A Global Perspective On Corporate Governance

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Corporate governance is obviously a matter of global concern, since large public companies operate globally and have worldwide investors. Yet, in many areas of regulation, rules of corporate governance are promulgated on a national, state, or regional (e.g., EU) level. This explains why U.S. rules, which significantly changed following the corporate scandals at the turn of the century, have had a significant global impact. The U.S. imposes its standards on public companies, often foreign as well as domestic, which offer their securities in the U.S. public market, because the U.S. markets remain the most important in the world. U.S. rules are imposed through legislation, such as the Sarbanes-Oxley Act of 2002, SEC regulations, and the listing rules of the exchanges, which are heavily influenced by the SEC. While some regard the application of U.S. rules to foreign

companies as an unwarranted assertion of U.S. extraterritorial reach, these rules are only imposed on foreign companies that seek to raise capital or have their shares traded in U.S. marketplaces.

An important question for the future is whether U.S. rules will remain predominant, either because of the dominance of the U.S. capital market or because they are viewed as superior (however that may be determined) by the marketplace. These two factors are themselves interdependent, since the dominance of the U.S. capital market may be positively or negatively affected by the perceived desirability of its corporate governance rules. If these rules are viewed as undesirable because of their excessive burden, fewer companies may seek access to the U.S. capital market. On the other hand, if investors view these rules as desirable, more companies may seek access to the U.S. market. Companies may also be willing to forsake U.S. market access if the economic benefits of such access decrease. For instance, European companies listed in the U.S. have discovered that trading liquidity is mainly in their home markets rather than in the U.S. Further, the costs to U.S. investors of trading securities in foreign markets continues to decrease because of technology, competition among trading venues, and legal reforms in those markets. The outcome of this dialectic is still in doubt.

I would like to turn to the international impact of three important components of U.S. corporate governance rules:

- The requirement for a majority of independent directors;
- The requirements for an audit committee of independent directors and the use of independent outside auditors; and
- Restrictions on shareholder activism.

A Majority Of Independent Directors

The rules of the U.S. exchanges require that there be a majority of independent directors on the boards of listed companies. Sarbanes-Oxley did not go this far, only requiring that the audit committee of public companies be composed entirely of independent directors. The U.S. listing rules do not, however, make this majority rule binding on foreign listed companies. Under NYSE rules, foreign companies can either comply with the majority rule or explain, through a "brief summary," how their governance structures differ from the majority requirement. NASDAQ has a similar approach.

No other major capital market requires listed companies to have a majority of independent directors. The U.K. corporate governance code regards this as best practice—which most large companies follow—but does not make it mandatory. Other European countries, as well as the EU, suggest that a substantial number of independent directors on the board is desirable but again do not make this binding. In Asia, there are fewer requirements and generally fewer independent directors. The failure to follow best practices generally requires an explanation.

The present difference in approach largely reflects the difference in the nature of public companies in the U.S. and elsewhere. First, U.S. companies tend to have less concentrated ownership than companies abroad, while in Europe and Asia, effective governance often comes from dominating shareholders, rather than independent directors. Second, increasing shareholder value is usually seen as the exclusive purpose of U.S. companies, while Continental European and Asian companies are devoted, in significant part, to serving the interests of stakeholders, including employees and suppliers. It is far from clear that the world will converge on the U.S. model. Indeed, Standard & Poor's Ratings Services sees a trend toward more significant shareholder stakes in U.S. public companies, as institutional owners, such as private equity funds, play more of a role in public markets.

Currently, the U.S. majority of independent directors requirement is not of significant concern for foreign companies since, unlike U.S. domestic companies, they need only comply or explain. If the U.S. mandatory governance model for U.S. companies becomes at odds with the efficient management of these companies, this could well cause U.S. governance rules to change, perhaps to the comply or explain model used here for foreign companies and abroad for all companies, or even cause U.S. companies to exit the U.S. capital market, either by going private or by listing abroad under more compatible governance rules.

This analysis assumes that there are real, not just nominal, differences between the U.S. and the rest of the world

with respect to the majority of independent directors requirement, but this is far from clear. Many believe that U.S. independent director requirements are easily avoided by selecting directors who are "legally" but not actually independent. If the U.S. requirements for a majority of "independent" directors can be easily avoided, then there are no real differences (other than possibly some additional U.S. transaction costs) between the U.S. and the rest of the world.

The U.S. auditing system is more regulated than systems in most of the rest of the developed world, where there are no mandatory independent audit committees, less strict auditor independence requirements, no equivalent of Section 404, and no comparable regulator to the PCAOB. There is, however, significant movement toward the U.S. model, particularly with regard to companies not retaining the same auditing firm to do consulting and auditing, and in providing increased public oversight of the accounting profession. Japan, for example, has adopted an optional independent audit committee alternative to its traditional statutory auditor system.

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Independent Audit Committees And Independent Auditors

Sarbanes-Oxley requires that all U.S. public companies have an audit committee composed entirely of independent directors that has control over the selection and work plan of the outside auditors. While the act only required that companies disclose whether they have a financial expert on the audit committee, U.S. exchanges require that at least one of the members of the audit committee have financial expertise. Sarbanes-Oxley also requires that outside auditors be independent, including a requirement that consulting be separated from auditing and that there be regular partner rotations. In addition, auditors are charged with certifying the adequacy of internal controls under Section 404 of the act. Sarbanes-Oxley also established a new regulatory body to license and monitor outside auditors, the Public Company Accounting Oversight Board (PCAOB), which replaced the self-regulatory role of the American Institute of Certified Public Accountants. These U.S. rules are applied to the auditing of all foreign subsidiaries and branches of foreign companies publicly traded in the U.S., and thus have a significant extraterritorial effect.

The extraterritorial impact of U.S. rules on the auditing of foreign subsidiaries of and branches of U.S.-listed companies has been somewhat alleviated by the "equivalence" approach of PCAOB. PCAOB will not apply its rules to auditing abroad if the foreign auditing system is equivalent to the U.S. system. While such equivalence recognition is on a case-by-case basis and a step-by-step process, it holds out the prospect of greatly reducing the extraterritoriality of U.S. rules.

The most significant international repercussion of U.S. auditing rules results from the significant costs imposed by Section 404 of the act. This cost may have a substantial effect on the attractiveness of a U.S. listing to foreign companies (and perhaps in the longer run to even U.S. companies). The SEC has recognized this burden by delaying the application of Section 404 to all foreign companies for a year, and to small foreign companies for two years. In the interim, the SEC and PCAOB (and perhaps the U.S. Congress) may seek ways to substantially lessen these costs.

Shareholder Rights

In the area of shareholder rights, the U.S. is more restrictive than many other countries, particularly the U.K. As with the majority of independent directors issue, restrictions on shareholder rights reflect the fact that U.S. companies are less controlled than non-U.S. companies by dominant shareholders. The U.S. has traditionally believed that directors are best placed to protect widely fragmented shareholder interests, e.g., long-term investors versus speculators, retail versus institutional, and large positions versus small. If, as I have suggested, U.S. companies are becoming more dominated by shareholders with large positions, this system may have to change. This is particularly true with respect to hostile takeovers where large institutional U.S. shareholders increasingly demand a vote on the adoption of anti-takeover defenses such as poison pills and staggered boards. At the margin, the unfriendliness of U.S. corporate governance rules to shareholder control may, as in the area of independent directors, make the U.S. capital market relatively less attractive to companies with a significant concentration of ownership.

Capital Markets Changes Might Lead To More Flexible U.S. Rules

Until recently, the U.S. appears to have believed that its predominance as an international capital market permitted it to impose its own regulatory rules without fear of losing market share of issuers and investors. This situation has fundamentally changed because of the increased attractiveness of private companies, due to the ability to mobilize larger amounts of capital through private equity and hedge funds, and because of the increased ease and lower cost of trading the securities of public companies on foreign markets. If this is true, then U.S. rules will have to become more flexible. Indeed, we may see convergence in the future away from the present mandatory U.S. model to one of comply or explain. **cw**

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