

## INSTITUTIONAL AND LEGAL PREMISES OF THE CORPORATE GOVERNANCE IN LARGE, LISTED ROMANIAN COMPANIES

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**Abstract:** *Corporate Governance has particular importance and relevance for the good management and governance of the companies. Even the disruption between the owners and the executives has been widely recognised since many decades, the frauds and manipulations we have witnessed in the 90s and later represent a turning point for both theoretical research and practical approaches in this matter. Moreover, for transition economies, the issue is much more relevant as many institutions involved in governance mechanisms have been emerged since then. As to reduce the differences between the interests of management and the shareholders' ones, several mechanisms of external and internal control can be imposed. The paper discusses main recent developments and evolutions with reference to legal aspects and institutional aspects, specifically the development of the stock exchange. Selected indicators concerning Bucharest Stock Exchange are analysed for the period 1995 (re-opening of the Stock Exchange after political transformations in the 90s), e.g.: number of companies, number of transactions with shares, capitalisation, number of issuing companies, number of new issuing companies. As for legal aspects, we have analysed both Romanian legislation and the Corporate Governance Code of the Bucharest Stock Exchange, and international reports on implementation of Corporate Governance in Romania, particularly OECD Report Corporate Governance in Romania (2001) and World Bank Report on the Observance of Standards and Codes (2004). Investigating the legal framework and the evolutions registered, we can conclude on the role of the above-mentioned mechanisms and on further developments and improvements necessary to enhance corporate governance mechanisms and ensure companies' compliance to these requirements. Moreover, as we will show, Bucharest Stock Exchange has known since its creation in 1995 times of development and consolidation, in terms of number and value of transactions, capitalization etc.*

**Keywords:** *corporate governance; stock exchange; legal aspects; Romania*

**JEL classification:** G32; G34

## 1. Introduction

Corporate Governance as research field has witnessed a very significant development, especially during the last 15-20 years, and many studies and analyses have been emerged since 1995. Starting from theoretical background on the concept of corporate governance and also from the mechanisms required to ensure companies' compliance to the Corporate Governance principles. For Romania, implementing these principles has particular important due to its history of the last decades and to the rapid transformations necessary for the convergence and catching up process. The paper investigates the role of institutional and legal framework for implementing CG principles, as to identify specific policy recommendation. In the first part we briefly review the concept of corporate governance; in the second part we point the role of control mechanisms. Most of the paper is dedicated to investigate relevant and significant development reported within Bucharest Stock Exchange (i.e. the institutional framework) and within the existing legal framework. Finally we can conclude on further steps required to be implemented, as to ensure companies' compliance to these requirements.

## 2. Theoretical background

Corporate Governance covers a broad range of economic, managerial, financial and legal aspects involved in approaching the relationship between the aims and objectives of the firm and the actual way it accomplishes them, and what actually do the relevant governance structures as to play a role in achieving the purposes. It also focuses on identifying control mechanisms to disable unethical procedures in the relation of large companies' management (i.e. the executives) with small shareholders and with all stakeholders of the company.

The study of these aspects is relatively new, even Adam Smith noticed the potential issues of the dissociation between capital owners and administrators, when he stated: *"The directors of companies, being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."* (Smith, 1776).

Some relevant interpretations on Corporate Governance as field of research are as follows:

**Table 1:** Selected definitions on corporate governance

Authors	Definition
Michel Albert (1994)	CG is about giving to the managers a unique objective: maximizing the profits and dividends. CG is, thus, the end of the managers' era
Shleifer and Vishny (1997)	The study of the processes by which the resources suppliers – reduced to the only financial investors – guarantee the profitability of their investment. Corporate governance deals with ways in which suppliers of finance to corporations assure themselves of getting return on their investment
Charreaux (1997)	CG system covers all the mechanisms that govern the managers' behavior and delineate their discretionary latitude. This broader definition covers the preceding

	one and presents the advantage of giving the manager the role of central actor (but non-single) in the value creation process.
Gillan and Starks (1998)	The system of laws, rules, and factors that control operations at a company
EC (2003)	Corporate governance is the system by which companies are directed and controlled

Moreover, during the last 10 years, some corporate failures have been reported, many of them due to fraud and illegal manipulation. As a result, important steps have been made to move forward from strictly theoretical debates to implementation and enforcement of corporate governance codes and policies within companies, especially within listed companies.

### 3. Role of control mechanisms

In order to reduce the differences of interests between executives and shareholders revealed by the theory of the agency and by the other theories, there are several mechanisms of external and internal control.

With regard to the external control, first there is the competition on the market of the goods and services. Indeed, a manager who opts for a strategy aiming to satisfy his/her/its interests in detriment to the shareholders can face consequences on the production costs and the selling price, that could let to a less competitive enterprise. Stronger would be the competition, more efficient will be this mechanism. Then, the labour market of the executives evaluates their "value" permanently. Being the fact that they could be anytime revoked, they have incentives to watch over their reputation: selection of the best and exclusion of the less competitive. Finally, in case of established opportunism or of mismanagement, the shareholders can sell their stocks to express their discontent ("vote with their feet"). These threats incite the executives to manage the business in accordance with the wishes of the shareholders.

The internal control takes place on multiple levels. First, the shareholders have a right to vote at the time of the general assembly, and that fact can be used in order to punish a non effective manager. Then, the assignment of stocks to the managers (stock options) has for objective to align his/her/its interests with those of the shareholders, while encouraging the investments long-term and to limit opportunism. A problem subsists however: the plan of purchase of stocks is often limited and can incite the managers to assume the risks to increase the potential stock value. Many authors showed the limits of the system of stock options, stigmatizing "the perversion of a good idea" (Jacquillat, 2001). Finally, the Board (Council) of administration exercises the main control of the managers. Its prerogatives are clear. It is charged to convene the general assemblies, to name and to dismiss the president of the Board and the executives, to control the management of the enterprise, to adopt the strategy, and to control the quality of information.

Starting from these points the good corporate governance practices can be applied: setting up of committees of audit and remuneration, independence of the administrators, active involvement of shareholders, transparency of the accounts, internal regulations etc.

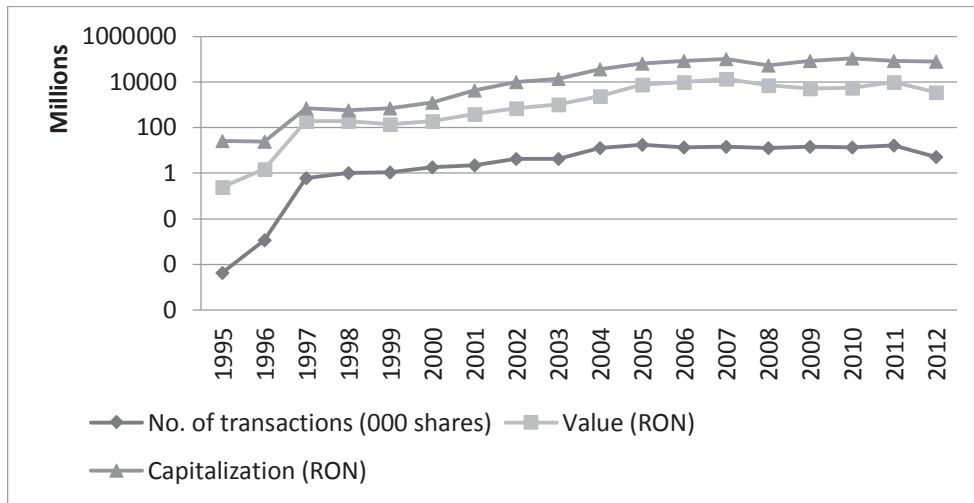
#### **4. Bucharest Stock Exchange: some relevant evolutions**

Bucharest Stock Exchange (BSE), created in 1882 and subsequently closed after the Second World War, was set up again after 1989. New political and economic realities determined the reactivation of Bucharest Stock Exchange (BSE), as it adopted a key role in supporting mass privatization campaigns launched at that time, more exactly trading certificate owner. Fifteen years later, its self-declared mission is "to provide and promote an efficient market, with fair rules, which should be attractive and compatible with European standards, to become a factor influencing economic and institutional trends and represent an environment for the development of entrepreneurship by offering services, mechanisms and rules to mobilize, attract and efficiently allocate financial resources, in conditions of transparency and safety" (BSE). Therefore the role of Bucharest Stock Exchange is to provide an organized market for trading securities, to help increase the liquidity of securities by concentrating a large amount of securities in the market, thus contributing to the formation of prices which should properly reflect the supply-demand relationship and disseminate these prices to the public. Principles governing Bucharest Stock Exchange as organized securities market are:

- Accessibility: The Stock Exchange is committed to ensuring equal treatment of all member companies, namely issuing companies listed on the Stock Exchange;
- Information: The Stock Exchange is committed to ensuring sufficient information about traded companies and the prices of securities issued by these to permanent stockbrokers and investors;
- The Ethics of the market: The Stock Exchange is committed to ensuring that securities markets operate in a manner that enhances the confidence of users, authorities and the public in general;
- Neutrality: The Stock Exchange is commitment to act neutral and to maintain integrity in relation to all participants to the market and to other institutions or organizations that oversee or operate in the capital market.

Bucharest Stock Exchange manages two market segments: the regulated one (or the operations on the regulated market) and "over-the-counter" RASDAQ market.

To some extent, the evolution of BSE is indicative of transformations and processes the Romanian economy underwent after 1989: the forms and methods of privatization, especially mass privatization campaigns, direct sales, entry of large players in the capital market, privatization of large companies, the emergence, increase or decrease of major domestic companies and so on, but also its own development: modernization of trading instruments and systems, mergers etc. (Badulescu, 2013) A brief look over the main statistics indicates that even though the value of transactions has shown an increasing trend until 2007 (with certain inflections due to legislative and organizational changes or to economic difficulties), the number of issuing companies varies greatly from one period to another.

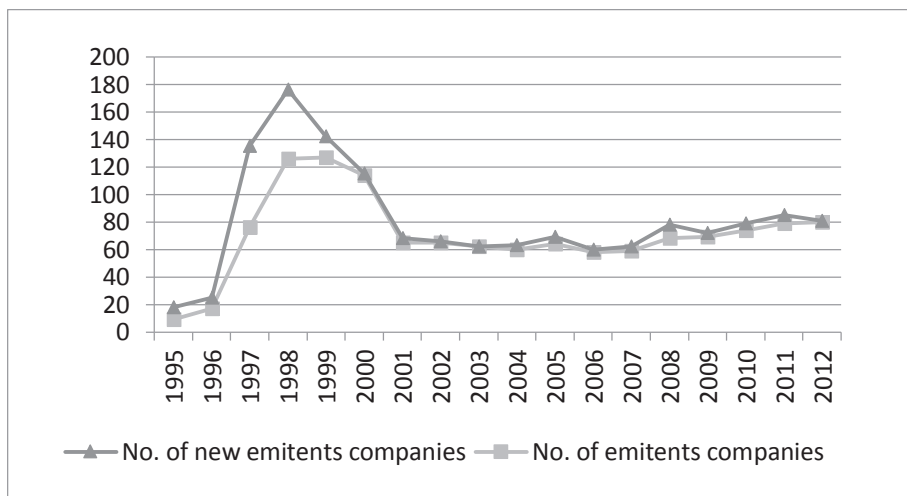


**Figure 1:** Evolution of selected indicators of Bucharest Stock Exchange, 1995-2012\* (log scale)

\*data for 2012 correspond to month of May

Source: Authors' representations based on Bucharest Stock Exchange data, available at

<http://bvb.ro/TradingAndStatistics/GeneralStatistics.aspx>



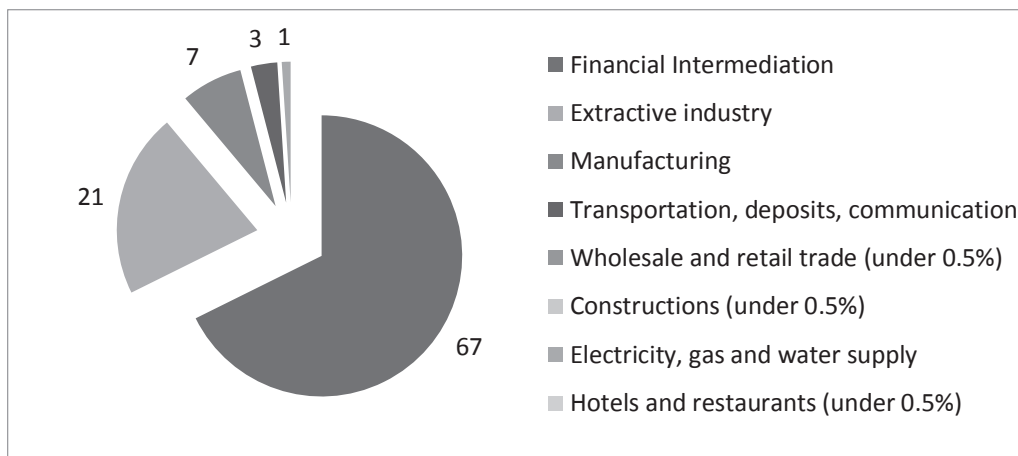
**Figure 2:** Evolution of selected indicators of Bucharest Stock Exchange, 1995-2012\* \*data for 2012 correspond to month of May

Source: Authors' representations based on Bucharest Stock Exchange data, available at

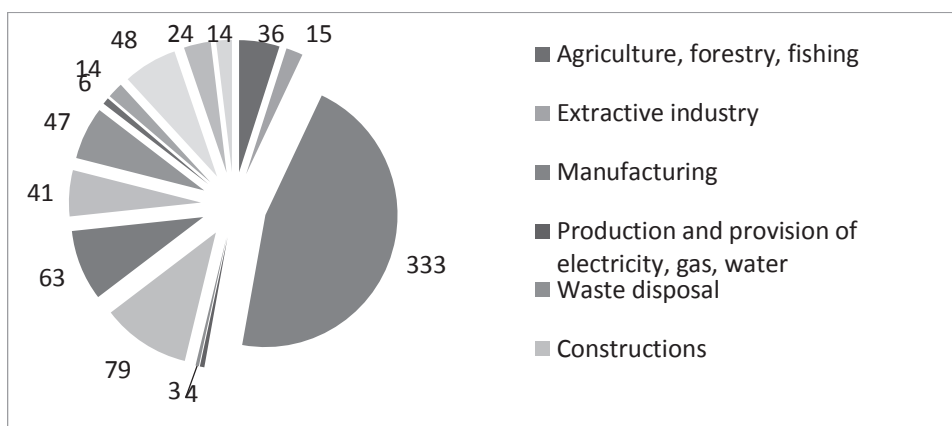
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As regards the distribution of companies listed by their sector of activity, an obvious concentration of three major sectors in terms of market capitalization (about 95% of the market) may be observed: companies of financial intermediation (primarily)

followed by companies belonging to either the extractive or the manufacturing industry (Pana, 2010).



**Figure 3:** Capitalization of companies listed on Bucharest Stock Exchange, by sector, 2010  
Source: Pana (2010).



**Figure 4:** Distribution of the companies listed on Bucharest Stock Exchange, by sector, May 2012  
Source: Authors' representations based on data reported by Bucharest Stock Exchange, *Lista companii*, <http://bvb.ro/Companies/ListedCompanies.aspx?t=4>

### 5. Legal issues for Corporate Governance in Romania

The relevant legal framework for corporate governance in Romania may be found in various laws, such as the Company Law, the Commercial Code, the Law on capital market (as examples of primary legislation), or legislation on privatization, the Law on insolvency proceedings, the Accounting Law, the Labour Code, specific regulations on the harmonization of the Romanian accounting system with the European Directives and International Accounting Standards, regulations issued by the Romanian National Bank and the Securities Commission.

On the other hand, we may find corporate governance provisions in "quasi-regulated" documents, which can be implemented on a voluntary or optional basis. Here we consider the "Corporate Governance Code" issued by Bucharest Stock Exchange and the Voluntary Corporate Governance Code. Corporate Governance Code (CGC) was issued by Bucharest Stock Exchange in 2002 (recently updated in 2008 with additional provisions, given by the legal obligations included in the Romanian legislation). However, publicly traded companies can adopt and comply with the Code only voluntarily. The second statement concerns the Voluntary Code of Corporate Governance, which is the result of a partnership, collaboration between the Strategic Alliance of Business Associations and the International Centre for Entrepreneurial Studies in Romania (University of Bucharest), also called "Corporate Governance Initiative for Economic Democracy in Romania". Although this code was very well received by the business environment at the time of its publication (2000), currently there is no available information on the number of companies which comply with its stipulations (Pana, 2010, Duca et al, 2007).

In what follows we consider it would be worth (even if not part of the direct or the indirect legal framework of corporate governance) looking over the main points of view on the implementation of these principles in Romania, from the perspective of the main international bodies involved.

Therefore we shall take into account:

- Corporate Governance in Romania, OECD 2001
- World Bank *Report on the Observance of Standards and Codes* of corporate governance in Romania (ROSC) (2004)

The results of the analysis made by the Organization for Economic Cooperation and Development in 2001 show that there are serious difficulties in the implementation of corporate governance, including the insufficiently active position of the Board in solving management-related issues or even the worsening of such problems due to the presence of executive team members in the Administration Board, or the possibility for such members to become chairmen; incomplete legal definition of rules for appointing Board members and, ultimately, a generally passive attitude of members appointed in the Board by the State. To all these we might add the limited use of specialized committees and the lack of independent members of the Board, which allow the management to assume excessive responsibility and intervene in the decisions of the Board. At the same time, among other weaknesses regarding the implementation and status of corporate governance in Romanian companies, the Report also points to a weak culture of capital, low levels of activism by minority shareholders, lack of information and assistance to companies and investors, ineffective voting systems. The system of management performance compensation was / continues to be a common practice in Romanian companies, but also if it would be implemented on a large scale, this could have effects on the alignment of managerial objectives to those of major shareholders and therefore "it cannot be considered a viable mechanism of corporate governance" (Pana 2010). The weak presence of the corporate governance mechanisms mentioned above, and the possible adverse effect of the Council are sufficient signs to allow us argue that concentration of ownership and formal monitoring techniques are the major vulnerability in the management of Romanian companies.

It should also be recognized that the OECD Report on corporate governance adds that "Romania, during the complex process of transition, has made important steps

to improve legislation and regulations supporting corporate governance" (OECD 2001), both as regards the issuing and adaptation of laws on companies, securities, legal responsibilities and the organization, but also in terms of increased availability of institutions, policy makers and the public to improve corporate governance in Romania. Assessing the strengths and weaknesses of Romanian corporate system after a decade since the launch of economic and political changes in the Romanian society, the report makes it clear that the next step should be based equally on reforms and on legislative activity, but places a strong emphasis on the effective application of legal provisions, arising directly or indirectly from the legislative assembly created.

Thus resources and the independence of institutions such as the National Securities Commission should be provided, as well as increasing the capacity of the judiciary in dealing with commercial disputes, property rights, the adaptation and insurance of transparency and clarity in accounting and auditing practices etc. The Report recognizes that decisive and constant efforts in this direction may place Romania in the international trend on the implementation and enforcement of effective corporate governance principles, even if results will become obvious in time.

The report also notes the importance of strengthening the private sector, especially with regard to large firms, which should demonstrate a balance between the interests of shareholders and management objectives, while control should be equally effective and stimulating: "This will not only increase the productivity of companies, but will lead to serious international and domestic demand for good corporate governance "(OECD 2001). Thus, the continuation of privatization and completion of these processes so that ownership structure might allow internal structural reforms, based on independence in decision-making and planning, given the predominance of private property, and de-listing small and medium enterprises from the stock exchange (as they are improperly there as a result of mass privatization campaigns) are mechanisms able to explain true corporate governance and not merely its formal aspect.

Finally, relying on the efforts of the Stock Exchange and of other similar institutions or voluntary codes, solutions may be found to prevent the wrongful expropriation of minority shareholders by controlling shareholders, mainly through capital increase or transactions with entities that are in close connection with the respective company. The second document considered is World Bank Report on the Observance of Standards and Codes of corporate governance in Romania (ROSC 2004). Its preamble states that it is a joint assessment IMF - World Bank on issues of corporate governance in Romania and that it updates previous reports of the World Bank and OECD over the period 2000-2004, using a valuation model developed by World Bank. Romanian and international legal companies, as well as specialists in corporate governance and investment climate analysis from major international financial institutions and the Ministry of Justice of Romania, (which actually authorized the publication of the Report in June 10, 2005 -World Bank 2004) were involved in data collection, interpretation and publication of the final form.

This report provides an assessment of corporate governance policies and their implementation, of practices and experiences recorded in Romania, especially starting with the latest recommendations from 2002, highlighting the achievements and deficiencies, strengths and weaknesses, and recommendations for future policy, where appropriate.



The major problems identified can be circumscribed to Romania's effort at that time to join the European Union and to the ongoing transformation of capital markets in Romania, the report recognizing the important improvements in corporate governance in the period 2002-2004: reviews of securities laws, increasing the protection offered to minority shareholders of listed companies (e.g. introduction of cumulative voting, rules to ensure payment of dividends, rules governing transactions with third parties or entities having special relations with that company and so on).

The report also mentions a number of areas where further work is necessary to improve legislation, practices and common goals such as a clear mandate and additional resources for the National Securities Commission in order to effectively protect shareholder's rights, for all publicly listed companies, including those that are less active, especially on RASDAQ market; further steps for creating a Corporate Governance Institute to provide training for Board members, and to develop and publish a new Code of Corporate Governance containing clear indications and changes on the role of boards of directors, review the Company Law with reference to the rights of shareholders and the attributions of the Board (World Bank 2004).

Among ROSC recommendations we might also mention (McGee 2010):

- Revising laws on the situation and responsibilities of the Board in joint stock companies, recommending the establishment of a minimum number of board members, so that this (the Council) might play a significant role in the company. A reasonable minimum number of board members might allow the possibility of setting up specialized committees composed of non-executive members, specialize in certain areas;
- Defining the authority of the Board in controlling the financial statements of the company;
- Adding laws on the opportunity for stock companies to sell and transfer assets at market prices or in conditions of equivalence;
- Appointing external auditors of the company at the general meeting of shareholders;
- Legislation on securities should be revised to expand the definition of ownership and over indirect control relationships;
- Guidance on the content of the Annual Report;
- Listed companies are required by law to disclose their annual obligations (especially as regards investment) resulting from privatization contracts and the company should be required to publish significant transactions (sales and purchases) made with the company's shares.

## **6. Conclusion**

Enhancing corporate governance and ensuring companies' compliance with the principles of transparency, disclosure, accountability etc. is an important requirement for Romania, as well for other economies that have faced transformation processes. For achieving it, both institutional and legal conditions are to be followed. In this paper we focus on these issues and investigated the emergence and developments occurred in these fields. After 2000, Bucharest Stock Exchange reported slighter evolutions than before and entered a mature stage. The number of issuing companies, the number of new issuing companies, as well as capitalization, and also number and values of transactions registered relatively slow increases. Moreover,

Bucharest Stock Exchange issued in the last decade (primary in 2002, revised in 2008) the "Corporate Governance Code", an important step on the road to better regulations and enhanced efficacy. Further work is still necessary, especially for improving legislation and practices for ensuring a real effective protection of shareholders rights, especially on RASDAQ market, and for further improvements regarding a new, revised Code of Corporate Governance with clear indications on the role of each part involved.

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