

Local Governance Rules and Global Capital Mobility

2005 Annual Meeting of the *Academy of International Business:*
"Local Roots, Global Links"

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Québec City, July 9th, 2005



Caisse de dépôt et placement
du Québec

40 years
of investing

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A Global Issue for Financial Markets

- Since 2001, the world has gone through a wave of corporate scandals
 - Enron, WorldCom, Tyco in the U.S.
 - Parmalat in Italy, Vivendi in France, Cinar in Canada
- In certain cases, top management made substantial gains by providing manipulated results to their respective boards
- As a result, the confidence of investors in corporate governance standards was shaken



A Challenge for Local Regulators

- Restoration of investor confidence requires improvements in corporate governance standards
- Thus, each country is looking to adopt a regulatory framework aimed at reaching that goal



Government Responses

- The United States adopted the *Sarbanes-Oxley Act* in July 2002
- 28 countries published governance codes or recommended best practices in the two years following *Sarbanes-Oxley*
 - Some of these initiatives were inspired by the OECD *Principles of Corporate Governance* endorsed in 1999 and revised in 2004



Local Differences and Global Mobility

- Governments have chosen different approaches to address the corporate governance agency problem
 - Is the *Sarbanes-Oxley Act* the best response, or has it gone too far?
 - What path have other countries chosen?
- Diversity of regulation or worldwide adoption of *Sarbanes-Oxley*
 - Does capital mobility require uniform regulations?
 - Or, is diversity a safer approach?



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What is Corporate Governance?

- Corporate governance
 - Relationships among managers and other stakeholders of a corporation
 - Determines and controls the framework for setting strategic direction and performance of the organization
- Good practices in corporate governance
 - Key to the efficient operations of the corporation
 - Helpful in alleviating "agency problems," particularly in the case of complex, modern publicly-listed corporations



The Main Agency Problem in Public Corporations

- In non-public corporations, governance rules can easily support the "first best"
 - For instance, in a world *à la* Adam Smith, firms are often owned and managed by the same person
- However, government policy for public corporations subject to the following agency problem can only achieve a "second best" solution:
 - Managers' and shareholders' interests not always aligned
 - Asymmetric information
- Good practices in corporate governance are aimed at solving this *main* agency problem



The Main Agency Problem in Public Corporations

- Agency problems are more common in public corporations since ownership and control are typically separate
- Managers may have incentives to act in ways that are contrary to the interests of shareholders
 - ➔ *Alignment of interests problem*
- Thus, monitoring is a key, but difficult, issue:
 - Managers' have more information than the shareholders
 - Insufficient monitoring may result from a collective action problem
 - ➔ *Asymmetric information problem*
- As a result, managers have the ability to behave opportunistically

Addressing the Main Agency Problem: Self-Regulation

- Internal and external mechanisms
 - Executive compensation
 - Board of directors
 - Auditing
 - Shareholder activism
 - Market for corporate control

"The honor code among CEOs didn't work. Board oversight didn't work. Self-regulation was a complete failure." (Eliot Spitzer, WSJ, April 5th, 2005)



A case of market failure



Addressing the Main Agency Problem: Government Regulation

- Two broad regulatory approaches
 - Mandatory, rules-based approach
 - Voluntary, principles-based approach
- Two enforcement tools
 - The amount of effort put into detection and conviction
 - The level of penalties for convicted wrongdoers
 - Fines
 - Imprisonment



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The United States' Approach

- *The Sarbanes-Oxley Act*
 - Majority of board of directors must be independent
 - More extensive financial disclosure required
 - Harsher penalties for wrongdoers
 - Management has direct responsibility for the assessment of detailed summaries of internal controls (Section 404)

Approach: Mandatory rules-based

More on *Sarbanes-Oxley* later...



European Union's Approach

- EU has proposed a pan-European law on statutory auditing, the 8th Directive
 - Companies would have to form audit committees
 - Annual report on internal controls by external auditor
- EU is in the process of amending the 4th and 7th Directives on accounts
 - Require the description of internal control processes in annual reports
- Member states have produced guidance or legislation, each taking a slightly different approach



United Kingdom's Approach

- *Combined Code* on corporate governance and *Turnbull Guidance* on internal controls
 - Listed companies advised to review the effectiveness of their internal controls, but not to disclose the results
 - Listed companies may choose not to comply with best practice codes if they disclose and explain the reasons to shareholders
- June 2005 report of the *Flint Review* rejects adoption of SOX-type detailed regulations
- This "comply or explain" approach is now the generally accepted model in Europe

Approach: Principles-based, voluntary compliance



Germany's Approach

- Corporate governance code for listed companies
 - Must establish a wide-ranging risk management system, but do not need to publish effectiveness assessment
 - Must state whether they have adhered to the code and identify sections where they have not complied
- A current government proposal would make the disclosure of executive pay mandatory

Approach: Mostly voluntary and principles-based



France's Approach

- The *Loi sur la sécurité financière* was introduced in 2003
- The Chairman of the board must
 - Explain the board's function
 - Report on the company's internal controls
 - Describe the limitations placed by the board on the chief executive's power
- To date, disclosures are descriptive and do not have to be conclusive about effectiveness of internal controls

Approach: Voluntary and principles-based



Australia's Approach

- Australian Stock Exchange (ASX) governance code released in 2003
 - Ten principles, including the requirement to implement a review structure and establish a risk oversight and internal controls system
 - No requirement to publish an opinion on effectiveness of controls, but recommendation that management certify to the board the accuracy of the financial reports

Approach: Principles-based



Canada's Approach

- Since 2003, Canadian Securities Administrators (except B.C.'s) have released new sets of rules, some of them inspired by SOX. Most are already in effect.
 - 52-108: support the work of the new *Canadian Public Accountability Board* in its oversight of the audit profession
 - 52-109: CEOs and CFOs must certify accuracy of reports
 - 52-110: role and composition of audit committee
 - [52-111: report on financial information internal controls]
 - 58-101: information regarding corporate governance practices ("comply or explain" approach)

Approach: Some mandatory, but generally voluntary, with certain distinctions based upon the size of companies



Same Trend, But Different Approaches

- Common core of general corporate governance principles among those countries
- Although most countries are moving towards implementing stricter rules
 - They have generally adopted laws less stringent than *Sarbanes-Oxley*
 - The most widely adopted framework tends to be principles-based
- Regulatory models range from U.K. voluntary principles-based model to U.S. mandatory rules-based model
 - Canada has gone the farthest in approaching the U.S. model, at least in the case of larger companies



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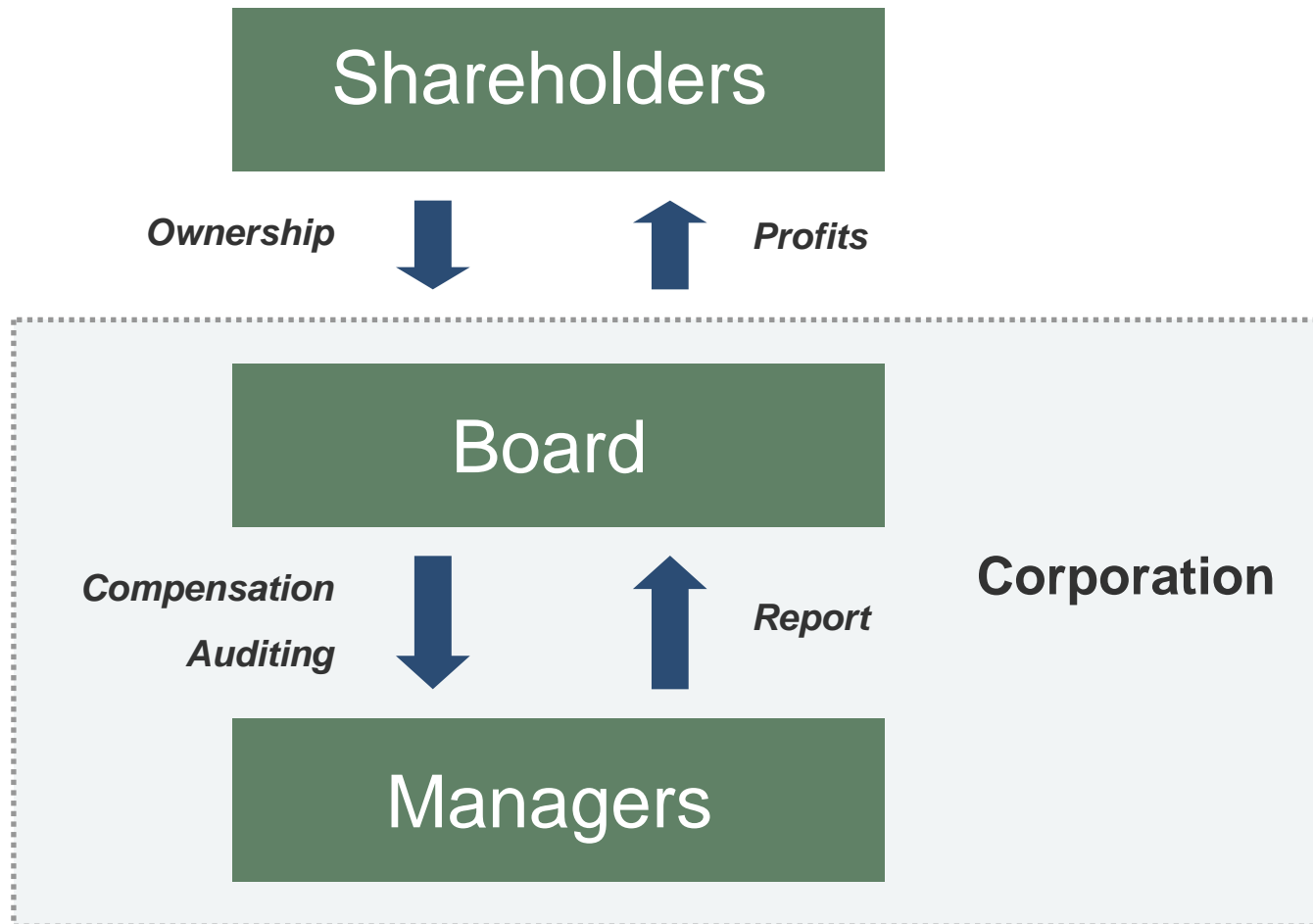
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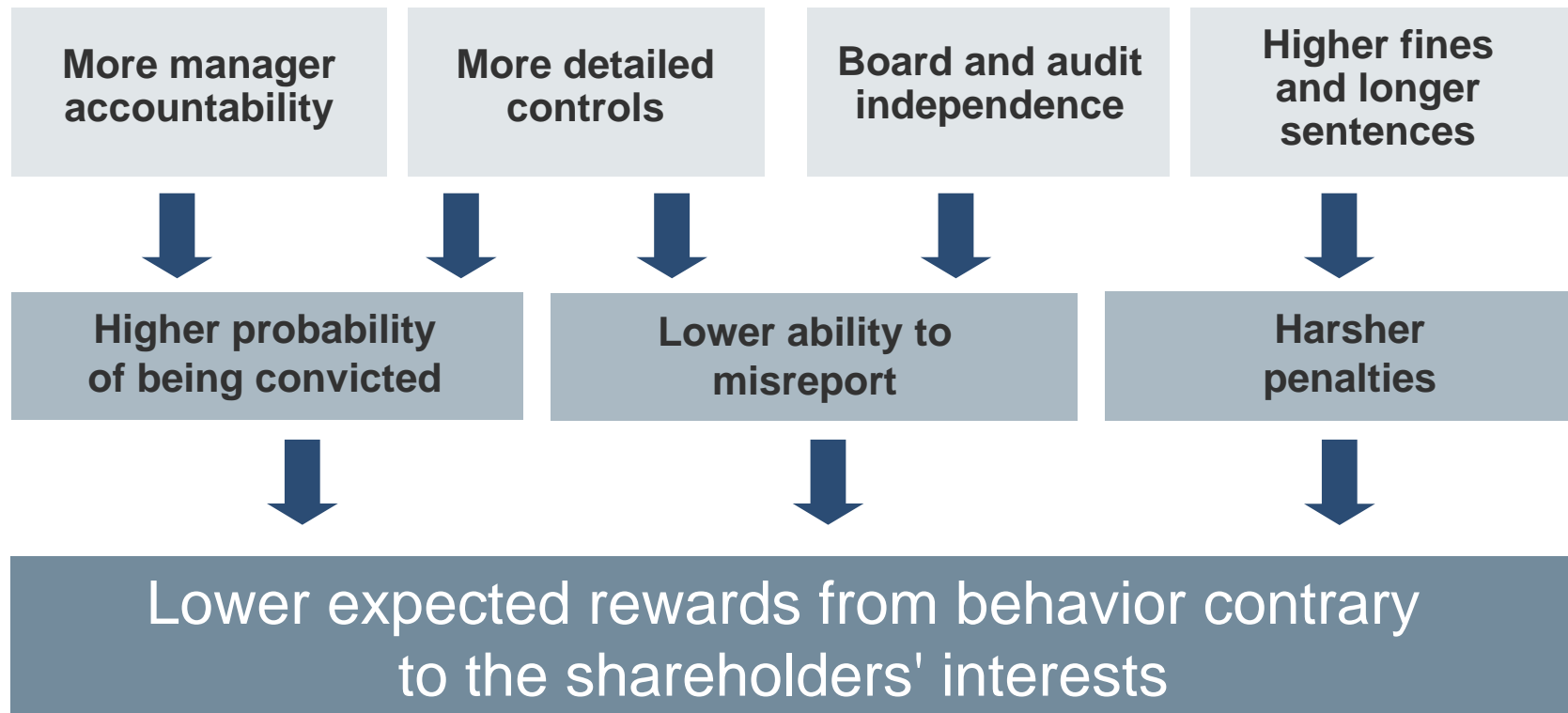


How Well Does SOX Address the Agency Problem?



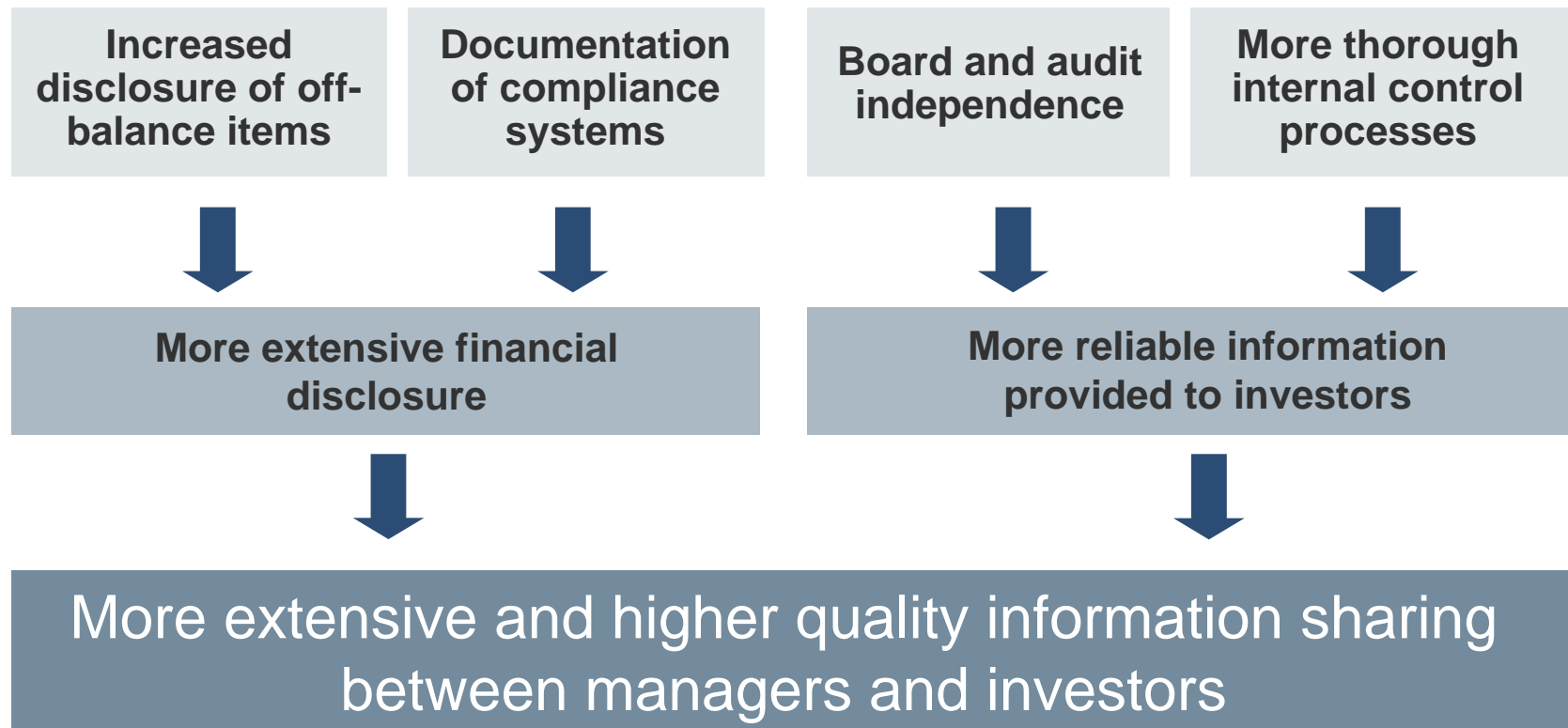
How Well Does SOX Address the Agency Problem?

- *Sarbanes-Oxley* ensures a better alignment of interests between the management and the shareholders



How Well Does SOX Address the Agency Problem?

- *Sarbanes-Oxley* reduces the impact of asymmetric information between owners and managers



Sarbanes-Oxley's Main Benefit

More extensive and higher quality information sharing between managers and investors



Lower expected rewards from behavior contrary to the shareholders' interests



Sarbanes-Oxley helps restore investor confidence in financial markets

Sarbanes-Oxley's Other Benefits

- Improved internal control can be a powerful instrument in improving operational efficiency
- Some evidence that it is effective in bringing to light the inadequacies of some companies' balance sheets
 - The number of financial restatements filed by publicly listed companies jumped from about 260 in 2001 to over 400 in 2004, according to Huron Consulting Group



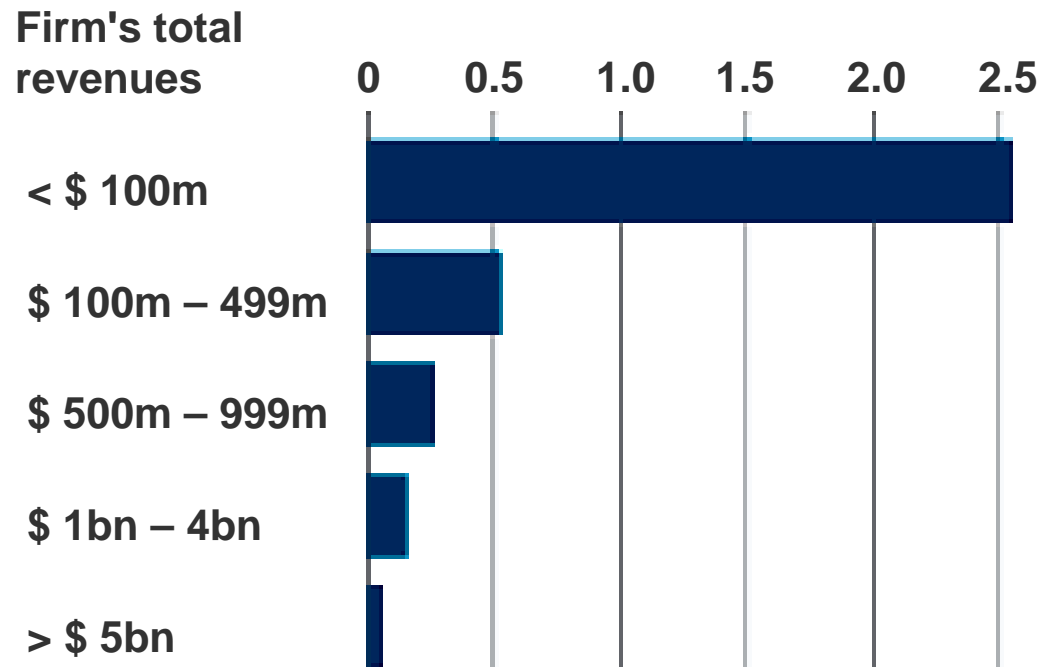
SOX Compliance Costs Are Large...

- SEC's original estimate of compliance costs
 - \$91,000 per company on average, adding up to \$1.2 billion dollars for all publicly traded firms combined
- Some associations' surveys and studies
 - Financial Executives International: costs for complying with Section 404 alone averaged \$4.36 million per firm last year
 - Business Roundtable Association: an average of \$10 million for each member (160 large U.S. corporations) last year
 - American Electronics Association: total compliance costs for *all* publicly traded companies combined will end up reaching an estimated \$35 billion
- However, cost increases could slow down...
 - ...as companies become more familiar with SOX



...And Fall Disproportionately on Small Firms

Big burdens on small shoulders Section 404 compliance costs as % of revenues



Are Economic Costs Even Larger? Impact of *Sarbanes-Oxley* on the Decision to Go Public

- Many small companies may decide not to go public
 - During 2003, the first full year under SOX regulatory regime, 200 companies delisted, against only 180 companies from 1998 to 2002
 - Start-ups may sell out to larger firms rather than going public
 - This in turn could lead to fewer venture capital investments since buyout prices seldom match IPO proceeds
- Small firms are today's innovators and tomorrow's corporate champions
 - Hurting small firms' growth prospects by reducing their incentives to get direct access to stock markets can impede long-term economic potential
- The SEC claims to be looking into these concerns



Are Economic Costs Even Larger? Impact of *Sarbanes-Oxley* on Risk-Taking

- Corporate leaders, exposed to heightened risk of both shareholder-led lawsuits and regulatory sanctions, could be dissuaded from embarking on profitable, but risky endeavours
- The extra regulatory burden diverts the use of scarce management time from strategic issues to compliance duties



Are Economic Costs Even Larger? Impact of *Sarbanes-Oxley* on Risk-Taking

- *"Sarbanes-Oxley is buckets of sand in the gears of the markets."* – **Scott McNealy, CEO of Sun Microsystems**
- *"If we frighten managers to the point that they're not willing to risk anything, we could damage our economy and our ability to compete in the world."* – **Stephen Odland, CEO of Office Depot**
- *"It is now becoming fashionable to believe that corporate behaviour should always be viewed with suspicion. This is a very dangerous premise upon which to develop a governance regime. I am afraid that by doing so, we run the risk of imposing onerous and impractical restraints that will stifle entrepreneurial activity."* – **Dominic D'Alessandro, CEO of Manulife Financial Group**



Benefits versus Costs

- PricewaterhouseCoopers

"The costs are tangible, quantifiable and immediate, while many of the benefits are intangible, harder to quantify and longer term."

- Donald Nicolaisen (chief accountant of the SEC)

"I suspect that the costs are not easy to estimate, but I know that it is even tougher to quantify the benefits."

- Michael Oxley (U.S. Representative)

"How can you measure the value of knowing that company books are sounder than they were before?"



Sarbanes-Oxley: In Summary

- *Sarbanes-Oxley* imposes large administrative and economic costs, but it helps restore investor confidence
- SOX may be a solution adapted to the realities of the very dynamic U.S. economy
 - The U.S. can probably bear a high corporate governance regulatory burden while maintaining strong economic growth
 - Proposals currently discussed (e.g.: flexible interpretation of regulations, exemption of small firms) would make the U.S. framework more competitive, without changing its fundamental characteristics
- Is SOX adapted to the realities of other economies?



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Corporate Governance Rules and Capital Markets

- Stricter corporate governance rules increase investor confidence in local capital markets, but at a cost
 - Increase in investor confidence, so supply of capital rises
 - Increase in social cost, so demand for capital falls



Net economic impact is ambiguous

- The net impact of stricter corporate governance rules depends on local initial economic conditions
 - U.S.: less regulated economy and strong growth
 - Europe: excessive regulations and slow growth
 - Emerging markets: immature capital markets and high growth



Different Local Solutions to the Agency Problem

- Thus, second-best solutions to the agency problem differ across countries
 - Regulatory framework appears to be endogenous
- Regulatory differences may also reflect other local characteristics differences
 - Relative importance of SMEs vs. large corporations
 - Relative importance of sectors (e.g., high-tech vs. natural resources)
- Corporate governance regimes must also address other agency problems related to ownership structure:
 - Majority vs. minority shareholder rights; dual-class shares
 - Particularly in the case of family-owned public companies



High Capital Mobility and Regulatory Differences

- The U.S. could lose out on IPOs from companies based in fast-growing emerging markets
 - These companies typically have less stringent corporate governance controls in place
- *Sarbanes-Oxley* regulatory burden has led some Chinese and Russian companies not to list in the U.S.
 - The Hong Kong and London stock exchanges have benefited the most
- This, in the long term, could increase market pressure on the U.S. to amend its regulations further
 - Increasing importance of emerging markets



High Capital Mobility and Regulatory Differences

- However, even with stricter rules, the U.S. remains attractive for large companies from advanced economies
- For example, even though U.K. corporate governance rules differ greatly from SOX, U.K. multinationals will likely find it in their interest to comply with U.S. rules
 - Advantages of being listed in the U.S. are likely to outweigh the compliance burden with U.S. rules, including litigation risks
- By being present in the U.S., multinational firms
 - Have greater exposure to the deepest capital market in the world
 - Send signals to investors that they take good corporate governance practices seriously



High Capital Mobility and Regulatory Differences

- When capital markets are highly integrated
 - Market pressures for harmonized corporate governance rules are likely to be higher than local pressures for distinct rules
 - Thus, regulatory convergence is likely to result
- Canadian regulatory authorities have largely adopted U.S. standards in the case of large firms
 - Canadian and U.S. capital markets are highly integrated, particularly for large firms
 - Large Canadian firms' funding requirements are often better served by being also exposed to the U.S. capital markets
- Convergence results from market forces



Low Capital Mobility and Regulatory Differences

- In the case of small to medium-size firms, demand for capital is more likely fulfilled in the confines of their local capital market
 - There is little incentive for these firms to adopt U.S. standards or to get exposure to the U.S. capital market
 - Such firms are unlikely to be disadvantaged by the presence of a different regulatory approach in their local capital market



Learning From Diversity

- The fact that different countries adopt different regulations
 - Allows for experimentation
 - Provides a manner in which countries can compare the relative merits of their regulations and improve upon them
 - The exemption of small business in Canada for SOX-type regulations
 - Possible softening of the rules in the case of U.S. small firms
 - In an era of mobile capital, it creates a "de facto" market for the best approaches



Learning from diversity and competition between regulators



Conclusion

Diversity is a Safer Approach

- In a second-best world, diversity is a safer approach
 - Indeed, it is unknown whether SOX, or any other set of regulations, is the ideal global solution
- All investors of the world believe in the importance of good corporate governance
 - However, they hold different views regarding the best way to reach that goal
- In other words, they believe in the same God, but they go to different churches!



Conclusion

An Old and Complex (But Recently Addressed) Problem

- The agency problem of public corporations
 - The danger posed by the separation of ownership from control has been known since the time of Adam Smith
 - Corporate governance rose in prominence during the 1990s
- Aligning interests of shareholders with those of top management in ever more complex organizations is a constant challenge
 - Regardless of the set of regulations in place, separation of ownership and control always create incentives for opportunistic behaviour at the expense of shareholders
- Corporate governance design should focus more on "*value creating governance*" (Yvan Allaire, 2005) rather than "*fiduciary governance*"



Conclusion

Globalization of Corporate Governance Issues

- Improving corporate governance in the developed world is a formidable challenge, but it is even more difficult in emerging markets
 - Property rights are often not well-protected
 - Rule of law is not as prevalent as in the developed world
 - Ethics rules have different meanings in emerging markets
- Adaptation of corporate governance to globalization is easier through a principles-based approach rather than a rules-based one



Merci!

Thank You!

