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# On The Road To Global Governance Standards

**By Harvey L. Pitt, Compliance Week Columnist—May 31, 2006**

With Nasdaq announcing its acquisition of nearly 25 percent of the shares of the London Stock Exchange, and the concomitant pressure on the NYSE to make a comparable foreign exchange acquisition, it's now readily apparent that we're moving toward global, and away from national, capital markets. In more prosaic terms, what this means is that decisions where to "list" a stock will be significantly less important in the future. What will be of paramount importance is where securities are traded, and who owns them.


As we move toward global markets, there are important consequences. When entities transact business in a foreign country, by definition they subject themselves to the possible jurisdiction and oversight of foreign regulators. After all, those who play in the same market should be bound by similar, though not necessarily always precisely the same, standards. That's because global markets, governed by global regulators, require global accommodations. We are witnessing the development of comprehensive and rational regulatory regimes governing areas of common concern.

There are three critical standards that will be employed in harmonizing different regulatory regimes—equivalence, reciprocity and transparency. Equivalence, or convergence, means foreign and U.S. regulators will produce standards and rules that are substantively addressed to the same concerns. We're on the road to achieving that result in the area of accounting principles. Reciprocity means that what's good for the goose is also good for the gander; regulatory accommodation is, and will be, a two-way street. And finally, transparency means that, where differences can't be reconciled, they must be disclosed, so investors know what they're getting, and what they're not.

At the moment, we see some exchanges literally bragging that companies listed on their exchange aren't subject to the standards of The Sarbanes-Oxley Act of 2002. But that's an enormous mistake. Whether or not the specific implementation of principles in SOX is the best that could have been achieved, the principles themselves, and the standards they impose, are worthy of replication in every country, and that's what we're seeing emerge.

Of course, even beyond regulators and prosecutors, forces within the marketplace are requiring companies to pursue good governance. Last month saw an announcement that 32 pension funds from around that world had entered into the first global charter placing environmental, social and governance standards at the core of their investment strategies. The pension funds, worth more than $2 trillion, represent more money than is currently managed by all hedge funds and private equity groups combined.

Other market forces also are at work. For example, rating agencies rate governance in determining debt ratings. This, of course, has a direct, bottom-line impact on the cost of raising capital in non-equity markets. Similarly, insurance companies, which have been hit hard in making payments on behalf of those companies that have surfaced with problems, are conditioning the grant of D&O and E&O insurance policies—and the amount of the premiums for those policies—on the extent to which good governance and transparency prevail. Companies lacking transparency and good governance are being abandoned by the Big Four accounting firms, rejected by investment bankers as candidates for raising capital, and finding it harder to attract quality directors.

What all this means is that, one way or another, wittingly or not, corporations the world over will be compelled to meet new governance and transparency standards in order to survive and prosper. Given this context, what are some of the pressing international issues over the coming months and year? While no one can be certain what the future will bring, here are a few of the issues.

- **Emerging Capital Markets.** Given the impressive achievements of capitalism, it isn't any surprise that capital markets are emerging all over the globe, even in countries that have eschewed capitalism as a mantra. This is a positive development, because capital markets provide the necessary financing for infrastructure and other societal improvements. We're witnessing an excess of capital, looking for investments around the globe. Some marketplaces have already been identified as "hot"—including India and China. But every country is either already participating in the tremendous growth of capital markets and the desire to invest in local initiatives, or planning to do so. This trend will lead to a confluence of four characteristics: integrity, rationality, accountability and transparency.

- **Market Regulation.** Problems within the financial services industry, exacerbated by the advent of new technologies, have created one of the most pressing issues facing our capital markets: the future of market regulation. And these dynamics have changed dramatically, especially over the past year. The two principal U.S. equity exchanges are now public, for-profit, entities, as is true of most of the world's exchange markets. When the U.S. securities laws were first passed, no one assumed that stock exchanges would be public entities, subject to the potential of conflicting pressures from both their members and their shareholders. Nor did anyone assume that exchanges would acquire one another, or potentially do so, as we've seen transpire recently. There's a real effort underway by market regulators to adopt the notion of convergence that's been successfully embraced in the accounting principles arena, and apply it to market regulation. The standards won't necessarily be the same, but they will be comparable. Investors will need to be told that they're protected against the kind of chicanery and fraud we've seen all too much of over the last five years, and those markets that presently advertise a lower standard will soon discover the painful dual reality of that status—lower quality companies and fewer investors.

- **Accounting Issues.** There has been far too little effort toward resolving global accounting concerns, such as improvement in the quality of audits, unaddressed auditor liability, and the development of a single set of principles-based accounting standards. Some of these topics are addressed below, but suffice it to say that standard-setters are going to be working more closely together in the coming decade, and auditors will likely consolidate efforts to improve the quality of audits. As a result, companies will increasingly feel pressure from a more unified global oversight community, and will need to bolster their own internal controls and internal audit functions accordingly.

- **Auditor Liability.** Part and parcel of this effort, of course, is to address the difficulty of auditor liability. If auditors perform in a substandard manner, or fail to produce quality audits, liability is an essential ingredient of any regulatory regime. But the goal should be to improve quality controls and performance, and liability assessment is not always the best way to achieve that goal. It's critical that the quality of audits be improved significantly, which will require accounting firms to work together to develop standards and training programs.

- **Accounting Principles.** In the U.S., our system of developing accounting principles is broken and broken badly. We produce accounting principles at a glacial pace, and then do so in prescriptive fashion, as compared with the effective approach of International Financial Reporting Standards. Regulators will be working together not only to develop a uniform system of accounting principles, but also to focus on the ways they can ensure uniform interpretations of those uniform principles. If different regulatory bodies interpret and enforce accounting standards differently, efforts toward convergence will be for naught.

- **Hedge Funds.** A final issue worth considering is the role of hedge funds. Hedge funds provide valuable liquidity for capital markets, and they are a source of great strength and profitability. But we are witnessing trends that bear some scrutiny. As many of the markets in which well-established hedge funds participate have become more and more efficient, these funds are finding their ability to provide the historical high returns associated with many such funds is diminishing. This means that many hedge funds are going to be turning to less efficient markets in which to make their investments, hoping to make large profits from the inefficiencies inherent in less well-developed marketplaces. This is all well and good, but it signals a higher degree of risk for those who actually invest in such hedge funds.

What does this mean for companies with a multi-national presence? Here are some considerations to keep in mind:

- **Take Inventory.** With regulation of corporations and capital markets becoming a full-time preoccupation for more and more jurisdictions, smart businesses will take "inventory." In addition to cataloguing the jurisdictions in which they do business, they will also keep a close watch of the localities in which their shareholders reside.

- **Know The Rules.** Standards are as variable as at least the number of countries in which companies do business. It's critical for companies to make certain that they've analyzed the relevant standards in each of the jurisdictions in which they do business, as well as the jurisdictions in which their shareholders reside.

- **Develop A Matrix.** Once the countries and their rules have been identified, it's important to develop a matrix setting forth the differing requirements, and explicating the ways in which a company's obligations may vary depending on those laws to which the company is subject.

- **Develop Global Compliance Procedures And Policies.** It's frequently the case that most differing standards can be harmonized, usually by adopting the most exacting requirements to which a company may be subject. Disparities in governing laws and regulations should not usually result in disparate compliance policies; if they do, companies may find themselves with added liability in those jurisdictions in which they've adopted a less rigorous standard.

- **Where Different Procedures and Policies Must Exist, Explain Them.** On occasion, what works in one jurisdiction will not work in another. Privacy laws are a good example— non-U.S. jurisdictions tend to have more exacting restrictions than the U.S. does on what data may be collected, and how it may be used. If differing policies and procedures are implemented, companies should make certain to acknowledge the difference in compliance manuals, and explain the reasons that they exist.

- **Use Global Training Mechanisms.** Along with the reality of having global standards comes the need to develop global training programs. Companies cannot afford to train employees in different countries differently.

- **Avoid Two-Dimensional Compliance Policies.** It is critical to avoid creating and updating compliance policies as if the company involved exists in a vacuum. There is much to be gained by developing a knowledge curve of what a company's peer competitors are doing, and to make certain your company has state-of-the-art best practices in place.

- **Establish Uniform Implementation Policies.** At many multinational companies, different locales have unique individuals assigned the responsibility of administering and implementing the company's compliance procedures and policies. This, of course, makes sense: It's important to have someone "on the ground" in each location to whom employees can turn for guidance or answers to questions. However, if similar misconduct is subject to variable sanctions within the same company, problems and liability are probably not far behind. It is critical to have coordination and communication between compliance administrators in different locales.

- **Keep Excellent Records.** Given the complexities of accommodating various global regulatory regimes, it's incumbent upon companies to maintain careful records, demonstrating they've paid attention to the requirements of each jurisdiction in which they do business.

Maintaining a handle on diverse regulatory requirements and compliance policies is becoming ever more complex in our global environment. But the rewards for achieving this are enormous, and the penalties for failing to satisfy that standard are equally daunting.

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