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Transparency, Corporate Governance and Capital Markets

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A remarkable transformation has occurred in the debate over the underpinnings of effective corporate governance and correspondingly vibrant capital markets. Economists have discovered the importance of institutions. While this epiphany may seem unremarkable to those who inhabit the world of practical affairs where institutions remind us of their centrality on a daily basis, economists see institutions as simply an equilibrium of contracts whose boundaries are defined only by the transactions cost barriers to accomplishing the same functions through markets. Thus, for example, some prominent economists have long argued that compulsory financial disclosure by publicly traded corporations was unnecessary; the market would induce the efficient level of disclosure.[1]

This gulf between men of practical affairs and men of theory has been bridged of late by the facts – an insistent reminder that, in the end, empirical evidence resolves any dispute between subjective experience and theoretical models. A rapidly expanding empirical literature demonstrates that the quality of a country's capital markets depends on the quality of its rules governing corporate

[*] This short paper was prepared for the first meeting of the Latin American Corporate Governance Roundtable. Rather than burden participants with the density of footnotes associated with an academic audience, I have self-consciously dispensed with most footnotes whose function is to identify support in the literature for the proposition advanced in the text. While such footnotes offer a form of academic accountability, this audience is in less need of such protection. Two excellent articles by colleagues, however, provide a useful starting point for further study. See Louis Lowenstein, Financial Transparency and Corporate Governance: You Manage What you Measure, 96 Col. L. Rev. 1335 (1996); Bernard Black, The Legal and Institutional Preconditions for Strong Stock Markets, Working Paper, Stanford Law School (Jan. 2000)(This paper can be downloaded without charge from the Social Science Research Network electronic library at: http://papers.ssrn.com/paper.taf?abstract_id=182169.
[1] This position is described in Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law ch. 11 (1991).

governance and disclosure.[2] In this paper, I want to briefly set out the analysis that links corporate governance and capital markets. Part I develops the concept that corporate governance functions as the corporation's equity contract, the set of rules that determine the terms of the stockholders' investment. As we will see, the growing empirical evidence strongly suggests that the quality of a nation's corporate governance system strongly influences the character of its capital markets and, in particular, it's the availability of external capital. Part II then takes up the central role of transparency in corporate governance, in terms of both disclosure of the results of the firm's operations, and disclosure of ownership. Part III considers the institutional underpinnings of effective transparency: accounting standards; an independent accounting profession; and, especially, efficient enforcement. Finally, Part IV assesses the extent to which one country's corporations can "piggy back" off another country's the institutional infrastructure.

I. Corporate Governance and the Equity Contract

When a lender provides funds to a corporation, the terms of the loan are set forth in a detailed contract. In its most evolved form, a bond specifies (i) the terms of payment, (ii) a set of detailed covenants commits the corporation to maintain a series of financial ratios, (iii) limits on the amount of additional debt it can take on, and (iv) the events that will constitute a default and the remedies then available. But what terms govern an investor's provision of equity capital to the corporation? When does a stockholder receive a return on investment? What obligations does the corporation undertake with respect to its operations? What happens if the corporation does not satisfy its obligations to stockholders?

The corporate governance system specifies the terms of the equity contract. Management is given great discretion to run the business of the corporation, but no discretion to favor themselves in their dealing with the corporation. Stockholders receive the residual income resulting from the

[2] See, for example, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert Vishny, Law and Finance, 106 J.Pol. Econ. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert Vishny, Legal

corporation's operations, thus giving them the incentive to monitor management's performance. And what happens if management is unsuccessful, either not operating the company efficiently or not returning to the shareholders the earnings on their investment when the corporation lacks opportunities with positive net present value? Shareholders have the right to vote to replace the board of directors; alternatively, shareholders may sell their stock to someone who will undertake the entrepreneurial act of replacing poorly performing management and thereby earn the capital gain resulting from improved corporate performance.

For present purposes my point is not that this short description captures the rich detail of a well functioning corporate governance system or that this ideal form fairly describes very many national corporate governance systems. Rather, it is that the value of the equity – the price investors will pay for a corporation's stock – depends directly on the quality of the corporate governance system, the contract governing an equity investment. For example, if management's performance cannot be effectively evaluated, if poor managers cannot be replaced, or if managers or a controlling shareholder can self-deal, the expected return from owning the corporation's shares will decline, and so will the value of its stock. Good corporate governance – an effective equity contract – results in more valuable stock and a lower cost of capital.

What happens in the absence of an effective equity contract? The relative cost of equity capital increases in comparison to that of debt capital, because the hard-edged debt contract can be monitored and enforced by a lender. But this bias toward a bank centered capital market is not without cost. For example, debt is an ineffective financing instrument for high risk, high return investment associated with early stage technology companies; the absence of equity financing restricts a country's ability to compete in these markets.[3] While this is not the place to recount the debate over the relative efficiency

Determinants of External Finance, 52 J.Fin. 1131 (1997).

[3] Bernard S. Black & Ronald J. Gilson. Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets, 47 J.Fin. Econ. 243 (1998) develop the relationship between a venture capital market for high technology companies and an effective stock market. Wendy Carlin & Colin Mayer, Finance, Investment and Growth, Working Paper (Oct. 1998),

of bank versus stock market centered capital markets, it is sufficient to note that different circumstances require different types of finance – weak corporate governance inefficiently limits the range of options available in a nation's capital market.[4]

II. Corporate Governance and Transparency

At this point, the relationship between good corporate governance and transparency should be apparent. Corporate governance at its core involves the monitoring of the corporation's performance and the monitor's capacity to respond to poor performance – the ability to observe and the ability to act. Transparency goes directly to the equity market's ability to observe a corporation's performance. Most information concerning a corporation's performance is uniquely available from the corporation. Without effective disclosure of financial performance, existing equity investors cannot evaluate management's past performance, and prospective investors cannot forecast the corporation's future cash flow.

One might well respond that corporations have an incentive to voluntarily provide financial information in order to lower its cost of capital. But as my colleague Bernard Black has pointed out, "[d]elivering information to investors is easy; but delivering *credible* information is hard."[5] Suppose honest and effective managers report good earnings. What keeps dishonest and ineffective managers from also reporting good, although false, earnings? To take a less extreme but nonetheless illustrative example, imagine two companies that find themselves in very different circumstances. The first accurately reports a substantial profit from its activities that year. The second also reports a substantial profit from its activities, but in this case the profit really results from reversing reserves created in

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provide empirical support for a relationship between the character of a nation's capital market and investment in research and development, and between investment in research and development and growth.

[4] Financial economists will note that in stressing the different characteristics of debt and equity, I violate the Miller-Modigliani Irrevelancy Propositions which demonstrate that, under specified circumstances, a corporation's overall cost of capital is not affected by its capital structure. Among the assumed circumstances are an efficient equity contract.

[5] Bernard Black, The Legal and Institutional Precondtitions for Strong Stock Markets 5 (working paper, Jan. 2000

better times that hide an actual loss from operations.[6] In the extreme, if investors cannot distinguish between accurate and inaccurate financial reporting, then the market cannot distinguish between them. If the market therefore discounts the value of both companies, a good company looks for a form of financing that allows it the ability to demonstrate, at greater cost, its actual quality. Higher cost bank financing thus may have an advantage based on the barriers that accurately reporting companies confront in distinguishing themselves from companies with less transparent accounting practices.

Thus, we have established a straightforward relationship: Equity investment requires good corporate governance, and good corporate governance requires the capacity to make credible disclosure of financial results. In the absence of effective financial disclosure, a country's capacity to support equity markets and, in turn, important kinds of industry, is compromised,

Effective corporate governance also requires a second form of transparency – ownership transparency. Shareholders can suffer from poor corporate performance; however, they also can suffer from a controlling shareholder's divergence of earnings or opportunities to itself. For this reason, it is also important that companies disclose the identity of shareholders who own significant amounts of corporate stock, as required in the United States by the Securities Exchange Act and in the European Community by the Tranparency Directive. To be sure, disclosure alone is insufficient to police self-dealing by controlling shareholders. As a rapidly growing empirical literature demonstrates, effective substantive protection of minority shareholders is also critical to effective corporate governance and a successful equity market, but knowledge of whether the potential exists is a necessary first step.

[6] Daimler-Benz financial statements for 1993 provide an example. During the first six months of 1993 the company reversed reserves totaling DM1.8 billion thereby turning an operating loss into a reporting profit. See Trevor S. Harris, Understanding German Financial Statements: Lessons from Daimler-Benz's Listing 5 (New York, Salomon Bros. Oct. 7, 1993), discussed in Louis Lowenstein, Financial Transparency and Corporate Governance: You Manage What You Measure, 96 Col. L.Rev. 1335, 1341 (1996).

III. Necessary Institutional Support for Transparency

To this point I have argued that financial and ownership transparency are necessary to effective corporate governance and, accordingly, an effective public equity market. In this section, I will sketch the institutional infrastructure necessary to support transparency.[7]

A. Legally Mandated Disclosure Requirements.

As discussed above, disclosure is not effective unless investors can rely on the credibility of the information disclosed. The most straightforward way to assure that credibility is to mandate disclosure by law, and impose significant penalties on those who publish inaccurate information. While in fully developed capital markets private intermediaries may support non-legal incentives to make accurate disclosure, in capital markets with less fully evolved private institutions, legal mandate and, as we will take up in Section III.C below, effective enforcement are necessary to allow honest companies credibly to distinguish themselves from dishonest companies.[8] For example, there is reason to believe that U.S. investment banks did not resist adoption of the Securities Exchange Act's imposition of penalties on underwriters of offerings with incomplete or misleading disclosure, in amounts far in excess of their underwriting fees, if the underwriters did not exercise due diligence with respect to the disclosure's accuracy. The effect of the higher penalty would be to raise the costs of poor underwriters much more than good underwriters, thereby allowing good underwriters to effectively signal their type.[9]

B. Good Accounting Standards.

[7] Obviously, this is a quite skeletal picture of the institutions necessary to support an effective disclosure regime. For a more detailed listing of the institutional preconditions to good corporate governance and an effective capital market, see Bernard Black, supra note __.
[8] Brian Cheffins, Company Law: Theory, Structure, and Operation 378-420 (1997), examines the benefits and costs of self-regulation in policing accounting standards.
[9] See Ronald J. Gilson and Reinier Kraakman, The Mechanism of Market Efficiency, 70 Virginia L.Rev. 549, 605n.164 (1984).

Disclosure must be useful as well as mandatory. That means the information must be easy for shareholders, managers, and other market participants to use. For present purposes, it is sufficient to note that there are many different users of a company's financial statements. Different information may of importance to different users, but the critical characteristic is that the form of disclosure allows users to restructure the information as they see fit.

For this purpose, the critical concept is that the adjective "hidden" should not appropriately attach to any disclosure. A number of current issues under U.S accounting standards illustrate the point. In recent years, the Financial Accounting Standards Board (FASB), the independent body that sets accounting standards in the U.S. has feuded with the high technology industry over whether the value of options given employees as compensation should be run through the income statement as a compensation expense. Putting aside for now whether the value of such options are fairly estimated by use of the Black-Scholes options pricing model, companies that make extensive use of options as compensation will find their earnings substantially reduced if their value is included in their income statements as a cost. For purposes of transparency (as opposed to accounting theory), whether the value of option compensation is disclosed as a line item in the income statement, thereby reducing primary earnings per share, or in footnote disclosure that separately discloses the amount of option compensation and its impact on earnings, is largely irrelevant. Either way, the financial statements allow a user to reconfigure the information to best suit the particular purpose – the information is not hidden.

Similarly, those who object to the FASB's proposed elimination of the pooling of interest method for accounting for certain acquisitions (including again the high technology industry and for essentially the same reason),[10] should be allowed to also disclose what their results of operation would have been like had the acquisition been accounted for as a pooling rather than the mandated purchase method.[11]

[10] Pooling of interest accounting does not require that the value of the target company's assets be written up to the current value reflected in the acquisition price. As a result, depreciation and amortization expenses are not increased by the

C. Independent Auditors.

A central feature of credible financial disclosure is the presence of independent auditors. Honest, competent, and independent auditors responsible for certifying that a company's financial statements were prepared in accordance with and fairly represent the results of the company's operations according to specified accounting standards play a critical role in assuring widespread compliance with the rules. By placing its reputation on the line, the auditors acts as an information intermediary that greatly enhances the credibility of reported information even where compliance with mandated disclosure is enforced.[12] The annual audit process is far more effective in policing accounting presentation than any government agency.

Here the problem is assuring the credibility of the intermediary. This is easy enough if the auditor is independent of the company whose financial statements it is auditing. It is more difficult if the auditor also provides non-auditing services to the audit client, such as management consulting, tax advice and, in Europe, legal advice. If the amounts received by the auditor for non-audit services loom large in comparison to audit fees, one may well be skeptical of the auditor's incentive to take issue with management's choices of accounting methods or their application in the course of the audit. This issue looms large now in the U.S., where the impact on auditor independence of the consolidation of the accounting firms into 5 multi-national, multi-disciplinary professional service firms is currently under examination by the Securities Exchange Commission.

D. Enforcement.

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acquisition, nor is goodwill created that then must be amortized against income in future years. See Ronald J. Gilson & Bernard Black, The Law and Finance of Corporate Acquisitions ch. 13 (2nd ed. 1995)

[11] This approach was followed by Wells Fargo when it acquired First Interstate Corporation. Although the pooling method was still available at that time, the particular acquisition did not meet the requirements for its use. Wells Fargo accounted for the transaction on the purchase method, but provided supplemental information that disclosed the differential impact of the two accounting methods.

[12] See Gilson & Kraakman, supra note 9.

In the end, mandatory disclosure is no more effective than a company's expectation that the rules will be enforced. That means in the first instance a politically insulated regulatory agency charged with the enforcement of disclosure obligations, and court system with the political independence to impose substantial sanctions on the largest economic actors in the country and with the funding and organization to assure that enforcement is at least relatively swift.

This is itself no small hurdle, but pubic enforcement alone is unlikely to be sufficient. Even in the United States where the Securities Exchange Commission is widely respected as a professional, non-political and effective policeman of the capital markets, private enforcement is viewed as necessary to maintain the capacity for credible disclosure. And private enforcement means litigation, plaintiffs' lawyers and, likely, contingency fees.

For purposes of this paper I can do no more than note the controversy in the United States over the potential for an over-production of time consuming, expensive litigation as a result of greedy lawyers and overly broad rules. Two points, however, are important even in this context.

First, U.S. rules governing private securities litigation are hardly optimal. While they have been improved in recent years by new legislation, they still allow the pursuit of a not insubstantial amount of baseless litigation. However, the current structure of the rules governing private securities litigation in the U.S. are path dependent. Their current dimensions are the result of history rather than careful design, and political barriers to change imposed by groups who have a stake in the current structure slow the process of reform. This barrier does not stand in the way of countries starting largely from scratch. The U.S. experience provides guidance about what not to do as well.

Second, the additional cost of effective enforcement of a disclosure regime resulting from baseless litigation, while certainly warranting efforts to minimize their amount, is in relative terms merely rounding error. Recent empirical work teaches that the quality of a country's legal system is a major determinant of the character and efficiency of its capital market. The importance of this factor on a national economy dwarfs the impact of the inevitable fact that any legal system will not perfectly screen proper from improper litigation.

IV. The Potential for Piggybacking on Another Country's Institutions

For many countries, this paper has set out a substantial agenda for institution building. An observer might appropriately respond that institutions are expensive and, more important, time consuming to build. To what extent can one country piggyback off the capital market institutions of another while building its own?

This idea is not new in the literature. Bernard Black and I have suggested that for countries seeking to develop a viable venture capital market, the securities market necessary for the IPO exit critical to the venture capital process can be supplied by listing on NASDAQ in the United States.[13] Israeli high technology companies have been particularly successful at this technique.

Similarly, John Coffee has stressed the ability of an issuer from a country whose law does not impose rigorous corporate governance standards to voluntarily accept a more demanding regime through the standards imposed by a foreign stock exchange listing agreement.[14] Taking the New York Stock Exchange as an example, listing imposes two different sources of corporate governance obligations on a company.

First, the listing agreement itself imposes governance standards such as a minimum number of independent directors, the existence of an audit committee, and an equal opportunity rule with respect to tender offers.[15]

Second, listing on the New York Stock Exchange imposes on a foreign issuer the obligation to register the listed class of securities under the Securities Exchange Act of 1934 (the "Exchange Act"). While some concessions are made to foreign issuers, the result of registration is an application of a

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[13] Bernard S. Black & Ronald J. Gilson. Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets, 47 J.Fin. Econ. 243 (1998).

[14] John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 Northwestern L. Rev. 641 (1999).

wide range of U.S. securities laws. With respect to transparency in particular, the non-U.S. issuer must reconcile its financial statements to U.S. Generally Accepted Accounting principles, and Section 13(d) of the Exchange Act requires that any person or group owning beneficially more than five percent of a registered class of securities must file a disclosure statement with the Securities and Exchange Commission.

Although a piggybacking strategy has obvious merit, it is hardly a substitute for effective domestic corporate governance and transparency standards. Most important, foreign listing does not necessarily provide the credible enforcement necessary to an effective system of corporate governance and disclosure. While U.S. rules do have extraterritorial impact, their practical impact depends on the location of a foreign company's assets. To the extent that substantial assets are not located within the United States, enforcement is more difficult, depending on the company's domestic court system, and the credibility of the obligations undertaken by foreign listing is diluted.

V. Conclusion

The point of this short paper is straightforward. Effective corporate governance is a prerequisite to a vigorous equity market. In turn, transparency, with respect to both operating performance and ownership, is critical to effective corporate governance. Important industries, and especially high technology industries, require equity financing. Effective corporate governance and an obligation of transparency are therefore necessary conditions to economic development in precisely those industries that will shape growth in the next millennium.

[15] See Coffee, supra note 10; Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Convergence of Function, Working Paper, Stanford Law School (April, 2000).