# **Corporate Governance: Separating the Good from the Bad**

By

Jack M. Mintz*

**CHECK AGAINST DELIVERY**

* President and CEO, C. D. Howe Institute and Professor of Taxation, J. L. Rotman School of Management, University of Toronto. Prepared for the session on "Governance and Capitalism", The Canadian Club of Montreal, May 12, 2004.

After *Enronitis*, we have been deluged with new legislation, regulation and debate over corporate governance. The greed that was displayed by some executives has no doubt devastated many investors who saw their wealth evaporate after the dot-com, bubble burst.

However, in our righteous haste to impose a new regime of harsh parsimony and regulation, we run the risk of creating new dangers. We can stifle productivity with a proliferation of ill-considered, if well-intentioned, new rules of governance and corporate regulation.

The pendulum swings both ways. While trying to cure the ills of corporate governance, we are entering a potential world of *Regulatoritis* in which governments and institutions overcompensate by bringing in regulations that can sometimes do more harm than good in markets. The key is to understand what works and what doesn't in a swiftly changing world.

Indeed, a careful study of the performance of U.S. stock markets – from the Dow Jones Industrials to the Nasdaq, the Standard and Poor's 500 and the Wilshire 5000 – indicates that in the past twenty years there has been a significant improvement in governance where managerial interests have been tied more closely to the company's performance. The world isn't perfect. But the fact is that U.S. equity markets outperformed most others in the world, even in the past two years.

We are in grave danger of swamping the system with corporate governance rules in the absence of careful analysis. Several principles of good corporate governance have to be understood before we cripple ourselves with superfluous regulations.

Let's start by simply understanding *why* good corporate governance matters to the health of the economy. If investors trust businesses to deploy their funds wisely, they will invest in those companies; otherwise, they will seek alternate ways to use their money profitably. When trust in a company erodes, the integrity of the market itself can be tarnished, and responsibly run companies may find it harder to raise capital. Overall, there's too much investment by badly managed companies and too little by good ones. Productivity is undermined.

One recent Canadian study by Bob Chirinko of Emory University and Huntley Schaller of Carleton University estimate that Canadian businesses in which managerial interests are not aligned with those of shareholders over-invest in capital by as much as 7-to-22 percent. Over-investment is as bad as under-investment in capital – both result in too little profit, poor productivity and lower incomes for Canadians. What the study did not estimate is the impact of bad behaviour on the well-behaved companies. Good firms, facing wary investors, may find it too costly to raise capital in the markets.

So, good governance *does* affect the economy. Having said that, the truly great challenge is in achieving good governance itself. Can market institutions themselves sort out issues, or is the heavy hand of government and other forms of intervention needed to ensure that good governance is practiced?

The economics of information helps sort out this issue for us. Without government intervention, well-behaved, publicly traded businesses will adopt policies that signal their quality to investors. Too often, however, those investors don't have sufficient information to sort out good signals from bad. For signals to work, it is important that badly managed businesses find it too costly to copy the signals sent by healthy companies.

So what are the signals that investors should look for and interpret? Dividend policy is a good one to start with. Well-managed companies are in a better position to pay dividends than badly run businesses. Another signal is the alignment of managerial compensation with profitability, reflecting both gains and losses. Bad managers are reluctant to have their personal wealth tied too closely to the performance of their business.

A third signal is transparency in financial affairs – weak companies mask their dealings with complicated transactions and opaque reporting that even the Board would fail to understand.

Some signals won't work at all. While separating the chairman of the board and CEO positions might make good practice, a poorly run company can easily copy that practice. The separation of the top positions will convey little information to investors about how well a business will perform. Having a majority of independent outside directors on the board, if manipulated by management, would not serve as a signal of good governance either. Inside directors have more information about the business and, so long as their personal wealth is tied to the performance of the firm, they would be more effective directors. In fact, many indicators of good governance, as used in the *Globe and Mail* ranking, for example, would suggest that Enron was well managed.

In the real world, the only signals that can work are those that are difficult for the bad to copy.

One well known point understood by economists since the 1930s is that the performance of closely held companies differs from those that are widely held. Some firms that are majority-owned by an individual, or small group of investors, often perform better than other firms, although we cannot necessarily forecast this result. Shareholders who have control have more information about the business and can ensure that management operates in the interest of the owner. Because a full 50 percent of large businesses in Canada are closely-held – compared with only 15 percent in the United States – it should be evident that governance issues are quite different here.

So is there a role for governments to improve the efficiency of markets? The answer is "Yes, but."

First, it's important to separate bad from good regulations. Even when well-governed businesses can separate themselves from the bad, a fundamental inefficiency remains:

well-run businesses will still invest in too little capital as a result of the information cost of raising capital in markets where bad practices have made investors wary. Governments, through regulations, can reduce these information costs by making it more difficult for poorly run companies to copy the good ones – and in the process, lift the returns for the whole market.

So what are the types of regulations that work? Two particular examples come to mind.

One is the requirement for transparency of reporting in quarterly and annual reports, prospectuses and other communications to investors. That information helps investors determine better the success of enterprises in raising capital from markets and makes it more difficult for poorly managed companies to manipulate earnings to look like those of good firms. Normally, companies that report earnings under GAAP accounting rules are likely to be more transparent and open to more rigorous scrutiny than those that report only “pro-forma” results.

Another requirement is the vigorous prosecution and punishment of managers participating in criminal fraud. Fraud undermines trust in the markets. Open prosecutions of criminal malfeasance will make it more difficult for bad firms to copy the good ones.

Are there some regulations that don’t work well? Well, we’ll have to see the outcome of Sorbanes-Oxley Act in the United States, though I would suggest that some regulations will take us backward rather than forward in improving the performance of capital markets.

For example, take the abolition of loans to executives. If managerial interests are to be aligned with shareholder interests, it is important that managers experience the downside, as well as the upside, of the business. Executive compensation in the form of stock options and profit-based bonuses cannot be linked to business losses since it would require compensation to be reduced, not just increased. Loans to executives provide an opportunity for a business to go after the personal wealth of managers should they directly contribute to a failing business. Shareholders are better protected if managerial wealth is tied more closely with the company. The objection to executive loans was the forgiveness provided by boards when the business did sink. Like huge separation payments to failing managers, the forgiveness of loans is inappropriate behaviour by board compensation committees.

A better approach than the abolition of executive loans to managers would have been transparency. A company should seek approval of its policy on separation pay and loan forgiveness from shareholders before those policies are implemented. The loans could be held with banks. That could limit the abuses that become apparent when bad management is rewarded with high salaries or forgiveness of loans.

The final question is who controls the regulators, some of whom are excellent and some whom, as Disraeli once said of Gladstone, “have not a single redeeming defect.”?

While governments are often well intentioned in their policies, we know that public decision-making itself depends on good governance. Regulators in a monopoly position can make harmful decisions without fear of retribution if those decisions turn out to have been ill considered. I leave this thought with you. One way in controlling bad governance among regulators is to encourage competition among them. Perhaps there is a role for international and inter-provincial competition among regulators to make sure their decision-making policies are sound...

Canadians should understand that while there is scope for improvement, our corporate sector has, in fact, performed relatively well. It is important that any cure offered for bad governance should be carefully analyzed before we unleash a landslide of governance indicators and regulations. Otherwise, the cure can be far worse than the disease. It's a matter of degree.