

**International Corporate Governance Network  
Eighth Annual Conference**

**Introductory address  
by  
Prof. Luigi Spaventa**

**Milan, 11 July 2002**

1. It is a pleasure and an honour for me to be asked to address the 8th annual conference of the International Corporate Governance Network, and we are very pleased that Milan has been chosen as the venue for this event. This is a timely moment for this meeting to occur: all what has recently happened, or more precisely all what has come to light, directly or indirectly regards issues of corporate governance. Now is the right time to rally for all those who are convinced that good corporate governance is a public good that benefits markets, companies and investors, and hence economic growth; for those who understand that the greed of few at the expense of many undermines the very foundations of a free-market capitalist economy.

2. Let me at the outset express my wholehearted agreement with two points made by Mr. Clapman in an interview to an Italian financial daily. First, he dubbed as bizarre the view of those who maintain that we are only facing a problem of few rotten apples: the number and size of the rotten apples, he replies, make us think that something has gone very wrong with the system. Second, he warns that the problems that have emerged concern not only the US, but also Europe and that there is no reason for complacency on this side of the ocean. Let me first briefly elaborate on both points.

The cases we have witnessed were not only exceptional manifestations of acute pathology, to use medical terms; they unveiled the existence of fairly widespread physiological disfunctions caused both by the gradual development of a wrong incentive structure and by the inability of conventional regulatory practices to cope with the effects of financial innovation and accounting creativity. The list of wrong incentives is long, and by now well known.

The manager driven by imperial ambitions has a vested interest in promoting a never ending rise in the price of his company's shares, this being the environment in which acquisition binges thrive: not only few or no questions are then asked, but what has been aptly termed acquisition accounting requires the flattering of future profits and hence a rising stock market. There thus develops an incentive not to let disappointing quarterly figures or conservative accounting stand in the way of ambitious projects. We would expect the institutions of corporate governance to check and sanction the managers' excesses. Non-executive directors, members of audit committees, auditors, banks, analysts are all subjects whose job should be in principle precisely that of asking the right questions at the right time and of providing the necessary checks and balances. In principle, but, as it has turned out, not often in fact. Those subjects may all become captive of the all-powerful manager, because the wrong incentives are at work: the independent directors, because they are dependent on the CEOs for their appointment and remuneration; the external auditors for their fat consulting fees; the banks because of the commissions they obtain for inventing and structuring complex financial architectures; the analysts, because they are employees of those banks. In short, there may develop a

convergence of interests between the manager and those who should control his actions. Reforms that do not address the flaws in the incentive structure are bound to be ineffective.

We also ought to recognize that the slow pace of regulation has lagged behind the new reality of sophisticated off-balance sheet arrangements, structured financing methods, valuation of complex contractual transactions. Detailed prescriptions with the ambition of covering all possible cases can only map the existing territory, but not the new one that continuously emerges. Especially in the case of accounting and disclosure rules the substance that can be extracted from more general principles may be preferable to specific rules for each specifically listed case.

**3.** I agree with Mr. Clpaman's second point that there cannot and should not be reasons for complacency and inaction in Europe. It may however be useful to consider some differences.

The first, and perhaps the most important, is to be found in the ownership structure. Diffused ownership, with relatively small shareholders entrusting the running of the company to an independent manager, prevails in the US. Concentrated ownership with one or more controlling shareholders prevails in continental Europe. The recent fashion in the law and economics literature and in some economic literature, driven by the stock market boom of the 1990's, was the superiority, *per se*, of a diffused ownership system: just as an earlier fashion theorized the superiority of German or Japanese-style systems. We should now recognize that both models are liable to produce potentially high agency costs and revert to a more balanced view. In the case of diffused ownership, managerial agency costs prevail, too easily neglected, but of the kind we have seen in all the recent cases: insufficient and inefficient monitoring allows the shareholders' interests to be sacrificed to an unchecked manager's ambitions and projects. This is less likely to happen when a controlling shareholder, being himself interested in the company's security benefits, internalizes the cost of monitoring to the advantage of the minority shareholders. A controlling shareholder, however, has the opportunity of appropriating private benefits by syphoning off the company's revenues and assets to his own advantage: all the more so, the greater the leverage between control rights and security rights (as is the case in the pyramid schemes so frequent in countries like my own). The consequence is that the thrust of ongoing and future initiatives aimed at increasing investor protection - at the legal, administrative and self-regulatory levels - must consider and allow for these differences in other matters: to exemplify, on this side of the ocean greater attention must be paid to conflicts of interest, transactions with related parties and all kinds of insider dealing..

Other relevant differences regard the set of safeguards available to ensure investor protection. One can readily acknowledge that legal means of protection are superior in the US: the access to courts is easier and less costly, judicial initiatives are more penetrating: in a word the known collective action problem facing minority shareholders is certainly lower than elsewhere. It is probably true that this has to do with the merits in this field of common with respect to civil law. Apart from legal remedies, which have however a residual nature, being the last revert, recent events have shown that there are fields of regulation where Europe has not lagged behind the US - being even ahead in some cases. Accounting principles, and especially the IAS, are more general, and as such more have more substance and are more easily adaptable to financial innovation; consolidation rules are tougher under the European directive; in some European jurisdictions regulators have the power to supervise and sanction internal and external auditors; disclosure of price sensitive information is

mandated as a general principle rather than with reference to a lengthy list of cases of specific events; attempts have been made to regulate the analysts' reports and studies.

The US have now shown, once more, an admirably quick capacity of reaction to deal with the problems unveiled by recent events: I am convinced that in a year's time, as a result of the initiatives undertaken by Congress, the administration, the SEC and the exchanges, the American regulatory environment will have profoundly changed, for the better. We shall watch and learn, engaging, I hope, in a race to the top.

4. There is already work in progress which may be of some relevance. After Enron, the IOSCO found that some matters were not adequately dealt with in its "Principles", which represent a useful international benchmark. It thus entrusted an examination of the issues regarding auditors' oversight and their independence to its standing committee 1 and created a task force (which I co-chair with my Hong Kong colleague) to set new principles on disclosure and transparency. This task force will be especially concerned with continuous and periodic information, and in particular with the disclosure that should be provided in the MD&A (very much along the lines defined by recent SEC statements). New or more stringent disclosure principles appear to be required in at least three areas: off-balance sheet arrangements and transactions, typically with special purpose entities, which often entail transfer prices of goods, services and assets below or above their fair value, can be a source of risk undetected by investors, and are not adequately dealt with by either the IDS or IAS24; transactions with related parties, where the definition of related parties should be broadened and the purpose of the transactions and their evaluation with reference to market prices should be clearly assessed; the valuation of contracts and assets in absence of reliable market benchmarks, which requires disclosure of the implicit assumptions underlying highly judgmental estimates and of their sensitivity to changes in the relevant variables. The main purpose of this exercise is to establish disclosure principles that allow shareholders "to see the company through the eyes of the management", to borrow an expression used by chairman Pitt in his submissions to Congress: an opportunity that shareholders were clearly denied in all the cases that have attracted the world's attention recently.

At the European level the Commission has issued a recommendation on auditors, while agreement has been reached on a regulation mandating the adoption of IAS by 2005. In the US the used of the IAS (IFRS) is still not allowed for incoming issuers without full reconciliation with the US Gaap, notwithstanding earlier agreements at the international level, and this creates problems with Europe. The IAS Board's intention to provide rules for expensing share options risks being another contentious issue (at least as things now stand) with the American standard setters. The Commission, following Enron and similar cases, has asked a committee of company law experts to identify the areas where reform is more urgent. The newly set up Committee of European securities regulators (an institutional metamorphosis of the pre-existing FESCO) is also working on post-Enron problems.

5. Let me finally come to Italy.

The legal protection of shareholders has been greatly improved by the innovations introduced by the 1998 reform law. Previously, a widely used (but highly questionable in my view) index of protection in terms of anti-director rights would give Italy the unflattering mark of one out of six. A

number of provisions introduced by the 1998 law, such as those regarding the quorums required for calling shareholders' meetings, for lodging complaints with the board of auditors and with the courts, for undertaking liability actions and for the adoption of some decisions, have raised Italy's mark to a more satisfactory level of five.

Though legal remedies are adequate and may represent an important deterrent, in fact they have been used very rarely, if at all, by minority shareholders. This is not very surprising, considering the cost and length of judicial procedures. The voice of minority shareholders has been relatively weak: the high degree of concentration of ownership and control (in 60 percent of listed companies one shareholder has the absolute majority; the average holding of the largest shareholder is 42 percent.; in the ten largest listed groups the ratio of control to cash-flow rights is almost 2.5) certainly discourages shareholders' activism and their participation to the company's meetings. This has also been true for institutional investors, at least until recently, when there have been welcome signs of greater activism on their part. This passivity has been the consequence of both, the lack of development of pension funds and the proprietary structure of mutual funds, which almost all belong to banking institutions engaged in complex relationships with listed companies. For this very reason Consob commends the autonomy protocol recently promoted by the mutual fund association.

Disclosure requirements regarding price sensitive and other material information are satisfactory and are consistently enforced by the regulator. A fair disclosure regulation has been in place in Italy for four years. The 1998 law has strengthened the system of controls. Consob supervises, and has the power to sanction, the activities of both the internal and the external auditors, and it has used its powers to challenge annual accounts. Auditing firms are not allowed to provide simultaneously consultancy services, though it must be recognized that they often find ways to get round this prohibition; their three years engagement may not be renewed more than twice.

There are gaps in the existing legislation, which Consob, and more recently Borsa italiana, have tried to fill. The law ignores the existence of analysts. A not so recent Consob regulation introduced the requirement that conflicts of interest be disclosed "in bold letters" and that reports and studies be promptly disseminated to the general public. This is a field however where regulatory arbitrage may encourage a race to the bottom, insofar as big firms established elsewhere in Europe are not subject to the same obligations as Italian firms. As from next October more stringent requirements have been introduced by Consob on the disclosure of transactions with related parties. Borsa Italiana, in its self-regulatory capacity, has introduced rules on the disclosure of directors' dealings in their company's shares. Issuers are often reluctant to accept these innovations: they do not seem to be fully aware yet that, especially after the recent events, lack of transparency is heavily sanctioned by the markets as is shown by the relatively better performance of the shares listed in the STAR segment of the Milan exchange, where more exacting rules of good corporate governance are required..

The Enron syndrome has prompted the Italian government to inquire what changes are needed to improve current legislation. The discipline of analysts and auditors, some rules of periodic and continuous information and the effectiveness of the system of sanctions are obvious candidates for useful revisions.

What we have witnessed recently, almost with disbelief, has been a sobering lesson for all of us, after too many years spent in a bubble, the bright colour of which blinded too many eyes. There is however a silver lining in all this: the political reaction has created a window of opportunity for undertaking the necessary reforms, while the voices of those who oppose them for the sake of their vested interests are mute, at least for the moment. I trust that this occasion will be seized, in Europe no less than in the US, and I am sure that your contribution to achieve this is and will be of paramount importance.