

Introduction

0.1 Objectives and Importance of Study

Globalisation has meant the widening and intensification of links between economies. In the context of the international movement towards privatisation, liberalisation and deregulation, capital flows — both portfolio and foreign direct investment — stimulate economic growth¹ and development. However, developing countries² have difficulty in attracting global capital flows,³ and the critical question to be asked is “what factor best promotes investor confidence, attracts global capital flows and is an essential determinant of economic development in developing countries?”. Corporate governance is increasingly identified as fostering economic growth and development by creating a secure environment for investment.⁴ The identification of this nexus between corporate governance and economic development has resulted in market forces and development assistance increasingly supporting the reform of corporate governance.

¹ R La Porta, L Lopez-de-Silanes, A Shleifer and R Vishny (‘LLSV’), Investor Protection and Corporate Governance (2000), 58 *Journal of Financial Economics*, 3; and B Black, The Legal and Institutional Preconditions for Strong Securities Markets (2001), 48 *University of California Los Angeles Law Review*, 781, illustrate a link between the development of capital markets and economic growth.

² This study uses the term ‘developing’ countries or ‘developing’ economies. Developing countries or economies are poorer states which are in the process of building economies and financial systems and reflect the related terminology used by the International Monetary Fund, *World Economic Outlook: Housing and the Business Cycle* (Washington DC 2008), Statistical Appendix, which classifies countries into two major groups: advanced economies and emerging and developing economies.

³ International Monetary Fund, *Global Financial Stability Report: Market Developments and Issues* (Washington DC 2002), 20, reports that in 2001 developing countries are estimated to have attracted only 6 percent of the total G7 outflows of capital.

⁴ S Claessens, *Focus 1: Corporate Governance and Development* (Global Corporate Governance Forum-World Bank Washington DC 2003), 14–24, indicates a positive correlation between corporate governance and economic development.

2 Corporate Ownership and Control

However, globalisation, the pressures for convergence of economic systems and the necessity of attracting global capital flows essential for growth and development, have resulted in corporate governance reforms in developing countries being tilted towards transatlantic systems and practices.⁵ Corporate governance reforms promoted by market forces and adopted by international financial institutions (IFIs), attempt to ensure the adaptation of a system of corporate governance based on dispersed ownership and prescribe corporate governance practices based on the dispersed ownership model. These reforms are not successful in developing countries due to two interconnected reasons. First, the reforms seek only to minimise the ‘agency costs’ arising from the separation of ownership and control.⁶ Many developing countries’ corporate governance concerns further involve minimising costs associated with protecting the minority shareholders from the extraction of private benefits of control by controlling shareholders, while at the same time, providing controlling shareholders with incentives to monitor management. Second, analysis of local market structures, which define with clarity corporate governance concerns and the agency costs within developing countries are largely ignored. For corporate governance to be effective, it must be meaningful in the context in which it is applied. Therefore, reform efforts cannot ignore local market structures that define the adaptation and effectiveness of corporate governance.

Corporate governance systems and practices are shaped and defined by economic, social and political factors within a country such as market structures, the legal system and culture. While it is inevitable that globalisation would bring about a certain degree of uniformity or convergence in corporate governance, it is also inevitable that economic, social and political backgrounds would be a barrier to the hegemony of one system over another.

⁵ E Berglöf and A Pajuste, *Emerging Owners, Eclipsing Markets? Corporate Governance in Central and Eastern Markets*, in P Cornelius and B Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press New York 2003), argue that despite institutional differences, corporate governance codes in Central and Eastern Europe are remarkably similar due to the costs of deviation.

⁶ For example, Commonwealth Association for Corporate Governance, *Corporate Governance Principles 1999* (Marlborough 1999), sets out 15 principles of corporate governance primarily for boards of directors of dispersed companies. Further, D Reed, *Corporate Governance Reforms in Developing Countries* (2002), 37 *Journal of Business Ethics*, 223–233, questions whether the Anglo-American model can generate responsible ownership in developing countries.

The primary thesis advanced by this study is that an analysis into the reform of corporate governance in developing countries should begin with a focus on local market structures, such as ownership and control structures of companies that define the adaptation and effectiveness of corporate governance.⁷

To support this proposition, the focus of this study is on an analysis of the implications corporate ownership and control structures (exemplifying local market structures) have on the governance of companies in Sri Lanka, an illustrative example of a developing country.⁸ The study advances three objectives. First, the study illustrates the significant and enlightening nexus between economic development and corporate governance. Second, it defines the corporate governance challenges in Sri Lanka in the light of its ownership and control structures. Third, in order to promote economic development, the study devises an agenda for corporate governance reform in Sri Lanka, based on an analysis of Sri Lanka's corporate ownership and control structures.

This study is mindful that corporate governance cannot be viewed in isolation,⁹ while acknowledging that comparisons across countries are difficult due to economic and cultural differences.¹⁰ This study is not meant to be an isolated study of corporate governance in Sri Lanka. While the study's main focus is Sri Lanka, where appropriate, reference is made to developed and other developing countries. However, it is hoped that the single-country focus would identify with clarity, core corporate governance concerns for both Sri Lanka and other developing countries.

There is a need for effective corporate governance systems and practices in developing countries as a part of their market and legal infrastructure to

⁷ Motivated by the prophesy that global competition in product and capital markets will bring about 'an end of history for corporate law' resulting in the cloning of the Anglo-American model of corporate governance. H Hansmann and R Kraakman, *The End of History for Corporate Law* (2001), 89 *Georgetown Law Journal*, 439–449.

⁸ Country classification in International Monetary Fund, World Economic Outlook Database. WEO Groups and Aggregates Information (April 2009), <http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/groups.htm#oem> [5 May 2009].

⁹ Isolated in terms of a jurisdictional basis: KJ Hopt and S Prigge, Preface, in KJ Hopt *et al.* (eds.), *Comparative Corporate Governance — The State of Art and Emerging Research* (Oxford University Press Oxford 1998), v.

¹⁰ PK Cornelius and B Kogut, Introduction, in PK Cornelius and B Kogut (eds.), *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press New York 2003), 1–2.

stimulate economic growth and development. Sri Lanka, as an illustrative example of a developing country is a good context of study first, because it has a positive attitude towards economic development through liberalisation of capital markets and has in the recent past undertaken rigorous programmes of privatisation and capital market liberalisation. However, it is relatively unsuccessful at attracting global private equity flows.¹¹ Second, despite inheriting English legal principles like many developing countries with a colonial history, particularly commercial laws that were transplanted into its legal system,¹² Sri Lanka, is unreliable in maintaining investor confidence.¹³ Third, Sri Lanka's corporate ownership and control structures, its social and political background and institutional capacity, provide fertile ground for an analysis of this nature. Fourth, similar to many other developing countries, corporate governance in Sri Lanka is the subject of increased scrutiny and prescription among IFIs engaged in structural adjustment programmes (SAPs).¹⁴ However, developmental emphasis on corporate governance fails to appreciate that market structures and institutions are embedded in indigenous social, cultural and political processes. Finally, developing country concerns, especially in South Asia, are largely ignored in studies on corporate governance. Sri Lanka, an illustrative developing country in South Asia, is also small enough to lend itself to a study of this nature.

Any scholar, practitioner or policy maker with an interest in corporate law, finance, economic policy and business is aware that corporate governance scholarship attracts a veritable flood of scholarship. This study is an attempt to make a contribution to a technically complex and relatively new area of scholarship. It does so in a number of ways.

First, this study gives a detailed account of the ownership structure of Sri Lankan companies based on original empirical research. Second, it

¹¹ World Bank, *World Development Indicators 2006* (Washington DC 2006), Table 6.1, reports private capital flows into Sri Lanka at 5.2 percent of gross domestic product (GDP), while other lower middle income countries attract over 10.7 percent.

¹² Civil Law Ordinance No. 5 of 1852 as amended, s. 3, states that the law of England be followed with respect to partnerships and corporations.

¹³ Sri Lanka was added to the California public employees' retirement system (CalPERS), Permissible Equity Markets (2005). However, its score fell below the permissible threshold of 2.0 in 2006. After a 1-year cure period during which its score improved but was still below 2.0, it was excluded from the list, Wilshire Consulting, *CalPERS Permissible Equity Markets Investment Analysis: Final Report* (California 2007) 19.

¹⁴ Asian Development Bank, *Sri Lanka: Financial Sector Assessment* (Manila 2005), 149, Recommendations.

develops the idea that in the absence of effective enforcement mechanisms and high-quality legal protection for minority shareholders, major lenders may be called upon to monitor the behaviour of controlling shareholders. Third, it uses Sri Lanka to illustrate that a detailed understanding of the context of a particular country needs to be taken into account to develop policy prescriptions for reform. Fourth, it exemplifies that the governance of companies is dependent on a wider context by highlighting the nexus between corporate governance and economic development, the use of a contextual framework¹⁵ of corporate governance and a focus on market structures.

The new paradigm that the study offers is not a simple prescription for reform but an effort to understand the importance of indigenous market structures, such as corporate ownership and control structures of companies, for effective corporate governance.

0.2 Overview of Research Methods

In supporting the thesis presented by this study, both a positive and critical approach is adopted, in that it aims to provide insight into current ownership and control structures in Sri Lanka, the costs and benefits of such structures, and also suggest a substantive and viable framework for reform.

Theoretical debates on corporate governance and economic development, and corporate ownership and control, are analysed in framing the objectives of the study. Empirical research is used to unravel the complex ownership and control structures and measure the costs and benefits of controlling shareholders. A contextual framework of corporate governance is used to understand the context of the study and create a paradigm within the reform context. The study is interdisciplinary and straddles corporate law and corporate finance.

Background statistical information collated from primary sources for the purposes of the study is available with the author.

0.3 Structure of Study

Chapter 1 illustrates and analyses the nexus between economic development and corporate governance, and lays the foundation for the primary

¹⁵ The term is used to denote the framework that depicts the variables in corporate governance and the relationship among them.

thesis of this study, that an appropriate model of corporate governance for facilitating economic development should begin with a focus on local market structures which are best able to define the adaptation and effectiveness of corporate governance. It does so, first, by an analysis of the literature relating to corporate governance and economic development and second, by supporting the argument that the appropriate model of corporate governance for facilitating economic development must be both holistic and context dependent.

Chapter 2 further supports the primary thesis of this study that an analysis into reform of corporate governance in developing countries should begin with a focus on local market structures that define its adaptation and effectiveness, by an analysis of the correlation between corporate ownership, control and corporate governance. The first section of the chapter is an analysis of why corporate ownership and control is a good starting point for this study in the context of Sri Lanka, a symbolic example of a developing country. Thereafter, the correlation between corporate ownership, control and corporate governance is subject to analysis.

Chapter 3 characterises the main features of the corporate governance challenge Sri Lanka faces by an examination of corporate ownership and control structures. Empirical data is used to answer questions on the concentrated ownership of companies in Sri Lanka, the significant owners of such companies, whether, these significant owners maintain control in excess of their economic stake and if so the mechanisms used, whether the companies have ultimate controlling owners, and if they are different to the significant owners identified before, and importantly, the specific corporate governance issues identified as a result of the analysis of corporate ownership structures in Sri Lanka.

The objective of Chapter 4 is to analyse the implications for corporate governance in Sri Lanka by an examination of the causes and determinants of ownership and control structures in Sri Lanka. An outline of the evolution of corporate ownership in Sri Lanka is undertaken and probable determinants for the persistence of concentrated ownership are examined. The chapter concludes by drawing implications for corporate governance reform in Sri Lanka in the light of the identified causes and determinants for the persistence of concentrated ownership.

The objective of Chapter 5 is to support the proposition that controlling shareholder systems present a trade-off between its costs and benefits and that such trade-off is dependent not only on functionally good law but also on the regulatory environment, market forces and the ratios between

the controlling shareholders' economic and controlling stakes (referred to as the 'trade-off thesis').

Chapter 6 develops a framework for the reform of corporate governance within controlling shareholder systems, which increases the benefits inherent in controlling shareholder systems and also curbs the costs of controlling shareholders, that is, tilts the trade-off balance and creates efficiency among controlling shareholders.

Chapter 7 advances the hypothesis that major lenders are an effective external corporate governance mechanism in controlling the costs of controlling shareholders. The chapter assesses the suitability of lenders as a corporate governance mechanism and thereafter, details a reform agenda based on the legal and institutional preconditions necessary for lenders to be an effective mechanism to control the costs of controlling shareholders.