

Research Notes: Regulatory or Non-Regulatory Corporate Governance: A Dilemma Between Statute and Codes of Best Practice

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CORPORATE GOVERNANCE IS AT THE CENTRE OF MY RESEARCH AND, MORE specifically, the regulation of corporate governance on both sides of the Atlantic (USA and EU). My main research question concerns the future of corporate governance regulation in Europe, following the wave of high-publicity scandals and the introduction of Sarbanes-Oxley Act (known as SoX) in the USA.¹

Corporate Governance has been a favourite and much discussed topic in business conversations during the last 10 years. A widely used definition, which has successfully stood the test of time, is that 'corporate governance is usually understood as the system by which companies are directed and controlled'.² To be a bit more analytical, the corporate governance structure specifies 'the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs'.³

With these definitions in mind, the question which needs to be addressed is, 'how all of these objectives will be achieved?' and, more specifically, 'who will regulate the conduct of all the actors in the game of corporate governance?'

Self-regulation

The first approach that was adopted is self-regulation. It is inspired by a broad-minded trend for economic liberalism and profit maximization, which emerged in the vast majority of developed countries, mainly in Europe, during the last part of the 20th century. The creation of a self-regulated market environment was based on codes of conduct, codes of best practice, governance guidelines and reports. Such codes and

¹ Also known as the Public Company Accounting Reform and Investor Protection Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted 2002-07-30) The full text is available at:

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf.

² Report of the Committee on the Financial Aspects of Corporate Governance-Cadbury Code (December 1992), section 2.5. Available at: <http://www.cg.org.cn/theory/zlyz/cadbury.pdf>.

³ Available at: <http://www.usoecd.org/us-mission-oecd-corporate-governance.html>.

This article has been written by a student participant of the 'Legal Research Methodologies in European Union and International Law' workshop series as detailed in the three Research Notes articles by Hervey *et al.* (2007, 2008a & 2008b). The article introduces the student's PhD project and details some of the methodological research issues which the AHRC funded workshops have helped the student to address.

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guidelines were basically a set of best practice recommendations regarding the behaviour and structure of a company. The aforementioned rules of conduct were non-binding, as compliance was purely voluntary, not mandated by law and were accompanied by a 'comply or explain' safety valve. 'Comply or explain' basically indicates a requirement for obligatory disclosure of the level of compliance. According to this theory, all the necessary sanctions will be imposed by the market itself (market discipline). The self-regulatory corporate environment looked as if it was the perfect solution. Certainly, it was not a faultless system, but it was a modern, ambitious approach for the 21st century. It was the most liberal version of regulation after complete deregulation.

Regulatory Shift

In 2001 something unexpected happened and the ideal corporate environment was destroyed on 16 October 2001. This is the date of the Enron scandal, the so-called 'point zero'.⁴ This suddenly precipitated a chain reaction of scandals, which shook the ground underneath the feet of the perceived powerful economic empire of the United States of America. The following domino effect of other company collapses, scandals, and investigations indelibly marked the corporate map of the world. WorldCom, Sunbeam, Waste Management, Xerox, Qwest, Global Crossing, Tyco, Adelphia, Parmalat, and Ahold are only some of the names that have monopolized the headlines of the newspapers.

Following these unforeseen developments, it became obvious that the self-regulatory framework was not sufficient enough to protect companies, investors and employees. In the USA, there was a general feeling of failure. The media played a significant role in the creation and the endorsement of such an atmosphere and there was an expectation that the government and the President would solve the problem and declare the episode 'a bad dream'. In Europe, the scandals did not receive as much attention and did not have the same impact. European countries did not feel any threat and there were no voices crying for immediate changes and reforms. The post-scandals era found the USA and Europe in diametrically different positions. Circumstances were clearly dissimilar and that was reflected by their response to the scandals. The USA converted the state of panic into a crusade to restore investors' confidence against fraud. The EU, by contrast, after a period of silence, started to organize its defence against future corporate scandals, preferring not to make crucial decisions under pressure. In simple technical terms, there is the SoX, on one hand, and the more modest European initiatives, such as the Action Plan, on the other hand.

Sarbanes-Oxley Act

The Public Company Accounting Reform and Investor Protection Act of 2002 represents 'the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt in the 1930s'. This new legislation is wide-ranging. It established new and enhanced standards for all U.S. public companies and accounting firms and it embodies the government's efforts to improve corporate disclosure and reporting, to protect investors and enhance their confidence and to increase the transparency and accuracy of financial statements. The agreement among the academic community is still far from unanimous on the evaluation of the Act. The main source of criticism has been the relatively high compliance cost, especially for the

⁴ The Enron scandal was a financial scandal that was revealed in late 2001 in the United States. Enron Corporation, an energy giant, collapsed after it was revealed that Enron and its accounting firm, Arthur Andersen, had used irregular accounting methods. The company filed for bankruptcy on December 2, 2001, after the systematic use of irregular accounting procedures in order to conceal its real financial condition. Since then Enron has become the synonym of corporate fraud and mismanagement.

medium and small-sized companies. Nobody can deny that SoX is indeed a landmark piece of legislation and a decisive step in the right direction, as it provides a strong shield against corporate fraud and mismanagement. It may fall short or it may not be as effective as its creators had in mind, but it has sent an unmistakably clear signal that this should never happen again.

European Response

The first thing to note about the European reaction to the corporate scandals is that it has been quite slow to formulate. The main reason for this period of silence and inactivity was the perception that such situations were not likely to arise in Europe. However, after Parmalat scandal⁵ in 2003 and other European corporate scandals it became apparent that Europe had no immunity and the trauma experienced in the USA could easily cross the Atlantic. At this point, judging from the American experience, a more drastic reaction was expected; perhaps even a Sarbanes-Oxley-like regulatory response. Surprisingly, that never came about and still has not come. The reason is that the European Union has different structures and, thus, is not comparable with the USA. The EU, unlike USA, is not a federal state; it consists of 27 member states, 27 separate countries with varying histories, cultures, traditions, languages and religions. The decision-making process is time-consuming, especially when unexpected events happen and put additional pressure on the Member States.

At the end of 2001, the Commission set up a High Level Group of Company Law Experts to develop an action plan in the area of company law. The Group's recommendations were published in 2003 under the title 'Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward'.⁶ The primary aim of this Action Plan is to protect investors from fraud and malpractice and also to ensure that those who lead companies in Europe behave more responsibly, by increasing transparency and disclosure requirements. The Commission has made it clear that the Action Plan is not set in stone and that it is open to ideas both about what should be done and how action should be taken forward. Keeping the content of the Action Plan under review and ensuring individual measures conform to the Better Regulation are both essential to enhance confidence in EU capital markets.

The Day After Tomorrow

If the US Sarbanes-Oxley Act and the EU Action Plan represent the next day of corporate governance after the black period of scandals, collapses, insecurity and panic, what will or should happen the day after tomorrow? This question, which is my main research question, appears to be more pertinent to the EU since the US has invested so much in SoX.

However, it is extremely difficult to give a definite answer, in the sense that there are new developments almost every day. The EU has undergone a phase of balancing and evaluating the options. Nevertheless, time for action has come. Skepticism can turn against the EU like a boomerang. If, for example, a new scandal is revealed in Europe, it could ruin the existing state of calmness. It would be ideal if there was a pan-European solution, but it is almost impossible to develop a 'one-size-fits-all' solution. Currently, a

⁵ Parmalat is a multinational Italian company, specialized in dairy products and food. At the end of 2003, Parmalat was involved in one of the biggest corporate scandals in history and was declared officially insolvent. Calisto Tanzi, its founder, was charged with money laundering and financial fraud, after the disclosure that there was a 4 billion Euro hole in the company's accounts. The Parmalat scandal has been characterized as the European version of Enron.

⁶ European Commission, 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward', COM (2003) 284 final of 21 May 2003. Available at: http://ec.europa.eu/internal_market/company/docs/modern/governance-consult-responses_en.pdf

combination of harmonizing a few essential rules with closer coordination between national codes seems to be the Commission's choice, given the fact that the creation of a European Corporate Governance Code has been rejected for the time being.⁷

After my presentation in the AHRC Workshop, I was advised to stop the data-gathering element of my research and conclude with an answer that will reflect my findings. That was really helpful, as I realised that a PhD is not a newspaper article to reproduce the news of the day, but a research project that focuses on a contemporary issue and deals with it from a certain perspective. As far as my thesis is concerned, I am not writing about the history of corporate governance, so there is no need to be descriptive. I have chosen a comparative analysis between the American and the European regulatory environment, which will help me identify what is the best regulatory solution for companies worldwide. The AHRC Workshop also came at a good time, because it helped me to familiarise myself with legal theories and we were shown ways to frame our research in a more theoretical context. Personally, I had no background on legal theory, but, in fact, there is a great variety of theories, some of which I at first could not imagine could be linked with legal research (like Marxism or feminism). I was advised to use one specific theory – communicative; or alternatively a combination, such as positivism with law and economics. It has been a fascinating experience to learn of and use legal tools in order to help shape my research questions and I am sure that as I take my research forward the knowledge I have learned from the AHRC workshop will be evident.

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⁷ Final Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, (2002), pg. 72. Available at: http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf