How Shareholder Reforms Can Pay Foreign Policy Dividends

James Shinn
Peter Gourevitch

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CONTENTS

FOREWORD

Corporate governance is not a traditional foreign policy topic. It is usually viewed more as an aspect of domestic politics, and of "low politics" at that, far removed from weightier security issues and remote from the traditional international economic agenda of trade and finance.

However, corporate governance is now receiving increasing attention in the media, in business, among investors, and among policy makers. It is no longer an obscure issue of concern to a narrow band of specialists, but a problem with broad areas of policy relevance.

The federal and state governments are currently debating several legislative proposals to "fix" our system of stockholder-manager relationships.

Yet the foreign policy implications of corporate governance are not widely appreciated by those debating the legislation. In this paper, James Shinn and Peter Gourevitch explore ways in which shareholder protections, at home and abroad, can affect vital U.S. interests. They demonstrate that corporate governance lies at the core of many trade disputes, though not usually recognized as such, and that it has implications for global financial stability. Governance failures are connected with corruption and money-laundering. And corporate governance practices abroad can affect, and possibly undermine, the unique securities regulatory approach at home, with its relatively light hand and extensive reliance on reputational intermediaries.

Despite its promise of paying foreign policy dividends, corporate governance reform is a controversial issue. There are strong lobbies on all sides. There is much intellectual disagreement. And governments themselves often have different stakes in the outcome of the corporate governance debate. As we pick our way through this complexity and controversy, Shinn and Gourevitch provide us with a way of structuring the debate and clarifying the goals.

They analyze the implications of corporate governance issues for foreign policy and propose a number of reforms, from an international agreement on corporate governance standards and accounting rules to changes in the laws governing hostile takeovers and international financial supervision. This paper, *How Shareholder Reforms Can Pay Foreign Policy Dividends*, is one of the first explorations of the corporate governance–foreign policy nexus. It will not be the last.

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From September 2001 through April 2002, well before the Enron debacle, the Council on Foreign Relations conducted a Roundtable on Corporate Governance in order to probe the connections between corporate governance and U.S. foreign policy. A talented group of money managers, securities professionals, economists, and regulators brought their collective wisdom to bear on the topic. This study reflects solely the opinions of the authors and does not necessarily represent those of any participants in the Roundtable.

The authors are grateful to the participants for their gift of time and expertise to the Roundtable's meetings, off-line contributions, and critical comments on this study. The authors are grateful to critical comments from Caroline Atkinson, John Biggs, Patrick Bolton, Carolyn Brancato, Peter Clapman, Andrew Clearfield, Stephen Davis, Stephen Deane, Stephen Friedman, Holly Gregory, Jon Hartzell, Barton Hill, Andrew Kim, Roger M. Kubarych, Sophie L'Helias, Peter Johnston, John Langlois, Bevis Longstreth, Jon Lukomnik, David Luna, David Martin, Barry Metzger, Ira Millstein, Nell Minow, Robert Monks, Roberto Newell, Hugh Patrick, Robert Pozen, Linda Quinn, Ailsa Roell, James Silkenat, Anne Simpson, Benn Steil, David Tweedie, Michael Useem, Michael Weinstein, and Guy Wyser-Pratte. We thank Robert Knake for his research and editing assistance. A full list of Roundtable participants can be found on the Council on Foreign Relations website (www.cfr.org).

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EXECUTIVE SUMMARY

Corporate governance—the rules that govern the relationship between managers and shareholders—belongs on the foreign policy agenda of American decision-makers. The vigorous debates underway about corporate governance, both at home and abroad, present an opportunity for the United States to advance its foreign policy goals of enhancing free trade and financial stability.

International capital flows are creating incentives for countries to adopt greater shareholder protections, or "corporate governance reforms." When adopted, these protections reorient the priorities of both industrial firms and banks in ways that can defuse many trade disputes and reduce the likelihood of destabilizing financial meltdowns. Corporate governance reforms abroad can also buffer the U.S. domestic securities regulatory model from some contagion risks caused by tighter integration with foreign capital markets.

Our claims regarding the foreign policy dividends of shareholder protections are modest: corporate governance reform is no panacea. It will not solve all trade disputes or eliminate the risk of all bank meltdowns. Moreover, the so-called Anglo-American shareholder model is not necessarily superior to the so-called stakeholder model at all times for all countries. The other models have strong supporters, and pressures to change them may provoke antagonism. And the principal merits of the shareholder model stem from its reliance on free markets rather than on bureaucratic intervention; the U.S. government can promote such reforms only so much before doing more ill than good.

We argue, however, that it makes sense for Washington to become engaged in promoting corporate governance reforms at the international level. The costs of this engagement are relatively modest and the gains are significant. Reforms abroad are linked to reforms at home. Insofar as the United States can improve its own governance rules with reference to a global "best practice," the gains from supporting broad-based corporate governance reform are even more attractive.

Corporate governance is not usually thought of as a major public policy issue; indeed, the public does not usually care about corporate governance at all. Enron, Arthur Andersen, and related scandals have ended that tendency. Americans have learned that the economy is powerfully affected by the rules that shape the way firms are run.

This is therefore an opportune moment to discuss the direction of corporate governance policy in the United States and its connection to foreign policy. The United States is now in one of those ten-year cycles in which financial regulations, including corporate governance, are undergoing close scrutiny and will likely face legislative change. Congress is currently considering 40 separate bills that deal with one or another aspect of corporate governance—ranging from the Senate's *Investor Protection Act of 2002* (S.1933.IS) to the House's *Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002* (H.R.3763.IH)—the effects of which will be felt at home and abroad. The laws that ultimately emerge from Congress will shape the contours of international corporate governance for years to come; it thus makes sense to consider how these decisions will affect U.S. foreign policy before the legislation is finalized.

In debates around the world over reform of governance practices, enhanced shareholder protections are central. It is this element of change that deserves the attention of foreign policy decision-makers. Improving corporate governance practices by means of enhanced shareholder protections has four distinct foreign policy advantages. First, such improvements will, over time, clear many contentious disputes from the agenda of international trade negotiations, reducing the political fallout from these often high-profile disputes and freeing up negotiators to tackle other complex issues. Second, they will enhance financial stability and reduce the need for the United States (the government as well as private banks) to get involved in expensive and unpopular bailouts. Third, corporate governance reforms will buttress the legitimacy of free-market capitalism at a time when it is under political siege, especially in emerging markets. And finally, they will preserve the merits of the "light-handed" method of securities regulation in the United States even as U.S. financial markets and services firms become increasingly integrated with foreign economies that have corporate governance practices that are often radically different from our own.

This study proposes seven policy recommendations to accelerate the pace of corporate governance reforms at home and abroad in order for the United States to reap the foreign policy gains in these four areas. These policies consist of the following:

1) The U.S. government should expand its support for the Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance and use them as the basis for developing a global "gold standard" of shareholder protections, in conjunction with enhanced standards of governance disclosure and streamlined shareholder voting procedures.

2) The U.S. Securities and Exchange Commission (SEC) should encourage Generally Accepted Accounting Principles (GAAP) to converge with International Accounting Standards (IAS) on a higher standard of accounting and audit rigor. The SEC should also explore alternatives to remedy some of the potential conflicts of interest faced by securities professionals and other "reputational intermediaries" in global capital markets.

3) The United States should openly endorse regulatory changes at home and abroad that promote contests for control of publicly traded firms, making common cause with the attempt by the European Commission (EC) to create a more competitive, pan-European takeover code.

4) U.S. government agencies with oversight for institutional investors should require fuller disclosure of these investors' corporate governance policies and proxy voting records, while pressing for sustained liberalization of pension fund and money-management services through the market-access negotiations of the World Trade Organization (WTO).

5) The U.S. Treasury Department and Federal Reserve Bank should engage with foreign prudential regulators to develop corporate governance standards for global financial institutions akin to the Bank of International Settlements (BIS) bank capital adequacy guidelines.

6) U.S. private-sector firms should support the creation and dissemination of objective, third-party corporate governance indices.

7) The U.S. government should place responsibility for coordinating corporate governance policies at a suitably senior level in Washington.

Corporate governance reform will be difficult: vested interests on all sides, in the United States and overseas, will resist or deflect change. There is a real challenge to define a public good that helps both the United States and the international community. Corporate governance reform is not a technical area best left to the specialists. It is a general policy problem that, like taxes, interest rates, and tariffs, deserves broader attention in a foreign policy context.

INTRODUCTION

It is an ancient truth in foreign policy that war is too important to be left to the generals. By the same token, corporate governance is too important to be left to the accountants, lawyers, and investment bankers.[1] Of course, this paper does not suggest that corporate governance is on a par with vital matters of national security—it is "low politics," a matter of trade and finance. But corporate governance is an important element in the trade and financial negotiations that are increasingly prominent in the conduct of foreign policy. It is also an area where the economic predominance of the United States and the relative attractiveness of U.S. regulatory procedures tend to spread without any outside impetus, through private markets. This fact presents the United States with an opportunity to set the rules of the game in the global economic system in ways that advance its strategic agenda.

Corporate governance is not an obvious foreign policy topic. Yet many corporate governance problems escalate into foreign policy problems, including the following examples:

- Contentious negotiations between the South Korean government and potential foreign acquirers of banks, such as Korea First Bank, and industrial firms, such as Daewoo Motors or Hynix—all accompanied by violent labor protests;
- Disputes within the European Union (EU) as state-controlled utilities, such as Electricité de France, acquire foreign utilities while remaining immune to takeovers themselves;
- Sharp exchanges between U.S. and Japanese government officials (and private-sector rating agencies) regarding the alleged

[1] The classic statement of the American system and of the implications of separating management and control is Adolph Berle and G.C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

corporate governance failures and looming debt problems of Japanese commercial banks;

- Struggles in Russia between the Vladimir Putin government and private "oligarchs"—over the heads of foreign shareholders—for control of partially privatized energy and media firms, such as Lukoil and Russian Telecommunications Network (RTN);
- Disputes over the global steel trade—which forces some firms to reduce capacity and lay off workers in reaction to market pressures—as charges of dumping and government subsidy fly back and forth between the United States, the EC, and Asian trading partners.

The common thread that runs through these anecdotes is the central question of corporate governance priorities: Who does the firm serve? This brings up the related question of who comes first when both gains and losses are being apportioned—the employees, the managers, the government, or the shareholders. And the shareholders themselves comprise different interest groups: the majority shareholders (often families and sometimes the state), the many minority shareholders at large, and even the "faceless" foreign portfolio investors.

When removed from the context of global governance reform, the disputes behind these headlines are dismissed as "low politics," relegated to the business pages rather than the front page, and resolved—if they are ever resolved—on an ad hoc basis with no strategic guidance. Going to the other extreme, treating these disputes as strictly foreign problems, isolated from similar domestic governance disputes, ignores the fact that the U.S. economy is now closely linked with many foreign economies, bringing diverse corporate governance regimes into collision. When the rules collide, and money or jobs are at stake, the contending parties are quick to drag governments into the dispute. Once politicians rather than markets start making the decisions, the outcomes are rarely efficient, and often messy.

As a result, for better or for worse, corporate governance reforms are on the policy agenda in the United States and many countries around the world, and they remain a central point of contention within regional organizations such as the EU. Moreover, governance reforms abroad are substantially (although not exclusively) shaped by Washington's regulatory and judicial guidelines, given the prominent role in world markets of U.S. financial intermediaries and global corporations.

This pervasive U.S. influence means that governance reforms abroad are inextricably linked with governance reforms at home. We therefore conclude that the issue is not the global spread of an Anglo-American governance model perfected in the United States and the United Kingdom. Rather, the crucial question is which governance changes at home and abroad could be useful to the goals of U.S. foreign policy noted at the beginning of this paper: free trade, international financial stability, control of corruption and money laundering, and protecting the American system of corporate governance regulation.

The United States is no consistent paragon of corporate governance. Recent scandals at Cendant, Waste Management, Global Crossing, and Enron; shortcomings of GAAP; and abuses of executive compensation have made that clear.[2] Improved shareholder protections, at home and abroad, can benefit the United States *as well as* its foreign partners, and such reforms lend considerable momentum to important U.S. foreign policy objectives. Governance reforms matter for U.S. strategy on trade, international financial stability, corruption and money laundering, and—surprisingly—the sustainability of the method of capital-market regulation in the United States itself. Governance issues often lie buried inside trade disputes and are a proximate cause of many

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[2] Compared to the system in the United Kingdom, American shareholder rights are relatively weak: for example, it takes only 10 percent of shareholders in U.K. firms to call an emergency general meeting at which the directors can be replaced by a majority vote, whereas it is much more difficult for this to take place in the United States. There is some evidence that U.S. standards of corporate governance declined from the mid-1980s through the 1990s. Public firms took more steps to adopt "classified" boards (making them harder to replace), dual classes of stock, anti-takeover poison pills, and tighter limits on shareholder rights to call special meetings or place other provisions on proxy statements. Virginia Rosenbaum, "Summary of Corporate Governance Provisions," in *Corporate Takeover Defenses* (DC: Investor Responsibility Research Center, 1998): viii.

financial crises. Thus, corporate governance reforms can help reduce or even eliminate both trade disputes and financial crises. Most important, the "neoliberal" regulatory approach (using a light official hand and delegating much authority to private actors and private law enforcement) is in jeopardy from the increasingly deep integration between U.S. capital markets and foreign capital markets with different corporate governance practices.

This study is presented in four sections. The first section outlines the politics of corporate governance, summarizing the case of the reformers and the riposte of those who object. In the second section, we explore the wave of portfolio equity investment that precipitated many governance reforms, define the terms used in the corporate governance debate, and describe the surprisingly pivotal role of governments, rather than privately owned firms, in responding to these demands by foreign investors. The third section examines the impact of governance reforms on four key areas of U.S. foreign policy. The final section summarizes a short list of recommendations stemming from our analysis.

This study represents an initial step in a broader research program exploring the nexus between corporate governance changes and foreign policy. Incorporating the foreign policy variable into the governance equation adds greater complexity to an already tangled debate, since corporate governance sits uneasily between economics, politics, and the law. Moreover, all three fields have produced an explosion of corporate governance literature over the past few years. Many of the points raised by this study are matters of fierce debate among scholars, and they remain unresolved as objects of empirical research. We therefore emphasize that this study is not the last word on the connection between corporate governance and foreign policy; it is merely one of the first.

THE POLITICS OF CORPORATE GOVERNANCE REFORM

Free trade, financial stability, transparency, and neoliberal regulation create a global economic environment in which the U.S. economy thrives and U.S. security interests are enhanced. Americans can assert the general global benefits of the neoliberal model of corporate governance, but they must acknowledge that the universality claim will be challenged. Skeptics abroad will argue that the U.S. interest in governance reforms stems mainly from its status as an international creditor, in sharp contrast to the overall net debtor position of the United States: U.S. investors now hold $1.5 trillion in foreign equities, overwhelmingly as minority shareholders, and thus have a big stake in how these foreign firms are run.[3] Others may notice that widespread adoption of the Anglo-American model of governance may promote a game that American (and British) firms know how to play best, at least for a while. Yet another group of naysayers will insist that changing rules of corporate governance merely benefit the earnings of New York- and London-based financial-services firms, which dominate most international securities markets.

These objections do not mean that global governance reform is a bad idea. But they do highlight that coordinating international approaches to governance may have to be sold carefully. In this sense, this study's approach of linking reform at home and abroad not only enhances the efficiency benefits of good governance but also makes reform more palatable to America's trading and financial partners overseas.

Conventional wisdom assumes that corporate governance reforms along the lines of Anglo-American shareholder protections

[3] Market value of foreign equities held by U.S. residents, including American Depository Receipts (ADRs), as of Q4 2001. "Federal Reserve Statistics Release Z.1: Flow of Funds Accounts of the United States," 67. Historical data available at www.federalreserve.gov/releases/Z1/Current.

are taking the world by storm.[4] In this view, institutional investors offer a price premium for shares in firms that voluntarily improve their corporate governance practices.

Instead, however, careful scrutiny of corporate governance abroad suggests that foreign markets have adopted governance reforms that protect shareholder interests rather selectively, often with more rhetoric than actual enforcement, and with wide variation among countries. There has been some progress in accounting and disclosure, as well as wider use (as well as some abuse) of executive stock options; but independent board oversight has not been widely embraced, and hostile takeovers have been downright rejected. Moreover, it is governments rather than private majority shareholders that have pushed through these selective changes—again contrary to the conventional wisdom. Notably, these "reforms" have almost always halted well short of the point where state or private control is replaced by the discipline of public markets.

Financial regulation in the United States and abroad usually changes after a substantial scandal exposes weaknesses and creates the political weight to offset the inner circle of specialized interest groups. Alternatively, change can also come as a series of periodic adjustments to make regulations catch up to evolving market realities and practices. Both types of regulatory change are now taking place simultaneously in the United States and abroad—a very complicated picture.

In Washington, New York, and financial capitals abroad, the traditional inner circle of specialized actors—the cognoscenti of accounting practices and financial engineering—has been joined in the governance debate by other groups with big economic interests at stake—some encouraging reform, others objecting strongly, and all invoking the shareholder versus stakeholder debate in their attempt to control the discourse of reform.

The side supporting governance reforms includes a mixed coalition of groups motivated by economic interest, philosophical

[4] See, for example, Henry Hansmann and Reinier Kraakman, "The End of History for Corporate Law," draft presented at the Tilburg University Conference on Convergence and Diversity in Corporate Governance Regimes and Capital Markets, Eindhoven, The Netherlands, November 4–5, 1999.

preference, and political objectives. The small shareholder, a growing bloc in society if one includes pension funds, is interested in protecting its position from manipulation by insiders or large investors operating outside direct market transactions, as did the partnerships formed by Enron. The aging population, across all social categories, worries about pension funds and retirement savings. Labor union leaders will seek to defend the savings of their members in corporate plans. Professionals have important pension plans with an interest in reform—TIAA/CREF is a notable example. Public employee pension funds such as CalPERS are another stakeholder. Senior citizens groups such as the American Association of Retired Persons (AARP) are another possible group with a reform interest.

Business and professional groups in the financial sector and reputational intermediaries sector (accounting, investment banking, securities law, bond rating, and stock analysis) also have an interest in reforms—or at least claim to. Yet there are important divisions of opinion within these groups. Some will seek to defend their autonomy and existing practices; having lobbied hard for loose regulations, they will not be happy to see stricter regimes return. Others prefer to restore credibility and honor to their professions and practices. They take seriously their obligations to their principles and conclude that "better housekeeping is in order." Enlightened self-interest will induce them to prefer a system with clear rules, an "honest" capitalism, to one that allows loose standards of correct behavior.

The reformers are opposed by three distinct groups and arguments; each of them, like the reformers, comprises a complex coalition of interests, views, and political objectives.

First, a group of free-market skeptics, including Washington insiders and some New York– and London-based financial professionals with a stake in the status quo, view any U.S. government attempt to improve corporate governance with suspicion. In their view, corporate governance is basically a private contracting matter between investors and firms. They say, let the markets sort this out. If the Anglo-American model spreads because of superior performance, fine. Indeed, they argue, the Anglo-American model is attractive precisely because the state is not involved. Any perception that convergence is being driven by Washington rather than markets will only raise the hackles of foreign governments, citizens, and interest groups.

These skeptics agree with the reform activists on the desirability, as a matter of principle, of a level playing field, reduced moral hazard, and the transmission of neoliberal values, but they object to policy intervention on practical grounds. Pushing the convergence line, they argue, will provoke conflict with U.S. allies that do not wish to move so far so fast. Moreover, putting governance matters on the official agenda adds another irritant to delicate security and trade negotiations. Corporate governance practices are deeply rooted in each country's legal and political institutions. The free-marketers thus warn that having outsiders (especially Americans) call for change can provoke a backlash against the United States in particular and against financial globalization in general.

Some skeptics' objection to official involvement in governance reform arises from narrow self-interest. One particularly vocal pressure group is a loose coalition of high-technology firms, which objects to the rigorous accounting treatment of stock options around which the Financial Accounting Standards Board (FASB) has tiptoed but which the International Accounting Standards Board (IASB) may tackle.

A second school of opposition thinks less in terms of its particular interests and more generally about economic efficiency. Many businesspeople, academic economists and social scientists, journalists, and more than a few European and Asian observers remain unpersuaded about the alleged superiority of the Anglo-American model of corporate governance. They first object to the presumed efficiency of the American shareholder model, pointing to cases like Cendant and Enron as examples of the flaws in U.S. corporate governance practices. These supposed flaws include the "capture" of U.S. boards by management, abuses of incentive pay for senior managers, and negative externalities associated with hostile takeovers (the objectors note in passing that hostile takeovers have become rare as a disciplining device in the United States since the late 1980s).

Moreover, these skeptics insist, the empirical evidence on the economic effects of Anglo-American outsider governance versus continental European or Asian insider governance is inconclusive; the alleged superiority of the Anglo-American model reflects mere U.S. triumphalism of the 1990s. The other models, they argue, have done well in the past and may do well again in the future, suggesting that governance diversity may be a form of comparative advantage along which countries will differentiate themselves.[5]

A third heterogeneous coalition derives its objections to governance reform from a heady brew of nationalism, anti-globalization sentiment, anti-Americanism, and social democracy. This group includes conservative businesspeople defending national autonomy; labor unionists and Christian democrats defending the "social market economy" of social services and unemployment insurance; environmentalists critical of rapid globalization; and anti-Americans who are reflexive critics of the U.S. role in the world economy.

This third school of thought insists that corporations must serve all their stakeholders, especially employees, as well as the broader social purposes of their nations, rather than shareholders alone. This group challenges the basic legitimacy of the shareholder model of corporate governance and argues instead for a stakeholder model, where all people affected by economic action have a voice in decision-making. They object to the notion that value-maximizing firms and return-maximizing investors are responsible only to their shareholders, not to the broader political process, thus placing corporate governance in the same democratic deficit bucket as other forms of economic globalization.[6] Corporations are a legal fiction, with governance practices forged in political compromise, this group argues; faceless portfolio equity investors in New York and London have no right to unilaterally set the governance rules for firms worldwide.

[5] Peter Gourevitch, "Corporate Governance and Global Governance," in *Globalizing Authority*, David Lake and Miles Kahler, eds. (Princeton: Princeton University Press, forthcoming 2002).

[6] Fritz Wilhelm Scharpf, *Governing in Europe: Effective and Democratic?* (New York: Oxford University Press, 1999).

THE DEMAND AND SUPPLY OF "GOOD GOVERNANCE"

Who are these faceless portfolio investors who presume to set a global standard of good corporate governance?

The rising profile of shareholder protections stems from several factors: the rapidly increasing weight of Anglo-American money managers in global equity markets; domestic criticism of failures of insider governance in many European, Asian, and Latin American markets; and a widely shared perception that robust equity markets with shareholder protections contribute to superior economic performance.

Global portfolio investors are the wellspring of demand for governance reforms. U.S. and U.K. investors account for three-quarters of the financial asset pool and, an even more striking fact, 87 percent of all equity holdings by the "Big Five" economies (the United States, the United Kingdom, Japan, France, and Germany), as indicated in the following table:

Table 1: Institutional Investor Assets, 1999 ($ billions)[7]

Country	Total Assets	% in Equity	Share of Total Equity
U.S.	$15,800	.45	.72
U.K.	$ 2,200	.67	.15
Japan	$ 3,200	.19	.06
France	$ 1,200	.30	.04
Germany	$ 1,200	.19	.02

As the value of stock markets around the world boomed during the last decade, money managers in New York and London doubled their share of these markets in the pursuit of both high returns abroad and the benefits of diversified geographic

[7] Carolyn Brancato, "International Patterns of Institutional Investment," *The Conference Board Institutional Investment Report* (April 2000): 9.

portfolios. As a result, these Anglo-American investors now account for most of the traded volume in many of the world's stock markets. U.S. institutional investors' holdings of foreign equities, for example, grew from $200 billion in 1989 to $600 billion in 1994 and $2 trillion in 1999, with the average institutional investor's allocation to foreign equities doubling from 5 to 10 percent over the same ten-year period.[8]

The size of this pool of funds is due to the immense growth of pension and mutual funds in the United States and the United Kingdom. Anecdotal evidence from fund managers in these countries suggests that this growth in assets has also been fueled by money cycling through Anglo-American institutional investors from household savings outside of the United States and the United Kingdom.[9]

As a result, Anglo-American portfolio managers have become big equity players in countries that traditionally paid little heed to the interests of investors—and they have thus paid close attention to prevailing local corporate governance protections.[10] These protections include detailed financial disclosure using standard accounting practices and third-party audits, independent boards of directors with a fiduciary duty toward shareholders, rules for voting and takeover provisions that discipline entrenched or incompetent managers, and incentives such as stock options that more closely align the interests of managers with those of shareholders.

Although there is considerable debate over exactly how governance practices affect the financial performance of firms, and a good deal of controversy regarding the interpretation of the empirical research, recent research has established a statistically significant relationship between corporate governance practices that

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[8] See www.federalreserve.gov/releases/Z1/Current/z1r-4.pdf.

[9] Authors' interviews with money managers in New York, London, Tokyo, and Hong Kong.

[10] For an excellent discussion of this process see Philip Davis and Benn Steil, "Implications of the Growth of Institutional Investors for the Non-financial Sectors" in *Institutional Investors* (Cambridge: MIT Press, 2001).

protect shareholders and equity returns in the United States.[11] There is increasing evidence that corporate governance protections are reflected in share prices abroad as well, especially in emerging markets. Statistical, survey, and anecdotal evidence indicates that portfolio equity investors assign a significant price discount, ranging from 20 percent to 100 percent or more, when they buy shares abroad in firms with poor governance practices. (It should be noted, however, that it is hard to pry apart the country-specific discount from the firm-specific discount, and little data exist on the relative priority that global investors give to the various corporate governance institutions.)[12]

It is also a matter of debate how well corporate governance institutions that protect investors in the United States would work when transplanted to foreign markets. In the United States, investors were threatened most by "agency costs," imposed by entrenched managers at the expense of fragmented, powerless shareholders. Abroad, these same investors found themselves threatened by so-called "expropriation costs," imposed by dominant blockholders at the expense of powerless minority shareholders. This posed a different challenge to the notion of corporate governance reform, to which we now turn.

The term "corporate governance" was coined in the 1960s but came into popular use in the United States about a decade ago and even more recently abroad.[13] Because of this novelty, many observers have conveniently read into this term what they want: some have focused narrowly on the role of the board of directors, with oth-

[11] Paul Gompers, Joy Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," National Bureau of Economic Research (NBER) Working Paper W8449 (August 2001). The authors constructed a "governance index" based on 24 factors for 1,500 firms, and found that firms in the highest decile of the index (best governance) earned abnormal returns of 8.5 percent per year over the sample period.

[12] McKinsey Investor Opinion Survey, 2001, reported in Ernst and Young, "Corporate Governance Update," www.ey.com/global/vault.nsf/Australia/Corporate_Governance_Update_-_0901/$file/CGU_0901.pdf (September 2001).

[13] Not only is the term "corporate governance" a recent arrival in Asia, but it doesn't travel well. For example, the formal Japanese phrase for corporate governance, *kigyô tôchi,* literally means "enterprise control." In order to capture the broader sense of accountability, many Japanese observers and journalists simply use a phonetic translation of the English term corporate governance, "coporato gabanasu."

ers defining the term so broadly as to confuse corporate and political governance.

Our definition of corporate governance focuses on shareholder protections, incorporating the broad spectrum of governance institutions that serve to protect investors—including accounting and audit conventions, rules governing changes in control (including takeovers), and management incentive compensation.[14] Thus the rules that define corporate governance go beyond the case law and statute books regarding boards of directors, which provide the narrow definition of corporate governance frequently seen in the popular press.[15]

Some of these rules are tacit; others are formal, embedded in statute. Both types of rule create an incentive structure for the managers and owners of firms. "Good governance" minimizes both agency and expropriation costs; it is a measurement of economic efficiency and can improve the quality of decision-making. But because governance involves power and authority, buttressed by official regulations, it has an inherently political dimension: sooner or later, this official regulatory framework must deal with questions of equity and legitimacy.

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[14] There is a fierce and unresolved debate in the academic literature regarding the effectiveness of each of these governance practices in actually protecting the interests of shareholders, particularly minority shareholders, in the United States and abroad. For example, some argue that boards of directors play a key role in monitoring management on behalf of shareholders, as in Ira M. Millstein and Paul W. MacAvoy, "Essay: The Active Board of Directors and Performance of the Large Publicly Traded Corporation," *Columbia Law Review* (1998): 1283-1322. Other studies present evidence that board independence and size have no effects on corporate performance, as in Benjamin Hermalin and Michael Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economics Literature," NBER Working Paper 8161 (March 2001). By the same token, some researchers find a high correlation between firm performance and CEO incentive compensation, as in Brian Hall and Jeffrey Liebman, "Are CEO's Really Paid like Bureaucrats?" NBER Working Paper w6213 (October 1997); whereas others contest this view, as in Lucian Bebchuk, Jesse Friend, and David Walker, "Executive Compensation in America: Optimal Contracting or Extraction of Rents?" NBER Working Paper 8661 (December 2001).

[15] Marco Becht, Patrick Bolton, and Ailsa Röell, "Corporate Governance and Control," in *The Handbook of the Economics of Finance,* George Constantinides, Milton Harris, and René Stultz, eds. (North Holland: Mimeo draft, 2001).

Generally speaking, two contrasting models of corporate governance exist for publicly traded firms today.[16] The United States and the United Kingdom have what is called a "shareholder" model. Here the rules—antitrust policy, insider trading restrictions, market-based contests for control, quarterly statements, accounting reports, external directors, and the diffusion of shareholding by pension funds and all institutional investors—serve to protect the interest of outside shareholders.[17] Publicly traded firms in the United States and the United Kingdom rarely have a controlling block shareholder or family shareholder. Shareholding is instead fragmented among many owners, although a relatively small number of huge institutional investors account for a growing percentage of the total stock market value—while remaining "outsiders" with regard to management.

An alternative "insider" or "stakeholder" governance model, found in continental Europe and Asia, exhibits concentrated ownership in insider blocks—often banks, which are represented on the oversight boards—sometimes combined with cross-shareholdings or vertical pyramid holdings.[18] In some countries, these blockholders are families, such as the founders of the great South Korean

[16] Luigi Zingales, "Corporate Governance," NBER Working Paper 6309 (December 1997); Andrei Schleifer and R. Vishny, "A Survey of Corporate Governance," *Journal of Finance* 52 (1997): 737-83; Clifford G. Holderness, "A Survey of Blockholders and Corporate Control," forthcoming in *FRBNY Economy Policy Review;* Maria Maher and Thomas Andersson, "Corporate Governance: Effects on Firm Performance and Economic Growth," paper presented at the Tilburg University Conference on Convergence and Diversity in Corporate Governance Regimes and Capital Markets, Eindhoven, The Netherlands, November 4–5, 1999.

[17] Although the terminology used to analyze these systems varies, the concepts are quite similar. See Mark Roe, *Strong Managers, Weak Owners: the Political Roots of American Corporate Finance* (Princeton: Princeton University Press, 1996); Suzanne Berger and Ronald P. Dore, *National Diversity and Global Capitalism* (Ithaca: Cornell University Press, 1996); W. Carl Kester, "American and Japanese Corporate Governance: Convergence to Best Practice," in *National Diversity and Global Capitalism,* Suzanne Berger and Ronald Dore, eds. (Ithaca, NY: Cornell University Press, 1996): 107–137; Peter Hall and David Soskice, *Varieties of Capitalism* (New York: Oxford University Press, 2001); Dani Rodrik, *Has Globalization Gone Too Far?* (Washington: Institute for International Economics, 1997).

[18] Marco Becht and Colin Mayer, "The Control of Corporate Europe," in *The Control of Corporate Europe,* Marco Becht and Fabrizio Barca, eds. (New York: Oxford University Press, 2002); Stijn Claessens, Simeon Djankov, and Larry H.P. Lang, "Who Controls East Asian Corporations?" (Washington, D.C.: The World Bank, February 1999).

chaebol conglomerates, often within cohesive ethnic groups, as in the "bamboo networks" of overseas Chinese *(hua-qiao)* family-owned conglomerates in East Asia. Other countries such as Japan have blockholding systems sufficiently complicated (i.e., the famous *keiretsu* cross-shareholdings) that there is ultimately no controlling individual or family owner of many firms, nor any control exercisable by outside shareholders, resulting in firms that are effectively controlled by the managers themselves.[19]

Corporate governance debates in these countries often invoke the term "stakeholder capitalism." The definition of stakeholders is broadened from shareholders to include employees, organized labor representatives, and at times communities or governments.

Proponents of the stakeholder model lay claim to a particular form of efficiency—the kind that allegedly comes from stable relationships—and a kind of equity associated with buffering a community of producers, managers and workers, suppliers, and shopkeepers from rapid change. These proponents credit the stakeholder model with encouraging investment in human and social capital, in training, and in building trust among members of the production network.[20] They fear that moving toward the shareholder model will lead to the dismantling of health, pension, and other social benefits, as well as to less job security. And they point to firms based on the stakeholder model that have done well, such as Nokia of Finland and Toyota of Japan, which rank among the

[19] "Cross-shareholdings have altered the concept of the stock company in Japan. They have freed management substantially from the influence of shareholders. Stable shareholders are selected by and are dependent on management, and cannot therefore play a disciplinary role on corporate management . . . This leaves the main source of disciplinary pressure coming from the need to satisfy employees." Seiichi Masuyama, "The Role of Japanese Capital Markets," in *Capital Markets and Corporate Governance,* N. Dimsdale and M. Prevezer, eds. (Oxford, England: Clarendon Press, 2001): 334.

[20] Ronald Philip Dore, *Stock Market Capitalism: Welfare Capitalism, Japan and German versus the Anglo-Americans* (New York: Oxford University Press, 2000); Michel Albert, *Capitalism vs. Capitalism: How America's Obsession with Individual Achievement and Short-Term Profit Has Led to the Brink of Collapse* (London: Whurr, 1993); Robert Boyer, *The Regulation School: A Critical Introduction* (New York: Columbia University Press, 1990); William Lazonick, "Maximizing Share Holder Value: A New Ideology for Corporate Governance," *Economy and Society* 29, no. 1 (February 2000): 13–35.

most innovative firms in the world while rejecting the shareholder model.[21]

Empirical research has yet to resolve conclusively the shareholder versus stakeholder debate, as results change according to the criteria and measurements used. Both models, outside shareholder and insider stakeholder, have generated high economic growth at various times: most notably, in the United States for the shareholder model, in Germany and Japan for the stakeholder paradigm. Moreover, many countries have managed to grow rapidly in the absence of minority-investor protections, including many former stars of the so-called Asian economic miracle. These contrasting governance systems appear to have different effects on economic performance—such as price stability, savings rates, and growth in real output—although these effects are hard to measure.

It has also proven difficult to measure differences between these governance systems in terms of capital costs or rates of return on investment.[22] The cost of capital has fluctuated among the systems (low in Japan and Germany in the 1980s compared to the United States, vice versa in the 1990s). Anecdotes suggest that the insider model seems to do well at incremental modernization and upgrading of established manufacturing and other practices—the German and Japanese reputation for quality manufacturing

[21] Most of all, they criticize the alacrity with which the shareholder system lays off workers following mergers or in response to financial difficulty, and they deplore the social dislocations that go with both unemployment and rapid change. They fear that movement toward the shareholder model leads to the dismantling of health, pension, and other social service systems. As managers respond to pressures to increase share prices, they may seek to reduce payroll charges, whether in total jobs or wages or in wage-related benefits. Workers fear unemployment all the more for its impact on their social services, and they are therefore likely to defend all the more a stakeholder system. Managers may see in the payroll charge system a way of maintaining a stable labor market for skilled employees. It is possible, as in Scandinavian countries, to shift the collection of social services charges from payroll to general revenue, thus shielding firm and shareholder alike. But that shift involves considerable adjustment as well as uncertainty and will certainly provoke controversy.

[22] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "Corporate Ownership around the World," *Journal of Finance* 54, no. 2 (1999): 471, 492; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Law and Finance," *Journal of Political Economy* 106, no. 6 (1998): 1113–1155.

may be linked to their use of insider stakeholder governance. The insider model allows managers and owners to retain capital and use it for a steady flow of investment in the firm's core activities, somewhat free of business-cycle fluctuations, with long-term time perspectives.

But these advantages come at a cost—what has been termed "the agency costs of free cash flow," as reflected in over-investment in declining sectors.[23] Ten years ago, when Germany and Japan were doing well and the United States was showing problems in adjusting to trade pressures, that capacity for steady investment was seen as an advantage by some stakeholder proponents, who argued that it incurred lower transaction costs, rewarded long-term relationships, and encouraged the sharing of information. The American model was criticized as overly oriented to the short term and not able to sustain long-range product development and improvement.[24]

The outsider model admittedly puts pressure on management to redeploy earnings. Shareholders want dividends or higher share prices. Management is forced to compare alternative uses of profits rather than to devote them to existing activities. Dissatisfied shareholders can support hostile takeovers or managerial overhaul, or they can sell shares. Yet on the plus side, the shareholder model brings higher rates of return on capital and allows for the abandonment of inefficient lines of activity, freeing up capital for new activities. Over the last decade, the outsider model appears to have redeemed itself in performance terms, despite the excesses of the dot.com bubble and other negative externalities of sharp-elbowed capitalism.

Proponents of the shareholder system argue that the insider system carries a high price in terms of wasted capital and other resources, stagnation, rigidity, and the privileging of insiders. The shareholder model, by contrast, creates a set of market checks and

[23] Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *The American Economic Review* 76, no. 2, Papers and Proceedings of the 98th Annual Meeting of the American Economic Association (May 1986): 323–329.

[24] Michael Porter, "Capital Disadvantage: America's Failing Capital Investment System," *Harvard Business Review* (Sept/Oct 1992).

balances on entrenched managers and private oligarchs alike by making firms responsible to a broad class of many outside shareholders. It is not clear in which direction the causal arrows run: whether strong insider governance discourages outside shareholders (by exposing them to expropriation) or the absence of shareholder protection leads to insider governance by default.[25]

Despite the unresolved empirical debate, the political and popular high ground has been occupied in recent years by the shareholder model. The sustained dynamism of the American economy through the long boom, contrasted with a decade of stagnation in Japan, slow growth and high unemployment in continental Europe, and the financial crisis in Asia, has contributed to a new round of debate about governance reforms.

Fueling this debate are the waves of capital mobility noted above. This mobility provides portfolio managers with a wealth of alternative investment opportunities across a global landscape of many variations of shareholder and stakeholder governance systems—some in which private blockholders are the dominant force, others in which the government itself is a key player in the transformation of ownership in response to global capital markets. Drawn into the controversy are discussions over which microeconomic institutions to include in the recipe for sustained growth, and how to accommodate incompatible regulatory approaches when they grind against one another. This is the backdrop against which "low politics" corporate governance disputes keep escalating into "high politics" adjustment problems, which periodically burst into the sort of headlines cited earlier.

Reluctant Blockholders, Progressive States

Given the large price premium on the demand side that enhanced shareholder protections bring, it was widely anticipated in the early 1990s that private actors would be the engines for bringing about governance reforms on the supply side.[26] This did not happen. As

[25] Mike Burkart, Fausto Panunzi, and Andrei Shleifer, "Family Firms," NBER Working Paper 8776 (February 2002).

[26] See, for example, Reimes H. Kraakman and Henry Hansmann, "The End of History for Corporate Law," 89 Georgetown Law Journal, 439 (2000).

noted earlier, foreign governments rather than private actors have been the primary force in changing corporate governance practices in response to the good governance premium.

The vast majority of listed firms outside the U.S. and U.K. markets are controlled by dominant majority shareholders: either founders, their families, tightly knit corporate groups (themselves usually controlled by a family), or the state itself. As global portfolio investors swept around the world looking for well-run share opportunities over the last decade, it was expected that private majority shareholders ("private blockholders" in corporate governance parlance) would seek reform in order to enjoy the associated lower capital costs (avoiding the premium for a closed model). They would, according to this argument, voluntarily adopt good corporate governance practices in those areas where they had the latitude to do so, and then lobby their respective governments to bring about change in official regulations to bring these more in line with good governance practice, if they had a large enough incentive to do so. If they adopted good governance, private blockholders would be trading the private benefits of control for higher stock market valuation.

Prior to the globalization of equity markets, private blockholders and employees supported domestic governance practices that allowed the blockholders to extract expropriation costs and the employees to extract agency costs from the firm, both at the expense of shareholders.[27] Once global equity markets began to open up around the world, it was thought that private blockholders, faced with the potential good governance premium from foreign portfolio investors, would defect from this arrangement in search of higher valuation by the global investors. They would encourage professional managers to support these new practices (and abandon any sense of solidarity with employees) by means of stock options that aligned them with the shareholders rather than other employees. These private blockholders would then ensure that firms adopted informal best practices such as enhanced dis-

[27] See Marco Pagano and Paolo Volpin, "The Political Economy of Corporate Governance," paper presented at the European Corporate Governance Network (October 1999).

closure and independent oversight wherever they could, while lobbying the state for formal regulatory changes where governance practices were fixed by statute. The state would presumably respond accordingly: formal governance regulations would change to provide enhanced shareholder protection.[28] Private blockholders would gradually sell down their concentrated holdings to portfolio investors, trading their private control for higher valuation.

That was how it was supposed to work. In reality, however, there is little evidence that private blockholders either unilaterally adopted corporate governance reforms or lobbied their governments to make formal regulatory changes.[29] On the contrary, in many cases they have lobbied *against* such reforms. For example, business federations have been hostile to governance reforms in the three countries with the highest concentration of private blockholder control of listed firms: Italy (80 percent), South Korea (68 percent), and Taiwan (65 percent). From the great *chaebol* families in Seoul to the Wallenbergs in Stockholm, private blockholders have frequently greeted corporate governance reforms with suspicion, and sometimes with active resistance.[30]

This opposition to reform should not have been surprising. Insider control is an attractive form of power and financial benefit. These insider benefits are known, whereas the change to outsider governance is fraught with uncertainty. Insider control can be enforced

[28] For an interest group approach to analyzing foreign economic policy behaviors, see Jeffry Frieden, "Actors and Preferences in International Relations," in *Strategic Choice and International Relations,* David Lake and Robert Powel, eds. (Princeton: Princeton University Press, 1999); and Jeffry Frieden and Ronald Rogowski, "The Impact of the International Economy on Domestic Politics: An Analytic Overview," in *Internationalization and Domestic Politics,* Robert Keohane and Helen Milner, eds. (New York: Cambridge University Press, 1996): 25–47.

[29] Simon Johnson and Andrei Shleifer, "Privatisation and Corporate Governance," paper prepared for the 12th Annual East Asian Seminar on Economics, June 2001, to be published in Takatoshi Ito and Anne Kreuger, eds., *Privatization, Corporate Governance, and Transition Economies* (Chicago: University of Chicago Press, forthcoming in 2002).

[30] Tarun Khanna and Krishna Palepu, "Emerging Market Business Groups, Foreign Investors, and Corporate Governance," NBER Working Paper 6955 (February 1999). The authors find that family owned corporate groups are hard to monitor, and therefore relatively unattractive to foreign institutional investors, although they find evidence that foreign institutional investors otherwise can serve a valuable monitoring function.

through the family or relational networks, without relying on contracts and a sometimes corrupt or time-consuming legal system. Limited private wealth can be leveraged by means of ownership pyramids, bank debt, and selected stock offerings into the control of vast assets. Insider benefits can be concealed from the tax collector, whereas outsider governance requires public disclosure and third-party audits. The vested interests in the older systems proved to be quite powerful, and in many countries, they were associated with periods of successful economic transformation and sustained high growth. Indeed, the absence of sophisticated institutions to protect the interests of minority shareholders made private blockholder control the most common ownership structure by default.

Instead of private-sector pressures, therefore, governments became the engine of corporate governance reforms during the 1990s.[31] States were motivated by three fiscal pressures: first, budget gaps (in the EU, the single-currency agreement included a lower deficit ceiling), which made governments seek revenue opportunities in the privatization of publicly owned firms; second, moral hazard losses from poor governance in their banking sectors, ultimately footed by the taxpayers and creating another pressure on the budget; and third, efforts to replace underfunded social security plans with fully funded private pension plans.[32]

As a result of this complex interplay between global investors, private blockholders, voters, and revenue-hungry governments, the terrain of governance reform varies a good deal among countries. Information institutions such as accounting and auditing firms have changed the most, with wider use of GAAP or IAS, and disclosure practices patterned on those of U.S. exchanges.[33] Management

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[31] William L. Megginson and Jeffry M. Netter, "From State to Market: A Survey of Empirical Studies on Privatization," forthcoming in *Journal of Economic Literature;* Takatoshi Ito and Anne Krueger, eds., *Privatization, Corporate Governance, and Transition Economies* (Chicago: University of Chicago Press, forthcoming in 2002).

[32] James Shinn, "Private Profit or raison d'état?" paper presented at the Seminar on the State and Capitalism, Center for European Studies, Harvard University, April 19, 2002.

[33] "Clash of the Titans: IAS v U.S. GAAP," www.kpmg.com/library/00/april/story1_m4_ac.asp.

incentives, especially stock options, have also come into wider use. The use of stock options for managers was pioneered, interestingly enough, by the managers of newly privatized former state-owned enterprises (SOEs), who eagerly adopted the option practices of their American peers—much to the consternation of politicians and bureaucrats alike.

There has, however, been little adoption of independent boards of directors and continued resistance to the use of market-based contests for control ("hostile takeovers"). Private blockholders still pack boards with their relatives or proxies in order to maintain control; even on those exchanges that require independent outside directors, the definition of "independent" is sufficiently elastic to permit compliance with the letter but not the spirit of oversight. Where the state is the blockholder, even in partially privatized or "corporatised" SOEs, boards of directors continue to be filled with politicians, union leaders, and retired bureaucrats whose concern for outside shareholders is dubious at best (although they may reflect valuable community and employment concerns). And both private and public blockholders have erected a thicket of anti-takeover devices, ranging from dual-class stock to preference or "golden" shares that are triggered in the event of a contest for control.

Confusingly, many of these regulatory changes employed the vocabulary of corporate governance reform and shareholder value, but the reality on the ground was often very different. Moreover, those changes in governance practices that did take place abroad were rarely accompanied by adjustments in the regulatory or legal scaffolding of governance to make local laws look more like those in the United States and the United Kingdom. Instead, the institutions encouraging good governance were implemented in different ways, usually grafted onto existing regulatory structures and law-enforcement practices. Legal and regulatory systems are highly resistant to change when change has big distributional consequences, particularly if those changes do not benefit powerful domestic interests.

Overextension of the Reputational Intermediaries?

It is important to point out that outsider governance does not thrive in a regulatory vacuum. Although the Anglo-American system is seen as neoliberal when compared with the state-centric and bank-centric European and Asian models, it is not "non-regulatory." Sophisticated free markets, such as New York's or London's capital markets, operate with an elaborate set of rules and regulations. What makes regulation in these countries distinctively effective is not the quantity or extent of rules, but their structure and enforcement.

The U.S. and U.K. securities regulatory models consist of a relatively small bureaucracy that presides over vast capital markets by means of largely self-regulating reputational intermediaries—such as accounting firms, investment banks, law firms, bond-rating agencies, and stock analysts—and private self-enforcement. In the United States, the SEC is small by the standards of federal bureaucracies—it does its work of overseeing the world's biggest and most sophisticated capital markets by delegating much regulation and enforcement to the stock exchanges and to the reputational intermediaries that underpin their activities. These intermediaries play a powerful role in enforcing good governance, out of self-interest, by monitoring firms and their managers—at least in principle.[34]

Changes in governance practices have played out against a backdrop of financial globalization in which the foreign portfolio investors have been accompanied abroad by the stock exchanges and by the reputational intermediaries in the financial services industry—investment bankers, accounting firms, securities lawyers, and rating agencies. The major U.S. stock exchanges rapidly expanded their international activities, both in acquiring U.S. listings for foreign firms and in making alliances with overseas exchanges. All three major U.S. exchanges—the New York Stock Exchange (NYSE), American Stock Exchange (ASE), and National Association of Securities Dealers Automatic Quotation system (NASDAQ)—were torn between demanding high stan-

[34] Bernard S. Black, "The Legal and Institutional Preconditions for Strong Securities Markets," *UCLA Law Review* 48 (2001): 781–858.

dards of governance disclosure on the one hand, and attracting as many foreign listings as possible on the other.

The concentration of global portfolio equity in the hands of a relatively small number of investors has been paralleled by an even more striking consolidation of the financial services sector, the reputational intermediaries who stand between the issuers of securities and the institutional buyers. The 1990s witnessed the emergence of so-called full-service financial entities that blurred the lines between commercial banks, investment banks, insurance companies, and money-management firms. By the end of the decade, the Big Five accounting firms—KPMG, Arthur Andersen, Deloitte Touche Tohmatsu, Price Waterhouse Coopers, and Ernst & Young—had emerged to dominate a previously fragmented industry worldwide (although recent events suggest that only a Big Four may survive).

This dramatic process of financial globalization also blurred the lines between products previously handled by financial-services firms. These consolidating financial-services entities offered a broad spectrum of financial assets providing continuous pricing of risk, thereby erasing the old line between debt and equity markets. For example, the complex equity derivatives and surety bonds revealed by the Enron partnerships are neither loans nor equity investments in the traditional sense.

Creeping Obsolescence of Regulatory Structures

Historically, banking and securities markets developed within radically different regulatory environments. Innovations in risk pricing not only left the accounting firms running to catch up; it also rendered national regulatory structures obsolete, in the United States as well as abroad. Equity derivatives and electronic trading challenged the way the SEC fulfilled its regulatory mandate, as the borderline between U.S. domestic financial regulations and foreign economic policy became increasingly blurred, and in some cases virtually meaningless, particularly for sophisticated institutional investors.[35]

[35] Benn Steil, "Building a Transatlantic Securities Market," working paper, Council on Foreign Relations (May 2002).

In parallel, the big accounting firms entered the consulting business, provoking a debate over the conflict of interest between providing independent audits and advising a firm on profitability. The Enron case raises additional questions about the incentives faced by law firms and securities analysts to maintain independence and objectivity in relation to their clients, balanced against their responsibilities to external shareholders and the public.

In sum, if efficient markets had worked their magic (as the optimists expected), the premium for good governance practices offered by global portfolio investors would have elicited a smooth, automatic supply of enhanced shareholder protections around the globe. Instead, the uneven and halting pace of corporate governance reform can be traced to distortions on both the demand and supply sides of the equation, compounded by alterations in the incentive structure of the reputational intermediaries that stand between them, and by the creeping obsolescence of securities and financial regulators. This discrepancy is interesting as a political economy puzzle in its own right, but it also has foreign policy implications, the focus of this study, to which we now turn.

THE IMPACT OF CORPORATE GOVERNANCE ON U.S. FOREIGN POLICY

Corporate governance intersects with foreign economic policy in four areas in which the United States has clear strategic objectives: trade policy, international financial stability, reducing corruption and increasing transparency, and the stability of regulatory practices at home.

Trade Policy

Many aspects of trade disputes incorporate buried corporate governance issues, although they are often not understood in this way. Frequent complaints about exclusionary supplier networks, closed bidding, predatory pricing (including export dumping), and other anti-competitive practices are rooted, at least partially, in contrasting corporate governance practices.[36] Growth of market share for its own sake, empire-building acquisitions, and ill-considered big-ticket production capacity investments are all examples of the agency costs of free cash flow. The shareholder model has mechanisms that force managers to disgorge profits as dividends; where these mechanisms are lacking, the managerial agents can do what they want with the funds.

This free cash flow is rooted in corporate governance practices that reward managers for size and growth of market share rather than for maximizing shareholder value, and that insulate managers from external discipline or hostile takeovers. Firms with empowered shareholders or private blockholders rarely allow profitless growth and other related practices for long, if the regulatory environment permits them to reform or replace management. This is hard to

[36] Laura D'Andrea Tyson, *Who's Bashing Whom?: Trade Conflicts in High-Technology Industries* (Washington, D.C. : Institute for International Economics, 1993). James P. Womack, Daniel T. Jones, and Daniel Roos, *The Machine That Changed the World: How Japan's Secret Weapon in the Global Auto Wars Will Revolutionize Western Industry* (New York: Harper Perennial, 1991).

do in a market like Japan, where fragmented, largely powerless public shareholders have few mechanisms to discipline entrenched managers. It is also hard to achieve in many firms where the state has a large blockholding but is unwilling or unable to discipline management, a common problem in continental European and emerging-market countries alike.

Corporate governance reforms can provide mechanisms for snuffing out these sorts of managerial activities that provoke trade disputes before they begin. And by providing an active market for control, corporate governance reforms facilitate cross-border investment, which in turn promotes new entrants as well as intrasectoral consolidation, by means of market competition rather than official intervention. If firms can compete to acquire one another under rules that promote market-based competition, this competition can reduce the instances when government officials get dragged into serving as the advocates (or defenders) of firms engaged in merger or takeover negotiations.

A cardinal merit of reducing trade disputes through internal corporate governance reforms is that reforms shift these disputes away from state-to-state negotiations or formal bureaucratic enforcement toward market mechanisms. Shareholders, investors, and reputational mediators become the vehicles for changes in control and, by extension, financial discipline. This market approach plays to Washington's strengths rather than those of, say, Tokyo, Paris, or Seoul.[37] By depoliticizing trade disputes, corporate governance reforms help clear the deck for more fruitful international cooperation on removing barriers to trade and investment.

Although little empirical research exists on the connection between trade disputes and corporate governance practices, several recent examples give credence to the potential of corporate governance reform to blunt trade frictions.

As a member of the Hyundai *chaebol* conglomerate, Hyundai Semiconductor was controlled by the Chung blockholder family

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[37] Peter Cowhey, "The Future Trade and Investment Order of the Pacific Rim: ASEAN, NAFTA, and APEC in the Context of Japanese and U.S. Diplomacy," in *U.S.-Japan Relations and International Institutions after the Cold War,* P. Gourevitch, T. Inoguchi, and C. Parrington, eds. (La Jolla, CA: IRPS Publications, 1995): 183–226.

and supported by billions of dollars of bank debt. Maximizing shareholder value was not a concern of Hyundai management, who were selected by the Chungs in order to maximize the value of the Chungs' total corporate holdings, not to maximize the value of other Hyundai shareholders. As a result, Hyundai Semiconductor proceeded to invest trillions of won in production capacity and to price products at below cost, with little attention to minority shareholder value. In the wake of the 1997–98 Asian financial crisis and the partial break-up of the Hyundai *chaebol*, the renamed Hynix undertook a variety of corporate governance reforms imposed by the Seoul government, including installing a more independent board of directors with a fiduciary responsibility to minority shareholders, which refocused the firm on making money rather than on winning market share.

In contrast, the steel industry provides a negative example. Despite excess worldwide capacity, many steel firms in Europe and East Asia have remained in the business by relying on state ownership to insulate them from contests for control and on loans from state-directed banks to keep from going under. The world's largest integrated steel producer, South Korea's Pohang Iron and Steel Corporation, is a good example. The managers of Pohang and other firms have resisted capacity consolidation and layoffs and reacted to excess capacity by expanding exports, with the United States often serving as the surge market.

As a result, some of the least efficient U.S. steel makers have shuttered capacity or gone under, while looking to Washington for relief from import-price pressure by means of dumping complaints, along with other requests for federal bailouts. This trend has resulted in a contentious cycle of trade disputes and threatens yet further market distortions. It would be a foreign policy windfall if steel producers worldwide were forced to compete for capital on the same playing field, and with similar corporate governance institutions to ensure that they did so, with minimal involvement by trade officials on all sides.

Deutsche Telekom, France Telecom, and Spain's Telefónica were able to use their domestic monopolies to fund a wide number of mergers and acquisitions abroad, while remaining effectively immune from hostile takeovers due to government-held golden shares and other restrictions on foreign investors.[38] One result was a run-up of debt by these firms during the late 1990s as they bid huge sums for "third-generation" mobile licenses at home and abroad, effectively turning into convenient piggy banks for ministries of finance that used the proceeds of these bandwidth auctions to plug fiscal budget gaps. Under the crushing burden of this rashly acquired debt, these firms have engaged in a series of asset sales and other spinoffs that have severely undercut their telecom service monopolies at home and accelerated the process of cross-border telecom liberalization, something that successive rounds of negotiations at the WTO and the EC failed to do.

Financial Stability

Corporate governance reform can mitigate the risk of financial meltdowns and currency crises by strengthening banks' internal governance and improving their external transparency. Many currency crises are caused by the old-fashioned time bomb of fiscal profligacy combined with fixed exchange rates. Some crises, however, are triggered by private mismanagement, usually in the financial sector. Indeed, errors on the part of poorly governed, privately owned financial institutions were a proximate cause of the Asian financial crisis in 1997–98.

The events in Asia during those years showed that national financial stability could be threatened by the obligations incurred by private institutions. Private corporate governance thus became a public and international issue. Although analysts often separate the regulation of financial institutions from corporate governance, this paper suggests that both are parts of the same general issue concerning the ways in which investors monitor important economic institutions.[39]

Poor corporate governance in the financial sector triggered many of the crises seen in the mid- to late-1990s: the unhedged

[38] Francesc Trillas, "Mergers, Acquisitions, and Control of Telecommunications Firms in Europe," Regulation Initiative Discussion Paper no. 39, London Business School.

[39] Albert Fishlow et al., *Miracle or Design? The World Bank's East Asia* (Washington D.C.: Overseas Development Council, 1994).

dollar liabilities of Korean and Thai merchant banks helped set off the Asian financial crisis; Indonesian and Russian banks were looted by their owners; and Mexican and Brazilian banks simply collapsed from slipshod oversight.[40] By the same token, much of official Washington's current hand-wringing over the bad debt burden of Japan's big banks, a burden directly traceable to decades of poor corporate governance in these banks and their customers, stems from the fear of a meltdown of Japanese financial markets that a string of big bank failures may trigger, and the enormous difficulties that the Treasury Department would face in insulating U.S. money markets from such a panic.

So-called connected lending runs through all these examples. Abuses by majority shareholders are particularly dangerous in financial-services firms, given the government's explicit or tacit guarantees as a lender of last resort—something the United States experienced itself in the Savings & Loan (S&L) crisis of the 1980s. Majority shareholder abuses, moreover, made it much harder to implement multilateral bailout packages once these were cobbled together by the United States and the International Monetary Fund (IMF). For example, at the height of their respective crises, privately owned banks in Russia and Indonesia were taking hard currency out of their countries, while the IMF was providing aid.

Such crises have drawn the U.S. government into bailouts, either through intermediates like the IMF or directly, as with Mexico. Corporate governance reforms are not a panacea for this problem, and they cannot work in the absence of prudential oversight from independent agencies with the authority of government and effective courts. But it is increasingly apparent that traditional prudential oversight has been hobbled by the dual effects of financial globalization and financial innovation. Without good internal governance of banks and securities firms—governance that includes protection of all shareholders, including minority shareholders—it is unrealistic to expect government authorities to be able to exter-

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[40] "Chronology of the Asian Currency Crisis and its Global Contagion: 1997," www.stern.nyu.edu/~nroubini/asia/AsiaChronology1.html.

nally ensure that banks and financial-services firms are correctly pricing risk.

At worst, majority shareholders are inevitably tempted to treat financial institutions as private piggy banks, making inside loans to themselves while shifting the risk to depositors and, by extension, to the government. If private blockholders are barred from holding majority shares in financial institutions, then by default, equity discipline must be imposed by the state as owner, or by shareholders. Historically, state ownership of banks has been costly. So if outside shareholders are to be relied on to discipline bank management, it is essential that shareholder rights be robust. Hence the imperative of corporate governance reforms.

Changes of control in East Asian banks have produced several examples of corporate governance reforms, with subsequent beneficial effects on the stability and development of market banking systems. As value-maximizing foreign owners have taken over majority control of bankrupt banks and financial-services firms in Japan and various emerging markets, they have imposed hard-budget constraints on borrowers, cutting off the obviously insolvent, and have imposed stricter rules of accounting, auditing, and disclosure on the part of their customers.[41]

As shown by the example of Korea First Bank, the presence of foreign majority investors imposed discipline on life-support for bankrupt *chaebol* firms, such as Daewoo Motors—many of which had been looted by their insider owners and then left to the Seoul government (and South Korean taxpayers) to foot the bill. Kept afloat by government-controlled banks, Daewoo kept on exporting even while losing money, thereby fueling trade disputes in the always-sensitive automotive market. Foreign-controlled banks are less willing to put up with such conduct; shareholder value, not exports, becomes the prime goal of the firm.

By the same token, foreign financial institutions have acquired minority or majority interests in several crippled Japanese banks,

[41] Jennifer Crystal, Gerard Dages, and Linda Goldberg, "Does Foreign Ownership Contribute to Sounder Banks in Emerging Markets? The Latin American Experience," Federal Reserve Bank of New York, www.nber.org/~center/2001/si2001/dages (May 2001).

such as Ripplewood's purchase of Long Term Credit Bank. These new owners have pushed back on bad loans, declining to participate in several "convoy"-type bailouts of the sort that have kept Japan from resolving its bad loan overhang. There, the unresolved bad-debt issue has inexorably grown to the point where it is now a major point of contention and concern in official relations between Washington and Tokyo. Corporate governance reform could have helped avoid this—and may keep it off the agenda in the future.

The U.S. government has found itself expending increasing energy on financial bailouts and concerns about financial meltdowns abroad not just because of expanded trade with foreign economies, but also because of increased integration between U.S. and foreign capital markets. There is a strong systemic linkage here, with implications for the U.S. financial regulatory model, to which we now turn.

Regulatory Stability in the United States

The most subtle foreign policy interest that the United States has in corporate governance reform is the sustainability of Washington's own neoliberal model of financial regulation. This is a *systemic* concern. It concerns itself with the rules of the game in international finance rather than with specific transactions of finance, and with the ability of the United States to not only shape the content of those global rules but also to mold them in the image of the United States.

Financial globalization—the higher degree of integration and expanded set of contact points between U.S. and foreign capital markets—has exposed the "light-handed" U.S. regulatory model to pressures that may lie outside of its control, placing the U.S. economy in possible jeopardy to a regulatory vacuum abroad. U.S.-based corporations, institutional investors, and financial-services firms have all spread globally, but the unique U.S. neoliberal regulatory model does not travel well.

This model resembles a pyramid, with the relatively small SEC on top, a complex body of reputational intermediaries just below, vast capital markets in the middle, and a diversity of state-level corporate governance legal regimes at the base. The SEC supervises these markets with few resources because of the roles fulfilled by reputational intermediaries and self-enforcing market participants—a complex web of self-regulation, peer-pressure, legal liability, and raw commercial self-interest that keeps them "honest," most of the time. The SEC's limited regulatory mandate circumscribes its supervisory powers, which are focused largely on ensuring full and proper disclosure. Moreover, many aspects of corporate governance are controlled by state rather than federal law—a situation reinforced by repeated court judgments in favor of state law whenever the SEC pushes its regulatory envelope.

Most changes in corporate governance, for good or ill, have taken place before the Delaware Chancery Court, where most large, listed U.S. firms locate themselves. Legal scholars disagree as to whether the SEC's deference to state-level governance statutes has served to promote market-friendly innovation, as states compete to offer "best practice" statutes and legal precedents for corporate governance, or whether it has merely provided entrenched managers with the option to "venue shop" for the friendliest laws that will insulate them from hostile takeovers or their own shareholders.[42]

There is some evidence that the Delaware Court has tended to protect managers and directors at the expense of institutional investors, since the state obtains 15 percent of its revenue from the corporation franchise tax. Other state legislatures, such as those in Ohio and Pennsylvania, have been even more sympathetic to locally headquartered firms, erecting barriers to takeovers and adopting other restrictions that insulate management from competition. As in politics, all governance is local—at least when a challenge to entrenched managers or private blockholders can be painted as a battle between evil capital and local folks. When tempted to harshly judge the resistance of foreign governments to gov-

[42] Bengt Holmstrom and Steven Kaplan, "Corporate Governance and Merger Activity in the U.S.: Making Sense of the 1980s and 1990s," NBER Working Paper 8220 (April 2001).

ernance reforms urged on them by portfolio investors, it is wise to remember the example of the many United States.

Despite this deference to state law, however, the SEC has incrementally built on the foundation of its disclosure mandate to impose corporate governance reforms on listed firms, either directly through its own actions, or indirectly through tighter standards enforced through the listing exchanges. Examples include streamlined rules for proxy voting, the criteria for placing shareholder resolutions on proxy materials, the composition of compensation and audit committees, details for business combination and line-of-business reporting, and promotion of the Electronic Data Gathering and Retrieval (EDGAR) system for information filings and periodic financial disclosure.

The peculiarities of the U.S. model of regulation, with the SEC pushing for more disclosure at the top while constrained by state-level governance laws at the bottom, are starkly revealed in the compromises by which foreign issuers in U.S. equity markets are subjected to a lower standard of corporate governance than are domestic issuers. The SEC's original strategy of exemptions (or "carve-outs") from U.S. disclosure requirements for foreign issuers was initially intended to be transitional, in order to allow firms to participate in U.S. markets without having to undertake complete internal transformations. Foreign issuers were required to convert their domestic accounts to GAAP, and to make periodic disclosure of their financial results in GAAP (although at less frequent intervals than U.S. firms), but were otherwise permitted to observe the corporate governance practices of their domestic jurisdiction.

There are costs to maintaining two tracks for corporate governance in U.S. capital markets, with one set of rules for U.S. firms and another, lower standard for foreign firms. The higher standard required of U.S. listing firms may expose them to some competitive disadvantages vis-à-vis the foreign listing firms, for example in terms of greater disclosure of line-of-business data. The existence of two standards may confuse some investors. And it presents the opportunity for some foreign firms to take advantage of U.S. capital markets while playing according to their own governance rules. For example, when Daimler acquired Chrysler, it used its U.S. listing to gain the stock "currency" for the transaction but then resorted to the looser German standards of governance and disclosure after the transaction.

The SEC has also spent a lot of time and energy nudging reputational intermediaries along, tightening their mechanisms for self-regulation, and stepping in to rebalance the interplay between issuers and buyers when outside shareholder interests—and market stability—are at risk. It has taken many years for this delicate institutional network and division of labor to establish corporate governance equilibrium, or a sort of commercial balance of power between issuers and buyers of equity securities.

Yet the globalization of capital markets has put both the original rationale for foreign carve-outs and the domestic equilibrium of reputational intermediaries in jeopardy.

On the buy side, institutional investors have increased their share of equity markets abroad, but they do not yet wield power in offshore equity markets commensurate with their power in the United States. Their total shareholdings are often small compared to those of governments and local majority shareholders in local markets, who have governance preferences at odds with those of the foreign portfolio investors.

At home and abroad, these institutional investors operate under rules that limit their ability to directly discipline firms as a means of protecting their interests as outside shareholders from entrenched managers or abusive blockholders. Direct intervention in management can subject institutional investors to insider trading rules, expose them to liability lawsuits, reduce their creditor rights in bankruptcy, and expose them to prosecution by the SEC or foreign securities regulators. They face sizeable procedural barriers to exerting their influence, even through otherwise straightforward proxy voting. Many foreign equity markets discount or completely ignore foreign proxy votes through restrictive registration procedures, share-blocking regulations, unrealistically short voting deadlines, or by taking advantage of voting rules that disenfranchise "pooled nominee" accounts. The International Corporate Governance Network (ICGN) launched a study to follow the paper trail of offshore proxy voting to gauge the actual voting percentage; anecdotal evidence suggests that the votes of many foreign portfolio investors never even make it to the counting table.[43]

Finally, many institutional investors use indexed investment methods that effectively lock them into country exposure levels. In markets with relatively small market caps, this forces them to hold some percentage of equity in the largest firms. As a result, they cannot "walk," no matter what corporate governance imperfections may exist.

Financial globalization threatens to upset the United States's delicate home-grown equilibrium on the sell side as well, by altering the role of reputational intermediaries, including accountants, investment bankers, and—in some cases—the institutional investors themselves.

As starkly highlighted by the controversy surrounding Arthur Andersen, accounting firms have long walked a narrow line between the interests of their notional employers (the shareholders) and their actual employers (the managers of the audited firms). Financial globalization amplified this problem. As the Big Five spread their global networks, they provided a single "name" on the audit sheet, but with widely varying internal standards. Bringing all local partners up to a common standard of professional practice is extremely time-consuming, and efforts to publicize the difference between national accounting standards and GAAP/IAS were received very badly by finance ministries abroad.[44] With only the Big Five to choose from, to whom else do institutional investors turn? The only option is to perform detailed credit analysis in-house, an expensive option that only a few giant portfolio investors can afford. The net effect of these changes has thus been to reduce the leverage of securities buyers vis-à-vis sellers, and of the small investors in comparison to the very large.

Rapid consolidation in the financial services industry worldwide has also blurred the boundary between commercial banking,

[43] The study is being conducted by Institutional Design on behalf of the International Corporate Governance Network. See www.ICGN.org.

[44] Robert Kutsenda, "The Short-Term Legends Program," presentation given at The Second Asian Roundtable on Corporate Governance in Hong Kong, May 31 to June 2, 2000.

investment banking, insurance and money management. For example, Deutsche Bank has one of Europe's biggest commercial lending portfolios, is a leading issuer of securities through its investment banking arm (Morgan Grenfell), and is also the largest institutional money manager in Germany (DWS Investments). Citigroup, Credit Suisse, and Allianz have also crossed these former borders, propelled in part by competition and in part by regulatory liberalization, such as the 1999 revision (incorporated in the Gramm-Leach-Bliley Financial Modernization Act) of the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956.[45]

Financial innovation and the expanded scope of these consolidated financial conglomerates have created new asset classes that provide seamless pricing for financial risk. Examples include asset-backed securities based on mortgages and credit cards, collateralized debt obligations, and a new fauna of credit derivatives and other synthetic instruments.

This industry consolidation has not only generated potential conflicts of interest for the reputational intermediaries; it has also left regulatory authorities behind. The blurring of functional boundaries and transformation of risk instruments has outrun the pace of innovation by U.S. security and banking regulators, whose prudential surveillance procedures and methods are slowed by bureaucratic procedures, limited budgets, and relatively static legal mandates.

Historically, U.S. security and banking regulators developed "stovepiped" methods of inspection for financial-services firms within a given asset class: the Comptroller of the Currency inspected national banks, the SEC oversaw securities firms, the Federal Reserve system looked over state banks and thrifts, the Commodities Futures Trading Commission (CFTC) kept an eye on derivative traders, state-level insurance commissioners watched over insurance firms, and so forth. But how could these regulators and methods come together to oversee the integrated financial oper-

[45] The Gramm-Leach-Bliley Act [P.L. 106–102] repealed the Depression-era barriers that separated banking, insurance, and securities.

ations of a Credit Suisse First Boston, Travelers/Citigroup, or Deutsche Bank, which represented a bank, a securities firm, a derivative trader, and insurance company all in one? In this new complex world, the internal corporate governance of these financial conglomerates—the internal oversight mechanisms to ensure that overall risk-management techniques remain in place—becomes a key ally of prudential regulators at home and abroad.

In sum, the net results of financial globalization and consolidation are that the U.S. economy is increasingly exposed to contagion and financial failures abroad, and that the regulatory duo of the Federal Reserve Bank and the U.S. Treasury is increasingly looked to as a sort of grand lender of last resort. Corporate governance reform on a global scale that reduces the risk of bank meltdowns can reduce the odds of that role being called upon.

Corruption and Money Laundering

Corporate governance activists insist that reform can be helpful in eliminating corruption and money laundering abroad. Persistent corruption is one of the biggest threats to democratic regimes in emerging markets; the flow of black money sustains terrorists such as Osama bin Laden's al Qaeda network, regional separatists, and *narco-trafficantes* alike. Advocates also allege that corporate governance reform can threaten authoritarian regimes in emerging markets by dismantling state control of assets and employment and making the managers of firms accountable to public markets rather than their political masters.

Corporate governance reform per se is unlikely to make much of a dent in the private flows of al Qaeda money; these funds move in relatively small amounts, largely through private networks rather than the international banking system. Improved corporate governance of banks may pose a more serious problem for the laundering of narcotics money, billions of illicit dollars that cycle through the banking system, by making these institutions more transparent and more accountable. Yet bank governance is a secondary tool in a more complex battle against the drug trade.

On the terrorist front, the SEC's closer scrutiny of the "risk factors" disclosure by foreign firms issuing equity in U.S. capital markets may have made such firms reconsider doing business with so-called rogue regimes on the U.S. State Department list of state supporters of terrorism, or with countries that are the object of U.S. trade or investment embargoes (these categories often overlap). For example, links between state-sponsored terrorism and international equities are now tracked by the Global Security Monitor recently offered by the Investor Responsibility Research Center and the Conflict Securities Advisory Group.[46]

Governance reforms may promote U.S. interests by plugging another vacuum: offshore tax, money laundering, and regulation havens such as the Cayman Islands. Governance reforms, particularly in terms of disclosure, will help increase the visibility of such lacunae in the international financial system and expose them to coordinated multilateral pressure (although we are reluctant to use problems in the tax code as a rationale for corporate governance reforms). Corporate governance reforms can pay some dividends by suppressing dirty money and corruption, but only as part of more systematic and focused efforts to attack the underlying problems.

Summary of Foreign Policy Goals

Corporate governance, in sum, bears on four important policy goals of interest to the United States: international financial stability, trade relations, reducing corruption and increasing transparency, and the internal neoliberal financial system of the United States. The relationships are clearest in the first two areas: governance mechanisms go to the heart of important concerns in finance and trade. The relationship between global governance rules and the sustainability of the American neoliberal regulatory approach is more subtle and indirect, but in an era in which capital-market integration will continue to expand, the risks posed to that model are increasing, and with them the importance of governance reforms to buffer that risk. Finally, corporate governance is relevant for issues of corruption in foreign countries, but there are many other variables at work. Fixing corporate governance cannot bring transparency to other countries, it requires transparency to already be there.

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[46] See www.irrc.com/products/Global_Risk.html.

POLICY RECOMMENDATIONS

We think it wise to limit our brief; we are concerned with the foreign policy utility of corporate governance reform rather than with corporate governance reform for its own sake. Moreover, these reforms are embedded in a broad set of institutions—including property rights, law enforcement, regulatory competence, reputational intermediaries, official transparency, and reasonably efficient capital markets—without which improved corporate governance cannot achieve the desired ends.

Moreover, we hesitate to recommend specific reforms of governance practices such as the separation of the roles of chairman and president, for example, because the research evidence on the effects of many such detailed reforms is still unclear. Nor do we wish to suggest a "one size fits all" approach to global governance; there is much to be said for diversity in governance practices for firms both within and among countries. And as we push for governance reform, it is prudent to beware of moving too fast and provoking unintended consequences. Gross errors, even catastrophes, can occur in a transition from one governance system to another—the U.S. S&L crisis of the early 1980s is one example. A wide range of intermediate steps must be taken first, to establish a robust regulatory framework and more effective legal enforcement of shareholder rights.

Instead, the thrust of the recommendations suggested in this paper involves relatively minor regulatory tinkering to reestablish the market equilibrium between buyers, sellers, and reputational intermediaries—thereby enhancing market incentives for the demand and supply of good governance on a global scale, while carefully preserving the light touch of the neoliberal regulatory model. The goal is to induce firms to produce better information—through accounting, audit, and disclosure—that will give investors incentive to discipline a firm when this information signals a governance problem.

The preponderant role of U.S. financial-services firms, Anglo-American institutional investors, and the magnetic appeal of the deep U.S. capital markets collectively magnify the international effects of largely domestic U.S. regulatory changes. Against the backdrop of varied governance terrain and partial regulatory vacuums abroad, these U.S. regulatory reforms should be undertaken in close coordination with the mixed assortment of international forums where national regulatory authorities rub shoulders and occasionally even cooperate.

Pursuing corporate governance reform on a global scale is an old problem in foreign policy. Corporate governance is similar to other technical policy domains such as competition or environmental regulation, which often fall below the public radar screen. It is another example of "deep integration," in which economic globalization has brought different economic microstructures, and their corresponding regulatory structures, grinding up against each other. The friction generated by these collisions shows up as a stream of political problems that are handled *ad seriatim*, when the headlines get hot enough to force themselves onto policymakers' plates. These problems are then handled without regard to the underlying cause, and hence with no plan for long-run resolution nor any reasoned linkage to long-term foreign policy strategy—both in the United States and abroad.

Meanwhile, the regulatory debate in each policy domain tends to be monopolized by technical experts within each government: in Washington, by competition lawyers at the Antitrust Division of the Justice Department, environmental experts at the Environmental Protection Agency (EPA), or aircraft engineers at the Department of Transportation. Similarly, corporate governance remains the preserve of a gaggle of domestic regulatory agencies that consider engagement with foreign governments a low priority, and each of which presides over one slice of the regulatory pie.

Among these fragmented agencies, the SEC regulates capital markets (with the CFTC supervising derivatives) at the national level, focusing on disclosure, while delegating much governance rule-making to the various states. The Department of Labor has oversight responsibility for many (but not all) institutional investors and company pension funds through the Pension and Welfare Benefits Administration (PWBA) and the Pension Benefits Guaranty Corporation (PBGC). The Comptroller of the Currency and the Federal Reserve concern themselves with the governance of banks and the supervision of financial conglomerates (while fighting viciously over who has prime authority). The Internal Revenue Service (IRS) sets the rules for the tax-deductibility of pensions and stock options. The Treasury Department looks after the IMF and the so-called development banks such as the World Bank and Asian Development Bank (ADB).

Looking inward, each agency has its own legislative mandate, body of case law, and oversight relations with Congress. Looking abroad, each agency has contacts with its "counterpart" foreign regulatory authority—in various stages of close coordination or neglect—and its own "seat" at international coordinating bodies such as the International Organization of Securities Commissions (IOSCO) or the BIS.

The foreign policy implications of financial regulations usually play second fiddle (or third or fourth fiddle) to their domestic impact. U.S. domestic financial regulation tends to move in cycles, culminating in an omnibus financial "reform" bill passed by Congress after lengthy debate and intensive lobbying. These cycles are in turn usually precipitated by crises of one sort or another and result in regulatory oversight being brought up to conformity with market realities. The 1999 Gramm-Leach-Bliley Financial Modernization Act, for example, remedied some of the anomalies that had been created as markets grew around the 1933 Glass-Steagall prohibitions. We appear to be in the early stages of such a cycle right now, which suggests that much could be gained by keeping the international implications firmly in view during this debate.

The federal government in general and Congress in particular have an ambivalent attitude toward international organizations as tools of reform—one reason for the marginalization of IOSCO over the years. But these organizations can be extremely useful in building a coalition around a reform program. They can help avoid the Anglo-American label that can otherwise taint governance reform. The United States can gain from adopting governance reforms patterned on best practice elsewhere, including IAS and the the United Kingdom's City Takeover Code, and thereby demonstrating that the reforms are part of a worldwide effort, not a simple projection of the U.S. system.

We make seven policy recommendations regarding corporate governance rules that can be modified in order to promote the foreign policy goals of the United States. These proposals include developing a gold standard of corporate governance which is reflected in the listing requirements on stock exchanges; changes to the system of reputational intermediaries and the regulations for contests of control; incentives for institutional investors to monitor firms; criteria for corporate governance; closer scrutiny of the governance practices of international financial institutions; and the assignment of overall corporate governance responsibility to Washington.

In many cases, we stress the need for cooperation with other countries. Indeed, in many dimensions the United States has much to learn from practices elsewhere. In others, international cooperation in setting common standards is vital to effective practice.

1. An International "Gold Standard" for Governance

A. *U.S. support for internationally accepted principles of corporate governance such as the OECD standards.* The U.S. government should expand on its support for the OECD Principles of Corporate Governance, with a goal of having them formally adopted by international financial regulators.[47]

A first step should be to begin a debate on the components of a governance "gold standard" for publicly traded firms. Relying on private consultations rather than on legislative debate could create a realistic set of principles without losing the benefits of diversity in governance arrangements or opening the door to heavy-handed government interference in capital markets.

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[47] Ira M. Millstein et al., "Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets," report to the OECD by the Business Sector Advisory Group on Corporate Governance (April 1998).

B. *U.S. support for global adoption of securities-filing and disclosure procedures similar to EDGAR.* This should be undertaken bilaterally with important financial trading centers such as the United Kingdom, and multilaterally through IOSCO.

C. *U.S. support for streamlined and robust proxy voting procedures bilaterally and through IOSCO.* This would encourage publicly traded firms to enfranchise all stockholders, including foreign shareholders, rather than nullifying their voting power through restrictive registration and block-out procedures.

D. *Carve-outs from U.S. disclosure requirements for foreign issuers.* The SEC should revisit the legacy of carve-outs for the corporate governance requirements of foreign issuers on U.S. capital markets. It should begin to exercise broader disclosure oversight of the corporate governance rules of foreign firms that list themselves on U.S. capital markets, as part of a global effort to enhance governance disclosure by regulatory authorities.

Given the gold standard of governance noted above, the SEC should build on its disclosure mandate to require that firms listed on U.S. capital markets "comply or explain" with this standard.

A reasonable objection to tighter scrutiny by the SEC is that issuers will simply flee offshore—mostly to London, or to the Euromarkets more generally—thereby increasing the transactions costs to U.S. investors. Moreover, equity derivative markets and a variety of electronic trading channels have already provided an easy "escape hatch" from SEC surveillance for buyers and sellers of equity assets alike: more interference by the SEC will simply accelerate that outflow.

Such an outflow from U.S. securities oversight is less likely if the United States and the EU engage in a sort of governance entente to ratchet up the mutual standards of corporate governance disclosure. The preponderance of New York and London in the flow of deals, combined with the huge weight of Anglo-American institutional investors, would make it hard for issuers to successfully "venue shop" outside of that entente. Forging this alliance requires, however, that the SEC move beyond its resistance to IAS (see the following recommendation) and acknowledge that access to global equity markets is a benefit for U.S. investors, rather than a poker chip in "reciprocal access negotiations" for stock exchanges.

2. Reputational Intermediaries of Governance

A. *U.S. support for converging GAAP toward the higher standards of IAS.* The SEC has vacillated in its response to IAS, sometimes encouraging them, sometimes raising more objections. The commission's ambivalence stems from a combination of bureaucratic inertia, garden-variety turf protection, and concern about the important connection between accounting standards and audit standards. The EC has also waffled in its support, apparently motivated by the same concern about expensing of stock options that triggered congressional criticisms of IAS in the United States. It is time to make convergence on a single, higher accounting standard a formal position of the U.S. government and to press for this convergence through IOSCO.

It is also helpful to make explicit the differences between often idiosyncratic national accounting standards and those of IAS or GAAP, as well as to highlight these differences in auditors' letters regarding financial statements in public offerings. The Big Five attempted to do this through their so-called legends pilot program but retreated in the face of fierce objections from various finance ministries, which objected to the prospect of even tighter scrutiny from international analysts. The United States, the EC, and IOSCO should put their collective weight behind such a standardized approach.

The Big Five accounting firms need more effective external oversight, common standards of global audit practices, and some resolution to the conflicts of interest engendered by the conflating of auditing and consulting functions. Several alternatives for reform are being debated in the United States in the wake of Enron. Whatever mechanism is ultimately adopted, the international scope of business by the Big Five and the prospective convergence between GAAP and IAS should be taken into account.

B. *Exploring the incentives of reputational intermediaries at home and abroad.* Although accountants are particularly important reputational intermediaries in the neoliberal governance system, other groups play an important role: stock analysts, rating agencies, and law firms. Overall, the shareholder model rests on the search for and reporting of information. The incentives may need to be strengthened.

If the alleged "Chinese Wall" between buy-side and sell-side activities of investment bankers has been breached, it is time to create the same effect by different means. The SEC is considering several ways to remedy conflicts of interest by analysts, and it has recommended severing the compensation link between deal flow and analyst bonus. Whatever mechanisms are ultimately adopted, they should be designed with the global scale of equity markets in mind.

3. Contests for Control

U.S. support for regulatory changes that maintain vigorous markets for control and serious consideration of adopting the British City Takeover Code. We recommend a frank endorsement of regulatory changes that make it easier to mount successful hostile takeovers of firms through equity markets—subject to procedural protections of minority investors. For example, the United States should consider adopting the U.K.'s City Takeover Code, which is more streamlined and investor-friendly in many respects than the hodgepodge of U.S. state-level codes, and encourage these principles on a global scale.

As a practical matter, such a move would engender fierce political resistance at the state level and considerable skepticism in the courts. In the medium term, the most that can be probably expected is for the SEC to nudge the *processes* for conducting contests for control, which it can affect, in the direction of the City Code whenever it can.

On this score, the U.S. government should make common cause with the EC, which has attempted for years to create a European-wide common set of takeover rules more in line with the City Code standards. The proposed European takeover code has been repeatedly blocked by the French and, most recently, German governments; Berlin intensively lobbied the European Parliament to reject the commission's latest proposed set of takeover rules. Still, the prospects for EU-wide reform on a model similar to the City Code are quite high. When that happens, it will amplify pressures for reform in the United States as well.

We acknowledge that it is controversial and politically troublesome to support hostile takeovers as an engine of shareholder protections. It is true that the majority of recent takeovers in the United States and abroad have ultimately resulted in the destruction of much shareholder value, as well as jobs, rather than enhanced efficiency. But many of these takeovers resulted from empire-building by entrenched managers who were themselves immune from market discipline. Poorly governed firms make bad acquirers, especially government-controlled firms where managers are protected by state blockholdings or golden shares. Rather than erecting yet more rules against takeovers, a more efficient market in corporate control is the best course of action.[48]

4. Institutional Investors' Incentives

A. *Market incentives for the monitoring of firms by institutional investors.* The U.S. government should explore ways of providing greater market incentives for institutional investors to monitor firms by means of enhanced disclosure of corporate governance policies and voting decisions.

Corporate governance depends on incentives for institutional investors to monitor and discipline firms in which they invest. For example, money managers and pension funds could be obliged to publicly disclose their corporate governance policies for firms in which they invest and, more important, their proxy voting records in these firms, at home and abroad. Similar rules have been proposed by the Myners Commission in the United Kingdom. Currently, the Labor Department and SEC require mutual and pension funds to disclose their asset risk profiles and other performance data.

[48] Chad Leechor, "Reviving the Market for Corporate Control," *Public Policy for the Private Sector* (Washington, D.C.: The World Bank, September 1999). See www.worldbank.org.

Many observers who lauded the promise of "institutional activism" in pressing for governance reforms on the demand side during the 1990s, welcoming it as a market-based solution to governance reform, neglected the fact that these institutional investors owed their existence in large part to regulatory changes undertaken in the 1970s. Congressional passage of the Employee Retirement Income Security Act (ERISA) in 1974 helped set in motion tremendous asset accumulation by U.S. institutional investors during the subsequent 25 years, both pension funds and mutual funds. These mega-funds could solve the collective-action problem of many fragmented individual shareholders by acting as their agent in monitoring and, when necessary, disciplining the managers of large public firms.

A few of these institutional investors took corporate governance seriously, leading to the wave of institutional activism in the late 1980s and 1990s. Others sat on the governance sidelines, with few incentives to discipline managers given the "free rider" problem of even the large institutional shareholders. Moreover, some professional money managers were understandably loath to antagonize corporate managers whose pension funds they competed to manage; they either abstained from negative votes or voted with management when necessary.

To these disincentives were added additional hurdles to institutional investor activism abroad, such as an attenuated custodial chain and complex local voting procedures that often nullified foreign proxies. Given the cost of exercising corporate governance agency rights on behalf of millions of fiduciary owners, the business risk of angering potential corporate customers, and the collective-action problem (governance gains are widely distributed and thus shared with many free riders), it is entirely rational that institutional activism should demand corporate governance reforms stalled at home and abroad.

B. *The United States should place a high priority on sustained liberalization of pension fund and money management in market-access negotiations for financial services in the WTO.* The privatization of pension funds in Chile and the Netherlands served to kick-start investor activism in those markets, as the newly aggressive funds rapidly demanded improved corporate governance practices on the part of domestic firms. As authorities in continental Europe, East Asia, and many emerging markets look to emulate the United States and the United Kingdom in promoting the development of institutional investors through domestic pension funding, the corporate governance function of these investors should be an essential part of that regulatory template.

It is important to note that pension funding is one area where corporate governance reforms could find a strong natural constituency in labor unions. Although labor unions may suffer a reduction in their share of firm "rents" (jobs and wages) as a result of enhanced pressures for financial performance, their pensions are also hostage to poor financial performance—or bankruptcy—by entrenched managers or blockholders (witness the Enron case, which led to the loss of both jobs and pension funds). Enhanced disclosure, penalties for breaches of directors' fiduciary responsibility, and rules guaranteeing the independence of pension fund trustees from political interference can reduce this risk substantially.

5. International Financial Supervision

The U.S. government should press for tighter scrutiny of the corporate governance practices of financial institutions worldwide. The Treasury Department and the Federal Reserve should continue to work with major U.S. economic allies on the common problem of prudential regulation. They should push for an agreement on tough corporate governance standards for global financial institutions, similar to the BIS banking capital-adequacy standards, through a forum such as the Financial Stability Forum.

6. Corporate Governance Indices

U.S. support for developing criteria for measuring corporate governance. The development of reliable, objective criteria regarding corporate governance performance of firms is critical to any reform process. Even those who support good governance find it difficult to apply to investment decisions because they lack clear indicators of good governance. Rating agencies, shareholder services firms, and suppliers of director's liability insurance are all scrambling to find some practical indices of corporate governance to aid them in their pricing of firms' risk. Some efforts to craft such indices are currently underway, in research institutions and in private firms such as Standard & Poor's, the Investor Responsibility Research Center (IRRC), and GovernanceMetrics.[49] These efforts deserve official encouragement and support.

With measurement yardsticks of this kind, it would become easier to incorporate governance measures in benchmark indices such as Morgan Stanley Capital International (MSCI), which increasingly drives portfolio allocation decisions as well as market valuations. For example, the MSCI recently re-weighted various country stock markets to reflect the traded "float" of the leading companies rather than simply the aggregate value of their equity, thereby discounting the value to global investors of closely held yet publicly traded firms—including many state-controlled firms. This re-weighting has been reflected in changing stock prices and in the real flow of funds allocations between various country markets. Were the MSCI to factor in corporate governance in its next re-weighting exercise, this would have a dramatic, and immediate, impact on stock prices, reflecting a market-driven incentive for better governance abroad.

7. Corporate Governance Point-Person

The United States should identify a specific person or office in the government to coordinate policy on the international dimensions of corporate governance. Against the backdrop of fragmented bureaucratic responsibility for governance in the United States, compounded by multiple overlapping international linkages, it seems prudent to have someone in Washington responsible for pulling together the various strands of responsibility and authority that involve reform of corporate governance practices.

From a practical standpoint, integrating corporate governance into the broad conduct of U.S. foreign policy presents some daunting problems. How can quasi-independent statutory regulatory agencies such as the SEC be harnessed to foreign policy, when by their very design these agencies are insulated from exec-

[49] See www.GovernanceMetrics.com.

utive control in many ways? What about the thorny problems created when state-level authorities engage in corporate governance changes that work at cross-purposes with a country-level strategy of governance reform?

These are quite complex problems over the best way to manage "turf wars." We cannot examine them in detail here. Instead, we simply recommend that authority for integrating a common corporate governance strategy in the multiple strands of policy decisions be placed at a suitably senior level in a suitably central agency of the government—perhaps in the National Economic Council, or the Treasury Department, or (less plausibly) the State Department.

In sum, it is time to take corporate governance off the back burner of obscure economic issues and move it toward the front burner of foreign policy debate. The United States is at a critical junction when its corporate governance rules are about to be rewritten. Careful attention to the global context of shareholder protections can pay real, if modest, foreign policy dividends.

APPENDIX 1: CORPORATE GOVERNANCE BILLS PENDING IN CONGRESS (MAY 2002)

1. Auditor Independence Act of 2002 (Introduced in the Senate) [S.1896.IS]
2. Comprehensive Investor Protection Act of 2002 (Introduced in the House) [H.R.3818.IH]
3. Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002 (Introduced in the House) [H.R.3763.IH]
4. Corporate and Criminal Fraud Accountability Act of 2002 (Introduced in the Senate) [S.2010.IS]
5. Corporate Responsibility Act of 2002 (Introduced in the House) [H.R.4083.IH]
6. Employees and Retirees Restoration and Assistance Resolution of 2002 (Introduced in he House) [H.CON.RES.300.IH]
7. Emergency Worker and Investor Protection Act of 2002 (Introduced in the House) [H. R.3622.IH]
8. Energy Trading Oversight Act (Introduced in the House) [H.R.3914.IH]
9. Enron Employee Pension Recovery Act of 2002 (Introduced in the House) [H.R.3634.IH]
10. Financial Accuracy in Reporting Act of 2002 (Introduced in the House) [H.R.3736.IH]
11. Fully Informed Investor Act of 2002 (Introduced in the Senate) [S.1897.IS]
12. Providing for consideration of the bill (H.R. 3762) to amend Title I of the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 (Reported in the House) [H.RES.386.RH]
13. Independent Investment Advisers Act of 2002 (Introduced in the House) [H.R.3671.IH]

14. Inside Stock Sales Employee Notification Act of 2002 (Introduced in the House) [H.R.3840.IH]
15. Insider Trading Full Disclosure Act of 2002 (Introduced in the House) [H.R.3769.IH]
16. Integrity in Auditing Act of 2002 (Introduced in the Senate) [S.2056.IS]
17. Investment Disclosure Act of 2002 (Introduced in the House) [H.R.3725.IH]
18. Investor Protection Act of 2002 (Introduced in the Senate) [S.1933.IS]
19. Independent Investment Advisers Act of 2002 (Introduced in the Senate) [S.1895.IS]
20. Independent Investment Advisers Act of 2002 (Introduced in the House) [H.R.3671.IH]
21. Investor Confidence in Public Accounting Act of 2002 (Introduced in the Senate) [S.2004.IS]
22. Investor, Shareholder, and Employee Protection Act of 2002 (Introduced in the House) [H.R.3795.IH]
23. Market Oversight Consolidation and OTC Derivatives Regulation Act (Introduced in the House) [H.R.4038.IH]
24. National Employee Savings and Trust Equity Guarantee Act (Introduced in the Senate) [S.1971.IS]
25. Passive Investor Regulatory Relief Act of 2001 (Introduced in the House) [H.R.2819.IH]
26. Pension Improvement Act of 2002 (Introduced in the House) [H.R.3918.IH]
27. Pension Security Act of 2002 (Engrossed in the House) [H.R.3762.EH]
28. Pension Security Act of 2002 (Introduced in the Senate) [S.1969.IS]
29. Protecting America's Pensions Act of 2002 (Introduced in the Senate) [S.1992.IS]
30. Providing for consideration of the bill (H.R. 10) to provide for pension reform, and for other purposes. (Reported in the House) [H.RES.127.RH]
31. Retirement Account Protection Act of 2001 (Introduced in the House) [H.R.3509.IH]

32. Retirement Enhancement Act of 2001 (Introduced in the House) [H.R.3445.IH]
33. Security and Savings Act of 2001 (Introduced in the Senate) [S.742.IS]
34. Seniors Protection Act (Introduced in the House) [H.R.3799.IH]
35. To amend the Internal Revenue Code of 1986 to treat nominally foreign corporations created through inversion transactions as domestic corporations. (Introduced in the House) [H.R.3857.IH]
36. To prevent accountants from providing non-audit services to audit clients. (Introduced in the House) [H.R.3693.IH]
37. To provide regulatory oversight over energy trading markets, and for other purposes. (Introduced in the Senate) [S.1951.IS]
38. To require the Securities and Exchange Commission to review the annual reports of accounting standards-setting bodies. (Introduced in the House) [H.R.1732.IH]
39. Truth and Accountability in Accounting Act of 2002 (Introduced in the House) [H.R.3970.IH]
40. Uniform Securities Disclosure Act (Introduced in the House) [H.R.4071.IH]

APPENDIX 2: ACRONYMS

AARP:	American Association of Retired Persons
ADB:	Asian Development Bank
ADR:	American Depository Receipt
ASE:	American Stock Exchange
BIS:	Bank of International Settlements
CFTC:	Commodity Futures Trading Commission
EC:	European Commission
EDGAR:	Electronic Data Gathering and Retrieval
EPA:	Environmental Protection Agency
ERISA:	Employee Retirement Income Security Act of 1974
EU:	European Union
FASB:	Financial Accounting Standards Board
GAAP:	Generally Accepted Accounting Principles
IAS:	International Accounting Standards
IASB:	International Accounting Standards Board
ICGN:	International Corporate Governance Network
IMF:	International Monetary Fund
IOSCO:	International Organization of Securities Commissions
IRRC:	Investor Responsibility Research Center
IRS:	Internal Revenue Service
MSCI:	Morgan Stanley Capital International
NASDAQ:	National Association of Securities Dealers, Automatic Quoting System
NBER:	National Bureau of Economic Research
NYSE:	New York Stock Exchange
OECD:	Organization for Economic Cooperation and Development
PBGC:	Pension Benefits Guaranty Corporation
PWBA:	Pension and Welfare Benefits Administration of the Department of Labor

RTN:	Russian Telecommunications Network
S&L:	Savings and Loan
SEC:	Securities and Exchange Commission
SOE:	State-Owned Enterprise
WTO:	World Trade Organization