Protecting investors

Corporations are instruments of entrepreneurship and growth. They can also be abused for personal gain. In July 2012 authorities in Korea imposed a $30 million fine on SK Group, the country's third-largest conglomerate, for illicit related-party transactions. The transactions were priced significantly above market averages and allegedly allowed the group's founder to misappropriate $87 million. The group's market capitalization declined sharply as a result.[1] Korea's strong institutions and extensive disclosure requirements played an essential part in addressing this situation and protecting minority investors.

Doing Business measures the strength of minority shareholder protections against directors' misuse of corporate assets for personal gain. The indicators distinguish 3 dimensions of investor protections: approval and transparency of related-party transactions (extent of disclosure index), liability of company directors for self-dealing (extent of director liability index) and shareholders' ability to obtain corporate documents before and during litigation (ease of shareholder suits index). The standard case study assumes a related-party transaction between Company A ("Buyer") and Company B ("Seller") where "Mr. James" is the controlling shareholder of both Buyer and Seller and a member of both their boards of directors. The transaction is overpriced and causes damages to Buyer.

Protecting minority investors matters for companies. Without adequate regulations, equity markets fail to develop and banks become the only source of the finance that companies need to grow, innovate, diversify and compete. A recent study shows that in economies with stronger investor protections, investment in firms is less sensitive to financial constraints and leads to greater growth in revenue and profitability.[2] Another study shows that regulating conflicts of interest is essential to successfully empowering minority shareholders.[3]

New Zealand provides the strongest minority investor protections as measured by *Doing Business*, ranking highest in this area for the eighth year in a row (table 14.1).

WHO IMPROVED INVESTOR PROTECTIONS IN 2011/12?

In the past year 13 economies strengthened investor protections as measured by *Doing Business*. OECD high-income economies, with 4 legal changes, continue to

TABLE 14.1 Where are investors most protected—and where least?

Most protected	RANK	Least protected	RANK
New Zealand	1	Haiti	176
Singapore	2	Gambia, The	177
Hong Kong SAR, China	3	Guinea	177
Canada	4	Micronesia, Fed. Sts.	177
Malaysia	4	Palau	177
Colombia	6	Djibouti	181
Ireland	6	Venezuela, RB	181
Israel	6	Suriname	183
United States	6	Lao PDR	184
United Kingdom	10	Afghanistan	185

Note: Rankings are based on the strength of investor protection index. See the data notes for details. Economies shown with the same number are tied in the ranking.

Source: Doing Business database.

- **New Zealand has the strongest minority investor protections in related-party transactions, for the eighth year in a row.**
- **From June 2011 to June 2012 *Doing Business* recorded 13 legal changes strengthening the protections of minority investors.**
- **Kosovo made the biggest improvement in the strength of investor protections in the past year.**
- **Tajikistan has advanced the furthest toward the frontier in regulatory practice in protecting investors since 2005.**
- **Improving disclosure was the most common feature of investor protection reforms in the past 8 years.**
- **Among regions, Eastern Europe and Central Asia has strengthened investor protections the most since 2005—and is quickly catching up with OECD high-income economies.**

For more information on good practices and research related to protecting investors, visit http://www.doingbusiness.org/data/exploretopics/protecting-investors. For more on the methodology, see the section on protecting investors in the data notes.

FIGURE 14.1 Kosovo's new Law on Business Organizations strengthened investor protections

Source: Doing Business database.

TABLE 14.2 Who strengthened investor protections in 2011/12—and what did they do?

Feature	Economies	Some highlights
Made it easier to sue directors	Armenia; Republic of Korea; Kosovo; Lesotho; Peru; Taiwan, China; Tajikistan	Korea clarified directors' duties in its commercial code. Now negligent directors can be held liable for damages caused by prejudicial related-party transactions.
Increased disclosure requirements	Armenia; Greece; Islamic Republic of Iran; Kosovo; Lesotho; Mongolia; Taiwan, China	Lesotho enacted a new company law that requires company directors to disclose to the board the full extent of any conflict of interest they may have relating to a proposed transaction.
Regulated approval of related-party transactions	Armenia; Kosovo; Netherlands; Peru; Slovenia; Taiwan, China	Kosovo amended its Law on Business Organizations. Now only disinterested shareholders can approve related-party transactions.
Allowed the rescission of prejudicial related-party transactions	Kosovo; Moldova	Moldova amended its law on joint stock companies. Shareholders can now petition the court for a rescission of transactions approved despite major conflicts of interest when such transactions cause damages to the company.

Source: Doing Business database.

provide the strongest protections. Eastern Europe and Central Asia, also with 4, remains the most improved region and the most active in making legal changes, with 24 recorded in 16 economies since 2005.

Kosovo improved minority shareholder protections the most in the past year, through a comprehensive revision of its Law on Business Organizations (figure 14.1). The amended law requires shareholder approval of related-party transactions and mandates greater disclosure both by directors to their board and by companies in their annual reports. In addition, the law allows shareholders to petition a judge for rescission of a prejudicial related-party transaction and clarifies the liability of directors. If found liable, directors must now pay damages and disgorge any profit made from the transaction.

Economies in other regions were active as well. In Greece the Hellenic Capital Market Commission issued a circular clarifying the concept of material transactions for purposes of disclosure by listed companies—helping to instill more transparency in an economy looking to restore confidence in its market.

Peru now requires that the terms of transactions between interested parties be reviewed by an independent external auditor certified by the securities commission.

Continuing a trend in Sub-Saharan Africa of upgrading company law, Lesotho adopted a new one setting out duties of care, diligence and skill for directors. Breach of these duties constitutes a cause of action for shareholders (table 14.2).

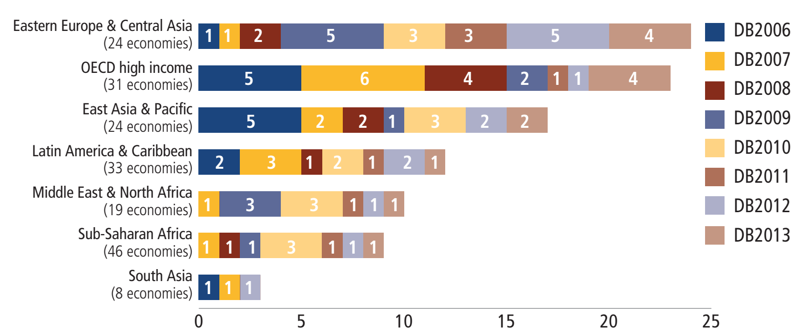
WHAT HAVE WE LEARNED FROM 8 YEARS OF DATA?

In the past 8 years 68% of economies in Eastern Europe and Central Asia implemented at least 1 reform strengthening investor protections (figure 14.2). Among OECD high-income economies 48% did, and in East Asia and the Pacific and the Middle East and North Africa 33% did. Of all these reforms captured by *Doing Business*, 49% improved the extent of disclosure index. But OECD high-income economies had a much higher share that did so, at 78%, followed by the Middle East and North Africa with 60% and Eastern Europe and Central Asia with 54%. In Sub-Saharan Africa the priority was increasing director liability. In East Asia and the Pacific and Latin America and the Caribbean the approach was more balanced.

While many economies have strengthened investor protections, Tajikistan, Albania and Rwanda have made the biggest improvements since 2005 (table 14.3). Two of them did so through one major overhaul of their company law,

FIGURE 14.2 Eastern Europe and Central Asia still leading in number of investor protection reforms

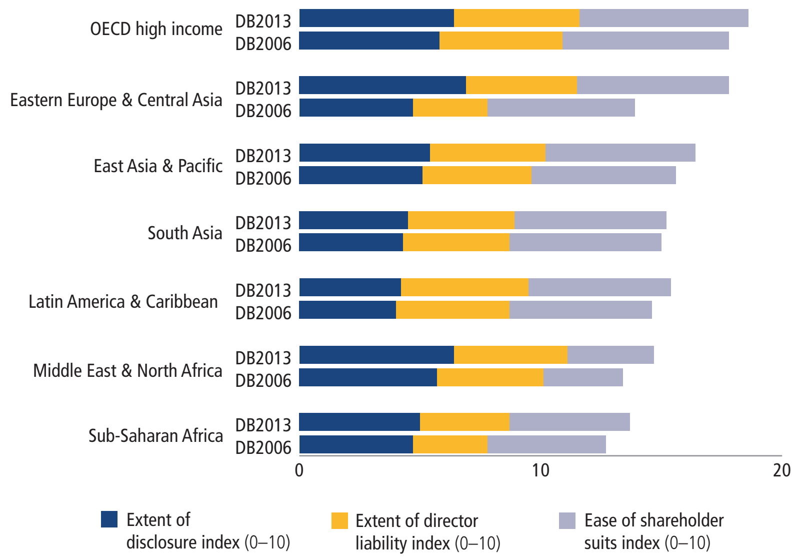
Number of *Doing Business* reforms strengthening investor protections by *Doing Business* report year



Note: An economy can be considered to have only 1 *Doing Business* reform per topic and year. The data sample for DB2006 (2005) includes 174 economies. The sample for DB2013 (2012) also includes The Bahamas, Bahrain, Barbados, Brunei Darussalam, Cyprus, Kosovo, Liberia, Luxembourg, Malta, Montenegro and Qatar, for a total of 185 economies.
Source: Doing Business database.

FIGURE 14.3 Strongest investor protections in OECD high-income economies

Regional averages in protecting investors



Note: To ensure an accurate comparison, the figure shows data for the same sample of 174 economies for both DB2006 (2005) and DB2013 (2012) and uses the regional classifications that apply in 2012. The economies added to the *Doing Business* sample after 2005 and therefore excluded here are The Bahamas, Bahrain, Barbados, Brunei Darussalam, Cyprus, Kosovo, Liberia, Luxembourg, Malta, Montenegro and Qatar. DB2006 data are adjusted for any data revisions and changes in methodology.

Source: Doing Business database.

TABLE 14.3 Who has narrowed the distance to frontier in protecting investors the most since 2005?

Most improved	Improvement in distance to frontier (percentage points)
Tajikistan	52 (17→69)
Albania	48 (29→77)
Rwanda	38 (29→67)
Georgia	31 (41→72)
Burundi	29 (34→62)
Tunisia	28 (35→63)
Colombia	26 (44→69)
Azerbaijan	25 (57→82)
Kazakhstan	25 (57→82)
Mexico	25[a] (37→63)

Note: The distance to frontier measure shows how far on average an economy is from the best performance achieved by any economy on each *Doing Business* indicator since 2005—in this case for the protecting investors indicators. The measure is normalized to range between 0 and 100, with 100 representing the best performance (the frontier). The data refer to the 174 economies included in *Doing Business 2006* (2005). Eleven economies were added in subsequent years. The first column lists the top 10 most improved economies in order; the second shows the absolute improvement in the distance to frontier between 2005 and 2012.

a. Swaziland also has an improvement of 25 percentage points.

Source: Doing Business database.

Albania in 2008 and Rwanda in 2009. Tajikistan achieved similar results by amending its law incrementally—in 2007, in 2009 (twice) and in 2011.

OECD high-income economies may have the strongest investor protections as measured by *Doing Business*, but Eastern Europe and Central Asia is quickly catching up, having passed East Asia and the Pacific in 2007 (figure 14.3). Policy makers in the region have emphasized stricter disclosure requirements and better standards for company directors.

Sub-Saharan Africa has had some of the most comprehensive investor protection reforms. Besides Lesotho, such economies as Burundi and Rwanda have also updated their company laws following global good practices. East Asia and the Pacific has focused mostly on strengthening disclosure requirements and directors' duties (as in Taiwan, China, and in Thailand).

Investor protection reforms have been sparse in Latin America and the Caribbean, with Chile, Colombia and Mexico among the few economies implementing them. In the Middle East and North Africa, despite some improvements (as in Morocco and Saudi Arabia), protections are often weak because of limited access to corporate information during litigation. South Asia has been the least active in strengthening investor protections. Over the past 8 years *Doing Business* recorded 3 investor protection reforms among the region's 8 economies—in India, Pakistan and Sri Lanka.

Improving disclosure was the most common feature of investor protection reforms in the past 8 years, accounting for 46 of the total. But in the past year, for the first time, the most common feature was increasing director liability (accounting for 8 of the 13 reforms).

Overall, smart, comprehensive regulations have had the strongest lasting impact (table 14.4). Economies undertaking a complete overhaul of their corporate, securities and civil procedure laws—including Albania, Burundi, Kosovo, Mexico, Rwanda, Swaziland, Tajikistan and Thailand—have improved the most on the strength of investor protections as measured by *Doing Business*.

TABLE 14.4 Who provides strong minority investor protections—and who does not?

Extent of disclosure index (0–10)			
Most		**Least**	
Bulgaria	10	Afghanistan	1
China	10	Bolivia	1
France	10	Cape Verde	1
Hong Kong SAR, China	10	Croatia	1
Indonesia	10	Honduras	0
Ireland	10	Maldives	0
Malaysia	10	Micronesia, Fed. Sts.	0
New Zealand	10	Palau	0
Singapore	10	Sudan	0
Thailand	10[a]	Switzerland	0

Extent of director liability index (0–10)			
Most		**Least**	
Albania	9	Afghanistan	1
Cambodia	9	Barbados	1
Canada	9	Belarus	1
Israel	9	Benin	1
Malaysia	9	Bulgaria	1
New Zealand	9	El Salvador	0
Rwanda	9	Marshall Islands	0
Singapore	9	Micronesia, Fed. Sts.	0
Slovenia	9	Palau	0
United States	9[b]	Suriname	0

Ease of shareholder suits index (0–10)			
Easiest		**Most difficult**	
Kenya	10	Lao PDR	2
New Zealand	10	Senegal	2
Colombia	9	Syrian Arab Republic	2
Hong Kong SAR, China	9	United Arab Emirates	2
Ireland	9	Venezuela, RB	2
Israel	9	Yemen, Rep.	2
Panama	9	Afghanistan	1
Poland	9	Guinea	1
Singapore	9	Djibouti	0
United States	9[c]	Iran, Islamic Rep.	0

a. The United Kingdom also has a score of 10 points on the extent of disclosure index.

b. Trinidad and Tobago also has a score of 9 points on the extent of director liability index.

c. Canada, Kazakhstan, Mauritius, Mozambique and Nepal also have a score of 9 points on the ease of shareholder suits index.

Source: Doing Business database.

NOTES

This topic note was written by Hervé Kaddoura and Jean Michel Lobet.

1. Sangim Han and Seyoon Kim, “SK Group Units Fall After Chairman Questioned by Prosecutors,” *Bloomberg News,* December 18, 2011.
2. Mclean, Zhang and Zhao 2012.
3. Hamdani and Yafeh 2012.