

## FUNCTIONAL CONVERGENCE: A WAY FORWARD TO IMPROVE CORPORATE GOVERNANCE IN MALAYSIA

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### ABSTRACT

Malaysia is generally characterized as having concentrated ownership structure in its corporate sector dominated by family-owned and state-owned companies. Although there seems to be a shift in ownership and control, there is nevertheless preservation of concentration of ownership and control. In contrast, the Anglo-American system has a dispersed ownership system which has the characteristics of an active share market and takeovers, high market transparency and rigorous disclosure standards. Despite the obvious differences, the concentrated ownership systems have been transplanting Anglo-American laws, regulations, codes and guidelines into the body of their corporate governance frameworks in the hope of precipitating corporate governance reform and strengthening financial and economic standards. Although the main objective of convergence of corporate governance is to improve a country's governance standard, the widespread reforms by way of converging practices have the potential to isolate the domestic problems. In particular, the mismatch of legal rules and regulations between dispersed ownership systems and concentrated ownership systems. Thus, this paper will look at the popular concept of convergence of corporate governance as a method to ameliorate the differences between systems. This paper argues that functional convergence can create a

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corporate governance structure that is closer to home without resort to direct formal regulation that carries the risks of cosmetic changes to the system. Examples from the US and the UK will be of useful insights to provide a sound solution to improve corporate governance in Malaysia.

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## INTRODUCTION

Corporate governance regimes have traditionally been broadly categorised into two types of ownership and control, namely insider and outsider systems, which entail different monitoring structures to counter specific problems. Outsider system have dispersed share ownership structure, with a number of individual shareholders and due to that, many have little or no incentive to monitor the managers because their shareholding in the company is so small to give them the power to do so (Rachagan and Nariman, 2013; MR Salim, 2009). Thus, outsider system tend to have advanced and liquid equity markets which allows the minority shareholder to exit as a solution. This has been seen as a method to discipline the management; that is, market for corporate control (Reisberg and Lowry, 2012).

In the meanwhile, the insider system is significant with not just families and banks as a source of funding and control but also employees, non-financial corporations and the State. There is no separation of ownership and control, as it is owned and controlled by major shareholders indicating a concentrated ownership pattern. Employees, creditors, the State and shareholder have an input into control. In insider system, managers are supervised by the concentration in ownership, or known as the blockholders. The insider relationships, substantial horizontal coordination among producers, and various stakeholder claims other than the shareholders were accepted in insider system.

Despite the obvious differences, the concentrated ownership systems have been transplanting Anglo-American laws, regulations, codes and guidelines into the body of their corporate governance frameworks in the hope of precipitating corporate governance reform and strengthening financial and economic standards. Although the main objective of convergence of corporate governance is to improve a country's governance standard, the widespread reforms by way of converging

practices have the potential to isolate the domestic problems. The differences in both systems tend to be ignored by law reformers and policy makers. In particular, the mismatch of legal rules and regulations between dispersed (outsider) ownership systems and concentrated (insider) ownership systems. Furthermore, the recent 2008 economic crisis challenged a host of established conceptions and theories of effective corporate governance.

Thus, this paper will look at the popular concept of convergence of corporate governance as a method to ameliorate the differences between systems. This paper argues that functional convergence can create a corporate governance structure that is closer to home without resort to direct formal regulation that carry the risks of cosmetic changes to the system. Functional convergence can bridge the gap between internationally recognised standards and national norms and cultures and may create a corporate governance structure that is closer to home. I will highlight the different problems that are addressed in formal convergence. Most examples highlighted herein will be from the United States because, having flexible and changeable laws, the features of the United States' system are better than others in facilitating functional convergence.

### **CONVERGENCE AS A METHOD**

Convergence in corporate governance occurs when there is similarity between governance practices in different countries. Convergence is “the process or state of com[ing] together from different directions so as eventually to meet’ and ‘gradually chang[ing] so as to become similar or develop something in common” (Oxford Dictionaries, 2010). A primary objective of socio-economic convergence is to make uniformity of law appear simultaneously possible and desirable (Teubner, 1998).

Convergence of corporate governance is not just about formal legal convergence, but also about broader market-institutional convergence (although arguably the same fundamentals dynamics and difficulties are involved in both). Since corporate governance is continually undergoing a process of gradual change, Wymeersch (2002) identifies convergence as the evolution of corporate governance, which improves the corporate decision-making process and places importance on what the shareholders and investors want.

Though it is possible to achieve a total adoption of law, convergence carries the risk of occurring only on the surface of the law and not within the deeper structures of the legal rules, mentalities and epistemologies, because each legal structure is historically and culturally unique and cannot be completely replaced. The factors that drive convergence may

include securities market integration, migration to foreign stock markets and international harmonization of standards (Coffee, 1999).

Product market pressure and product market competition also have been identified as major contributing factors driving convergence of corporate governance (Höpner, 2001). This is because, by having good corporate governance measures, convergence allows the company to have greater access to capital and gain credibility with its customers, thus giving the company a competitive advantage in the global market. Nevertheless, according to Teubner (1998), the efforts of internalisation of various national legal structures may unintentionally produce new divergences as consequences. However, despite the above assertions, there are successful and rapid institutional transfers among Western societies.

### **THE COSMETIC CHANGES OF FORMAL CONVERGENCE**

The best approach to understanding law is through its history, origin and development. It is to be understood that all legal rules are created due to the social, political or economic factors of the particular nation and, once rooted in its legal tradition, will tend to live on; these circumstances will often represent a significant source of what has been termed “path dependency” (Roe, 1995-1996, 2000-2001). In debating which legal (or corporate) systems are more desirable, Gilson (2001) supports the one which is successful at that particular time. Gilson argues that the development of the governance of a national system is usually shaped by “the accident of history or the design of politics” (Gilson, 2001). Two types of convergence as characterised by Gilson (2001): (1) formal convergence and (2) functional convergence.

According to Gilson (2001), formal convergence (or convergence in form) is done through legislative amendments of a governance system, or when a country makes changes to its laws that require the acceptance of best practices. When two countries adopt similar corporate governance laws, Khanna, Kogan and Palepu (2006) call it “de jure convergence” as opposed to “de facto convergence” (that is, convergence of actual practices).

Convergence in form occurs when there are increasing similarities between different sets of legal frameworks and institutions (Gilson, 2001). According to La Porta et al. (2000), legal convergence refers to successful changes in rules and enforcement instruments to some standard. Formal convergence includes changes in the legal framework, and thus it must go through legislative processes and requires political support. As legal change requires legislative action, it is not surprising that formal convergence proceeds more slowly compared to soft-law governance

practices (Hansmann and Kraakman, 2002). Soft law is a non-statutory and non-binding form of law which usually requires judgement rather than adherence to prescriptive regulation. It is also known as principles-based.

Formal convergence is often associated with legislation as it provides the primary way for a legal change, as it can be very systematic and generalistic in its purpose and implementation (Watson, 1978). Legislative process can be long, tedious and time-consuming, as legislation is designed to be stable and predictable once instituted. To ensure that any law has been thoroughly examined, discussed and debated, any proposal for a new law and/or changes to an existing law will typically be subjected to pre-legislative scrutiny whereby the relevant reform proposal will be tabled, read, examined, debated at length and voted on by the legislature. Simply put, a legislative bill goes through several stages that may take years to complete.

This also means that legal instruments such as statutes cannot be quickly altered to reflect changing events. Although formal rules offer the most stable instruments, legal instruments such as statutes and by-laws are often not dynamic enough to operate effectively within robust competitive economies. While economic entities are (ideally) rapidly adaptable to changing commercial, economic and technological realities, legal instruments are not (and rightly so) as legal institutions are made to last (Ayres and Braithwaite, 1992). Legislation has always been known to be rigid. Thus, formal convergence is slow compared to other methods. Despite the laborious legislative process, legislators often provide the direction behind every bill that is tabled. Often the persons adversely affected by any new legislation proposed are a lot more than those who have an advantage from it, but the profits to the few are more extensive than the harms to many.

Furthermore, as a matter of convenience, legal reforms have gone a step further by borrowing pre-existing rules and principles from foreign jurisdictions instead of allowing laws to develop over time by interacting with local socio-economic environments (Gillespie, 2006). The principles of law that are formulated outside a domestic context are used to help construct the local legal framework. Several examples of developing countries have been observed whereby the countries were urged to look at the institutional features of the Western world as a model: for example, the World Bank's strengthened pressure for legal harmonisation in developing Asian states, or the OECD's constant recommendation of convergence of international standards and practices (Gillespie, 2006). Often, reformers use laws and institutions from other nations in an attempt to stimulate immediate economic growth. When a rule is borrowed, there is no practical experience as to how the rule will work (Watson, 1978).

Although the rule may look the same after a formal transfer, Legrand (1997) cautions that, it may have been changed. The assimilation into a new network of legal institutions and culture can expose the transferred rule to the disparities of episodic bonds that are rooted out of different legal formations. Legal cultures vary mainly from the way which they connect their solutions with “episodes of conflict” (Legrand, 1997, p.120).

The interpretation of an adopted rule is perplexing, as it is subjectively and intangibly conditioned by a number of factors, such as its historical background, culture and society, the community of the said rule and the articulation of the interpreter. This is because different interpretations occur based on different understandings of the rule adopted. For example, an effort by leading United States academics to reform Russia’s corporate law regime by importing United States style corporate law did not deliver the anticipated outcome (Paredes, 2004). The ability to transport both the rule and its intended meaning makes for a successful transplant; however, based on Legrand’s (1997) statement above, the original meaning of the rule may not survive the trip from one to another legal system.

### **WILL THE CONVERGING PRACTICES BE TRANSPLANTED IN FORM AND FUNCTION**

When embarking into formal convergence, there is a risk that a law will provide only a superficial, cosmetic change that may not solve the existing problems in governance. It is thus important to ensure that the introduction of new laws (or legal reforms) into a system can and will be able to work hand in hand with the current legal system and corporate culture. A rule which is too rigid will eventually have a negative impact on economic growth, and there is a danger of an unbalanced legislative framework forming, with the potential for over-regulation on one hand and no regulation on the other. The risk in formal convergence occurs when countries compete to attract international recognition without any consideration of their own peculiar political and socio-economic landscapes.

In 2000, Katharina Pistor measured the degree of legal change in 24 transitional economies and her cross-country analysis showed that there is an inclination towards formal convergence as a result of widespread legal reforms. Elsewhere, Coffee (2002) observed that complete set of legal reforms, commonly devised by foreign legal advisors become a wholesale transplantation. Thus, the outright transplantation of rules from the common law legal systems to the civil law legal systems, as observed in Pistor’s study, seems to indicate that, when confronted with external pressures, lawmakers in transitional economies have no qualms about

diverting from their own traditional legal system. This leads to the occurrence of formal convergence. Although shifts in legal rules may follow, shifts in the system of corporate governance and the structure of share ownership may not necessarily occur, especially when the corporate governance system pre-dates the rules.

From this perspective, one might predict that once this wholesale transplantation occurs, there will be a corresponding movement towards the system it adopted. As Coffee (1999, 2002) reminds us, “if legal rules are determined by the system of corporate governance that pre-exists those rules, then no similar rapid legal transition should necessarily be expected” (p.86-87). The evidence brought forward by Coffee (1999, 2002), however, further shows that there are significant shifts in continental European countries which traditionally have had concentrated ownership structure. Changes such as the decline of concentrated structure of share ownership, the increase in listing on European stock exchanges, the growth of equity markets and increase of corporate takeovers involving European counterparts may suggest a transition towards the Anglo-American model. Despite the above changes, however, the insider system remains entrenched in continental Europe.

It is important to recognize that functional convergence is useful for jurisdictions that wish to emulate another’s system, typically in order to create a better governance system for themselves. However, there is a danger that the applied system will not be implemented at “ground level”. For example, greater concentration of ownership within a firm can mean that the firm curtails its capability to increase investment in capital markets. In this respect, outsider system differs from the insider system. An outsider (Anglo-American) system is a market-based governance system and has more widely dispersed shareholdings, whereas an insider system is a relationship-based system and is mostly controlled by major shareholders, causing it to have a concentrated ownership structure. Thus, in trying to adopt features characteristic of outsider system into traditionally insider systems, any outsider system that is adopted within an insider system must be able to accommodate the concentrated ownership structure and, at the same time, manage the danger brought about by large blockholders (Easterbrook, 1997).

Arguably, dispersed ownership denotes that risk can be diversified away and increase liquidity with lowered capital cost. These features, which are seen in the majority of public listed companies in the United Kingdom and the United States, are due to the fact that no single shareholder has enough wealth to become a large blockholder – and even if a shareholder is wealthy enough, the risk is too high for them to bear (Easterbrook, 1997). It is thus apparent that the corporate laws which are applicable in the United States are different in significant ways from those that have developed in concentrated ownership systems, as both types of

systems have different characteristics and objectives. Previous studies have established a distinction between legal and functional convergence (Coffee, 1999). According to La Porta et al. (2000), convergence on effective investor protection using formal methods requires all-encompassing legal and regulatory reform, and also judicial reform. On the contrary, functional convergence appears to be more effective because it does not involve these reforms. Rather, the latter type of changes are more wide-ranging and market-driven.

### **FUNCTIONAL CONVERGENCE**

Functional convergence occurs when institutions adopt foreign practices and bring about changes in their corporate governance systems without changing their statutory law. In order for functional convergence to succeed, there must be flexibility to the existing regulatory instruments. This is to allow the law to act in response to new conditions without any formal change (MacNeil, 2002). According to Gilson, functional convergence can only occur when institutions are flexible enough to adopt amendments without any formal changes: that is, when different countries perform the same function by using their own pre-existing rules and institutions. According to Khanna, Kogan and Palepu (2006), when actual practices of corporate governance are implemented, it is a form of de facto convergence.

It has been suggested that managers of multinational companies make reference to international sources when bringing about changes in internal governance processes. These acts by managers indicate a form of functional convergence (Sassen, 1998). In essence, functional convergence is a “bottom-up” process, which only occurs when a company consents to a change in its governing rules rather than these being enforced at the national level (Bratton and McCahery, 1999). This happens because, when companies learn from the mistakes of another’s governance shortcomings and emulate their optimal practices, governance measures are less rhetorical and more tangible. As the legal framework in the company’s national system continues unchanged, it not only creates a more effective and cheaper control tool, but also an instantaneous one, as it requires no legislative action. Hansmann and Kraakman (2002) assert that reform of corporate governance practices commonly leads to the reform of corporate law, largely because it is a matter of private ordering. It is thus necessary to look into the examples from the United States’ and the United Kingdom’s corporate governance environments, to determine whether the methods in the United States and the United Kingdom offer any paradigm for the development of this idea (which idea) in other environments.



## **SHAREHOLDER PROPOSALS IN THE UNITED STATES**

Examples from the United States can be useful in employing functional convergence in a system, institution or jurisdiction because of the enabling nature of many of its rules. When the United States Securities Exchange Commission (SEC) introduced Rule 14a-8, it opened up a floodgate of shareholder activism (Kahan and Rock, 2010). Rule 14a-8 of the Securities Exchange Act allows shareholders to force a company to include a resolution in its proxy materials with minimal cost. Voting by way of proxy is to allow someone else the right to vote on your behalf at the general meetings. In case where there is no instruction to vote in particular way, the usual instance would be that the proxy holders would vote the shares following the recommendation of the board of directors. The rule states that management must permit shareholder proposals that form a “proper subject for action by the security holders” (Gillan and Starks, 2007). The main advantage of the shareholder proposal rule is that it is inexpensive for the proponent, as they need not pay any of the printing and mailing costs, all of which must be paid by the corporation.

For example, under SEC Rule 14a-8, shareholder proposals are merely advisory in nature. Shareholders may not initiate corporate actions under Rule 14a-8, but may only approve or disapprove of corporate actions placed before them for a vote (Bainbridge, 2008). These precatory shareholder resolutions thus represent a low-cost and relatively uncoercive form of activism with no binding effect (Kahan and Rock, 2010). Therefore, even if a proposal passes with hundred percent of the vote, there is no requirement by the management to implement the proposal’s directives. Some view it as an ineffective tool, since most of the proposals are phrased in precatory language that cannot bind the board of directors to action.

However shareholder proposals, despite the absence of binding legal effects, can still be very persuasive. The first incidence (or movement) of shareholder activism emerged during the mid-1980s when the Council of Institutional Investors was formed with the intention of acting as a lobbying group for shareholders’ rights (Gillan and Starks, 2007). It was formed after Jesse Unruh, who was at that time the California State Treasurer, and a California Public Employees Retirement System (CalPERS) board member learned about the abuse of stock buybacks by the board of directors of Texaco with a repurchase offer that was not advanced to other shareholders, such as CalPERS and California State Teachers Retirement System (CalSTRS). In this case, a shareholder proposal was presented to the company to call for an advisory committee of major shareholders to be created to work with management. However, upon direct negotiation with Texaco which resulted in an agreement for

the management to nominate a shareholder representative as a candidate to its board of directors, CalPERS withdrew its proposal (Gillan and Starks, 2007).

### **CONCLUSION: FUNCTIONAL CONVERGENCE TO BE FACILITATED**

This paper has provided an overview of some of the issues and debates which have emerged within the literature on the idea of convergence of corporate governance. It first focused on the question of how a foreign rule may be transplanted into the domestic culture in the specific context of corporate governance. The discussion clarified the theories of convergence that have been advanced by various scholars, particularly the concepts of formal and functional convergence as developed by Gilson (2001).

Then, the paper highlighted the limits of formal convergence, especially in attempting to introduce legal changes that are not merely cosmetic, but are able to function alongside the current legal system and be adapted culturally without causing any ancillary (detrimental) effects. Thereafter, this paper examined legal transplants through functional convergence and the need to facilitate functional convergence as a method for establishing a more localised and custom-made corporate governance structure within a particular legal system.

Through the example highlighted in this paper, it is acknowledged that international standards can provide a certain degree of “learning” between nations, and thus convergence cannot be abandoned totally. However, the main objective of convergence can be undermined as reforms have unintended consequences. The example quoted above highlight the ways in which functional convergence can be facilitated at the micro-level with more flexible and adaptable mechanisms. It is hoped that the example from the United States as highlighted in this paper demonstrate that functional convergence can be relied on by an insider system to find appropriate corporate governance measures without resort to formal laws adopted from outsider systems. The state can apply the functional method of adopting foreign practices without any formal change to solve the central problem of abuse of blockholder power in the insider system.

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