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ECONOMIC VIEWPOINT

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Corporate Standards: Raise the Bar Around the World

There's lots to do to improve governance in the U.S., but in a global economy, reforms must take place abroad, too

Although the Enron ([ENRNQ](#)) and Arthur Andersen debacles reveal cracks in the foundations of America's financial markets, there is now an imperative to fix not only the problems at home but to push for higher corporate governance standards abroad. After all, the marketplace is global. Institutional investors such as Fidelity Investments and the California Public Employees' Retirement System now hold \$2 trillion in foreign equities, up from virtually zero a decade ago. The New York Stock Exchange and the Nasdaq together have listed nearly 1,000 foreign companies. A strictly American approach to corporate governance won't protect U.S. investors nor satisfy the needs of an international market.

The top priority is for the Securities & Exchange Commission to begin embracing international accounting standards, ultimately as a replacement for the American system. It should work closely with the London-based International Accounting Standards Board, chaired by former Federal Reserve Chairman Paul A. Volcker, to create one global accounting framework. The current scandals demonstrate that the U.S. financial reporting model, devised generations ago for an industrial age, needs an overhaul. That model places a higher priority on meeting the letter of the law than on presenting a clear and honest picture of a business and its prospects. It should be improved in terms of accounting for off-balance-sheet entities, stock options, intangible assets, and much more. As KPMG Chairman Steven Butler put it at a conference: "In our post-industrial economy, our accounting system doesn't do a good job of describing any modern company."

The SEC should also establish national standards relating to the qualifications and responsibilities of boards of directors by refining the definition of what constitutes an independent director and specifying the duties of the audit and compensation committees. Although compliance should be voluntary, any company operating in the U.S. that does not conform to all the principles should be asked to explain why. There should be no legal sanctions; with disclosure, the market will render its own judgments.

As both the NYSE and Nasdaq proceed to upgrade corporate governance standards for their members, they should also institute the comply-or-explain procedure for their non-American listings. The two exchanges should also work with their counterparts in London, Frankfurt, Hong Kong, and Tokyo to press for higher governance standards,

starting with a series of corporate summits on the subject.

Global financial institutions represent another set of challenges. Bank holding companies such as Citigroup are regulated by the Federal Reserve, but broker-dealers--Goldman, Sachs & Co. ([GS](#)), for example--report to the SEC. In Britain, the Financial Services Authority supervises both kinds of institutions, as well as insurance companies. Given that large financial conglomerates are in similar businesses, their disparate regulators should agree on the best common set of governance practices for all of them.

Standard & Poor's ([MHP](#)) and Moody's Investors Service ([MCO](#)) should develop metrics to evaluate corporate governance practices and include them in their credit ratings. With SEC encouragement, the Big Five accounting firms should be working with regulatory authorities and clients around the world to tighten auditing procedures. Institutional investors like Vanguard Group Inc. and TIAA-CREF should publicly identify the best- and worst-governed companies.

The stakes are high not just for investors but for the global economy. Ira M. Millstein, senior partner at Weil, Gotshal & Manges LLP, made this point to me in an interview: "Good corporate governance protects shareholders' interests and therefore leads to more investment from the U.S. and elsewhere into developing countries."

The research of my Yale School of Management colleague, Florencio López-de-Silanes, who directs the school's new International Institute for Corporate Governance, shows that the quality of governance influences companies' cost of capital, as well as the size and vibrancy of a country's capital markets. His work demonstrates why, in a financial crisis, the exchange rates and stock markets of countries with poor governance crumble--as they have in Indonesia and the Czech Republic--while those with higher governance standards suffer far less--as have Poland and Chile. Princeton University's James Shinn believes that governance problems underlie major trade disputes in steel, semiconductors, and aircraft, where corporate directors subordinate profits to the protection of market share. He is working on a project at the Council on Foreign Relations examining how the U.S. can promote good corporate governance abroad.

From Brussels to Beijing, there is growing awareness that problems relating to auditing, transparency, and boards of directors need serious attention. It's an important moment. Regulators and CEOs should take advantage of it.