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23. Corporate Governance and the Integrity of Financial Markets: some current challenges,

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CORPORATE GOVERNANCE AND THE INTEGRITY OF FINANCIAL MARKETS: SOME CURRENT CHALLENGES

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1. The views expressed in these remarks in no way commit the OECD or its Member countries.
2. The 30 OECD Members are the following: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Norway, New Zealand, Netherlands, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

Ladies and Gentlemen,

It is a great honour for me to represent the OECD at this meeting of IOSCO, and to discuss corporate governance with such esteemed colleagues. Recent events have reinforced the essential role that effective regulation plays in ensuring good corporate governance, and in that sense, there could not be a better forum for what I will talk about today. As you may have noted, this was also a major topic for discussion when OECD held its annual Ministerial meeting last week in Paris. In my remarks, I will first discuss the general economic importance of good corporate governance, and then will turn to some of the current challenges.

I. The Economic Importance of Good Corporate Governance

Good corporate governance ensures transparency, fairness, and accountability with respect to shareholders and other stakeholders. It is a prerequisite for the integrity and credibility of market institutions, including institutional investors, stock exchanges and individual corporations. By building confidence and trust, good corporate governance allows access to external finance and the firm to make credible commitments to creditors, employees and others.

The ability for such contracting underpins economic growth in a market economy. Achieving economies of scale, undertaking risky ventures, engaging in projects with more distant payoffs, and employing innovative work and organisational structures requires the institutional certainty and trust that good corporate governance can provide.
Of particular importance for economic growth is the role of good corporate governance in promoting an efficient channelling of savings to productive investment - especially investment in the fast-growing firms and industries that are particularly dependent on external funds.

Good corporate governance plays a critical role at every stage of the investment process. In particular:

- for mobilising equity capital on a large scale;
- for allocating capital efficiently among alternative uses; and
- for monitoring the use of this capital once it is invested in an individual company.

Let me provide a few examples:

At the very first stage in the investment process, effective property protection and secure methods of ownership registration are basic corporate governance provisions that will influence a company's ability to mobilise capital.

At the second stage, reliable and transparent disclosure is essential if the market is to allocate available funds efficiently among various competing ends.

And at the third stage, the procedures for corporate decision-making, the distribution of authority among company organs, the design of incentive schemes, etc. are examples of governance arrangements that have to be in place to effectively monitor the capital that is handed over to companies.

Making this link between corporate governance, investment, and economic growth not only illuminates the profound importance of what we are discussing here today. It also makes it possible for us to conclude that, from a policy perspective, the significance of good corporate governance goes far beyond the interests of shareholders in an individual company. Indeed, the central corporate governance principles of transparency and accountability are crucial to the integrity of our market system. These are the core concerns that have triggered and nurtured the discussions on corporate governance in OECD Member countries and the development of the now globally recognised OECD Principles of Corporate Governance.

Today, the importance of good corporate governance is amplified around the globe by a reliance on the private sector that is significantly greater than it was in earlier post-war decades. More than decade of capital market liberalisation, improved competition policy and wide-ranging privatisation programs have played an important role in strengthening the private sector basis for economic growth. We increasingly trust privately owned corporations to create jobs, generate tax revenues and to provide markets with goods and services. Increasingly, we also make use of the private sector institutions to manage our savings and secure our retirement income. Related developments are the much-increased importance of equity markets and of institutional investors. These developments underlie the widespread public – and hence political - interest in corporate governance practices to ensure investor confidence and the integrity and credibility of our market institutions. Such interests have become even more important in an international context where the full benefits of free capital flows will only be realised if there is a mutual understanding concerning the basic elements of good corporate governance.
This increased interest in strengthening corporate governance hopefully can be mobilised behind needed reforms; but we need to be vigilant to avoid hasty, unwise reactions to some of the challenges now facing policy makers in this area.

II. Current Challenges

Changes in corporate structures, financial innovation, shifts in the corporate asset base and the ongoing process of globalization all present new challenges to achieving and maintaining good corporate governance. Recent high profile cases of governance failure and corporate misconduct - where the public has lost billions in investment and savings while insiders appear to have benefited - have shown that corporate governance mechanisms sometimes have not kept up with market developments. Also, various conflicts of interest and situations in which rules can be exploited require attention. The result has been an undermining of investor and public confidence in our markets and institutions. We need to develop governance tools and incentive structures that are more robust in the face of rapid changes in the markets and financial innovation.

To be a little more specific, I will present very briefly several key corporate governance issues that I believe have a bearing on the integrity and stability of financial markets.

1. *We need to develop a global consensus on the key prerequisites for a fair presentation of the company in order to limit present inconsistencies and confusion.*

Inconsistencies begin at the most basic level of rules for properly accounting for and disclosing financial transactions. There are discrepancies within as well as between accounting standards. Inconsistencies and controversy also exist at the measurement level of financial disclosure. Accounting and disclosure practices should address the possibility of misuse of special purpose entities in ways that can mis-state the financial situation of a company. Another timely example is the proper disclosure and fair valuation of employee stock options, which do not represent a cash flow of the company but nevertheless dilute earnings for other shareholders.

This example also illustrates how disclosure, measurement and incentives can be inter-related. When stock options became popular, they made good economic sense for a company. An employee could be hired at a relatively low cash compensation that was affordable to a young but growing company. That employee would be rewarded with stock options if that company stock grew in value. Hence shareholders were also rewarded – indeed, the interests of management, the employee and shareholders appear to be aligned. Problems of diverging interests may well arise, however, when the options and their specific conditions for exercise are not fully disclosed to shareholders and potential investors. Such a lack of transparency has proven to be conducive in some cases to manipulation of the stock's value through earnings management. In addition, the real costs of the stock options and the effects on the value of the firm are not known by investors.

I believe that it is critical that efforts to promote a convergence of standards - notably, a convergence in the IAS and US GAAP - be pursued with determination. In international discussions, for example, in the Financial Stability Forum and in the OECD, there has been strong support expressed for a move towards principles-based accounting standards – as opposed to rules-based standards. Such a move would both reduce efforts to exploit – to engineer around – existing rules-based standards and facilitate eventual convergence.

2. *There is a need for improved governance and regulation of the financial disclosure process, particularly external auditing.*

The independent audit of the company and the required disclosures to the regulatory agencies constitute the backbone of effective capital market regulation. And the standards of financial disclosure, typically issued by an independent body, are the tools used for such a disclosure process. Developments in the 90's have illuminated some areas of weakness in this system. The rules governing financial transactions have in some cases failed to keep up with the complexity of corporate transactions. Concerns have been expressed about both the breadth and timeliness of disclosure and, more generally, about whether the incentives of external auditors are properly aligned with the interests of boards and shareholders. Recent events have sounded a wakeup call, underlining the need for an accelerated effort to provide improved guidance.

It is highly important that the credibility of external audits be maintained. Yet, independent auditors have, on commercial grounds, been tending to enter into activities that risked compromising the objectivity that the shareholders and the investing public require and expect. Such questions have arisen where there are simultaneous external and internal auditing relationships and/or a co-mingling of consulting and auditing. While some jurisdictions have few barriers in this respect, others are considerably more restrictive, limiting the activities of the auditor with regulation or recommendations. There is an ongoing international debate as to which system is superior. Perhaps a balanced approach that attempts to combine the best elements of both approaches should be considered, with the objective of assuring that auditors' incentives are aligned with the interests of investors and other users of the accounts.

The current discussion on the proper role of government oversight of the audit profession also calls for a balanced response. Recent events have led many to argue that the traditional concept of relying solely on "self-regulation" of the audit profession needs some serious review, that a lack of greater regulatory vigilance could perpetuate a lack of investor confidence. But the other extreme of relying fully on government control of the profession could well have stifling consequences for the development of the profession.

3. *The integrity and accountability of the Board*

It is in the interest of the company for the Board of Directors to assume primary responsibility for the management of risk as the company and its investors are the parties that are the most interested in the success and growth of share value. Since the company and its owners have the most to lose, they should have the greatest interest in the protection of their assets. The welfare of the employees of the company and the integrity of their pensions constitutes another major responsibility of the Board. One implication of this is that companies should do everything possible to ensure the integrity of their management and board. Knowledgeable and independent board members who understand their fiduciary responsibilities are critical to the markets and the individual company. The board position of a listed company is more than a token role to reward favors. Integrity and objectivity are absolutely essential.

This all sounds pretty obvious, but there have been striking examples where these standards have not been met. Tougher legal accountablity standards for board members, as has been proposed by President Bush in the United States, appear to go in the right direction.

4. *Governance of and by institutional investors*

As more companies become large and multinational with widely dispersed ownership, the typical individual investor must either accept the actions of the corporation or choose to sell their ownership interest in the company. The investor can, of course, attend shareholders meetings and participate in shareholder votes. But in most cases the investor will conclude that it is not financially practical to challenge the actions of management. Often, only institutional investors will be of sufficient size and influence to be able to hold the large corporation accountable - outside of the legal recourses of the government. Institutional investors, therefore, provide an important opportunity for improved accountability. Increasingly they are recognizing their responsibility to their clients to carry out oversight of the corporate governance procedures followed by the firms whose shares they own. Indeed, in some cases institutional investors are required by law to play a pro-active role. However, their position also creates the potential for abuse of this influence. This suggests that we also have to examine the governance structures and incentives of institutional investors themselves, their objectivity and fair dealings within the system if investor confidence in the integrity of the markets is to be restored and maintained.

Concluding Remarks

In closing, I would like to underline that good corporate governance is essential to economic stability and growth in developed and developing economies. In their meeting last week, the OECD Ministers called upon our Organization to strengthen its efforts both within the OECD area and – in partnership with the World Bank – in other countries around the globe to promote the development of sound corporate governance systems and practices. Considerable progress has been achieved. Fortunately, our economies and the global financial system have proven impressively resilient to recent shocks, including the spate of large corporate failures.

Yet, as we have seen, there are also signs that developments such as increased internationalization and financial innovation, leading to the emergence of new corporate structures and more complex transactions, have sometimes outpaced the development of corporate governance systems and practices – even in the most advanced economies. In an ever-changing world, this is nothing new – financial policy – makers, supervisors and regulators are always trying to catch up with the evolution of markets. But it is, nevertheless, a reminder of the important role being played by IOSCO and other international organizations, such as my own, involved in this work.

Thank you.