STRENGTHENING ECONOMIC LEGAL INFRASTRUCTURE IN APEC

SUPPORTING TRADE, INVESTMENT AND ECONOMIC DEVELOPMENT
ABOUT THIS REPORT

This report highlights the importance of strengthening economic legal infrastructure, as part of a good mix of open market policies, in order to achieve social objectives and sustained economic growth. Strengthening economic legal infrastructure, including establishing good governance practices, involves improving laws and building the capacity of institutions and individuals to implement, apply and enforce those laws.

The report is designed to provide a platform for future deliberations on strengthening economic legal infrastructure within the Asia-Pacific Economic Cooperation (APEC*) forum to help progress its work in this area. Also, it suggests ways in which improving governance can enhance individual members’ economic legal infrastructure, taking account of efforts to date, including through the APEC Finance Ministers’ Process and other international forums.

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*The 21 member economies of APEC comprise: Australia; Brunei; Canada; Chile; China; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; Mexico; New Zealand; Papua New Guinea; Peru; Philippines; Russia; Singapore; Chinese Taipei; Thailand; United States and Vietnam.
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HIGHLIGHTS

- Strengthening economic legal infrastructure is about improving the quality and accessibility of the written law and the capacity of individuals and institutions to implement, apply and enforce those laws. In conjunction with trade and investment liberalisation and facilitation initiatives, strengthening economic legal infrastructure can deliver significant benefits to APEC communities through economic growth and improvements in living standards.

  - research suggests that significant improvements in governance can lead to a 2 1/2 to 4-fold increase in per capita income and to a 15 to 25 percentage point increase in literacy over the long term.

- A critical issue for regulatory and institutional reform now is implementation and enforcement rather than the creation of new laws.

- Recent failures of major corporations which revealed questionable corporate accounting and auditing practices have specifically brought attention to corporate governance weaknesses in various jurisdictions in the region.

- There is severe competition among economies to attract new foreign investment. Increasingly, international investors are assessing economies by their economic legal infrastructure and the quality of governance, directing their investment to those economies which on a comparative basis best meet their needs.

  - a survey of global investors showed that they are prepared to pay an average premium of 21 per cent for the shares of a well-governed company in APEC economies.

- Strengthening economic legal infrastructure and corporate governance-related reforms would:

  - improve transparency, predictability and fairness in the rules and regulations and administration of the corporate and public sectors;
- engender business and investor confidence and enhance competition; and
- lead to economic efficiencies, innovation and reduced compliance costs for business.

- Room for improvement remains: APEC member economies need to constantly review their governance (including corporate governance) practices and systems in order to meet the constantly changing market environment.
- APEC can make a significant contribution to strengthening economic legal infrastructure and corporate governance reform through greater advocacy and provision of capacity-building projects.
1.0 INTRODUCTION

Strengthening economic legal infrastructure – that is, improving the quality and accessibility of the written law, and the capacity of individuals and institutions to implement, apply and enforce those laws – helps create a better business and investment climate. In conjunction with trade and investment liberalisation and facilitation initiatives, strengthening economic legal infrastructure can help deliver significant returns in the form of social outcomes and sustained economic growth.

Failure to provide an appropriate standard of economic legal infrastructure could prove costly as a consequence of market uncertainty and loss of investor confidence.

The causes and effects of the financial crises in the 1990s (including the East Asian and Latin American experiences) are varied and complex, revealing among other things, underlying regulatory and institutional weaknesses in many of the economies in the Asia-Pacific region. The response from the affected economies was immediate with reforms made to regulations and institutions, including efforts to strengthen economic legal infrastructure and governance practices. Evidence, however, suggests that reforms may not have gone deep enough, particularly in the implementation and enforcement of corporate governance, insolvency and competition policy.

Recent events in the region, in particular the high-profile corporate collapses and questionable financial disclosure and auditing practices, as well as incidents of lack of judicial capability to interpret and apply commercial laws, provide a further reminder to all economies – both developed and developing – of the need for vigilance and regular review of current systems and practices to meet the constantly changing market environment.

While bilateral, regional and multilateral assistance is already being provided to assist individual economies in the region to strengthen economic legal infrastructure, more can be done, and APEC can provide a valuable helping hand.
In addition to its work through the APEC Finance Ministers’ Process, APEC can build on its initiative to strengthen economic legal infrastructure by developing new programs on advocacy and promotion, information-sharing and awareness-building, and confidence and capacity-building of individuals (in the legal, accounting and economics professions) and of institutions and government agencies in applying and enforcing rules on corporations, competition and other commercial activities.

As the issues that need addressing are complex, and in some cases entrenched in culture and history, measures will need to be undertaken with a medium to long-term perspective, giving rise to incremental but substantive improvements.
2.0 STRENGTHENING ECONOMIC LEGAL INFRASTRUCTURE

What is Strengthening Economic Legal Infrastructure?

Economic legal infrastructure encompasses the structure and functions of the legal system. It includes the formal laws, codes, regulations and judicial decisions, and their enforcement. These in turn rely on the capacity and skill of legal institutions such as the courts, judges, the legal profession, government enforcement agencies, non-government regulators and other private sector professions such as accountants, auditors and insolvency specialists/administrators. It provides the framework through which businesses pursue their objectives and on which investors rely in safeguarding their interests. It helps establish confidence, predictability and certainty in commercial activities and transactions, including in areas as important as enforcement of contracts, investment security, property rights and competition.

The strength of an economy’s economic legal infrastructure can be measured by the extent to which its laws are clear, comprehensive and accessible, and the extent to which the administration, application and enforcement of those laws is reliable, certain, fearless, independent and transparent. The quality of those legal institutions and support organisations is part of the governance element of economic legal infrastructure. Efforts to strengthen economic legal infrastructure can deliver significant benefits through economic and employment growth, and ultimately improvements in general living standards.

Governance a Factor of Investment

Economic legal infrastructure differs from one economy to the next, for historical and cultural reasons, and as a result of prevailing business, legal and governmental practices. However, increasing economic integration, including participation in the WTO processes, has meant some convergence in expectations about what constitutes a good
economic legal infrastructure. This includes: a fair, transparent and predictable legal system based on the rule of law; effective protection of contractual and property rights (including intellectual property rights); low risk and fair compensation for expropriation; and sufficient access to legal professionals.

International private sector investors are increasingly looking at economic legal infrastructure and governance-related issues prior to making investment decisions and will direct their investment to those economies which on a comparative basis best meet their needs. [See Box 2.0: Perceptions of Governance and Investment]

Box 2.0
Perceptions of Governance and Investment

Potential investors consider a wide range of issues when deciding the best destination for their investment or with which economy to trade. These include:

- the expected return on the investment;
- the timeframe for cost recovery and profit repatriation;
- the host economy’s political and social stability;
- input costs such as labour, electricity, freight and shipping costs; and
- incentives offered to investors such as tax holidays, or export or import duty exemptions.

A number of international organisations, notably the Organisation for Economic Cooperation and Development (OECD) and World Bank, have emphasised that investment decisions comprise a two-stage process. The first stage consists of identifying a list of acceptable sites based on their economic and political “fundamentals”, with the availability of fiscal and financial incentives from host governments only being considered at a later stage.

Economic legal infrastructure is a key “fundamental” or prerequisite to be considered by investors within the first stage of decision-making. A

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1 “The rule of law prevails where (1) the government itself is bound by the law; (2) all in society are treated equally under the law; (3) the government authorities, including the judiciary, protect the human dignity of citizens; and (4) justice is accessible for its citizens. Legal and judicial reform is a means to promote the rule of law.” Initiatives in Legal and Judicial Reform, The International Bank for Reconstruction and Development/World Bank, 2002, Washington DC, p. 3.

potential new investor to an economy will need to know that there are fair, equal treatment and transparent processes provided by the economic legal infrastructure. This entails a predictable and certain set of rules which will be enforced equitably and not in an arbitrary way. If commercial disputes are solved in an arbitrary or unfair way, without recourse to a set of predictable rules, then all the different incentives offered by an economy’s foreign investment regime amount to little.

Country (economy) risk assessments, including by organisations such as Moody’s and Transparency International, have emphasised that an investor will want to know:

- all of the rules which affect the making of the investment;
- the way in which the rules can be implemented;
- the time and manner in which profits can be derived and enjoyed;
- that the investment cannot be confiscated by the state without fair compensation, or damaged by the unlawful acts of competitors or business partners;
- that, if there is a dispute with the government, competitors or business partners, there are fair and transparent procedures for resolving those disputes; and
- that contracts and the outcomes of dispute resolution procedures (for example, in relation to law suits for collection of unpaid debts or seizure of collateral) will be honoured by the parties affected and, if not, will be capable of being directly enforced.

Investors rate potential host economies against these criteria in either formal or informal ways. They may seek advice from professional advisers, consult with their business colleagues or rely on their own experience, but ultimately they will complete that rating. They may then compare several possible host economies and rank them. Based on that process, investors will consider possible rewards from the investment against the risks. The outcome, simply, will be that the internal rate of return required for the approval of an investment in a host economy which rates poorly on these criteria will be higher than for other host economies.

This means that the investment may not proceed at all unless returns are higher than those achievable elsewhere for the same investment. Economies which rate poorly on this kind of analysis may lose investments and consequently employment-creating opportunities and revenues.
Economies in the region will need to be more conscious of investors’ increased regard for governance. Transparency International’s survey of business perception of the level of corruption of economies suggests that APEC members have room to improve on this matter, with more than half of APEC member economies scoring less than five out of a clean score of ten. [See Table 2.0]

Table 2.0
Transparency International’s Corruption Perceptions Index 2002\(^3\) for APEC Member Economies

<table>
<thead>
<tr>
<th>Rank</th>
<th>Economy(^{(a)})</th>
<th>Corruption Perceptions Index (^{(b)})</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>New Zealand</td>
<td>9.5</td>
</tr>
<tr>
<td>5</td>
<td>Singapore</td>
<td>9.3</td>
</tr>
<tr>
<td>7</td>
<td>Canada</td>
<td>9.0</td>
</tr>
<tr>
<td>11</td>
<td>Australia</td>
<td>8.6</td>
</tr>
<tr>
<td>14</td>
<td>Hong Kong, China</td>
<td>8.2</td>
</tr>
<tr>
<td>16</td>
<td>United States</td>
<td>7.7</td>
</tr>
<tr>
<td>17</td>
<td>Chile</td>
<td>7.5</td>
</tr>
<tr>
<td>20</td>
<td>Japan</td>
<td>7.1</td>
</tr>
<tr>
<td>29</td>
<td>Chinese Taipei</td>
<td>5.6</td>
</tr>
<tr>
<td>33</td>
<td>Malaysia</td>
<td>4.9</td>
</tr>
<tr>
<td>40</td>
<td>Korea</td>
<td>4.5</td>
</tr>
<tr>
<td>45</td>
<td>Peru</td>
<td>4.0</td>
</tr>
<tr>
<td>57</td>
<td>Mexico</td>
<td>3.6</td>
</tr>
<tr>
<td>59</td>
<td>China</td>
<td>3.5</td>
</tr>
<tr>
<td>64</td>
<td>Thailand</td>
<td>3.2</td>
</tr>
<tr>
<td>71</td>
<td>Russia</td>
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<tr>
<td>77</td>
<td>The Philippines</td>
<td>2.6</td>
</tr>
<tr>
<td>85</td>
<td>Vietnam</td>
<td>2.4</td>
</tr>
<tr>
<td>96</td>
<td>Indonesia</td>
<td>1.9</td>
</tr>
</tbody>
</table>

\(^{(a)}\) data is unavailable for Brunei and Papua New Guinea  
\(^{(b)}\) scale of 0 (highly corrupted) to 10 (highly clean)

Table 2.0 provides the ranking and corruption perceptions results for nineteen APEC member economies. Transparency International prepares an index each year which charts the perceptions of business persons and risk analysts as to the degree of corruption in particular countries. In 2002, 102 countries were covered in the index which used fifteen surveys from nine independent institutions.

Such perceptions matter as many economies (perhaps with the exception of China) are finding it increasingly difficult to attract foreign investment. There is also a significant risk that if investors leave a market due to disapproval of a regulatory environment, it could become contagious and difficult to reverse. Economies will therefore need continuously to demonstrate real efforts to strengthen economic legal infrastructure.

**A New Focus**

The immediate focus of economic reforms in the region in the 1990s was to meet the pressing challenges relating to potentially volatile international capital flows, as experienced during the East Asian Financial Crisis, through improvements in economic laws [See Box 2.1: Some Reforms]

**Box 2.1**

**Some Reforms Immediately Following the 1997-98 Financial Crisis**

**Korea** introduced wide-ranging reforms to liberalise its foreign investment regime in the aftermath of the 1997 financial crisis including: the elimination of ceilings on foreign investment in equity, bond and money markets; the liberalisation of foreign ownership in most industries and financial services; the establishment of a “one-stop” service to simplify the foreign investment approval process; and the elimination of restrictions on foreign investors to purchase land for investment projects. These reforms contributed to increased inflows of portfolio and foreign direct investment. The role of the Fair Trade Commission (FTC) was also strengthened, particularly in enforcing regulations against illegal transactions within *chaebols* (large corporations/conglomerates). In 1998, new debt guarantees between affiliates were prohibited, with existing guarantees to be wound back by 2000. The FTC has conducted a range of investigations and imposed fines on those *chaebols* found engaging in intra-unit transactions.

**Thailand’s** immediate efforts were aimed at stabilising the baht, tightening monetary policy and government spending before shifting focus to economic stimulus measures under the auspices of the International Monetary Fund (IMF) program, including bank recapitalisation, fiscal measures and corporate law reforms. Two broad initiatives were introduced to reform the corporate sector. Firstly, the legal framework for recovery of non-performing assets was strengthened by improving the legal regime for insolvency, including the creation of a specialised Central Bankruptcy Court, a more effective *Bankruptcy Act*
and amendments to the Code of Civil Procedure concerning enforcement of security interests. Secondly, a process for voluntary out-of-court settlements was established, with institutional support from the Bank of Thailand. In addition, changes were implemented to the Alien Business Law governing foreign investment designed to encourage new foreign direct investment. These changes were consolidated into the new 1999 Foreign Businesses Law which reduced the number of economic areas closed to foreigners by almost one half.

**Indonesia** revised its *Company Law, Anti-Monopoly Law, Consumer Protection Law and Banking Law* in order to encourage competitive business behaviour by improving transparency, defining the roles and obligations of key actors and protecting the interests of investors and the general public. The National Law Commission was established in February 2000 to advise on deficiencies in the legal system and steer national reforms. Judicial changes resulted in the removal of approximately 70% of Jakarta court justices. The *Company Bankruptcy and Debt Restructuring and/or Rehabilitation Act*, modelled on US Chapter 11 laws, was introduced to address concerns that the good theoretical protection afforded to creditors was being undermined by poor implementation. These reforms provided for the establishment of a Commercial Court and the training of specialist judges to preside over bankruptcy cases. Some implementation and enforcement problems remain as insolvent companies have continued to trade and some corporate entities were refinanced by the government and exempted from bankruptcy proceedings.

**Malaysia** consolidated and restructured its financial system after 1997. *Danamodal* was established to recapitalise weak financial institutions and *Danaharta* was created to acquire and manage banking sector non-performing loans to maximise their recovery values. A merger program was established for the domestic banking sector and finance companies and the Corporate Debt Restructuring Committee was established to develop feasible debt restructuring proposals without resorting to legal proceedings. Overlapping regulatory requirements were addressed and corporate governance standards enhanced through amendments to the *Securities Commission Act 1993, Banking and Financial Institutions Act 1989, Futures Industry Act 1993, Securities Industry (Central Depositories) Act 1991* and the *Companies Act 1965*. These amendments effectively centralised the approval process over prospectus and debenture requirements with the Securities Commission, introduced a disclosure-based regulation scheme, imposed higher statutory responsibilities on trustees for debenture issues and removed the requirement of having to seek Central Bank approval for debt issuance.
These early reforms helped to:

- improve the efficiency of investment allocation;
- create more stable corporate financing structures that are less prone to disruption from future shocks; and
- recapitalise viable companies and financial institutions.

Reforms eventually covered a broader field including corporate governance and competition policy. More recently, however, it has become clear that implementation and enforcement (that is, the governance element) is becoming the critical issue for reform, rather than the creation of new laws, especially with respect to corporate governance and competition policy. Governance is becoming the critical issue for business, rather than whether an economy has clear laws on paper.

Strengthening economic legal infrastructure efforts will therefore have to focus on the building of capacity and skill of individuals and institutions in order to ensure effective implementation and enforcement of laws. In comparison to the relatively short-term nature of establishing or updating laws and regulations, this will be a medium to long-term challenge for many economies in the region.

**Judiciary**

Central to any efforts to strengthen economic legal infrastructure are improvements to the judiciary, with measures focussing on increasing judicial independence, strengthening accountability and transparency, and helping to ensure judicial decisions are consistent, fair and predictable. Improving domestic court systems and implementing comprehensive judicial reforms should include:

- strengthening judicial skills and experience through targeted capacity-building, education and training programs for judges and court officials in the areas of law in which they are working (eg. insolvency, commercial law etc);
- ensuring that the selection of judges is based on professional qualifications and merit and achieved through a transparent process, and equally that the removal of judges is based on good cause and solid evidence and is dealt with in a fair and transparent way;
resourcing adequately the administration of courts so that they can deal with cases expeditiously and efficiently and without the need to seek government support;

- increasing the salaries of judges, where necessary, to allow them to meet their ordinary living expenses and in order to attract suitably qualified new judges without the need for them to look for alternative sources of income; and

- improving the public availability of judicial decisions and administrative procedures, including the publication of written judgements.

Considerable attention should be paid to capacity-building for recently established specialist commercial (e.g., bankruptcy) courts, which have particular relevance for business interests.

**Legal Profession**

Strengthening economic legal infrastructure efforts will also need to focus on strengthening the capacity of the legal profession, both in the public and private sectors, to operate in a professional and ethical way. An inadequate, untrained or incompetent legal profession will negate the effects of even the best laws. Key measures that could help build the capacity of the legal profession include:

- increasing the number and quality of trained legal professionals and in so doing improving access to the legal system;

- improving the curriculum and training (including continuing professional legal education) for legal professionals;

- improving the rules of ethical conduct and professional practice for legal practitioners; and

- capacity building for Bar Associations so that they are able to regulate adequately the professional practice standards of their members in a non-discriminatory, transparent and ethical manner.

**Public Sector Governance**

Efforts will also need to be directed toward building appropriate public sector governance, particularly in relation to legal and justice departments and specialist regulatory
agencies with oversight or direct involvement with the commercial and financial sectors, including banking, securities, and competition law.

Key measures might include:

- training and technical assistance to government legal and justice departments, including through the provision of expert advisers;
- improving the standards of academic and practical professional training by improving the capabilities of university law schools;
- helping Bar Associations to develop ethical codes of conduct for their members and to provide ongoing training;
- improving the capacity of legal officials and institutions to understand and implement amendments to commercial laws and regulations;
- enhancing public access (including through publication) to information on government decisions and rulings, and the standards and criteria on which they are based;
- enhancing the independence of regulators and commercial law enforcement agencies, including through greater resourcing of their analytical, research and enforcement capabilities;
- improving the reporting and disclosure requirements for government agencies; and
- improving public procurement processes so they are more efficient, transparent and predictable.

**Corporate Governance**

Strengthening economic legal infrastructure efforts, including corporate governance practices, will also need to target:

- capacity building, through the provision of specialist training and education, for corporate and professional associations, particularly those relating to company directors, accountants and auditors (such training should include assistance in developing codes of good corporate governance and business ethics); and
- the operation of domestic and international commercial dispute resolution mechanisms, particularly arbitration and alternative dispute resolution.
Benefits from Governance

A recent study, commissioned by the Asian Development Bank, examined the role that economic laws and legal institutions played in the economic development of China, Japan, Korea, Malaysia and Chinese Taipei during their dynamic 35-year-period of economic growth. The study concluded that law and legal institutions played an important role in facilitating economic development, particularly when governments pursued economic policies that fostered free markets and reduced the role of government as the primary decision-maker in the economy.

Studies by Kaufmann and others have developed indicators of governance across a large number of economies. This work argues that there is a strong positive relationship between various indicators of governance and per capita income (illustrated for APEC in Graphs 2.0 and 2.1), and that the direction of causation flows strongly from improvements in governance to better development outcomes. The authors’ econometric estimates, based on data for more than 150 countries, are that a significant improvement in key areas of governance can lead to an increase in per capita income of between 2 1/2 times to 4 times and a 15-25 percentage point improvement in literacy over the long term.

Other empirical studies across a wide range of economies have found more specifically that the quality of the bureaucracy, likelihood of government repudiation of contracts, security of property rights, risk of government expropriation and overall maintenance of the rule of law have a significant impact on trade and investment flows. The existence of enforcement mechanisms for long-term contracts and an effective civil court system were also highlighted as important contributors to a good business and economic environment.

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5 D. Kaufmann, A. Kraay and P. Zoido-Lobaton, 1999, Governance Matters, Washington, DC: World Bank. The indicators of governance covered by this work include accountability, political instability and violence, government effectiveness, the burden of regulation, the rule of law and corruption. The changes indicated are those which flow from one standard deviation improvement in these governance indicators. Updated estimates of the data are given in D. Kaufmann, A. Kraay and P. Zoido-Lobaton, 2002, Governance Matters II: Updated Indicators for 2000-01, Washington DC, World Bank.

For example, there is considerable evidence to suggest that those economies which give a high priority to creditors receiving the full present value of their claims in bankruptcy or corporate reorganisations have more developed financial intermediaries and therefore higher rates of economic growth.\(^7\)

Graph 2.0 plots the governance indicator of rule of law against Gross National Income (GNI) per capita at purchasing power parity (PPP) in 2001 for 19 APEC member economies. The trendline shows that those economies with high GNI per capita have commensurately strong rule of law, reflecting the improved business and investor sentiment that has resulted from strong economic legal infrastructure in those economies.

Graph 2.1 plots the governance indicator of regulatory quality against GNI per capita PPP. Three-quarters of APEC member economies surveyed achieved a positive result for the measure of their regulatory quality – a positive indication that most APEC member economies have been making significant efforts in establishing a good regulatory environment. The graph shows a positive correlation between good regulatory quality and high GNI per capita PPP.

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3.0 CORPORATE GOVERNANCE

The OECD considers corporate governance to be the relationship between a company’s management, its board, shareholders and other stakeholders, which involves articulation of their roles, responsibilities and obligations. Corporate governance is the structure through which the company’s objectives are determined, attained and monitored. OECD members have agreed on a set of principles covering the rights of shareholders; the equitable treatment of shareholders; the role of stakeholders in corporate governance; disclosure and transparency; and the responsibilities of the board.8

While business failure or success is not automatically a function of bad or good corporate governance practice, good corporate governance is important at both the firm level and economy level as a whole. Corporate governance is fundamental to the efficient allocation of resources and capital within and through firms – when an economy uses its resources more productively, the total welfare of the community is lifted.9

Corporate governance has particular implications for investors seeking places to invest, given the ease with which investors can reallocate their portfolio. The importance of good corporate governance to global institutional investors is highlighted by the findings of a 2002 survey by McKinsey and Company. Fourteen APEC member economies were included in this survey which found that investors are willing to pay a premium ranging from 11 per cent for Canada and up to 38 per cent for Russia for shares in a well-governed company. The study found that investors are prepared to pay an average premium of 21 per cent for the shares of a well-governed company in an APEC member economy.10 [See Graph 3.0 for results on APEC member economies.]

8 OECD, 1999, OECD Principles of Corporate Governance (see: www.oecd.org/).
The survey results also showed that 63 per cent of respondents would avoid investing in companies perceived to have poor corporate governance. A further 31 per cent of those surveyed indicated that they would not invest in certain countries due to corporate governance concerns. Strengthening shareholder rights, improving accounting standards, more effective disclosure and stronger enforcement were cited by investors as the top reform priorities for policy makers.

Leaving aside the premium, investors may still enter a high risk economy but the nature and extent of their investment will be limited and will require higher rates of return. However, in these cases investments are likely to be skewed toward short-term profitability rather than long-term real economic development.

**Graph 3.0: Investor Premium for a Well-Governed Company in 2002**

Graph 3.0 plots the results for fourteen APEC member economies. In most cases, the premium investors would pay for stock in a well-governed company in APEC member economies is between 15 and 25 per cent which highlights the importance of implementing strong corporate governance standards across the region. The relatively good results achieved by such economies as Mexico, Thailand and Korea also demonstrate that investor confidence has rebounded following the implementation of institutional and regulatory reforms and financial sector restructuring in the aftermath of their financial crisis.

**Recent Experience**

Corporate collapses during 2002 have revealed questionable financial disclosure across the region (as well as in Europe) highlighting weaknesses in corporate governance practices in
even the most developed economies. These clearly have had an impact on capital markets in the short term but the long-term impact is still unknown. The corporate and sharemarket losses might cause a rise in equity risk premiums with consequential effects on the allocation of capital and asset prices. Also, investors might demand higher rates of return on their invested capital due to the rise in equity risk. While stricter regulation and enforcement is being imposed in some economies, this could also mean greater compliance and an increase in transaction costs, which affect productivity growth.\textsuperscript{11} The clear immediate lesson (for developed and developing economies) is to remain vigilant via regular review of corporate governance practices.

\textit{Areas for Attention}

Different models of corporate governance apply in different economies – shareholders play a central role in Australia, Canada and the United States, while families and governments are critical stakeholders in many Asian economies.\textsuperscript{12} This means that potential problems and solutions applied in corporate governance may differ across economies.

There would seem, however, to be some common features that translate into weak corporate governance practices including, but not limited to the following:

- high concentration of economic activities in a relatively small number of firms and conglomerates;
- a conglomerate-bank-government nexus which undermines competitive disciplines and appropriate accountability;
- concentrated ownership and control by minority shareholders, particularly founding families;
- weak transparency as a result of inadequate accounting standards and disclosure requirements; and
- lack of oversight by boards of directors and weak protection of shareholders’ rights.


In addition, the implementation and enforcement of the rules are often weak and/or inconsistent. Courts and supervisory bodies frequently lack the political will, professional expertise, capacity training, and resources to enforce laws and regulations. Where multiple organisations with supervisory responsibilities exist, approaches can be fragmented and ineffective. [See Box 3.0: The Need for Greater Enforcement]

**Box 3.0**  
**Corporate Governance: The Need For Greater Enforcement**

There are certain areas in which shortcomings in enforcement are particularly noticeable, including:

- **Enforcement of Transparency Requirements**
  
  Enforcement of disclosure, accounting and auditing requirements across the APEC region varies considerably. In relation to disclosure requirements, regulators in many East Asian economies rarely fine or de-list companies, although they may threaten to expose publicly the offending company. Similarly, very few companies are prosecuted or punished for fraudulent accounting practices or for failure to comply with national or international accounting standards. Auditors sometimes fail to provide accurate and independent reports due to a number of factors, including lack of independence, ineffective legal sanctions for non-compliance, and absence of knowledge about the legal requirements and standards.

- **Enforcement of Protection of Minority Shareholders**
  
  While the legal rights and position of minority shareholders has been improved in many APEC developing economies, legal actions by shareholders and judicial enforcement against directors remains extremely rare in practice. Weak penalties for non-compliance with director obligations and systemic weaknesses in the legal system have been cited as the major causes for the low litigation rates.

- **Enforcement of Insolvency Laws**
  
  Processes in many jurisdictions remain slow. Often there is a lack of suitably qualified or experienced judges and the court processes are unpredictable and unreliable, particularly in jurisdictions which lack a system of precedent. In some jurisdictions, the effective enforcement of judgements against debtors largely depends on the debtor’s cooperation. Cultural factors and public perception of the rule of law in a number of jurisdictions have also led to a preference to use informal and sometimes even illegal ways of dealing with business debt.13

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Enforcement of Secured Transactions Laws

The legal uncertainty of some of the new secured transaction regimes has been accentuated by the problems faced by secured creditors in enforcing their rights. In a number of APEC member economies, creditors must rely on the court system to enforce their interests. The two-stage process of collection provides that a creditor firstly requests a court order for seizure of the property, and second, the creditor sells the property under a court-administered process. Such a process should be cheap and fast. In various member economies, however, it can take secured creditors months and even years to take control, and realise the collateral. Court processes are often extremely slow, expensive and uncertain. In addition, arbitration is not sufficiently fast or independent of the courts to substitute for court enforcement.

Insolvency

An effective insolvency regime is a key aspect of corporate governance and economic legal infrastructure which aims to allocate risk among market participants in a predictable and transparent manner and to maintain economic value. The two key objectives are to enable exit from the economy through liquidation of inefficient businesses and to rehabilitate viable and productive businesses that are experiencing operational or short-term liquidity difficulties.

The Asian financial crisis has provided the impetus for a number of economies to reform their insolvency laws, many of which were outdated legal transplants from other jurisdictions. In many of these economies prior to the crisis, insolvencies were dealt with in informal, unofficial ways so neither the courts nor businesses had any experience in modern, formal corporate bankruptcy practices. The laws were old and inadequate to deal with modern business, trading, financial and securities transactions but when new laws were introduced, there were very few experienced judges, administrators or professionals to administer them.

Corporate insolvency laws are heavily reliant on a developed institutional court or tribunal system, particularly given the complexities involved in interpretation and application of the relevant laws. The experience in many APEC economies has been that it is unsafe to leave the jurisdiction to courts or judges that do not have wide commercial law experience and familiarity with the principles underlying the laws. In many
cases, the administrators and supervisory judges are understandably inexperienced, particularly in asset recovery and business reorganisation. They have the difficult responsibility of ruling on insolvency issues arising out of complex foreign language, western-style financing documents, often without there being any precedents upon which they can rely and without training in these areas.

Dispute Resolution

Effective dispute resolution mechanisms comprise an important part of an economy’s corporate governance framework and economic legal infrastructure. Alternative, out-of-court means of dispute resolution such as mediation and arbitration are essential elements, although they are still subject to the laws and judicial process for enforcement of their outcomes. Certainty in relation to dispute resolution is critical for businesses, particularly those considering investing in infrastructure projects.

It is important that domestic legal systems recognise foreign judgements or awards. This can be achieved by becoming a party to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and introducing the necessary domestic legislation to implement the convention.

APEC members should also bear in mind the ongoing contribution to international dispute resolution made by the International Centre for Settlement of Investment Disputes (ICSID), which was established in 1996 pursuant to the 1965 Convention on the Settlement of Investment Disputes between States and Nationals of Other States. Pursuant to the Convention, ICSID provides facilities for the conciliation and arbitration of disputes between member countries and investors who qualify as nationals of other member countries. APEC members which are party to this Convention should therefore ensure they have the capability to enforce ICSID’s arbitral awards as required under the Convention.

The outcomes of dispute resolution through local arbitration are less predictable and reliable in many APEC jurisdictions than those achieved through international arbitration and often involve lengthy delays. Nonetheless, efforts have been made by many APEC members to strengthen their domestic arbitration institutions and processes in order to develop a track record of
predictable and fair decision-making. In China, for example, the China International Economic and Trade Arbitration Commission (CIETAC), which provides arbitration services in foreign-related commercial and investment disputes, has developed a reputation for its increasingly competent and consistent decisions.

Challenges Ahead

Much has been done in corporate governance in the region. [See Box 3.1: Recent Reforms] Further improvements, however, are justified, particularly in the implementation and enforcement of governance rules. Recent failures of major corporations resulting from questionable corporate accounting and auditing practices, and incidents of lack of capacity by the judiciary to interpret and apply commercial laws have highlighted the need for regular review and updating of corporate governance practices across the region.

In undertaking such a review, it would be worthwhile to keep in mind that effective measures to strengthen corporate governance practices need to involve, but are not restricted to:  

- establishing good frameworks of laws governing property, contracts and insolvency, and encouraging or legislating for good accounting, auditing, reporting and disclosure standards for companies, and clear accountability on company directors to achieve those standards;

- governments taking a lead role in demonstrating and ensuring compliance with best practice, and encouraging the private sector to take responsibility for improving corporate governance practices and enforcement, and for continuous self-improvement in governance practices and professional skills and independence;

- a clear commitment on the part of authorities to strengthen the primacy, impartiality and efficiency of the legal and regulatory systems, as well as building up the institutional capacity of legal and regulatory agencies to monitor and enforce rules, through higher levels of resourcing, training and professional expertise of officers and staff;

14 More detailed measures to strengthen corporate governance can be found in the APEC, 1999, Strengthening Corporate Governance Report to APEC Finance Ministers. Other corporate governance issues are also highlighted in the APEC Conclusions of the Policy Dialogue: Strengthening Corporate Governance in the Financial Sector, Hong Kong, China, 1-2 August 2002; and in the APEC Symposium report, Corporate Governance in APEC: Rebuilding Asian Growth, November 1998.
improvements in domestic market structures and market competitiveness through more effective competition policy to strengthen market discipline; and

greater shareholder and stakeholder activism for good corporate governance practices, through education and training of corporate executives and directors, accountants, bankers, individual retail shareholders, as well as the media to bring to public attention both positive and negative practices.

These are significant challenges. And for some economies in the region, reform will require greater political, institutional and cultural shift, and will demand active participation across the board from bankers, financiers, government regulators, CEOs, auditors and corporate directors to make good corporate governance happen.

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**Box 3.1 Recent Reforms In Governance**

**The United States** instituted the *Sarbanes-Oxley Act* in July 2002 in response to the recent large-scale corporate collapses in the US in 2001 and 2002 resulting from accounting irregularities and the perceived failures of corporate ethics and controls. The new Act is aimed at increasing the reliability and accuracy of corporate reporting and accounting and auditing practices, and ensuring the independence of securities analyst advice and recommendations. The Act includes provisions which increase accounting and auditing regulation, enhance disclosure requirements, create new federal criminal offences and increase penalties for existing federal crimes.

**Australia** has undertaken a wide range of corporate law reforms in the last decade, particularly via the Corporate Law Economic Reform Program (CLERP) which commenced in 1996 and overhauled Australia’s corporations law. In September 2002, Australia released a comprehensive set of policy proposals on audit regulation and a wider corporate disclosure framework. The 41 proposals in the paper are aimed at ensuring that Australia enhances its effective disclosure framework and provides the structures and incentives for a fully informed market. A copy of the paper can be found at http://www.treasury.gov.au.

**The Philippines** revised the *General Banking Act* and the Securities Regulation Code to improve corporate governance practices. Minority shareholders are afforded better protection under the Securities Regulation Code with mandatory tender offers, defined listing rules, a
prohibition on insider trading and separation of the broker and dealer functions. In addition, a new regulatory framework for financial reporting, based on international standards, was implemented by the Securities and Exchange Commission. Amendments in 2000 to the General Banking Law require the full disclosure of bank subsidiaries and affiliates through the mandatory auditing and publication of financial statements by banks on a solo and consolidated basis in general circulation newspapers once a quarter.

**Vietnam** took a major step forward with the introduction of the Enterprise Law in 2000, which reduced red tape and regulations governing the creation of private companies. The Enterprise Law has liberalised the regulations governing the establishment of new companies with the start-up time reduced from 98 days to one week and registration costs reduced by 60 per cent. Between January 2000 and August 2001, approximately 26,000 new private companies were registered in Vietnam, equal to 58 per cent of total new registrations between 1991 and 1999.15

In preparation for WTO accession, Vietnam is also revising its Commercial Law and the Ordinance on Arbitration to create a favourable legal environment for commercial activities in the context of economic integration. Key areas for revision are the provisions on commercial activities and commercial conduct of traders and the need for a procedural law to bring commercial disputes to court.

**China** is bolstering its corporate governance requirements to facilitate the development of its capital market. New accounting and disclosure guidelines entitled “Accounting Systems for Business Enterprises” were introduced by the Ministry of Finance in 2000. In addition, the China Securities Regulatory Commission (CSRC) has increased disclosure requirements, clarified reporting rules and statements on dividend policies and introduced new rules on secondary offerings. In January 2002, the CSRC introduced “Guidelines on the Management of Listed Companies” – implementation of the new requirements has proceeded well with the CSRC launching several successful prosecutions against companies that have breached listing rules.

**Peru** has accelerated its structural reform program in 2002, in accordance with its IMF commitments, in an attempt to improve economic production efficiency, foster private investment and reduce public sector borrowing needs. Some of the key reforms have been in the areas of taxation system reform, privatisations and concessions, strengthening banking supervision and revamping fiscal responsibility laws. For example, Peru received assistance from the Inter-American Development Bank to revise their Law on Fiscal Responsibility and Transparency by mid-2002.

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4.0 COMPETITION LAW

Competition law provides a regulatory framework to promote competitive practices in markets, including by addressing anti-competitive agreements between competitors, abuse of dominant position and anti-competitive mergers and acquisitions. It is well recognised that effective competition laws strengthen corporate governance and are a key tool for sustainable economic development. Put simply, they encourage businesses to focus on efficiency and the provision of goods and services at lower prices and with improved quality.

The introduction and revision of competition laws in APEC’s developing economies is a critical priority but it should be borne in mind that it represents a sea change in economic legal infrastructure which requires gradual acceptance over time in each of these economies. Competition law, by itself, will not create competition but if effectively applied, can help to prevent anti-competitive behaviour.

Many of APEC’s developing economies have recently implemented competition laws. For example, Indonesia’s new Anti-Monopoly Law came into effect in March 2000. China’s legislation to deal with unfair competition has only been effective since December 1993 and it is now in the process of finalising its anti-monopoly law. Other APEC members, including Vietnam, are currently compiling basic competition laws.

Given the ongoing and significant work on competition policy already underway in APEC, this report does not seek to canvass specific changes in competition law. Rather, the report suggests that competition laws should only be formed in the context of existing laws, regulations and policies that influence entry, exit and the degree of rivalry among incumbent suppliers. Competition laws can be a challenge to formulate and implement because they represent fundamental changes to the organisation and functioning of public and private markets.

Enforcement of Competition Laws

The enforcement of competition laws in both developed and developing APEC economies remains a complex challenge. The
critical issue centres around the role of the supervisory, regulatory or enforcement and implementation agency. The success of the agency will be highly dependent on the level of financial and human resources provided, its status within the community and the extent to which it is able to perform advocacy roles (including to challenge government practices and decisions), engage in research and educate key stakeholders, primarily business and the public.

Many APEC members have found it necessary to adjust incrementally the roles and responsibilities of competition law enforcement agencies as the competition policy framework has matured. For example, in May 2002 the Australian Government announced a formal and wide-ranging high-level review of the Trade Practices Act 1974. Among other things, the Review is examining the implementation of the Act and issues relating to the powers and processes and operation of the enforcement and supervisory agency, the Australian Competition and Consumer Commission (ACCC). The Review provides a valuable opportunity to consider the operation of Australia’s competition law regime and address both the concerns of the business community and the ACCC.

Developing APEC members are gradually addressing the need to provide “teeth” to their competition law enforcement agencies. For example, in June 2000, the Indonesian Government appointed 11 commissioners to run the Supervisory Commission for Business Competition (KPPU), the new independent regulatory agency in charge of implementing the Anti-Monopoly Law. The Commission’s effectiveness will depend upon its capacity to remain independent from business and government, address competition issues in a technical, transparent and fair manner, and develop an effective advocacy strategy for public policy measures affecting competition.

In order to address the gap between the law and its proper enforcement, APEC members will need to devote considerable resources to strengthening the regulatory, analytical and enforcement capabilities of the relevant agency, training judges on enforcement and compliance with competition law, initiating dialogues between government officials, business and the public on the competition law regime, and disseminating public reports and information about the competition law to government bodies, business communities and the public at large.
5.0 APEC RESPONSE AND NEXT STEPS

APEC is already making a valuable contribution to advancing good governance and strengthening economic legal infrastructure in the region, recognising that these have potentially significant consequences for trade and economic performance as a whole. APEC can, however, do more to address outstanding areas of concern and encourage continuous reform.

APEC efforts to strengthen economic legal infrastructure and to improve corporate governance regimes can complement the work of other international forums, including the World Bank, the International Monetary Fund, the Asian Development Bank and bilateral donors. As structural weaknesses in certain economies in the region tend to be entrenched by historical and cultural factors, every effort that delivers incremental gains should be welcomed.

APEC Finance Ministers’ Process

APEC, through its Finance Ministers’ Process, has undertaken initiatives to develop regional financial and capital markets and to support free and stable capital flows in the Asia-Pacific region. These include:

- strengthening financial market supervision through training of banking supervisors and securities regulators;
- assessing banking supervisory regimes;
- improving credit rating agencies’ ability to channel timely and accurate information to capital markets and strengthening financial disclosure standards; and
- designing a Voluntary Action Plan for supporting freer and stable capital flows.

Also through the Finance Ministers’ Process, a pathfinder\(^\text{16}\) proposal to strengthen the corporate governance regimes of member economies, based on the

\(^{16}\) The pathfinder approach enables a group of economies to move more quickly on initiatives, with other economies free to join at any time.
recommendations of the *1999 APEC Corporate Governance Report*, was recently adopted.

Corporate governance has been a topic of discussion at several symposiums and policy dialogue sessions organised by the APEC Finance Ministers’ Process, the most recent being a policy dialogue on strengthening corporate governance in the financial sector, held in Hong Kong, China in August 2002.

The September 2001 report of the Taskforce on Company Accounting and Financial Reporting also recommended that member economies review and strengthen their accounting and auditing requirements, assess the adequacy of their accounting and auditing professions and address any deficiencies. A commitment was given to undertake further policy dialogue on implementing the report’s recommendations and strengthening company accounting and financial reporting practices in APEC member economies.

**Strengthening Economic Legal Infrastructure**

Strengthening economic legal infrastructure became a key issue for APEC at Auckland in 1999 with Ministers recommending the development of initiatives “to strengthen market infrastructure, particularly legal infrastructure…”. This was followed in July 2000 by the first *Strengthening Economic Legal Infrastructure Symposium* held in Jakarta to consider APEC’s role in improving economic infrastructure and the establishment of the APEC Strengthening Economic Legal Infrastructure Coordinating Group to progress work in this area.

*A Cooperation Framework for Strengthening Economic Legal Infrastructure*, including Menus of Options, was endorsed by APEC Senior Officials and Ministers in 2000. In 2001, APEC Ministers and Leaders endorsed the development and implementation of cooperative projects and urged further efforts “in building capacity and skills of individuals, institutions and agencies in developing and applying commercial, corporate and competition law”.

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The objective is to promote continued regulatory and institutional reform in APEC economies but Ministers explicitly noted the critical importance of legal institutional change, rather than changes to statute laws alone. Australia, Japan and Peru are leading the development of cooperative projects in Capacity and Institutional Building, Corporate Law and Competition Policy respectively.

A number of cooperative projects to advance strengthening economic legal infrastructure initiatives have been conducted by APEC members. Several workshops have been held under the APEC-OECD Cooperative Initiative on Regulatory Reform led by Peru, which is designed to open and progress dialogue, increase understanding and transparency of relevant laws and policies in the region, and promote awareness of the competition policy work within APEC.

Specifically on competition policy, a training program, co-organised by Japan, Thailand and Vietnam, is underway to help build institutional capacity in APEC member economies to enforce laws on competition.

Japan, Indonesia and Australia co-sponsored a second *Strengthening Economic Legal Infrastructure Symposium* in July 2002 which helped increase awareness of the continuing need for regulatory and institutional reform in the region and identified areas for further attention. In particular, the Symposium noted that reforms had focussed on changes in the written law but there was little evidence of improvements made in implementation and enforcement across the region.

Australia completed a pilot project to deliver Intensive Training in Commercial Laws seminars in Vietnam and the Philippines. Successful outcomes were achieved as a direct result of the close and productive collaboration between Australia and the participating economies. The tailor-made approach applied in the pilot project will be followed in the delivery of three additional commercial laws seminars in Indonesia, China and Thailand in 2003.

**Next Steps**

Experience shows that structural weaknesses in governance remain in many economies in the region,
resulting in significant costs. In light of this, individual APEC member economies – both developed and developing – need to monitor regularly and, where necessary, strengthen their economic legal infrastructure to meet continuing changes and demands in the market environment. On the positive side, there is strong evidence of the potentially large pay-off from strengthening economic legal infrastructure in terms of social development and economic growth. These factors should encourage APEC member economies to make strengthening economic legal infrastructure a high priority.

APEC can and should play a role in strengthening economic legal infrastructure and promoting good corporate governance practices among its members. To progress coherent work and initiatives, APEC needs to put this issue high on its agenda, and provide an appropriate and credible forum to be responsible for steering and progressing APEC work in this area. The Strengthening Economic Legal Infrastructure Coordinating Group has done a commendable job in progressing these issues, but is hampered by the lack of a well-defined mission and set of objectives. A revamped Strengthening Economic Legal Infrastructure Coordinating Group, with more active and positive participation by individual members, will help ensure worthwhile outcomes are achieved.

Future APEC efforts need to be gradual, strategic and fit within the target economy’s future policy direction – such projects should be provided through collaborative partnerships between APEC members in order to meet the specific needs of the target economy.

While recognising that resources are limited and that reform is a long-term process, APEC has further scope to make concrete contributions through:

- **Advocacy**

  APEC can help build member economies’ understanding of the nature of strengthened economic legal infrastructure and corporate governance. APEC can also promote the benefits of such reform in achieving sustained economic growth through policy dialogue, information sharing and research.
Capacity-building

APEC ought to continue with capacity-building efforts through training seminars, workshops, fellowships and exchanges catering for various professions and covering a range of areas including corporate law, competition policy, insolvency and property rights. Projects need to be targeted and tailor-made to meet the specific needs of the relevant participating economies. [See Box 5.0: Potential APEC Capacity-building Projects]

Box 5.0
Potential APEC Capacity-building Projects

APEC could play a key role in strengthening economic legal infrastructure through among other things:

- providing targeted training, workshops and symposiums on specialist areas of corporate law (including insolvency, secured transactions, competition law and policy) to government agencies, regulators, professional bodies (including directors and auditors), dispute resolution centres, private law firms and universities;

- providing capacity-building to Bar Associations, the legal profession, the judiciary and court officials, with a focus on issues of legal ethics and transparency;

- facilitating the electronic and hard copy exchange of legal materials on specific laws, systems and institutions;

- implementing capacity-building measures to strengthen and improve the resources of specialist commercial and bankruptcy courts; and

- encouraging collaborative training, research and joint ventures between authorities and institutions.

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19 See APEC, 2001, Strengthening Economic Legal Infrastructure: Menus of Options on Capacity and Institutional Building, Corporate Law and Competition Policy.
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