THE EVOLVING FRAMEWORK FOR CORPORATE GOVERNANCE

Over recent years there have been important regulatory developments in corporate governance. A number of initiatives to strengthen the laws, rules and principles for corporate governance have been adopted in the EU, the United States and at the international level. The objective of this article is to take stock of these measures and provide an overview of the evolving framework for corporate governance.

The article starts with an analysis of the reasons behind the recent surge in corporate governance initiatives, looking, in particular, at the impact of recent corporate scandals, structural changes, globalisation and innovation in the financial markets, and the wider economic and financial implications of corporate governance. It then goes on to describe the main elements of corporate governance, focusing on the three mutually reinforcing pillars of internal corporate governance, external corporate governance and disclosure, and on the importance of selecting the appropriate regulatory instruments. Against this background, an overview of the main measures for enhancing the corporate governance framework in the EU, the United States and at the international level is provided. The article concludes with an assessment of the remaining challenges for the evolving corporate governance framework.

I REASONS FOR THE GROWING IMPORTANCE OF CORPORATE GOVERNANCE

Efforts to strengthen the corporate governance framework have been partly in response to the series of corporate scandals which have surfaced over recent years, such as Enron (2001), WorldCom (2002) and Parmalat (2003) (see Box 1). While there are no corporate governance arrangements that will eradicate corporate fraud entirely, there are clear indications that the checks and balances of corporate governance failed to work sufficiently well in these cases. Poor oversight by company boards, insufficient arrangements for the control of management by shareholders, inadequate internal audit and risk management processes, and a lack of public disclosure and transparency were compounded by ineffective external audit. These shortcomings went largely unnoticed by financial analysts, investment firms and credit rating agencies, which further hampered the early detection of the deteriorating financial situation of the companies. Consequently, the fact that managers had been grossly misrepresenting the true economic and financial situation of their companies was only revealed when the companies were already on the verge of insolvency.

The growing political prominence of corporate governance issues should also be seen in the context of structural changes in the financial system, in particular the increasing role of market-based financing in the EU. While the US financial system has traditionally been market-based, corporate financing through equities and bonds has only picked up in the EU in recent years.1 Owing to this evolution, a wider group of stakeholders, in addition to companies’ creditors and employees, have become concerned with corporate governance. This applies not only to companies’ shareholders, but also to the growing number of small investors. Savings are increasingly being channelled through financial markets by institutional investors, such as investment funds and, in the light of recent pension reforms, private pension schemes. Given their enhanced involvement in corporate financing, market forces need to assume a stronger disciplinary role in companies.

As a result of the wider economic and financial implications of corporate governance, effective checks and balances in this area have also become more important from a broader macroeconomic perspective. Sound

1 See the article entitled “Recent developments in financial structures of the euro area” in the October 2003 issue of the ECB’s Monthly Bulletin.
### MAJOR CORPORATE SCANDALS IN RECENT YEARS

<table>
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<th>Company</th>
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| **Parmalat (2003)**     | • In November 2003 Parmalat failed to repay a €150 million bond despite apparently large amounts of cash and liquid assets on its balance sheet.  
                          | • On 19 December 2003 Bank of America stated that a document purporting to show a large account of a Parmalat subsidiary at Bank of America had been forged. As a result, a €3.95 billion black hole emerged in Parmalat’s accounts.  
                          | • On 27 December 2003 Parmalat was declared insolvent.  
                          | • In January 2004 Parmalat’s new administration admitted that the company’s level of debt was over €14 billion, almost eight times more than previously stated.                                                      |
| **Ahold (2003)**        | • Doubts about the reliability of Ahold’s financial statements grew during 2002-03.  
                          | • In February 2003 Ahold admitted it had overstated profits for 2001 and 2002 by at least €463 million, sparking an immediate 63% slump in share prices.  
                          | • From late 2001 to February 2003, Ahold lost 90% of its market value.                                                                                                                                                  |
| **WorldCom (2002)**     | • In June 2002 WorldCom admitted to having significantly manipulated its accounts, especially by wrongly declaring costs as capital expenses. Looking at the period from 2001 alone, USD 3.8 billion of alleged profits should instead have been stated as losses.  
                          | • WorldCom filed for the largest bankruptcy in US history in July 2002.                                                                                                                                                   |
| **Vivendi Universal (2002)** | • In spring 2002 Vivendi reported unexpectedly high levels of corporate debt (€19.1 billion at the end of 2001) and losses (€12.6 billion for 2001 and €12.3 billion for the first half of 2002).  
                          | • Markets discovered that they had been misled by Vivendi’s aggressive use of opaque accounting practices.  
                          | • Vivendi’s share price fell from €141 in March 2000 to €30 in June 2002, bringing Vivendi close to collapse.                                                                                                           |
| **Enron (2001)**        | • In October 2001 Enron declared a USD 1 billion write-off on bad investments and a USD 1.2 billion reduction in equity capital; US authorities launched an inquiry into Enron.  
                          | • In November 2001 Enron restated its financial statements for the period 1997-2001 to account for nearly USD 600 million in losses which had been concealed in complex financial transactions. Standard & Poor’s downgraded Enron’s debt to junk bond status.  
                          | • Enron filed for bankruptcy in December 2001.                                                                                                                                                                             |
corporate governance provides an incentive structure for the efficient allocation of resources, thereby fostering economic growth. It is also beneficial for financial stability as incentives for efficient resource allocation reduce the risk that large financial imbalances may develop. Moreover, weaknesses in corporate governance could threaten financial stability by undermining overall market confidence. The potential impact on financial stability lay behind the ECB’s interest in establishing an adequate corporate governance framework.\(^2\)

Finally, changes in corporate structures and practices resulting from globalisation and financial innovation necessitated amendments to the existing corporate governance framework. For instance, owing to the growing complexity of companies’ financial transactions stemming from the use of derivatives and asset securitisation, the existing accounting standards were no longer sufficient to inform investors adequately about companies’ performance and risk profiles. Similarly, complex corporate structures based on special purpose vehicles and spanning several jurisdictions, including offshore centres, created a need to step up internal risk management processes and to enhance disclosure.

\section*{2 THE MAIN ELEMENTS OF CORPORATE GOVERNANCE}

\section*{BASIC RATIONALE}

The fundamental motivation for corporate governance is the separation of ownership and control in public companies. The interests of managers and owners may not be entirely congruous as managers neither bear the full costs nor reap the full benefits of their actions. Consequently, there is always a risk that principal/agent problems may arise, i.e. that the actions and decisions of the agent (management) do not sufficiently meet the interests of the principal (owners). Corporate governance seeks to address this problem by establishing a system of internal and external checks and balances on corporate behaviour. An effective framework for corporate governance is based on three main pillars: internal corporate governance, external corporate governance and transparency and disclosure.

\section*{THE THREE PILLARS}

\subsection*{INTERNAL CORPORATE GOVERNANCE}

Internal corporate governance refers to the mechanisms that enable shareholders to exercise management control. These include the adequate organisation of the board of directors, effective arrangements for the exercise of shareholder rights, and a well-developed internal audit function. As regards the role of the board, the competence and efficiency of management should be promoted and monitored by an independent body within the board. Depending on the company law framework, the functional division between management and control can be implemented in different ways. In a two-tier board system, the management board is responsible for the company’s day-to-day operation, while the role of the supervisory board is to appoint, supervise and dismiss members of the management board. In this regard, the supervisory board may receive support from specific committees, such as nomination, remuneration and audit committees. In a one-tier board system, the distinction between executive and non-executive directors within the board constitutes the main instrument for internal monitoring, with non-executive directors exercising the control function. The positions of board chairman and chief executive officer may also be separated. To ensure that shareholders are able to exercise their rights effectively, adequate access to all relevant information, as well as effective arrangements for shareholder communication.

\(^2\) Under Article 105(5) of the Treaty establishing the European Community, the ESCB contributes to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system.
and decision-making are indispensable. Finally, internal processes and controls should be properly scrutinised, which is a task performed by internal audit. Unlike external audit, internal audit does not have a legally prescribed role and mandate, which means that management needs to define its responsibilities and provide it with the appropriate tools.

**EXTERNAL CORPORATE GOVERNANCE**

External corporate governance relates to the controlling function performed by financial markets. Primary markets are part of the checks and balances of corporate governance because they provide direct access to corporate financing. Market participants may be reluctant to invest in new equity or bonds of companies with corporate governance deficiencies. Companies’ prospectuses published at the point of public offering are of key relevance in providing potential investors with information in this regard. Adequate investor information is also an important issue on the secondary markets, namely in the context of the prospectuses for financial instruments that are admitted to trading. Furthermore, financial and reputational intermediaries provide an important contribution to corporate governance. Given that their task is to evaluate and price financial instruments, they may provide investors with warning signals about companies with dubious internal controls and help to uncover deficiencies in internal corporate governance at an early stage. To ensure that the “gatekeepers” do their job, it is important to have a set of rules on sound methodologies as well as on the prevention and/or management of conflicts of interest. Markets for corporate control, i.e. for corporate mergers and takeovers, reward good and penalise bad management, and in this way promote good corporate governance. The market for takeover bids is especially important in this context, as, unlike mergers, takeovers do not require management approval. A precondition for the effective functioning of the corporate control market is therefore an adequate framework for takeover operations.

**TRANSPARENCY AND DISCLOSURE**

Transparency and disclosure form the link between internal and external corporate governance. Adequate accounting standards are crucial in this regard. Moreover, an effective framework for external audit plays a key role, given the statutory duty of the external auditor to verify that all financial reports are prepared in accordance with the existing accounting standards. The competence and independence of external auditors and mechanisms to prevent or manage conflicts of interest are therefore essential.

The corporate governance framework does not exist in isolation, but depends on a country’s broader legal and regulatory framework. Rules on internal corporate governance and the market for corporate control need to be considered in the context of the wider company law, while provisions targeting primary and secondary markets and transparency and disclosure form part of the overall regulatory framework for securities markets. The effective functioning of corporate governance also depends on the existence of an appropriate framework for monitoring compliance and ensuring enforcement.

**THE CHOICE OF REGULATORY INSTRUMENTS**

Corporate governance seeks to promote both the efficiency and the integrity of companies. The choice of adequate regulatory instruments is therefore a key issue. While corporate governance provisions should ensure that the interests of shareholders and other stakeholders are adequately protected, they should not be unduly onerous, nor undermine business flexibility and competitiveness. It is therefore important to strike an appropriate balance between these two considerations.

3 This term refers to those market actors – such as financial analysts, investment banks and credit rating agencies – which provide information about a company’s financial situation and prospects on the basis of their reputation as independent parties. Reputational intermediaries provide an important service both to companies and stakeholders: they “lend” their reputation to companies, while at the same time acting as “delegated monitors” for stakeholders, thus helping to overcome collective action problems of widely dispersed shareholders, investors and other stakeholders.
A variety of regulatory instruments may be employed, ranging from fully market-based solutions to monitored self-regulation, principles-based public regulation and detailed legal rules. Identifying the appropriate tool requires a careful analysis of the specific policy area in question. For instance, in the area of external audit, recent corporate scandals have led many observers to argue that reliance on self-regulation of the profession is no longer sufficient. Largely in response to these concerns, public oversight of the auditing profession has been introduced in the United States and is in the process of being established in the EU. Similarly, there is a shared understanding between the EU and the United States that more transparency and stricter disclosure requirements are necessary to facilitate the monitoring of companies. Consequently, detailed legislation on this matter has been adopted or is in the pipeline. However, as far as the role of reputational intermediaries is concerned, greater regulatory flexibility is considered necessary to minimise the potentially stifling effects of new rules. The EU and the United States have also stepped up legal requirements in this area, especially with regard to the need to avoid or manage conflicts of interest, but these have consequently been more principles-based.

The choice of regulatory instruments also depends on the overall political and institutional setting. For example, international fora, such as the Organisation for Economic Co-operation and Development (OECD), the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) comprise a wide and highly heterogeneous membership. They are also based on a “soft” mode of cooperation, whereby decisions are taken by consensus and implemented on a voluntary basis. Any corporate governance provisions issued by these bodies therefore take the form of principles rather than specific rules. In this way, there is sufficient room for implementation in line with the different legal and institutional settings across countries. Conversely, the EU corporate governance framework needs an appropriate infrastructure for sustaining the Single Market, which requires a greater degree of regulatory convergence. However, even in the EU, the appropriate level of regulatory harmonisation is not the same across policy areas. In particular, full harmonisation of internal corporate governance provisions would neither be feasible nor desirable in the light of the substantial differences in the legal settings of Member States. By contrast, the close convergence of external corporate governance and transparency and disclosure requirements is recognised as an essential element in the legal underpinning of the single financial market.

3 RECENT EFFORTS TO STRENGTHEN THE CORPORATE GOVERNANCE FRAMEWORK

In recent years several important initiatives have been taken to improve the corporate governance framework. The following sections provide a brief overview of the measures that have been adopted in the EU\(^4\), the United States and at the international level.

3.1 EU INITIATIVES

FINANCIAL SERVICES ACTION PLAN

The Financial Services Action Plan (FSAP), which was adopted in 1999\(^5\), constituted a major overhaul of the existing regime for financial services in order to promote the development of a truly integrated financial market, focusing, in particular, on securities markets regulation. FSAP measures affect the corporate governance framework in the areas of external corporate governance and transparency and disclosure.

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\(^4\) Regulatory measures for improving corporate governance in the EU have been taken both in several Member States and by the European Commission. This article only covers the initiatives taken at the Community level.

In the area of external corporate governance, the new Prospectus Directive standardises initial disclosure requirements for issuers, and thus reinforces the functioning of the primary markets. As regards the secondary markets, two new directives strengthen the role of reputational and financial intermediaries: the Market Abuse Directive, inter alia, requires the fair presentation of investment recommendations as well as the disclosure of interest and conflicts of interest to the public, while the Directive on Markets in Financial Instruments introduces stricter conduct of business rules and requirements to address conflicts of interest. In addition, the FSAP included the 13th Company Law Directive on takeover bids, which constitutes an important measure for improving the functioning of the markets for corporate control.

In the area of transparency and disclosure, a new regulation requires all listed companies to prepare their consolidated financial statements in accordance with the International Accounting Standards by 2005, while the Transparency Directive substantially tightens periodic information requirements for issuers.

ACTION PLAN ON COMPANY LAW AND CORPORATE GOVERNANCE

Another milestone in strengthening the EU framework for corporate governance was the European Commission’s Action Plan on Company Law and Corporate Governance, which was published in May 2003. The Action Plan closely followed the recommendations of the report of the High Level Group of Company Law Experts set up by the Commission. It provided a comprehensive agenda for modernising the regulatory framework for EU company law in view of the growing degree of financial market integration and new market developments, and for improving internal corporate governance in response to the lessons learned from recent corporate scandals. More specifically, the Action Plan highlights four strands of work in the area of internal corporate governance, namely the need to:

i. improve the functioning of company boards, among other things by strengthening the role of non-executive (or supervisory) directors, by establishing minimum standards for companies’ regimes concerning the remuneration of directors, and by establishing the collective responsibility of board members for financial statements;

ii. heighten the role of shareholders by improving shareholders’ access to the relevant information and by facilitating the exercise of shareholder rights, especially in a cross-border context;

iii. improve company disclosure on corporate governance; and

iv. promote convergence of national corporate governance towards best practices by setting up a European Corporate Governance Forum.

As a follow-up to the Action Plan, the Commission took a number of initiatives in October 2004. It adopted a Recommendation on directors’ remuneration, a Recommendation on independent directors, as well as a proposal to revise the existing EU Accounting Directives, which would give collective responsibility for financial statements to the board, provide for greater transparency in off-balance sheet arrangements and transactions with related parties, and require the issuance of an annual corporate governance statement from all listed companies. In addition, the Commission set up the European Corporate Governance Forum, which comprises 15 senior corporate governance experts and is chaired by the Commission.

**COMMUNICATION ON REINFORCING THE STATUTORY AUDIT**

The Commission Communication on Reinforcing the Statutory Audit, issued in May 2003, was an initiative specifically targeted at strengthening the external audit function in the EU. The main proposal of the Communication was to update and substantially broaden the scope of the 8th Company Law Directive, among other things by laying down new requirements for auditor independence, external quality assurance and disciplinary sanctioning, and by requiring the use of International Standards on Auditing (ISA) by 2005. It also provided for the introduction of public oversight of auditors, which is to be performed by a new Audit Regulatory Committee comprising representatives from each Member State. The Commission presented its proposal for the new Directive on Statutory Audit in March 2004, and it is currently being discussed in the EU Council and the European Parliament.

**MEASURES IMPLEMENTED AFTER THE PARMALAT CASE**

When the Parmalat group declared insolvency in December 2003, it marked the end of Europe’s largest ever corporate scandal (see Box 2). Several important initiatives to strengthen the EU corporate governance framework had already been instigated (but not yet adopted or implemented) before the Parmalat scandal, but some of these were slightly modified after the event to incorporate the specific lessons learned from the case. For example, the Commission, in its proposal for the new Directive on Statutory Audit, introduced the principle that the main auditor bears full group responsibility, made audit committees mandatory in listed companies and tightened potential sanctions. Furthermore, according to the proposed revision of the EU Accounting Directives, companies would be required to provide full information about all off-balance sheet arrangements, including special purpose vehicles.

In a Communication issued in September 2004, the Commission stated that its efforts to improve corporate governance were part of a broader strategy against corporate and financial malpractice in the light of recent scandals. The overall aim of this strategy is to strengthen four basic lines of defence, namely internal controls, independent third parties (including external auditors), supervision and oversight, and law enforcement. The Communication covers several policy areas, including Financial Services, Justice and

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15 Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).
17 The Commission announced the creation of the Forum on 18 October 2004. Its main role will be to identify best practices in corporate governance across Member States and to provide advice to the Commission. It will not, however, have any advisory powers with regard to regulatory matters.
Home Affairs and Tax Policy. No new measures have been proposed for Financial Services, as it is felt that the measures under way are sufficient for the time being, and that the focus should be on ensuring their timely implementation and strict enforcement.

INITIATIVES RELATING TO CREDIT RATING AGENCIES

Unlike other reputational intermediaries, such as investment firms and financial analysts, credit rating agencies are not bound by EU rules. In response to the Enron scandal, however, the Commission proposed to the ECOFIN Council at its informal meeting in Oviedo in April 2002 an examination of the role of rating agencies in the financial markets, and an assessment as to whether or not regulatory intervention in the area of credit ratings should be considered. Further impetus was added to the issue by several recent developments, in particular

- the new role of credit rating agencies as “external credit assessment institutions” in the forthcoming revised capital requirements framework for banks and investment firms;\(^{21}\)
- the adoption of the Market Abuse Directive and the related implementing measures

regarding conflicts of interest and fair information\(^{22}\) (which will apply to financial analysts, but not to rating agencies); and

– the Parmalat case, in which credit rating agencies did not issue a timely warning about the company’s deteriorating financial situation.

The issue was also taken up by the European Parliament. In its resolution on the role and methods of rating agencies, which was adopted on 10 February 2004, the Parliament asked the Commission to assess, by 31 July 2005, the potential need for and scope of EU action on rating agencies.\(^{23}\) In July 2004 the Commission asked the Committee of European Securities Regulators (CESR) for technical advice on possible EU measures for credit rating agencies by April 2005.

### 3.2 US INITIATIVES

#### SARBANES-OXLEY ACT

The Sarbanes-Oxley Act (SOX), signed into law in July 2002, constituted a major overhaul of the US corporate governance framework. This new law applies to all companies with more than 500 shareholders (“public companies”) and listed companies. Most of the SOX provisions require compliance also from all foreign issuers reporting to the US Securities and Exchange Commission (SEC) as well as from the foreign auditors providing services to those companies.

One of the main areas targeted by the SOX is internal corporate governance. Among other things, it requires a company’s chief executive and financial officers to personally certify each annual and quarterly report, tightens the legal provisions on corporate and financial fraud accountability (including significant penalty enhancements), and provides for more comprehensive disclosure on internal controls.

In addition, the SOX prohibits insider trading and loans, and requires listed companies to have a fully independent internal audit committee. Another prominent feature of the SOX is a substantially enhanced regime for statutory audit. In particular, it provides for the creation of a Public Company Accounting Oversight Board (PCAOB), which marks the shift from a self-regulatory framework for external audit to external oversight performed by an independent body. As a result, all accounting firms auditing public companies will be subject to the PCAOB’s requirements on audit quality, registration and regular inspections as well as to possible sanctions. The SOX also includes provisions that address potential financial analysts’ conflicts of interest. Finally, it steps up the rules for the ongoing disclosure of issuers, for example by expanding disclosure requirements for off-balance sheet arrangements and by requiring issuers to report on any changes in their financial situation and operations “on a rapid and current basis”.

While some of the SOX provisions came into effect immediately, most required specific rule-making by the SEC. In addition to these statutory measures, the two main market operators – the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation (NASDAQ) – revised their listing requirements in response to the SOX.

#### INITIATIVES RELATING TO CREDIT RATING AGENCIES

The SOX invited the SEC to review the role of rating agencies in the United States, focusing on the overall importance of rating agencies for securities markets, possible obstacles to performing this function efficiently, barriers to entry in the ratings industry, and potential conflicts of interest. The SEC delivered its report to the US Congress in January 2003. It


\(^{23}\) The resolution was based on the “Report on the role and methods of rating agencies” of 29 January 2004, which had been prepared by the European Parliament’s Committee on Economic and Monetary Affairs.
then, in June 2003, issued for consultation a concept release on several issues relating to rating agencies, including the use of credit ratings for regulatory purposes and possible oversight measures. Market participants were invited to provide feedback on the concept release by the end of July 2003. The SEC has not yet decided on any further action.

3.3 INTERNATIONAL INITIATIVES

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

In May 1999 the OECD issued its Principles of Corporate Governance, which were subsequently adopted by the Financial Stability Forum as one of the 12 key standards for international financial stability. In 2002 the OECD launched a general assessment of its principles in the light of several corporate scandals, new developments and calls for more regulation in many countries. As a result of this wide-ranging review process, which involved taking stock of corporate governance developments in OECD countries and a round of worldwide public consultation, a revised version of the OECD Principles of Corporate Governance was published in April 2004.

As in the 1999 version, the revised OECD principles focus on internal corporate governance and disclosure, covering five areas: the rights of shareholders; the equitable treatment of shareholders; the role of stakeholders; disclosure and transparency; and the responsibilities of the board. The respective provisions, however, were expanded and rendered more specific. For instance, in terms of shareholders’ rights, the revised version explicitly recognises shareholders’ right to dismiss members of the board and participate in key decisions such as the nomination, election and remuneration of board members. More emphasis is also placed on the conditions needed for an effective exercise of shareholder rights and on the protection of minority shareholders. Regarding the role of wider stakeholders, a new principle on the protection of “whistleblowers” (any stakeholder that may wish to communicate concerns about illegal or unethical corporate practices to the board) has been introduced. The section on disclosure and transparency includes additional disclosure obligations and also highlights the importance of auditor independence. Furthermore, a new principle states that the work of rating agencies and financial analysts should not be compromised by conflicts of interest. Finally, the new principles concerning the responsibilities of the board stress, in particular, the fiduciary role of the board as well as the need for independence and objectivity.

BASEL COMMITTEE ON BANKING SUPERVISION

Adequate checks and balances on corporate governance are even more important for banks than for other companies because of their crucial role in channelling funds within the economy and the comparatively higher risk of contagion in the banking sector. Sound internal corporate governance significantly enhances banks’ capacity to adequately identify, measure and monitor their financial risks.

In September 1999 the BCBS issued guidance on “Enhancing Corporate Governance for Banking Organisations”. This document formed part of the Committee’s ongoing efforts to improve banks’ risk management and disclosure, and also responded to the national and international initiatives to enhance the corporate governance framework, in particular, the development of the OECD Principles on Corporate Governance. Taking into account previous supervisory experience of specific corporate governance problems at banks, the document identified a number of fundamental principles for effective internal corporate governance of banks. The BCBS is currently assessing the possible need and scope for updating this guidance.

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

In February 2004, following the recent corporate scandals, IOSCO launched a broad strand of work to strengthen the defences of international capital markets against financial fraud and market abuse. A high-level task force was mandated to identify the main policy issues of concern and to assess the possible need for and scope of a regulatory response from IOSCO. Based on this work, IOSCO published its “Report on Strengthening Capital Markets against Financial Fraud” on 1 March 2005, which summarised the main findings of the task force and set out an action plan for improving the current regulatory framework. The report identified several areas that were instrumental in recent corporate scandals, including internal corporate governance, external audit, issuer disclosure and transparency, the role and obligations of reputational and financial intermediaries, and the use of complex corporate structures. For each of these areas, the report analysed existing IOSCO standards and principles, and the possible case for measures to improve implementation and enforcement of existing provisions and/or for additional guidance. Particular emphasis was placed on suitable mechanisms for promoting more effective implementation and enforcement of IOSCO standards and principles across countries.

In previous years IOSCO had already taken several other important initiatives to improve the corporate governance framework. In its role as an association of securities commissions, IOSCO has, in particular, developed guiding principles and best practices for external corporate governance and for transparency and disclosure, for example with regard to the role of credit rating agencies and financial analysts in securities markets and the framework for external audit.25

4 CHALLENGES AHEAD

Ensuring a sound framework for corporate governance is an ongoing task. New market developments may always require adaptations of the corporate governance framework and new corporate governance problems may come to light. In recent years a large number of major initiatives have already been adopted to strengthen the three pillars of corporate governance in the face of the current challenges for effective corporate governance. Work is still under way in a few areas, such as the implementation of the Commission Action Plan on Company Law and Corporate Governance and possible initiatives for credit rating agencies. In the coming period, public policy should therefore focus mainly on the implementation of the revised framework. Above all, new provisions should generally be allowed to show their effects before additional regulatory initiatives in these areas are contemplated. The costs and benefits of any further regulatory initiatives should also be assessed very carefully.

Effective implementation will not only depend on the strict application and enforcement of the new principles and provisions on corporate governance. Indeed, even the best rules can be circumvented and never prevent fraud entirely. This highlights the importance of adequate business ethics and shareholder culture. For example, internal corporate governance not only rests on formal compliance with the rules for the organisation of the board and the rights of shareholders, but also on the promotion of an appropriate corporate culture by senior management and the board, and on the active

25 As regards credit rating agencies, IOSCO issued its “Code of Conduct Fundamentals” in December 2004, focusing on three main areas: the quality and integrity of the rating process, the need for independence and avoiding conflicts of interest and rating agencies’ responsibilities to investors and issuers. The Code of Conduct Fundamentals was developed on the basis of IOSCO’s earlier work on rating agencies, especially the “Principles Regarding the Activities of Credit Rating Agencies” and the “Report on the Activities of Credit Rating Agencies”, both published in September 2003. With respect to financial analysts, IOSCO presented, in September 2003, a “Report on Analyst Conflicts of Interest” as well as a “Statement of Principles for Addressing Sell-Side Securities Analyst Conflicts of Interest”. For the area of external audit, IOSCO issued in October 2002 “Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence” as well as “Principles for Auditor Oversight”.
role of shareholders. In a similar vein, while strengthened rules on transparency and disclosure will facilitate market discipline, all stakeholders must assume their responsibilities as active monitors of companies.

In the light of the closer integration of financial markets, the pursuit of close cross-border convergence is another important implementation issue, both at the EU and the international level.

In the EU context, the timely and consistent implementation of the relevant new Community legislation in Member States is an important prerequisite for the efficiency and integrity of the single financial market. It should also be carefully monitored whether the various non-binding Community measures, particularly in the area of internal corporate governance, are successful in spurring effective convergence towards best practice.

At the international level, one priority will be to ensure that the commonly agreed standards and benchmarks for good corporate governance are adequately reflected in national rules and practices. While international principles need to be closely observed across countries, there will be no “one size fits all” approach to corporate governance regulation owing to substantial differences in financial systems, legal settings and corporate ownership structures. Because of these differences, regular cross-border exchanges of information between the responsible authorities are essential, especially with regard to the ongoing or forthcoming regulatory initiatives. Such dialogue will help to promote a better mutual understanding of the respective corporate governance systems. They will also facilitate cross-border coordination of regulatory measures aiming to reduce the risk of a possible duplication of requirements or level playing-field distortions. The EU-US Financial Markets Regulatory Dialogue\textsuperscript{26}, an informal bilateral exchange on regulatory and supervisory issues of mutual interest, is a significant example of such cooperation.

\textsuperscript{26} The EU-US Financial Markets Regulatory Dialogue was launched at the EU-US summit in May 2002. It involves the European Commission, the SEC, the Board of Governors of the Federal Reserve System and the US Treasury.