition** requires corporate managers to balance two sets of interests: competition for equity induces them to maintain equity value, while competition for debt finance induces them to maintain debt-to-equity ratios and certain levels of cashflows. In addition, prudential regulations ensure that competition among banks does not lead them to take on excessive risks with depositors' assets.
- **Financial market policy and efficiency** can be strong influences on company management and the Board of directors. A falling share price can provide good insight into a company's business plans, and can push the Board and shareholders to take corrective action. Low prices can also lead to the accumulation of shares and potential takeovers (see below).

- **Competition for corporate control** also disciplines managers to maximize shareholder value. Managers who fail to do so may risk takeover (and losing their jobs), when outside investors perceive higher earnings potential in the company's assets.
- **Bankruptcy** is the ultimate punishment for poor managerial performance. Where bankruptcy procedures do not function, because of weak laws or institutional support, poor managers may face fewer penalties for risking insolvency, but shareholders and creditors may be more cautious, and the cost of capital higher.

The markets (often represented by the institution of the stock exchange) and their regulators tend to be most interested in corporate governance reform. Disclosure is the lifeblood of the market, and market participants and regulators both tend to be at the forefront of efforts to increase disclosure. Governance reform increases investor participation and deepens markets. All market participants thus benefit and tend to support reform.

WHAT FORCES ARE PUSHING FOR IMPROVE CORPORATE GOVERNANCE?

As regulatory barriers between national economies fall and global competition for capital increases, investment capital will follow the path to those corporations that have adopted efficient governance standards, which include acceptable accounting and disclosure standards, satisfactory investor protections and Board practices designed to provide independent, accountable oversight of managers. [26]

Many forces have pushed the issue of corporate governance to the top of the agenda. Twenty-five years ago, the world divided quite clearly into two camps. At one extreme, there was the "Anglo-American Model" in which shareholder value was paramount. On the other extreme there was the Continental / Japanese model, in which "collective achievement and consensus are seen as the keys to long-term success".[27]

The basic differences between these two models are presented in the Table 9 below.

Table 9:
The Traditional Corporate Governance Debate

	Anglo-US Business Model	Continental / Japanese Model
Representative Countries	US, UK	Continental Europe, Japan
Corporate goal	Increase shareholder value	Collective achievement and consensus
Capital markets	Important, large and liquid	Unimportant and illiquid (except Japan)
Ownership structure	Widely dispersed	Often concentrated and interlocked
Institutional Investors	Large share of assets	Small share of assets
Market for corporate control	Active	Inactive
Role of "stakeholders"	Relatively unimportant	More important and often crucial
Role of banks as owners	Relatively unimportant	Central
Levels of corporate disclosure	Relatively transparent	Relatively opaque
Level of shareholder rights	Relatively strong rights	Relatively weak rights

In the US and similar countries the key institutions are brokerage firms, pension funds, and mutual funds. In the rest of the world, banks figure much more prominently as owners, the equity market plays less of a role, and is much smaller. In 1997 there were about 2,000 quoted companies in the UK, with a market capitalization of more than 130% of GDP. This compared to an EU average of around 44% of GDP and about 85% in the USA. Germany, Europe's largest economy, had around 670 quoted companies, whose market cap amounted to about a quarter of GDP.[28]

Across Europe, many "stakeholders" were often accorded equal priority to shareholders. The interests of employees, for example, are often recognized in law. In both the Netherlands and Germany, employees play an explicit role in corporate governance through their seats on works councils and supervisory Boards. Most importantly, employee representatives on such bodies must give their consent to management decisions that affect the terms and conditions of employment. In France, the government continues to play an important role, reflecting the constant circulation of senior executives between the civil service and industry Boardrooms.

Thus two different business cultures coexisted: one focused on "insiders", and the other promoting "outsiders".

Movement towards a "global standard"

In the 1980's the world began to change, until today when a "global" corporate governance culture seems to be emerging.

- **Stagnation.** "The correct system of corporate governance can be graphically compared with the relationship of a patient with his doctor", said a leading German finance director in 1994. "As long as there are no acute pains there is no reason to see the doctor. At best one might think about talking over preventative measures."[29] Throughout the post-war period, European and Asian governance systems delivered above-average economic growth. Even in the early '90s, US-style governance was seen as "short-termist" and relatively ineffective. However, in the 1990s the combination of relative stagnation in Europe and Japan and the dynamism of the US economy suggested that older governance structures may have impeded industrial restructuring and thus hindered economic revival. The Asian financial crisis made the point clear for Asia.

- **Foreign Investment**. International institutional investors have played a major role in bringing new governance values around the world. By the 1990s, foreign investors (particularly large US and UK mutual and pension funds) became the key source of capital for European and other companies at the margin. Growing international competition for capital meant that companies could not escape new standards for corporate governance imposed by foreign investors, unless they consciously or unconsciously accepted disadvantages when it came to raising money. In 1997, institutional investors owned up to 40% of the "free float" in German shares, a third or so of the French stock market, and significant stakes in leading companies in many European countries.[30] Since they competed with other companies to raise capital, it was inevitable that companies raising money had to make substantial adjustments. Most importantly, companies had to show high profitability, as measured in terms of return on capital, earnings per share growth and dividend payouts. Examining financial performance went hand in hand with greater transparency of financial information and greater accountability of management.

- **Privatization**. Privatization programs around the world also forced governments and companies to accommodate the demands of equity investors. Privatization also directly focused policy attention on the factors that lead to good corporate governance. For example, Italy's privatization program has attempted to diversify the focus of Italian capital markets away from bonds and into equity issues. In order to fulfil its privatization targets, the State has sought to attract both retail and foreign institutional investors, the latter group being more demanding of corporate behavior.

- **Scandal.** In the UK and later in the rest of Europe, the corporate governance debate was ignited by a series of prominent corporate failures at the end of the late 1980s. The collapse of companies such as Credit Lyonnais, Blue Arrow, Coloroll and Polly Peck prompted company directors, institutional investors, auditors and financial advisors, supported by government, to engage in an unprecedented public discussion about the shortcomings of existing models of corporate accountability, some possible remedies, and some tangible changes.

- **Pension reform.** Many countries around the world have underfunded pensions systems. The development of private pension funds will almost certainly to lead to increased levels of equity ownership, increasing pressure on companies to deliver acceptable returns to shareholders. In Europe, one estimate predicts that the pension fund asset base could expand ten-fold in real terms by the year 2020.[31]

Convergence in Europe

Since American and British investors are driving the demand for change in international corporate governance standards, it is natural that the UK and the US come out ahead in international comparisons. However, countries that previously formed the core of the "insider culture" are closing the gap. Recent changes in France and Germany are described in Table 10 below.

Table 10:
Recent Corporate Governance Developments in Germany and France

Germany	France
♦ Germany passed the "KonTraG" law in 1997 that made significant improvements to shareholder rights and overall transparency as it took effect in 1999 ♦ The new law curbed voting rights restrictions and takeover defenses, placed new responsibilities on supervisory Boards and limits on members ♦ The new law also allowed companies to move to international accounting standards. By 1999 as many as 63% began reporting financial accounts using International Accounting Standards or U.S. GAAP, as compared to just 17% in 1998. ♦ The percentage of large German companies (the DAX 30) reporting supervisory Board audit, remuneration or nomination committees leapt from as low as 3% to as much as 53%. ♦ The DSW shareholder rights group began issuing target lists of poor-performing companies.	♦ Several codes of best practice (the Viénot Committee codes and the AFG-ASFFI code) are forcing real change. ♦ The codes represent bigger changes than in other large markets. ♦ Recent reforms propose to force firms to release more details on executive compensation, and recommend the separation of the président-directeur général position to create a separate Board chairman and chief executive. ♦ The AFG-ASFFI will alert its fund-management-firm members when CAC 40 company AGM resolutions breach the code. ♦ The government has drafted changes in corporate law to respond to the new climate. ♦ Companies made progress in complying with Viénot recommendations on Board structure.

Source: Davis Global Advisors, *Leading Corporate Governance Indicators 1999: An International Comparison*, November 1999

Change in Asia: the results of the Asian financial crisis

Change has also been forced upon many emerging market countries in Asia. The Asian financial crisis put corporate governance under the microscope throughout the region. The situation and its aftermath merit a special case study.

East Asia is a unique case of the effects of poor corporate governance, because of its history of strong growth and high foreign investment. Growth had been so strong for so long that the idea of a unique "Asian miracle" was well accepted. However, poor corporate governance is now considered to be one of several factors that resulted in the unprecedented "financial crisis" and macroeconomic meltdown.

East Asia is also interesting because of the reforms many countries have made (sometimes under pressure) since the crisis. Their program of reforms is instructive for other countries attempting to strengthen competition and corporate governance.

Few if any of the factors that promote good governance were present:

- **External Factors did not promote market discipline**. Competitive market discipline for many large firms was weak or non-existent. Government banking supervisors exercised too little prudential control over banks and demanded little transparency and competition; domestic banks actually became a huge part of the problem, as underdeveloped securities markets meant corporations were over-reliant on short-term bank debt. Takeovers were not possible.
- **Shareholder rights were inadequate.** Legal protection of shareholders was poor. The easy availability of bank loans as a source of capital in East Asia removed the incentive for companies to protect minority shareholder rights as a means to attract capital. This problem was magnified by equally poor regulatory systems and a judiciary and legal infrastructure unable to enforce bankruptcy and corporate law.

  As noted above, ownership concentration went hand-in-hand with weak rights. Concentration of ownership took the form of a high share of ownership by insiders and insider groups, including managers, founder relatives and member companies.

- **Disclosure was inadequate.** Disclosure in Asia was poor or non-existent. Investors had no source of information on corporate performance, in a form that could be compared to that of other firms. Boards could not independently monitor performance. Inadequate disclosure and the lack of fully consolidated financial statements allowed some firms to hide debts on the books of affiliates, preventing lenders and shareholders from discovering the firm's real exposure to high levels of dollar dominated debt. Such information as was available was questionable, given auditing standards that did not meet international best practices.

- **Lack of independent oversight of management.** Prior to the crisis, independent Board members were seldom found in East Asian companies. Directors were appointed as employees of the firm or a controlling shareholder, not a representative of all equity holders. In most East Asian countries, there were few legally enforceable responsibilities for the actions (or inaction) of directors, and no ban on a director voting on any matter in which he (or she) had a personal (i.e. conflict of) interest. In countries such as Korea and Thailand, the inclusion of directors who were genuinely independent of the controlling shareholders and of management was extremely rare. In Korea, appointment to the Board came automatically for executives once they reached a certain seniority, thus giving rise to another conflict -- between their role as executives dependent on the company president for their jobs and their responsibility to supervise management. Furthermore, in large companies, Boards of directors were very big (in some cases up to 80 members), precluding effective decision-making. A few senior directors (or the owners) make the decisions, with the rest simply rubber-stamping them.

  Heads of large corporations were usually members of the owning family. They regarded the corporation as a personal possession. The interests of outside stockholders were largely ignored. An outside director appointed to the Board of South Korea's SK Telecom Co. observed: "At the very beginning, we had a very difficult time.... We felt like we were treated as an outsider, as an intruder at these Board meetings. We were not given enough information from the management."

Poor governance compounded macroeconomic problems. When currencies began their downward fall and foreign portfolio investors first began pulling their money out of East Asia in 1997, it was already too late for governments and corporations to make the fundamental reforms that could have averted crisis. The lack of information and transparency magnified investor panic, and resulted in runs on regional shares and currencies.

Post-crisis reforms. In the aftermath of the crises, some countries have begun corporate governance reforms. The wisdom has been accepted that without effective corporate governance, long-term foreign investors will likely shy away from the region, thus aggravating the volatility of capital markets and magnifying any future instability. Hong Kong, Korea, Malaysia and Thailand have all adopted codes of best practice of corporate governance, and have linked them to the listing rules of the stock exchanges. It appears that the new rules are being taken seriously. However, the speed of their recovery has led some observers to suggest that the changes are too cosmetic, and that good times will allow managers to return to their former practices.

Summary

Worldwide the changes have been significant. In the words of one prominent analyst,

> *Corporate governance has become a significant factor considered by institutional investors when making worldwide investment decisions and tending ownership stakes. Increases in cross-border equity trading have coincided with the rise in shareholder activism. Many brokers and shareholders now compare ownership rights and governance characteristics as part of their routine due diligence reviews of companies. Some are under a mandate to do so. Others have come to the conviction that appropriate governance structures reduce risk and promote performance, and that shareholder participation can motivate Boards to produce higher long-term returns.*
>
> *Either way, those companies and markets that feature corporate governance characteristics appealing to shareholders have a competitive advantage in attracting international equity capital over those whose practices discourage shareholder participation. As a result, markets have moved the battle to draw global investment beyond fiscal and monetary policy to corporate governance reform.*[32]

CORPORATE GOVERNANCE IN EGYPT

But where is the problem? They are only financial investors?…
- Egyptian Businessman

Most observers of the corporate governance scene in Egypt in the middle of 2000 might share the opinion of the anonymous Egyptian businessman, expressed above. The system could be said to work reasonably well at a formal level: shareholders vote at annual general meetings, Boards of directors meet, many companies are restructuring and preparing for the more competitive market environment to come. Policymakers are focussed on matters of much more immediate import: a liquidity crisis, a low level of foreign currency reserves, slow privatization, and the impending drop in import duties.

However, the need for corporate governance reform remains urgent and although much has already been done, Egypt has some distance to go. Where and how far is indicated by a comparison of its present corporate governance policy framework with emerging international standards. Corporate governance reform attacks the core problem of the Egyptian economic transition — how to convince economic actors to act differently, to become efficient, to look outwards, to search for new opportunities rather than waiting for current problems to go away or to be solved by government. Because it involves changing (at least) 45 years of behavior and tradition, corporate governance reform is bound to be a long-term, slow, and thankless process. But it is one of the keys to realizing the gains of privatization.

BACKGROUND

Egypt's experience with market-based governance was put on hold by the period of nationalization and statist intervention that took hold in the 1950s. A move to market-based principles began in 1974 with the open-door policy, but only really accelerated in the last 10 years. Since the early 1990s, Egypt has successfully undertaken a comprehensive reform, and has decisively shifted towards a market economy.

After an early focus on monetary policy and price de-regulation, Egypt began in the mid-90s to begin to privatize its State-run enterprises. Large-scale privatization began in 1996, and tapered off to a lower level in 1997 and after. The supply of shares created by the privatizations stimulated the development of the capital market, and led to the creation of modern institutions to support the market.

The results of privatization are at this stage promising but mixed. Although many companies have been privatized, the definition of privatization (the selling of more than 50% of the shares to a private buyer) means that in many cases the State still has large stakes in many companies. In addition, the process has slowed as the "good" companies are sold, leaving the "difficult" companies in the State portfolio, with few obvious buyers.

The transition is not complete. Egypt's corporate sector still shows many aspects of State intervention.

Corporate sector overview

There is little data available on the entire population of joint stock companies in Egypt. Data on ownership structure, cross-holdings, and Board structure that would allow us to paint a broad picture of the corporate sector from a governance perspective will apparently be collected as part of the revisions to the disclosure requirements now underway at the stock

exchange. For now data is limited to some basic ownership structure data for large listed companies. Table 11 below shows the ownership structure of the top 40 companies in Egypt. Several observations can be made about the ownership structure in Egypt:

- As in other emerging market countries, even large companies in Egypt tend to be closely held
- Companies are often controlled by "family groups"
- Employee involvement and shareholding, as expressed through Employee Shareholder Associations (ESAs), are relatively common.
- Companies tend to have considerable State ownership

Companies are closely held

Even the heavily traded companies in Egypt tend to have little "free float" (shares available for trading).

- Most shares are controlled by strategic investors, the State, or the ESA.
- Few if any companies in Egypt could be defined as "widely held." All but three of the 40 companies listed meet the "closely-held" test of having at least one shareholder with more than 20% of the shares.
- By regulation ESA shares are held as a single position, and are illiquid.

Companies tend to have considerable State ownership

In addition, Table 11's data for large companies indicates a huge State role in the governance of actively traded companies, including companies that are "private".

- Of the 40 large companies listed, holding companies or private sectors entities (banks, funds, and insurance companies) held stakes in 26 (or 65 percent of the total).
- The State (including private sector entities) held more than 20% of the shares in 21 companies, and more than 50% of the shares in 12 companies.

Privatized companies tend to have some employee ownership

Most privatized Egyptian companies have a degree of employee ownership and involvement. Table 11 shows that in many privatized or privatizing companies the employees have received ten percent of outstanding shares.

Employees do not tend to own shares directly. Rather, they are owned as a pool through the legal vehicle of the Employee Shareholder Association (ESA). The ESA is the legal vehicle created to involve employees in the privatization plan. Shareholders interested in participating in the program must join an Association. They receive shares ("stacks") in the Association, and the Association (as the sole legal shareholder) receives the employee shares in the company. In many privatized companies employee ESAs receive ten percent of the company's shares at the time of privatization. In other (smaller) privatizations the ESA is the majority owner. Effectively the ESAs borrow the shares from the State Holding Company, and pay back the loan over time.

The ESAs are somewhat controversial, because employee shareholder rights are somewhat vague, due to uncertainties in the law.[33] As in all employee ownership schemes, the corporate governance resulting from employee ownership is a bit shaky. Employees will tend to resist change and discourage major restructuring. Management will be in effective control of the company. In fact, the ESA role in corporate governance is somewhat uncertain. Several companies do not appear to have ESA representatives on the Board.

**Table 11:
Ownership Structure of 40 Actively Traded Companies**

Company name	Holding Company	Government Owned/ Controlled	Strategic Investor	ESA	Private Investors
Abu Kir Fertilizer		89%			11%
Acrow Misr Scaffolding			37%		63%
Al Ahram Beverages			12%	10%	78%
Al Ezz Porcelain			67%		33%
Alexandria Flour Mills	60%			10%	
Alex Iron and Steel		56%	13%	26%	5%
Amreyah Cement	34%	19%		10%	37%
Arabian Int'l Construction			56%		44%
Commercial Int'l		19%	28%		53%
East Delta Flour Mills	39%			10%	51%
Eastern Tobacco	66%			10%	24%
Egypt Gas		80%			20%
Egyptian American bank		39%	41%	4%	16%
Egyptian Electric cables				8%	92%
EFIC Fertilizer	25%				75%
MobiNil Mobile Phone			70%		30%
EIPICO Pharmaceutical			62%	7%	31%
Export Development Bank			67%		33%
Helioplis Housing	73%			10%	17%
Helwan Cement	47%			5%	48%
IEEC Contracting	10%			10%	80%
MIBank		26%	43%		31%
Mid & West Delta Mills	39%			10%	51%
Miraco Air Conditioning		9%	71%		20%
Misr Aluminum	80%			10%	10%
Misr Free Shops				10%	90%
Misr Hotels (Hilton)	50%	23%			27%
Nasr City Housing	25%			10%	65%
Nat. Soc. Gen. Bank		18%	51%		31%
North Cairo Flour Mills	58%			8%	34%
Olympic Group			40%		60%
Orascom Construction			61%		39%
Orascom Projects			76%		24%
Oriental Weavers			77%		23%
Pachin Paints			43%	5%	52%
Savola Sime Egypt			70%		30%
Suez Cement		55%			45%
Torah Cement	67%			5%	28%
Unirah Textiles	33%	12%		7%	48%
Upper Egypt Mills	39%			10%	51%
Watany Bank		8%	13%		79%
Unweighted Average	**47%**	**35%**	**50%**	**9%**	**42%**

Source: EFG Hermes, Country Report, May 1999

A large number of companies in Egypt are listed

Egypt is unique in the world in terms of the large numbers of companies listed on its national exchange (the Cairo and Alexandria Stock Exchange or CASE). As of the end of May 2000, there were 1,051 companies listed on the Official and Unofficial schedules.

However, in Egypt, a large tax advantage is given to companies listed on the exchange. Article 120 of the Tax Law 157/1981 stipulates that all joint-stock companies, public or private, listed on the Stock Exchange, are tax exempt on the equivalent of the CBE deposit rate (currently about 9.25%) on their paid-up capital. The magnitude of the subsidy is so great that companies will apparently go to great lengths to be listed – even very closely-held companies, with a few shareholders, that have no likelihood of having any real liquidity, are listed on the exchange.

Although the tax policy is dubious, the benefit for the capital market as a whole is enormous:[1] most of the corporate sector is listed on the stock exchange, and is subject to the disclosure requirements of the exchange and the CMA. Unlike in many emerging markets, where introducing tough disclosure requirements may have the effect of causing publicity-shy companies to delist from the exchange, in Egypt companies will be willing to pay a great price to stay listed.

A qualitative assessment of corporate governance: a typology of governance styles in Egypt

Another approach to gaining an understanding of the state of corporate governance is to look at companies from the ground up. Following a review of previous case studies and interviews with several private-sector companies, Egyptian companies can be placed into one of four "governance styles", on the basis of their basic corporate governance and other factors. While placing companies in categories is somewhat arbitrary, and many companies will not easily fit, categorization allows us to review some of the common similarities and differences among many Egyptian companies. It should be mentioned that little systematic data exists on governance structures of Egyptian companies, and more should be collected to carry out a more detailed analysis.

The four categories are as follows:

1. International-standard governance
2. Industrial group governance
3. Crisis governance
4. Privatized Public Sector governance

The characteristics of these categories, and some case studies of example companies within each category, are described below. These examples are intended to give no more than a flavor of governance in Egypt. In a forthcoming paper, the PCSU plans to study 15 privatized companies in detail to gain a more complete understanding of the process of governance in privatized enterprises today.

International Standard Governance

[1] Some analysts estimate that the total "cost" of the tax deduction is in the neighborhood of 25-50% of corporate tax revenues. This issue requires further review, as some interviews suggested that the deduction may apply to all companies, not only listed ones.

Companies in this category already believe in much of the ideology described in the previous sections. They understand the benefits of full disclosure, and have investor relations departments to maintain contact with their shareholders. These companies tend to have little involvement by the State, and a greater or lesser degree of international involvement. Many of these companies are international branches of multinational companies. Boards tend to be professional, and dominated by their majority owners.

The challenge for these companies is to increase shareholder value, through growth and new market entry. They have relatively little to learn from international lessons, and are instead models for the rest of the corporate sector in Egypt.

Case Study: Al Ahram Beverages

Al-Ahram Beverages Company (ABC) is typically considered to be a model privatization of the Egyptian reform program. In many reports and equity research material, the company is described as an extremely successful privatization and a "buy" opportunity. Chairman, Ahmed Zayat has a vision of turning ABC into a "globalized" beverages company. Zayat represents a new generation of Egyptian businessmen who themselves are a product of a global private sector.

Privatization. Mr. Zayat, with the support of a group of US investors (the Luxor Group), acquired control over 75 per cent shares in ABC in late 1996 by paying a deposit of about one percent of the value. Luxor then floated 63 per cent of the shares on the London Stock Exchange in the form of a GDR in February 1997. Luxor Group retained an ownership stake of 12.22 per cent and replaced the holding company as the controlling shareholder in March 1997.

Governance Structure. Ahmed Zayat became the Chairman of a new nine-person Board. Today there are four "non-executive" directors, representing different shareholder interests. The State and the ESA are not represented on the Board.

Since according to the Company Law the GDR shares held in the GDR depository cannot be separately voted by the beneficial holders, in practical terms the GDR shareholders (64%) cannot use their voting rights, and the Chairman and Luxor Group have effective control of the company.

Restructuring Since Privatization. The new Board appointed 12 new senior executives (including several foreigners) within the six months of privatization. Management was added the area of investor relations and media, human resource management, marketing, export promotion and sales management. Another 45 people were appointed to ABC's sales force.

The new management team began to implement major changes at the company, including improvements in management style, production techniques, the company's reputation, and alliances with major multinational corporations. The public sector management structure was removed (including 27 sector heads and 72 general managers!), and corruption was ended.

Summary: This case study confirms the fact that changing governance can make a major impact. It also raises some problems, including the large continuing role of the State and the ownership vs. control problems caused by the custodianship of the GDR issue.

Industrial Group Governance

Typical companies in this category are subsidiaries of one of the many industrial groups (holding companies) found in Egypt today. These groups were typically founded as private sector enterprises, and have grown to comprise much of Egypt's corporate sector. They tend to be family owned, controlled, and managed, and have a "patriarchal" business culture in which most control and oversight functions are vested in the founder/family patriarch. There is little distinction between management and the Board, and the same individuals are often part of both groups. The concept of "independence" on the Board is (anecdotally) unknown.

These companies have acquired State-owned companies, and are folding them into the larger group.

The challenge for these companies is to transform themselves into international-standard multinationals, with the governance procedures to match. Their current approaches have

worked well in environments wherbe personal connections (particularly with the government) are vital, but as trade barriers come down, efficiency and access to capital will become increasingly important. As a result, those companies that can tap a broader shareholder pool and can appeal to foreign investors will have advantages.

At the same time, these same companies must modernize and professionalize their internal governance structure. One force in this direction is returning expatriate Egyptian professionals. These people have seen how multinational companies function in other countries, and are interested in a comparable level of authority and responsibility in Egypt. This type of delegation of responsibility is difficult in the traditional patriarchal business culture, in which all decisions tend to be centralized.

Thus these companies will have to pay increased attention to both internal and external governance procedures as they mature going forward. International standards and codes of best practice may have a relatively large impact, and will support the "internal reformers" in each company working to build a modern firm.

Case Study: Ideal (Olympic Group)

IDEAL is another example of a successful privatization and restructuring, but with a different flavor. Ideal is now a subsidiary of the Olympic Group, which is working hard to restructure a traditional State-owned enterprise, and to integrate it into the larger holding company.

Privatization. IDEAL was privatized in 1997 in two separate transactions - a 25 per cent share offering through the stock exchange and a 75 per cent equity sale through a public tender to a strategic investor (Olympic Group).

The Olympic Group initially acquired 54 per cent of the company, then raised its holdings to 64 per cent and finalized its ownership stake when it formed a consortium with the Al-Abd family, who also acquired another 14.4 per cent of Ideal equity. The remaining shares were held by the ESA (10%) and a free float of 11.6%. In meetings with the company, management appeared to believe that the "free float" was also controlled by the Salaam family.

Governance Structure. The new owners created a 13 member Board of Directors, chaired by Dr Niazy Sallam, Vice-Chairman of the Olympic Group holding company. The other seven "non-executive" directors are all on the Olympic Group Board. The remaining 5 are employees of Ideal. None could be considered "independent". The board meets once a month. In 2000, the Ordinary General Meeting took place in early April, and about 100 people attended. No annual report for Ideal was produced; all information was in the Olympic Group annual report.

Senior management of the company is structured as follows:

- Dr. Niazy Sallam, Vice-Chairman of Olympic Group, is Chairman of Ideal.
- The Vice-Chairman and Managing Director of Ideal is also a member of the Sallam family.
- The General Manager / Executive Vice President of Ideal reports to the Vice-Chairman, is a hired professional manager, and is also a member of the Board.

All marketing and pricing decisions are now made at the Group level.

Restructuring since Privatization. The holding company quickly made many changes in the new subsidiary. The Group's goal was to upgrade all the mainstream aspects of the company's business, including the production, procurement, marketing and retail. Ideal would benefit from a number efficiencies in being part of the Group, including an established international network of suppliers, resulting in greater efficiency in the privatized company's procurement policies. By 2000, most operational decisions were being made at the Group level, including marketing and pricing.

Substantial operational changes have been achieved:

- Greater efficiencies and financial returns
- Commercial innovations through the launch of new products
- Agreements with leading multinationals
- Significant capital investment
- Reduction in work force to just over 2,500, from a peak of over 11,000

Summary. The achievements at Ideal are substantial. However, the challenge of moving to the next level of development remains a major challenge. Deregulation and the lowering of trade barriers will result in continually increasing competition over the next five years.

Ideal also raises questions about the governance of holding companies in Egypt. Considerable potential exists for expropriation of small shareholders of subsidiaries, when assets are passed between subsidiaries with different sets of minority shareholders, or when key decisions are made at the Group level. The attitudes of management may be somewhat typical of large companies in Egypt, particularly family-owned ones: small shareholders are considered to be "financial investors", and content with the current situation.

Crisis governance

Companies in this category tend to be in a difficult situation. They include recently privatized firms that are typically using outmoded equipment or technologies. They have little access to outside financing. Their major customer is a Ministry or other State organization, and there is has been little strategic thought to moving beyond their current situation.

One example of companies that fall into this category are the majority-ESA (Employee Shareholder Association) companies. These companies typify the category in that, while the State is not a large shareholder, it controls most of what happens at the company in terms of management.

The typical goal of most of these companies is simply to survive. In the case of the majority-ESAs, the goal is to do whatever possible to pay back the installment loan owed to the respective holding company. Although the high level of informal State involvement will hinder future restructuring, governance reform might help to push the management of these companies in new directions.

Case Study: Middle East Paper Company (Simo)

The Middle East Paper Company (SIMO) was established in 1945 as a private sector enterprise for the production of various types of paper and the conversion of paper and board for packaging, but was nationalized in 1961. Before privatization SIMO was seen as an attractive investment: debt had been restructured, its labor force was skilled, and it had potentially valuable assets and over 87,000 square meters of land in Cairo.

Privatization. SIMO's IPO on June 18th 1997 resulted in the Holding Company for Chemical Industries (HCCI) and the National Investment Bank (co-owners of the company since 1995) selling 85 percent equity in the company. New shareholders included the ESA (10%), the HCCI (15%), a group of investors led by Kuwait's Khorafy family (22%), and a group of Egyptian investors led by the financier Ahmed Diyya with 48 per cent.

Governance Structure. Ahmed Diyya became the new Chairman and the other Board positions were filled by representatives from the leading shareholders, with the Diyya-Khorafy consortium in effective control. No State representatives were on the Board. New managers were appointed in key positions.

Restructuring after privatization. Within a year of the IPO, internal problems led to a near-renationalization of the company. The main issue was conflict between the owners and employees. Rumors apparently predicted that the new owners were preparing for company liquidation. Industry technocrats complained that SIMO's new owners had no industry experience and were acting as exploitative "bad capitalists". In addition, the company's financial performance suffered when cheap imported paper made big inroads into the market.

In late 1998, the HCCI removed both the new Chairman and Managing Director from their positions at the head of the company and replaced them with "temporary" staff (industry executives approved by the government, still in place today) until the company's problems were "solved". The legal basis for this intervention remain unclear. Five new members were appointed to the company's Board internal management was reorganized. Increasing production was now the goal.

However, shareholdings do not appear to have been formally affected.

Summary. This case has shown that when the State and its technocratic bureaucracy is frustrated or threatened by the threat of liquidation in one of its former companies, it is willing to intervene in the internal affairs of the company, bypassing most legal governance mechanisms. The "temporary" situation caused by the intervention continues, and no clear strategy is in place.

Public/private governance

Companies in this category are effectively controlled by the State, either formally (with a majority stake, with the company still operating under Law 203) or informally, with the company formally privatized, but with the State as the largest shareholder. Some companies may be relatively dynamic and others not, depending on the strength of their management. However, it is somewhat difficult to ascribe problems at these companies to poor corporate governance. Since the State is the controlling shareholder, it will set many of

the strategic directions of the firm, or abdicate and propose no strategy at all (or the continuation of the current one).

Standard corporate governance practices need to be established in these companies prior to privatization.

Case Study: Electro Cables Egypt (ECE)

Electro Cables Egypt (ECE) was established in 1954 as a joint stock company and became the first enterprise to engage in industrial scale production of wires and cables in the Middle East. As a crucial link in the development of Egypt's power-infrastructure, the company was performing reasonably well before privatization. It had successfully established export markets, and created efficiencies in procurement, marketing and production.

Privatization. The Holding Company for Engineering Industries (HCEI) had already sold a 30 per cent minority stake in ECE through a Stock Exchange IPO in 1995. A further ten per cent stake had also been allocated to the company's ESA. However, neither sale had much influence over the company's management or decisionmaking. In December 1997, the HCEI again offered ECE to the public and sold off its remaining (majority) stake in the company to a diverse group of private investors, including several investment funds and public sector financial institutions. None of the new shareholders controlled more than 10 percent of the shares.

Governance Structure. The relatively dispersed ownership structure predicted that management would have a relatively strong voice, because of the absence of controlling shareholders. This has proven to be the case: while the privatization resulted in a complete change on the Board, Mr. Hassan Helmy Said was retained as the company's chairman. The new Board included representatives from the financial sector, a paper manufacturer and some private stock market investors. However the lack of Board leadership and industry background, combined with the Chairman's past ties to the public sector, virtually ensured that the State would continue to play a strong informal role.

Restructuring after privatization. Today there is little evidence of ECE's new governance structure having any noticeable impact on the company's management. The company is required to buy aluminum from a State enterprise at a predetermined price, and to sell to public sector enterprises with a poor payment history. The company remains highly overstaffed.

Summary. Privatization has made many changes to the governance structure of privatized companies, including ECE. However, it is still difficult to see an emerging private-sector style and personality. The former public sector Chairman continues to lead management (and the Board) without any profound changes.

Regulatory players

Several regulatory and government institutions have an interest in corporate governance. As noted above, this is particularly true of the capital markets regulatory institutions, which have a natural interest in growing the market. The institutions below act both as regulators and as "reputational agents".

- **Companies Department of the Ministry of Economy and Foreign Trade.** The Companies Department is responsible for all administrative processing for joint stock companies — filing applications, approving founding documents, etc. It works closely with the CMA to oversee the corporate sector, but currently plays no active enforcement role.

- **Capital Market Authority (CMA).** The CMA is empowered by the capital market law to regulate Egypt's capital markets. In particular, it is responsible for approving all public offerings of shares, and regulating the issuers of those shares. The CMA appears to be a competent and active organization. Its main problem has been the lack of administrative (financial) penalties that it could legally impose. The new draft capital markets law will reportedly augment those powers and improve the CMA's legal authority.

- **The Cairo and Alexandria Stock Exchange (CASE)**. The CASE is one of the world's oldest stock exchanges. However, since the nationalizations of the early '60s it was

essentially inactive. With the advent of privatization, the exchange (the result of a merger between two exchanges) is quickly moving to become the leading trading platform in the Middle East. The exchange is in the process of a number of reforms, including the development of revised listing rules, revised membership rules, a new trading floor, the implementation of new trading software, and integration with the enhanced MCSD.

- **Misr Clearing, Settlement and Depository agency (MCSD)**. Egypt is fortunate in having an up-and-running central depository, the MCSD. The MCSD is recognized by the world as the central depository for Egypt, and is financially and operationally capable of taking on the assignment. Egypt's companies are going through an inevitable consolidation and conversation process as shares are gradually deposited in the MCSD.

- **Market Participants.** The number of market participants has grown in line with the growth in market activity. As of mid-1999, there were about 130 brokerage firms, 9 investment management funds, and 19 mutual funds. The Egyptian Capital Markets Association (ECMA) represents most of these institutions, and appears to be in line to become a self-regulatory association.

As noted, the growth in market institutions is very favorable to improvements in shareholder rights, information disclosure, and corporate governance reform.

A COMPARISON WITH INTERNATIONAL STANDARDS

The following sections are a detailed comparison of the international standards reviewed in section 2, with the situation in Egypt. Eighteen specific recommendations are made for changes to the current framework, or for issues to be investigated further.

Legal framework

As discussed above, the foundation of any corporate governance framework is provided by the basic legal framework, as reflected in the basic company, civil, and securities laws, the regulations of the stock exchange (especially the listing rules), and the basic accounting standards in place. These laws are the basic rules of the road for Board and management behavior, and in the long term tend to reflect the values of the underlying business culture.

The basic corporate governance legal framework in Egypt is contained in two laws and their supporting Executive Regulations:

- The **Companies Law** (Law 159 of 1981), or **CL**, containing provisions on Joint Stock Companies, Limited Liability Companies, and Partnerships. It can be considered to be Egypt's "Corporate Law". It's provisions apply to most Egyptian commercial companies, unless specified otherwise.
- The **Capital Market Law** (Law 95 of 1992), or **CML**, Egypt's main law regulating the securities markets.

This study was carried out at an interesting juncture in Egypt's legal development. Several new laws are in the process of being approved by the government and by parliament, including:

- **A new Capital Market Law**. This draft law, which is intended to modernize the existing Law 95, was originally drafted by the US firm of Sullivan and Cromwell in 1997. Because of the confidentiality required by the approval / enactment process in Egypt, we were not able to review the draft law as part of the study.
- **A new "Depository Law"**. This law is intended to legalize and formalize the legal principles behind the Misr Clearing, Settlement and Depository agency (MCSD), including the introduction of nominee ownership and other basic legal principles to support modern shareholder recordkeeping, and clearing and settlement. Although this law was close to approval, it was also unavailable for review.
- **New Listing Rules**, promulgated by the Stock Exchange and to be approved by the CMA, promise to tighten up the listing process, with the goal of improving and enforcing disclosure requirements.
- **In addition, a new draft "Uniform Companies Law"** is next in the queue for approval by the government. It is intended to update Law 159, and to try to harmonize all Egyptian company law. This study will comment on both existing company law and the new draft law that was made available by the Ministry of Economy's legal advisor, Dr. Ziad Bahaa-Eldin.

Although these draft laws and rules were unavailable for direct review (except for the draft companies law), conversations with advisors and participants in the drafting, and others who appear to have seen at least parts of the draft laws indicate that certain basic assumptions can be made about the new laws. These assumptions will be identified below.

Overview

Egypt starts with a disadvantage in its legal framework, as far as shareholder rights are concerned. Egyptian commercial law is based on the French legal family, and its ancestor is the Napoleonic Code. Many features of Egyptian Company law are very similar to French ones. Recent legal and economic research indicates that the French legal tradition is the least shareholder-friendly of all legal systems around the world.[34] Because of the lack of shareholder protection, countries with this legal framework tend to have smaller capital markets and more concentrated ownership structures.

However, Egypt appears to have overcome this initial disadvantage. The Companies Law is relatively recent (1981) and has been updated and revised. Several basic conclusions emerge from a review of the Company Law:

- **The law supports many basic shareholder rights.** Although some provisions are weaker than what international observers could wish for, basic legal protections appear to be in place.
- Future **enforcement is thus the key issue**.
- As the Ministry of Economy already well knows, the draft company law will desperately require harmonization with both the new capital market law and the depository law. Provisions in law 159 that deal with the nature of shares, share ownership, "coupons", share certificates, etc. are obsolete in a dematerialized environment.

Recommendation 1: The draft companies law should be harmonized with the new capital markets and depository laws after their enactment.

Legal Checklist

As noted on page 9, Appendix A contains a legal checklist shareholder rights issues. **The intent is to flag important issues, not to explore all potential solutions.** The checklist is based on the *OECD Principles*, but goes further to examine many issues that may be specific to emerging markets. The highlights of the results are discussed below for the following sets of issues:

- Basic organization / assignment of responsibilities
- Ownership registration / shareholder recordkeeping / share settlement
- Equitable protection of all shareholders
- Voting of shares
- Responsibilities of the annual general meeting
- Duty of loyalty or fiduciary responsibilities
- Takeovers
- Enforcement

Basic Organization / Assignment of Responsibilities

Like its international counterparts, the Joint Stock Company (JSC) in Egypt is a type of company where shareholders have limited liability and shares are freely transferable. The JSC is organized around two main institutional bodies: the shareholders and the Board of directors.

The Board, headed by a Chairman, oversees the management of the company. Members of the Board are elected by shareholders. Shareholders meet in General Assemblies (GAs). The Board has a managing director (sometimes translated "delegated member") who is the Board member responsible for the Board's detailed oversight of the company. The Board

can also hire a "general manager" who is an employee of the company, to run the operations*.

> *Recommendation 2: The draft companies law should include a list of specific responsibilities for the Board of directors. It should also recommend the mandatory creation of audit and other committees of the Board.*

Ownership registration / shareholder recordkeeping / share settlement

A modern shareholder recordkeeping system is central to the protection of shareholder rights. A basic shareholder right is confidence in the system, and its legal underpinnings. The system should be able to transfer shares within international norms (e.g. "T+3") and should be accountable to the securities regulator.

Egypt is fortunate in having an up-and-running central depository, the MCSD. The MCSD is recognized by the world as the central depository for Egypt, and is financially and operationally capable of taking on the assignment. Egypt's companies are going through an inevitable consolidation and conversation process as shares are gradually deposited in the MCSD. Government, the securities industry, and issuers should encourage rapid conversion of registries and depositing of shares.

One potential problem results from the fact that the MCSD only concentrates on listed companies. Should the new Stock Exchange Listing Rules result in mass delistings from the stock exchange, potential shareholder ownership problems could result as the registries are returned to the companies to manage. The CMA may want to put special surveillance on the registries of non-listed companies with relatively large numbers of shareholders (assuming it is statutorily able in the new Capital market / depository laws).

> *Recommendation 3: All parties (the Holding Companies, regulators, the securities industry, and issuers) should encourage rapid conversion of registries and depositing of shares into the MCSD.*

> *Recommendation 4: Careful attention should be paid to companies with relatively large numbers of shareholders not maintained by the MCSD. A review of off-exchange transfer procedures may be worthwhile.*

This study did not review the many provisions related to the formalities of share transfer and issuance because of the changes expected from the new laws.

Equitable protection of all shareholders

One-share/one-vote

The law is relatively clear on the notion that, within a given share class, all shareholders have the same rights (Art 9, ER/CML). Any caps or interference with voting rights within the class would be illegal.

The current law is weaker on the concept of "one-share/one-vote". Article 9 of the Executive Regulations to the capital markets law states that "…the Articles of Association may provide

* In US terms, the "Managing Director" appears to be equivalent to the Chief Executive Officer, while the "General Manager" is akin to the "Chief Operating Officer". However, under the law only the General Manager would be considered an employee.

for determining certain privileges for certain types of nominal shares, in voting, or profits, or the net of liquidation, providing that the shares of the same type share be treated equally." This is contrary to notion of "one-share / one-vote", which forces cash-flow rights to be the same as voting rights. However, Egyptian law does appear to comply with the basic OECD standard, which took no position on one-share / one vote.

Anecdotal evidence suggests that multiple share classes are currently rare in Egypt, although there is no guarantee that more will not be added in the future.

In any case, Article 10 does not allow changes to be made to the voting rights without a vote of a "special assembly" of the affected shareholders.

To reiterate the one-share/one-vote argument: by matching voting power with economic interest, the law increases the likelihood that corporate actions will maximize shareholder value.

Insider trading

Insider trading does not appear to be explicitly illegal. However, Article 64 of Law 95, which punishes those who uses confidential information for personal benefit, could be used to sanction such activities were they detected.

The role of custodians

Because current Company Law does not recognize nominee ownership, there appears to be a voting rights problem for shareholders who hold their shares with custodians, and especially those who hold Global Depository Receipts (GDRs) of Egyptian companies. As noted above, the GDR depository is not allowed to vote its share position separately, because it is the only name formally recorded in the registry. The GDR depository will naturally tend (as do most custodians) to vote in ways desired by management, since it is appointed by management. As a result, the GDR holders are effectively denied voting rights.

It can be expected that the new Depository Law and its executive regulations will address this issue. It is crucial to providing voting rights to international investors.

Other minority protections

There are two key "last-ditch" provisions to protect minority shareholders. One is Article 76 of the companies law is Article 76 of the Companies Law. It states that "…all resolutions issued for the benefit of a certain category of shareholders or causing harm to them, or bringing special benefit to the members of the Board of directors or others without considering the company's position, shall be revoked." It is unclear who makes this determination; if it is the CMA then it should be so stated.

The CMA has direct power in the Capital Markets Law. Article 10 gives the CMA Board of Directors the power to "suspend resolutions" of the GA if they are issued for the benefit of a certain category of shareholders. The CMA receives a complaint from investors (representing more than 5% of capital) or on behalf of shareholders from a CMA staff member attending an annual meeting. If the CMA legal department determines that the case has merit, it is passed on to the CMA Board of Directors for review. The CMA Board can then pass the case to a securities market arbitration panel.[35]

This provision is important for shareholders rights, because it gives a regulatory body direct responsibility for enforcing shareholders rights. It has apparently been invoked up to "4-5

times per year" for the past few years.[36] However, the arbitration panel's decisions are apparently not binding unless the two parties have contractually agreed. In many cases, the majority of the disputes apparently go on to court in any case. These legal issues are a key area to resolve for the next version of the capital market and companies laws.

The Companies Law and the new Capital Market Law must be reconciled on this point. If Article 76 must be adjudicated in Civil Court, then the value of the provision will be much less than the protection provided by the CMA, simply because of timeliness.

Recommendation 5: Egypt does not comply with one-share/one-vote. Although this is not an OECD requirement, it is encouraged by international investors.

Recommendation 6: To the extent it is not covered in the new Capital Markets Law, insider trading should be made illegal, as part of the executive regulations, and steps should be taken at enforcement.

Recommendation 7: Per the OECD Principles, "Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares."

Recommendation 8: The laws and procedures related to shareholder appeals to the CMA and shareholder arbitration should be reviewed, and lessons learned should be incorporated into the Executive Regulations of the new Capital markets Law. Contractually binding arbitration may be a good solution to the problem of a slow court process.

Voting of shares

Although shareholders are explicitly given the right to vote and participate in GAs, some restrictions are in fact placed on the voting of shares:

- Shareholders "are entitled to attend the General Assembly", personally or by proxy. (Article 59, CL)
- Voting by mail or electronically is not allowed.
- Shares must be blocked before the GA. In the age of the central depository, the policy rationale for doing so is unclear. International standards suggest that "…procedures should not make it unduly difficult or expensive to cast votes."[37]
- In general, the use of proxies is severely restricted. Article 9 of the CML prohibits (and article at of ER 135) a shareholder from representing more than 10% of the total nominal shares or more than 20% of the shares present in the meeting. It must also be confirmed with a written power of attorney. Previous studies have also recommended abolishing this provision and requiring full disclosure of those seeking proxies and establishing appropriate and clear sanctions for fraud and deception along with clear rights of shareholder who hold their proxies accountable.[38]

Innovative and modern voting procedures should be introduced if possible. Voting by mail and even electronically should be explored to encourage the expansion and use of voting rights.

In addition, a completely new approach to tabulating votes could be explored: cumulative voting. Conceptually, if the Board has eleven seats, each shareholder would get eleven votes that can be voted separately for the election of Directors. With cumulative voting, shareholders can concentrate all their votes on a single candidate, and force him or her onto the Board.

Cumulative voting addresses several problems at once:[39]

- It allows large minority shareholders a voice in Board actions;
- It increases the probability that at least some directors will be independent of management,
- It reinforces the principal that directors owe their allegiance to the shareholders;

If cumulative voting were adopted, then certain other changes would be required, including requirements for annual election of directors (staggered elections would dilute the power of cumulative voting).

Empirical studies in mature markets suggest that shareholders benefit from the availability of cumulative voting. For emerging markets, at least one analysis states that "…the likely benefits greatly outweigh its potential costs.[40]"

Recommendation 9: The restrictions on the use of proxies and the blocking of shares required at annual meetings represent an unnecessary burden on shareholders, and are out of line with international standards. A working group should be convened to study the entire question of voting rights, procedures, and proxies, with the final goal of drafting provisions for the new draft company law that will modernize voting procedures and the use of proxies.

Recommendation 10: Mandatory cumulative voting should also be explored by the working group as a way of increasing minority representation on closely held Boards.

Responsibilities of the Annual General Assembly (GA)

Under the law, the GA is supposed to be held once a year, not later than six months after the end of the company's fiscal year. Typically the meeting is called by the Chairman, although a small group of shareholders (5%) can require that the meeting be held (Law 159, Article 61).

Prior to the GA, the Board must publish in "daily newspapers":

- the financial statements of the company
- the report of the Board
- the report of the company's auditors.
- according to the Capital Markets Law, the financial statements must be in Egyptian Accounting Standards

If the company's founding documents allow, the information can be mailed to shareholders before the GA. The Companies Law protects minority shareholders by allowing those representing more than 5% of the capital to force a specific topic onto the agenda at the GA, and call it to a vote, even if it is not already on the agenda.

Duty of Loyalty or Fiduciary Responsibilities

No obligations (duty of loyalty/fiduciary duty) appear to be imposed on managers or large shareholders. Board members do appear to be required to disclose various conflicts of interest, although these articles of the Company Law (Articles 96-100) should be further reviewed and tightened. In some countries (e.g. Korea) shareholders who are "influencing" Board members are treated as Board members for these provisions – this might be a way of attacking the fiduciary responsibility of the controlling shareholders.

Each of these areas should be investigated further.

Recommendation 11: Imposing a duty of loyalty of another fiduciary duty on controlling shareholders and/or officers of the company is a direct approach to reducing the risk of expropriation of minority shareholders. It should be investigated if these obligations could be inserted into the draft Uniform Companies Law.

Recommendation 12: The laws regulating Board conflicts of interest should be reviewed in the draft law.

Takeovers

Relatively detailed rules regulate takeovers of publicly traded (listed) companies. The regulation could be considered excessive, and may discourage future takeovers:

- Any shareholder who wants to acquire more than 10% (5% for Board members) of the shares as part of a public tender must give the company at least 2 weeks notice. The company is then required to notify all shareholders with more than one percent of capital.
- To acquire more than 20% (Board Members 15%), the acquirer must make a public tender to buy all of the remaining shares at a certain price.

The threat of a takeover ensures that companies with widely distributed shareholdings are managed in the public interest. Takeover restrictions tend to be viewed as anti-shareholder rights, and the threat of a takeover is often viewed as critical to development of a market in corporate control and a positive incentive to corporate governance.

To the extent that new takeover rules are not specified in the draft Capital Markets Law, new regulations should be developed that impose fewer restrictions on takeovers. In particular, pre-notification requirements should be removed, and privately negotiated block trades allowed. Pre-notification requirements serve to discourage potential acquirers from investing time and money to identify opportunities to increase shareholder value by pursuing new corporate strategies and taking the financial risk of acquisition.

Recommendation 13: To the extent not addressed in the new draft Capital Markets Law, takeover regulation should be reviewed to ease the regulatory burden as much as possible.

Enforcement

In general, as in many emerging markets, enforcement of company and securities laws is the big problem. Many jurisdictions suffer from inefficient legal systems, and regulatory bodies with insufficient authority or legal clout.

In Egypt, the powers of the regulator are important because of the relatively inefficient court system. The current perception in the market is that while the court system is actively used to resolve shareholder disputes, it takes 3-4 years to receive a judgement.

Therefore a lot depends on the new powers granted to the Capital Markets Authority (CMA) in the draft Capital Markets Law (which was not available for review as part of this study). According to hearsay, considerable new legal authority is granted the CMA in the new law, including the ability to impose administrative penalties (including fines), and the ability to bring criminal and civil cases.

However, it is unlikely that the new law would stress an important function of the CMA from the point of view of minority shareholders: the right of appeal of 5% of the shareholders to the CMA. In cases where General Assembly resolutions are "…issued for the benefit of a

certain category of shareholders or causing damage to them or deriving a special benefit to the Board of Directors or others…", CMA can suspend the resolutions.

Although CMA staff attend selected annual meetings, they do not appear have the power to regulate proxy disclosure. The new company law should give that power to the CMA.

Recommendation 14: The CMA should be the "relevant administrative authority", the official guarantor of corporate governance in Egypt, and should work hand-in-hand with the Companies Department of the MOEFT to regulate the activities of joint stock companies.

Disclosure in Egypt

Disclosure is critical to good corporate governance. However, disclosure runs against many traditions in Egypt. All corporate information has traditionally been thought of as secret. As in many countries, financial managers can be assumed to have kept many different sets of books: one for the "owner", one for the tax inspector, and one for the outside investors. As in many countries, public disclosure was the exception, not the rule.

However, the capital markets development of the past few years has resulted in many important first steps:

- The capital markets law requires quarterly financial disclosure, according to Egyptian accounting standards. Disclosure is also stipulated in the listing rules of the CASE. Rules require all listed companies to publish audited quarterly financial statements adhering to IAS. Companies are also required to make timely disclosure of all material news that may affect their business and earnings.

- Egypt has essentially adopted International Accounting Standards as the national standard. Egyptian accounting standards are the same as IAS, with some minor changes.

However, the existing situation needs improvement, according to market participants:

- Many companies that are supposed to file apparently do not follow the law. While the exact percentage of non-filers or late filers is not publicly available, it is considered to be significant by market participants. According to the stock exchange, the reason is that there are no administrative penalties that can be applied to non-filers. The only current weapon is delisting. However, a large number of listings was seen as a measure of the success of the exchange, relative to its international competitors. Thus the delisting penalty has only been employed rarely, until recently.
- Many of the other international standard OECD requirements, including ownership structure, Board membership, etc. was not included in the original disclosure requirements.
- It remains somewhat uncertain how much the new accounting standards have been adopted outside of the companies audited by one of the affiliates of the international Big 5 firms.

According to the CASE, the exchange will soon issue new listing rules to repair many of the deficiencies in the existing system.[41] While the new rules are currently waiting for approval by the CMA, they are understood to include the following features:

- Financial penalties that can be imposed by the CASE.
- New required information, including voting rights possession, shareholder representation of large shareholders (over 3%), voting rights restrictions, shareholder coalitions, and banking relationships.
- A new web site will allow investors to get easy access to the information, and highlight the identity of non-disclosers, as an additional incentive to report regularly.

The development of the listing rules appears to have spurred the exchange to greater activity – according to the CMA, the pace of delistings has increased in recent months.

To continue the momentum, the Exchange should:

- Rapidly obtain approval for the new rules from the CMA

- Implement the rules as soon as possible
- Impose a "full compliance" rule from the start. Financial information should not be enough; if other information (especially ownership information) is missing, the filing should be regarded as non-compliant.
- Impose financial penalties before delisting. Financial penalties are crucial, since delisting tends to hurt existing shareholders more than company management, by reducing their rights to sell.
- Make all information as widely and easily available as possible.
- Build a base of statistics of governance information that can be used to track future developments.

Recommendation 15: The Ministry of Economy and the CMA should develop a strategy for future development of accounting rules, application of the accounting standards, and improving the training of the accounting profession.

Recommendation 16: The CASE should be supported in a vigorous enforcement of its new listing rules, even if large number of delistings should eventually result. Delisting should only take place once all other alternatives and penalties have been exhausted.

Recommendation 17: The CASE should encourage compliance with all aspects of the new rules, including the crucial data on ownership structure, names of directors, bank relationships, voting rules, etc.

Management oversight and Board Structure in Egypt

A review of Board practices and management oversight is many ways simpler than looking at the legal framework or disclosure practices. Egypt is at a starting point. No formal standards or laws exist to guide Boards of directors. There is little tradition of public companies, and many large companies are run as sole proprietorships or by management with little awareness of shareholders.

There is little data on governance in Egyptian companies. As noted above, many of the typical governance tools appear to work as expected. General meetings are held, dividends are paid, shareholders sue each other, and appeals are made to the CMA – all creating Boards of directors that should reflect the interests of shareholders.

However, we know that at the Board level Egyptian companies do not meet international standards for providing oversight of management. Based on the qualitative assessment described earlier, Egyptian companies appear to share several characteristics:

- **Independence is rare or non-existent on Boards.** None of the companies we interviewed had Board members that could be considered independent. Several examples of "independence" were cited in interviews, but related to other companies. Most often these Board members are eminent academics or legal experts. However, they tended to represent the State's seats, and by appearances were representing the State's interests rather than the interests of the company and all its shareholders. Boards are thus completely driven by strong managers or owners, and there is no oversight or second-guessing of their decisions.

- **Lack of Board committees**. Likewise, there were no reports of any Board committees, other than "executive committees" of the Board.

- **Confusion between Board and management roles.** More fundamentally, there appears to be a lack of separation between the role of management and the role of the Board. In many of the companies interviewed, the Board functioned more as a German-style management Board, with no "supervisory Board" oversight. The Chairman tends to be the managing director, and many of the Board members are both major shareholders and managers.

- **Holding company issues.** The lack of oversight is particularly serious at the subsidiaries of large holding companies. Many of these subsidiaries are publicly traded companies with separate Boards and governance structures. However, the Board may have no real authority. Decisions about pricing, strategy, and marketing are made at the holding company level. Expropriation due to low transfer prices or to moving assets among subsidiaries is currently almost impossible to recognize or control. Note that in many cases the majority shareholder at the subsidiary level and the majority shareholder at the holding company level are the same. Thus majority shareholders are not affected by inter-company accounting, and minority shareholders (and workers) could well be. This lack of shareholder control should also be addressed.

The current framework can work reasonably well in an environment with simple ownership structures, relatively small companies, and a growing economy. But as competition increases, or growth slows, or a company needs to take a new strategic direction, many companies will be subject to increasing stress. It is at that moment when a strong Board will become very valuable.

Recommendation 18: The revision to the company law (and any work towards a code of best practice) should include a review of holding company law and practice. This area is a potentially large problem for shareholder rights.

Recommendation 19: Egypt should begin the process of putting together a code of best practice. The Code should specifically address the Management Oversight / Board Structure issues. Shareholder rights and disclosure issues that are raised can be inserted into Law and Listing requirements.

Some countries to look at as models are Korea, Brazil, and especially Mexico, whose economies were similar in structure to Egypt. Moving quickly is important because the some of the Best Practice Committee's recommendations could be incorporated in the final version of the new Uniform Companies Law and perhaps even the Capital Markets Law. Moving quickly would also show Egypt's eagerness to embrace foreign investors and the global capital market.

AN INITIAL STRATEGY FOR REFORM

CREATE A WORKING GROUP TO DRAFT A CODE OF BEST PRACTICE

The opportunity now exists in Egypt to draft a code of best practice for corporate governance for Egyptian companies. The advantages of a code of best practice were described in some detail earlier (page 7). A code of best practice could deliver a complex set of negative and positive incentives to companies to improve their governance:

- The code of best practice could assist in building a consensus around certain required legal changes. These changes could be incorporated in the draft Uniform Companies Law or in the capital markets law (depending upon timing), or in their executive regulations.
- The code could eventually become part of the stock exchange listing requirements. Companies could deviate from the code, but would have to disclose the deviations.
- A code of best practice can set a target for managers and directors wishing to hit international standards and attract international capital.
- By moving quickly, Egypt would get a jump on the majority of emerging market countries, and would clearly differentiate itself in the eyes of international investors.

The timing is now good for several reasons. The past three years have been an intense period of privatization and capital market development. The market has now matured to the point where basic corporate governance development is a logical next step. In addition, the legislative process should have fixed the depository law and the capital markets law, making major modifications to the company law a logical next step.

There are two basic approaches to developing the approach: "bottom-up" and "top-down". Each has advantages and disadvantages:

- **"Bottom-Up".** A bottom-up development process would imply a form of self-regulation. Egypt's corporate and capital markets communities would assemble a committee that would meet (with staff support) and develop a code. From the point of view of international investors, this approach would probably be ideal. It would provide the code with more legitimacy in the eyes of company Boards, and would probably have greater acceptance. On the other hand, because corporate governance has not been widely discussed in Egypt, the process would run the risk of producing a code that was somewhat weaker than required.
- **"Top-Down"**. In a top-down process, the code development would be effectively driven by the government. International investors would probably be less happy with this approach, but it would have the advantage of producing a code quickly and with less uncertainty.

USE THE OPPORTUNITY TO DRAFT A WORLD-CLASS COMPANY LAW

With or without the code of best practice, an opportunity exists to build on the existing draft Uniform Companies Law and draft a world-class company law. If the legislative calendar forces the discussion of the new law into 2001 (which now seems likely) then additional technical assistance could provide review and assistance on all aspects of the law, including the sections relevant to corporate governance.

THE ROLE OF THE STATE IN BUILDING CORPORATE GOVERNANCE

In meetings with Egyptian policymakers, market participants, and company officials, one message that comes through loud and clear is the continued importance of the State in the life of most (if not all) Egyptian companies. As noted above, most large Egyptian companies still have a large percentage of State ownership, both directly and through various State bodies. In addition, the State plays a large formal and informal role as customer, regulator, and competitor. The continued presence of the State has led some observers to quietly doubt the seriousness of the privatization program.

Two main conclusions are important. First, the privatization process should be accelerated. More companies should be sold, and equally importantly, the holding companies should sell off the “residual share packages’, the minority stakes remaining from previous privatizations. While speeding up privatization is not (to say the least) a new recommendation, acting on it will improve corporate governance, lead to more of a focus on shareholder value, and allow companies to restructure more quickly.

Second, and more subtly, the State needs to be careful to use the corporate governance mechanisms of private companies, and not revert to the “old ways” of doing things. One of the case studies cited earlier (Simo Paper) suggests that the State is not always a good loser. When the majority of shareholders made a “bad decision”, the State (probably prodded by management and workers) was willing to remove a Chairman of the Board, and appoint a “temporary” management team. This behavior is very corrosive to corporate governance processes and the rule of law.

This case and others suggests the development of a training program for the Holding Companies to develop an appreciation of basic governance processes. The Code of Best Practice could of course address these issues as well, and would be helpful in creating the training program.

TRAIN DIRECTORS

Even before the results of the Best Practice committee are in, it should be possible to set up organization and begin training directors in basic corporate governance. As with the Code of Best Practice, international observers would prefer that the initiative was led by the private sector. However, the initial push could come from regulators. In Thailand, the country’s three top regulators (the Stock Exchange of Thailand, the Securities and Exchange Commission, and the National Bank of Thailand) launched an “Institute of Board of Directors” to take the lead in corporate governance initiatives. The Institute trains directors with funding from the founders, with additional support from the World Bank.[42]

A similar approach could be taken in Egypt. The Directors Institute could be an explicit outgrowth of the development of the Code. The Institute would maintain the code, amend it occasionally, and provide publicity and training to change the values of corporate directors, managers, and shareholders across Egypt.

ENDNOTES

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[4] Davis Global Advisors, *Leading Corporate Governance Indicators 1999: An International Comparison*, November 1999, p.12.

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[13] Gregory, Holly, of Weil, Gotshal & Manges LLP, International Comparison of Board "Best Practices in Developing and Emerging Markets (Revised Nov. 1999). Available from World Bank website http://www.worldbank.org/html/fpd/privatesector/cg/research.htm

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[15] Gregory, ibid.

[16] Gregory, ibid.

[17] Gregory, ibid.

[18] Gregory, ibid.

[19] Gregory, ibid.

[20] European Union Green Paper "The Role, Position and Liability of the Statutory Auditor in the European Union", as cited in Converging Cultures: Trends in European Corporate Governance, Price Waterhouse, (April 1997).

[21] (See, in the U.S., the Report of the National Association of Corporate Directors Commission on Director Professionalism (1996), and the General Motors Board of Directors Guidelines (1994); in the UK, the Hampel Committee Report (1998))

[22] Explanatory note 4 of the Malaysian Code of Best Practice, as cited in Holly Gregory, Weil, Gotshal & Manges LLP, International Comparison of Board "Best Practices in Developing and Emerging Markets (Revised Nov. 1999).

[23] See for example *World Bank Corporate Governance Forum Background Materials*, September 1999.

[24] This section borrows heavily from Stone, Andrew, Kristin Hurley and R. Shyam Khemani, *Business Environment and Corporate Governance: Strengthening Incentives for Private Sector Performance*. The World Bank/IMF Annual Meetings 1998. Background Papers / Program of Seminars, Responding to the Global Financial Crisis.

[25] "Prodding From Nafta Helped Mexicans Think Globally to Meet U.S. Challenge," Wall Street Journal, May 9, 2000.

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[27] Brooks, Jermyn (Chairman Price Waterhouse Europe). Converging Cultures: Trends in European Corporate Governance, Price Waterhouse, (April 1997), p. 5.

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[32] Davis Global Advisors, Leading Corporate Governance Indicators 1999: An International Comparison, November 1999, p. 11.

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[40] Bernard Black, Reinier Kraakman, and Jonathan Hay, *Corporate Law from Scratch*, Paper for a joint conference of the World Bank and the Central European University Privatization Project, December 15-16 1994, page 30.

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[42] Davis Global Advisors, Global Proxy Watch, September 17, 1999.