AN ANALYSIS OF ENABLING VS. MANDATORY CORPORATE
GOVERNANCE STRUCTURES POST SARBANES-OXLEY

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ABSTRACT

I argue that firms have incentives to adopt corporate governance practices in the absence of a legal requirement to do so. I further contend that a partially enabling governance regime, and particularly one coupled with mandatory disclosure of a firm’s governance practices, is likely to yield a high level of compliance at lower direct costs to the issuer than a wholly mandatory regime. While a wholly mandatory structure may yield slightly better compliance, its other benefits are uncertain and its costs are likely much higher. I seek to push the boundaries of existing comparative corporate governance scholarship by arguing that the enabling/mandatory dichotomy informs analyses of corporate governance regimes across countries.
I. Introduction

In the United States, certain aspects of corporate governance have become the subject of mandatory regulation under the Sarbanes-Oxley Act.¹ Other major common law jurisdictions, such as the United Kingdom, Australia and Canada, have rejected mandatory corporate governance legislation of this nature. These countries have instead opted for an enabling, or partially enabling, regime under which companies can choose the governance practices they will adopt but they must make disclosure regarding these choices. The question that arises is whether an enabling structure gives rise to the benefits of a mandatory governance regime but at less cost.

Free marketers of course dismiss the notion of a mandatory corporate governance regime, arguing that if enhanced corporate governance practices were beneficial and desired by investors, firms competing for scarce capital would implement them voluntarily. On the other hand, investor advocates argue that an enabling regime is insufficient, since there is no guarantee that all firms will implement the reforms necessary to provide investors with adequate checks on agency problems. On this view, mandatory corporate governance is necessary -- just like rules prohibiting insider trading -- to protect investors.

These extreme positions do not capture the complexities inherent in a choice between enabling and mandatory governance regimes. In this paper, I argue that firms have incentives to adopt corporate governance practices in the absence of a legal requirement to do so. I further contend that an enabling governance regime coupled with mandatory disclosure of a firm’s governance practices is likely to yield a high level of compliance at lower cost than a wholly mandatory regime. While a wholly mandatory structure may yield slightly better compliance, its costs (particularly direct costs) are likely much higher.

I do not seek to slot entire governance regimes into either the mandatory or the enabling category: most regimes exhibit characteristics of both. In particular, in the United States, corporate law as a whole is largely enabling at the state level, providing default rules to which corporations must adhere if they do not choose an alternative arrangement that will govern them. Despite the enabling character of state corporate law, most would agree that Sarbanes-Oxley cannot be characterized as enabling legislation. Thus, in this paper, I address the conspicuous aspect of US corporate governance reforms.

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governance regulation that is mandatory under Sarbanes-Oxley, conspicuous because of the enabling character of state corporate law and because other principal common law jurisdictions have not adopted a similar approach.

While the US regime under SOX is largely mandatory, other jurisdictions have adopted a different governance model. Canada’s regime dates back to 1995 when the Toronto Stock Exchange (TSX) issued a list of best practices that Canadian listed firms may but are not obliged to follow. Disclosure regarding the extent of a firm’s compliance with the best practices was required in the firm’s proxy circular or annual report. Provincial securities commissions now bear the responsibility for formulating and administering the corporate governance guidelines. They have issued a voluntary code of best practices coupled with a mandatory disclosure rule.

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4 See SOX, supra note 1 at § 302, 304, 401, 403, 404.
5 The TSX best practice guidelines deal with the board’s mandate; board composition (including minority shareholder representation); board committees; board approval; structures in place to facilitate an independent board; procedures for recruiting new directors and assessing board performance; measures for receiving shareholder feedback; and the board’s expectations of management. The guidelines emanated from the Toronto Stock Exchange Committee on Corporate Governance in Canada, “Where Were the Directors?” Guidelines for Improved Corporate Governance in Canada, (1994) [Dey Report]. The TSX adopted the Dey Report in February 1995 and on May 3, 1995, released TSX By-Law 19.17, which requires companies incorporated in a Canadian jurisdiction and listed on the TSX to make disclosure annually regarding their corporate governance practices in an annual report or information circular. These guidelines came into effect beginning with companies whose fiscal year ended on June 30, 1995.
The U.K. regime is also partially enabling under the 1998 Combined Code which creates best practice guidelines.  

Compliance with these guidelines is voluntary, but companies listed on the London Stock Exchange are required to include in their annual report a statement indicating how the company applies the Combined Code’s principles or explaining why it does not comply. Similarly, the Australian corporate governance regime revolves around the Australia Stock Exchange (ASX) guidance which presents recommendations on how to achieve best practice in governance. Each company listed on the ASX is required to provide a corporate governance statement containing disclosure of non-compliance in its annual report.

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9 This requirement is found in the Preamble of both versions of the Combined Code, at ¶ 4.

10 U.K.L.A. Listing Rules, supra note 8, Rule 12.43A(b).


12 Ibid. at 3.

13 The ASX regime takes an “if not, why not?” approach: it does not usually require disclosure of compliance; rather, it requires disclosure of non-compliance, with an explanation of why the company’s board believes that non-compliance is appropriate. See ASX Guide, ibid. at “Foreword”;

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Thus, in three major common law jurisdictions outside the United States, the corporate governance regimes are what I term “partially enabling” where a code of best practices is coupled with a mandatory disclosure obligation. The seeming popularity of the partially enabling structure presents a puzzle as to why these jurisdictions have adopted a hybrid corporate governance regime and, in particular, what are the benefits and costs of such a regime. This is the starting point for this paper.

Up to this point, the “mandatory” vs. “voluntary” or “enabling” typology has infrequently been used in studies of comparative corporate governance though it has certainly been the subject of academic discussion in the context of state corporate law. Existing comparative corporate governance literature is divisible into two broad categories. One focuses on the differences between the dispersed ownership model found in the United States and concentrated ownership models such as those found in Germany and Japan. This stream of the literature has examined whether the end of corporate law is here, since shareholder primacy has prevailed, or whether path dependencies exist that prevent convergence in corporate governance systems. The

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14 But see Gilson & Milhaupt, supra note 3.
15 See e.g. Easterbrook & Fischel, Economic Structure of Corporate Law; Gordon, supra note 3; Romano, supra note 3; Black, supra note 3; Bebchuk & Hamdani, supra note 3.
other category stems from empirical work that examines the impact of a country’s legal system (common vs. civil law) on corporate performance. A main point in this strand of the debate is the importance of law, and particularly minority protections, in enhancing capital markets. By introducing the idea of enabling vs. mandatory corporate governance, I add a third category to the comparative corporate governance debate.

To be clear, the term “mandatory” used here means legally mandated, with penalties applying to those who fail to comply with the legal rule in question. The term “voluntary” or “enabling” (here used interchangeably) denotes a firm’s choice to adopt corporate governance practices or standards in the absence of a legal requirement to do so. Such practices can, but need not be, set forth in guidelines or best practice regulatory instruments, typically issued by securities regulators or stock exchanges. The enabling code does not necessarily replace but can be in addition to a corporate governance regime already in place under statute, for example.

In Part II, I contend that there are powerful incentives for voluntary behavior in the area of corporate governance. In Part III, I examine policy implications of

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19 There is also a “hybrid” type of rule, which is one that firms comply with because they feel compelled to do so for any number of reasons, such as to avert the loss of capital that would occur if they did not do so. In other words, firms would adopt these hybrid-type rules even if they were not required to do so. Such rules, therefore, also fall into the “voluntary” category. See infra Part III on incentives.

20 See e.g. the TSX Guidelines in the TSX COMPANY MANUAL, supra note 6 at § 474 [TSX Guidelines].

21 See e.g. NI 58-101, supra note 7.
recognizing that firms have incentives to adopt governance practices voluntarily, arguing in favor of a partially enabling structure in which firms have the flexibility to design their own corporate governance regime but they must disclose the compliance with suggested best practices. Finally, in Part IV, I discuss the need for mandatory disclosure in an otherwise enabling system of corporate governance.

My argument has both descriptive and prescriptive elements. It is descriptive in examining incentives for voluntary adoption of corporate governance practices and in illustrating benefits and costs of both mandatory and enabling regimes. However, the argument is also prescriptive in postulating that a partially enabling regime is ultimately preferable to a purely mandatory or purely enabling system. The prescriptive argument is based on an analysis of costs and benefits of enabling vs. mandatory governance regimes as well as the benefits of mandatory disclosure.

II. Incentives for Voluntary Behavior

One way to maintain a high level of investor protection without creating excessive costs to issuers is to take advantage of firms’ incentives to adopt voluntarily certain recommended corporate governance practices, such as those contained in a list of best practices. But if we are to favor this or any other voluntary structure of corporate governance, we must be certain that these incentives exist. What are the reasons that a firm would adopt corporate governance practices in the absence of a legal requirement
to do so? In this section, we will see that there are incentives to adopt corporate governance practices voluntarily and to disclose whether these practices have been adopted. Firms will assess the costs and benefits of a proposed course of action and will adopt practices that result in net benefits to them.

To begin with, firms may seek to pre-empt government regulation by adopting governance practices in advance of a legal rule compelling them to do so.²² For example, in the environmental area, some empirical analysis has been conducted on the willingness of firms to adopt cleaner products or processes.²³ Several studies show that a threat of mandatory environmental regulation can be one reason behind a firm’s decision to reduce its pollution levels.²⁴ For example, Khanna and Damon demonstrate that voluntary programs to control pollution are likely to be successful because firms participate out of rational economic self-interest, seeking to avoid high costs of compliance in the future under a mandatory regime.²⁵ Voluntary programs can thus be considered a means to forestall more costly mandatory regulation.

However, firms may see proposed regulation as a fait accompli and move to implement the proposed rules in advance of their becoming law. However, as discussed below, firms would be unlikely to implement standards voluntarily if the costs of doing

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²⁴ Ibid.
so exceeded the net benefits. So simply attempting to comply with impending regulation seems a plausible but insufficient explanation of firms’ voluntary behavior.

Firms may also seek to deter investors from devaluing them. First, managers may believe that if they withhold information, investors are likely to conclude that the information is bad news. Withholding information increases market noise because of the range of possible interpretations of that information. As a result, the expected cost of investors’ discounting the value of the firm is so high that the manager is better served by making disclosure. Thus, disclosure assists in preventing devaluation of the firm by the market. Second, firms will seek to prevent network externalities that could occur if they do not adopt governance practices, including making disclosures, that are otherwise the norm. They will seek to ensure that they do not support a governance structure that is unfamiliar to investors. Otherwise they risk being seen as an outlier.

Admittedly, investors will not always discount the value of the firm if they do not have information about its corporate governance practices. Investor skepticism will depend on many factors: the disclosure history of the firm and the firm’s performance, including its share price, for example. If the return on equity is high, investors will have

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25 Ibid. at 23. See also Maxwell, Lyon & Hackett, supra note 22 at 584.
much lower incentive to analyze and evaluate the firm’s governance structure. If the firm is under-performing, analysts and investors will search for reasons why this may be so. Such inquiries may lead them to conclude that the firm has a weak governance structure and, indeed, that the firm’s performance might experience a turnaround if its governance structure were enhanced.

Firms may have specific incentives to make disclosure of their governance practices. If we assume that investors are primarily concerned with obtaining information in purchasing securities and maintaining their investment portfolios, it stands to reason that management will disclose information, believing that investors require it prior to making the decision to invest or remain invested. Thus, the competition for capital among firms determines the optimal level of disclosure. Firms are likely to respond to investors’ desire for information in order to remain competitive.

By the same token, voluntary disclosures can also create competitive disadvantages for the firm. Firms may be reluctant to disclose information from which their competitors can benefit. If a firm’s rivals can use voluntary disclosure to become

30 See Diamond & Verrecchia, ibid.
31 This is a type of proprietary cost. See ibid. at 182. See also Réal Labelle, “The Statement of Corporate Governance Practices (SCGP), A Voluntary Disclosure and Corporate Governance Perspective” (June 2002), online: <http://ssrn.com/abstract=317519> at 10.
more competitive, the benefits of the disclosure are reduced.\textsuperscript{32} In their interviews with British multinationals, for example, Gray and Roberts discovered that disclosures especially sensitive to the costs of competitive disadvantage include future-oriented financial information that quantifies forecasts of sales and profits as well as information relating to sales and profits in narrowly defined geographical or business areas.\textsuperscript{33} Incentives for voluntary disclosure of information relating to corporate governance practices will be stronger if a firm has positive news to report about its governance practices than if the information is negative.\textsuperscript{34}

This is all to say that voluntary disclosures can be costly. For example, pre-dissemination costs associated with disclosure include the cost of gathering, organizing, and preparing the information. If a firm is not certain of the requirements embedded in the legal regime, such as the information it must disclose, additional costs arise from having to hire legal experts to advise the firm of its obligations under applicable law. Further costs arise in disseminating the information, including mailings to shareholders and other market participants as well as press releases, website updates, and analyst conferences.

\textsuperscript{32} Verrecchia, “Discretionary Disclosure,” \textit{supra} note 27 at 182.
\textsuperscript{34} Gray & Roberts, \textit{ibid}. at 118.
Certain other costs affect firms disclosing information such as costs associated with updating and revising disclosure as well as “proprietary costs,” or costs associated with disclosing negative information.\textsuperscript{35} Proprietary costs arise, for example, when a firm issues unfavorable information and a bank then asks for its loan to be repaid.\textsuperscript{36} Proprietary costs could conceivably also arise if a firm disclosed that its audit committee members were not financially literate and, as a result, the firm was subjected to greater scrutiny by rating agencies and lenders.

In sum, firms will assess the costs and benefits of possible governance practices and will voluntarily adopt practices, including making disclosures, that are likely to result in the highest net benefit to the firm.\textsuperscript{37} The costs and benefits will vary depending on the particular pressure giving rise to the perceived need for the practice and in the disclosure context, on the information being disclosed. Given certain disincentives to voluntary disclosure, it seems necessary also to consider the potential usefulness of a mandatory disclosure regime in the corporate governance context. But we will first analyze whether we can structure a regime that takes into account a firm’s predisposition to implement governance changes voluntarily.

\textit{III. Implications for Devising a Legal Regime}

\textsuperscript{35} Verrecchia, “Discretionary Disclosure,” \textit{supra} note 27 at 181.
\textsuperscript{36} Ibid.
\textsuperscript{37} Gray & Roberts, \textit{supra} note 33. \textit{See also} Kelly, \textit{supra} note 33.
I have argued that firms have incentives to voluntarily adopt governance practices and disclose their adoption of such practices. In this section, I take the examination one step further by comparing enabling to mandatory governance regimes using as points of reference certain costs and benefits, including: direct costs (costs to regulators of designing, monitoring and enforcing regulations); compliance costs (costs to firms, including internal and external expenditures); costs of production (including increases or decreases in quantity of goods produced); and, efficiency of competition (i.e. this is the idea that where consumers have sufficient information in making their purchasing decisions, market competition maximizes social welfare. Sellers compete on the basis of price and quality rather than trying to dupe consumers).38

To begin, we should note that if the state accords primary importance to a certain objective, such as investor protection, it may seek to ensure that its objective is achieved through mandatory legislation. The assumption is that the state can achieve its goal directly because market participants will be compelled to comply with the law, not wishing to face the regulatory penalties of non-compliance. Mandatory laws with penalties act as a deterrent.

38 This list derives from the Financial Services Authority which recommends that regulators focus on six “impact categories”: in calculating the cost-benefit effects of their policies. The FSA also examines two categories which are: quality of goods offered (increase in consumer surplus that results from regulations that improve the quality of the goods offered) and variety of products offered (increase in consumer choices). However, these are difficult to quantify and may have less relevance than the others in the corporate governance context. They have thus been excluded from this discussion. For further discussion of the FSA policy, see also Edwin Sherwin, online: <http://www.law.harvard.edu/faculty/hjackson/pdfs/Sherwin.Cost.Benefit.Paper.April.2005.pdf>. 
But are investors better protected under a mandatory system? La Porta et al. have found that in countries with better legal protections for investors, financial markets are more developed. Analyzing securities laws of 49 countries, they found that both disclosure rights and liability standards were positively correlated with larger stock markets. In short, mandatory law matters because it leads to strong markets by facilitating private contracting.39

However, while mandatory law may matter as a general proposition, there may be a threshold above which additional investor protection laws do not enhance capital markets or at least not at the same rate (a diminishing marginal utility argument). In advanced economies such as the United States where investor protection laws are strong, it stands to reason that an ever-increasing volume of investor protection law, including so-called corporate governance law, will not always result in a corresponding efficiency gain.40 As Winter explains, “…interventionist legal rules may reduce the yield to shareholders generally and this cost must be weighed against the benefits to be gained by the reduction of self-dealing or mismanagement.”41

39 Raphael La Porta, Florencio Lopez-de-Silanes, & Andrei Shleifer, “What Works in Securities Laws?” (2004) at <http://post.economics.harvard.edu/faculty/shleifer/papers/securities_final.pdf> at 12-13. See also La Porta et al., supra note 18, who argue that countries with poorer investor protection have smaller and narrower capital markets. French civil law countries have significantly weaker investor protection, and the less well developed capital markets, than common law countries.

40 In this vein, Roe acknowledges that the La Porta et al model may explain the economies of less developed countries but not developed economies such as the United States. See Mark J. Roe, Political Determinants of Corporate Governance: Political Context, Corporate Impact (Oxford: Oxford University Press, 2003).

Thus, additional regulation may not lead to better protection for investors. Further, it will be difficult to measure whether the appropriate level of protection has been achieved. As Jackson states, it seems impossible to measure the benefit of moving investors from some (presumably) lower level of protection to a higher level of protection.\textsuperscript{42} It is true that we could attempt to aggregate and compare utility across investors with and without the regulation. But, apart from being vague, this calculus likely neglects individual preferences in favor of paternalistic choices.\textsuperscript{43}

Some ostensible benefits of a mandatory corporate governance regime thus seem hard to quantify. But we can reason that compliance under mandatory rules may be relatively high, especially if the penalties for non-compliance are onerous. Further, if the regime has been in place for a number of years, and market participants are aware of the “rules of the game,” including punishments in the case of breach, the regime exhibits a certain predictability. The assumption is that once the regime is implemented, the number of actors who deviate from the regime will be much smaller than the number of actors that comply.\textsuperscript{44}


\textsuperscript{43} \textit{Ibid}.

\textsuperscript{44} of control by general rules of law may impose costs on investors which damage them in both quantity and quality quite as much as self-dealing or fraud.” (at 259).
In an enabling regime, if the state establishes a set of guidelines or best practices to be followed, there is no assurance that market actors will abide by them since no penalty attaches to those who fail to comply. Furthermore, rates of compliance are likely inconsistent in these regimes. This may occasion other costs associated with an enabling system, including information costs incurred by investors to determine the governance practices of a firm and to assess them in relation to other firms’ practices. Conversely, mandatory rules may be more direct: If the state wants to achieve a certain objective, it need only set forth the legal rules and, provided that the rule is made known and has a penalty attached to it, it will likely be followed.

However, enabling regimes can nevertheless encourage compliance in the long term. As more and more firms adopt corporate governance practices, over time these voluntary practices can become the norm among a majority of firms. In year one of its inception, relatively few firms may comply with a voluntary code. Over time, however, more and more firms may comply, believing that they will lose investors or be outdone by their competitors (i.e. because of “peer pressure”) if they do not. Thus, compliance in the voluntary regime increases in year two and can continue to do so thereafter. This “clustering” or “snowball” effect is a pure market mechanism that can occur without the presence of legal rules. An example of this effect is the separation of the roles of chair of

44 See Darren Sinclair, “Self-Regulation Versus Command and Control? Beyond False Dichotomies” (1997) 19 LAW AND POLICY 529 at 534. I should add that this is an assumption for which I have not found empirical support.
the board and CEO, or the expensing of stock options, where more and more firms have adopted these practices.45

Thus, it is not the case that compliance is necessarily low, or does not increase, under a voluntary regime. Some may question whether peer pressure from firms to adopt additional governance practices effectively renders these practices mandatory. This is the idea that “we have to adopt this practice because our competitors are doing so.” Industry pressure is a market-driven incentive to act voluntarily. A mandatory rule is mandatory because it carries with it legal, not financial or competitive, pressures or sanctions. Where a firm chooses to adopt a practice in the absence of a legal requirement to do so, this is an example of voluntary behavior as defined above.

Now, if a firm is adopting practices that would have been mandatory, then there is no difference in cost from the firm’s perspective. But micro, small and mid-cap issuers will bear costs of a mandatory regime disproportionately and may choose not follow suggested best practices. The enabling structure is more flexible in this regard and is especially important in jurisdictions such as Canada and Australia given the preponderance of small to mid size public companies in these capital markets.

45 In Canada, this has certainly been the case since the 1994 issuing of the Dey Committee Guidelines. See Dey Report, supra note 5. The Globe & Mail’s 2003 “Board Games” study found that 65% of companies in the S&P/TSX index had separated the roles of chair of the board and CEO. See Board Games, The Globe and Mail (7 October 2002) B1, online: The Globe & Mail <http://www.theglobeandmail.com/series/boardgames/stories/20021007main.html>. See also Phyllis Plitch, “Post of Lead Director Is Catching On” Wall Street Journal (7 July 2004) 1, stating not only that more US companies are separating the roles of chair and CEO, but also that “[m]ore and more US companies
A mandatory governance system may benefit investors by decreasing the cost of becoming informed. An informed investor may like to know the governance practices of Company X and how they compare with those of Company Y. Under a mandatory governance system, assessing the relative strength of companies’ governance practices is straightforward: Since each company’s governance practices are based on the legal regime, a rational investor can use the same terms of reference – namely, the rules embodied in that legal regime – to assess all potential investments. The law thus constitutes a standard form. The costs of learning the terms of the standard form can be spread out among as many companies as the investor assesses.

Contrast this with the costs of becoming an informed investor under an enabling governance system. There would be less certainty that the firm is complying with best practice guidelines. This uncertainty would make it difficult for investors to assess the relative strength of a company’s governance practices; in other words, the practices of different companies are not inherently comparable. The investor must learn about the governance regime that each individual company has adopted, and therefore incurs more costs for becoming informed about each company. The investor is less able to spread the costs of becoming informed because she is unaware of the particular

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are naming lead directors, embracing the increasingly popular board position as a palatable alternative to separating the chairman and chief executive jobs.”
governance regime that any one firm has adopted. This will not be the case if disclosure about a firm’s governance regime is mandatory.46

We should recognize that from a practical standpoint, a firm’s governance structure may be a relatively minor aspect in the overall investment decision. That is, when an investor is considering making an investment, the firm’s governance structure is only one of a number of important factors that investors evaluate. Furthermore, even an enabling regime may be viewed as a standard form if recommended best practices are set down in a code or policy statement. The regime may also compel disclosure of whether and to what extent a firm has complied with the governance guidelines. This is the “comply-and-explain” system that has been in place in Canada since 1995, when the Toronto Stock Exchange began requiring that listed firms disclose their compliance with the voluntary guidelines. As noted above, a number of countries have adopted this structure, although the United States has not. Thus, at least under a partially voluntary regime, voluntary codes can exist as a standard form, allowing investors to refer to standardized disclosure.

In terms of direct costs, the enabling structure is also less costly for the state and, of course, for the firm. In implementing any governance regime, the state will bear policy design costs, implementation costs, and enforcement costs (including the costs of

46 See the discussion in Part IV, below. Note, however, that even under a hybrid system, the investor must still assess the impact of different (disclosed) governance practices on investor protection, and whether they are “efficient” for the particular firm.
monitoring the market for abuses). In addition, costs to firms arise from monitoring and assessing their own practices (e.g., conducting internal control reviews); implementing new governance structures; producing disclosure and reports; and distributing disclosure information. There may be ex post hidden costs that will be significant in a mandatory structure in particular such as increased insurance premiums for directors or officers who are required to certify financial statements. Of course, the presence and extent of each of these costs will depend on the content of the mandatory legislation itself (i.e., what does the law require?).

While all of these costs arise in a mandatory structure, some but not all of them exist under an enabling governance regime. Presumably, the state will continue to monitor the activities of capital market participants. But two costs in particular will be reduced (though not necessarily eliminated) under an enabling structure. First are the issuer’s compliance costs, which can be divided into direct and indirect categories. Direct compliance costs include fees that must be filed prior to or following a transaction. While these costs may not decrease under a voluntary system, indirect compliance costs – including internal management costs, or the internal costs that an actor bears to organize itself to comply with a legal rule – certainly will. For example,

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47 SOX is an example of costly mandatory legislation. A recent survey found that compliance costs will be US$5.5 billion in 2004. Costs to the issuer now include restructuring the board and finding CEOs and CFOs who will be prepared to certify financial statements. Management time will be spent on assessing internal controls and disclosing their effectiveness. A hidden cost of these and other provisions is a dramatic increase in insurance premiums. Gartner Inc. reports that “in early 2003, director and officer insurance premiums had exploded by 300% to 900% over 2001 levels. Professional liability insurance costs for accountants have risen similarly, increasing the cost of outside auditing services.” FileNet
under the SOX internal control requirement, management will incur significant costs not only in establishing and maintaining the internal controls but also in drafting and issuing the appropriate disclosure. These costs will not necessarily arise under an enabling structure, since firms can decide which costs they wish to incur and when.

Again the question may arise that if issuers are complying with best practices that are the identical to what would be a mandatory rule, then their compliance costs are not decreased. However, issuers can elect whether to comply or not and certainly amongst small or mid-cap issuers it may make sense not to comply because in their individual calculations, the aggregate costs of the practices outweigh the net benefits. If investors value the particular governance practice at issue, issuers (small and large) will face market discipline for non-compliance.

Second are the state’s enforcement costs. In any regulatory system, enforcement costs can be significant. Under a purely voluntary code, the state will bear policy costs.
design and implementation costs, as it does under a purely mandatory system; but enforcement and market surveillance costs will be less. It is true that the regulator will still need to ensure that firms are making full, true, and plain disclosure of all material facts in respect of certain documents such as the prospectus. However, where there is no requirement for implementing governance practices and no corresponding remedy for failure to implement governance practices per se, enforcement costs including investigation costs must be less than if the requirement and accompanying remedy existed.

Overall, the costs to issuers of an enabling regime are likely less than the costs of a mandatory system, mainly because of reduced compliance costs on the issuer’s side and reduced enforcement costs on the regulator’s side. It is true that the benefits of a mandatory system can be the establishment of minimum standards, enhanced compliance, and reduced information costs for investors. But these benefits can also be realized under an enabling system. For example, information costs can be relatively low for investors where a list of best practices has been issued. In this case, the voluntary code serves the same function as a standard form legal instrument by setting out what regulatory authorities will consider to be minimum standards for good behavior.

Committee to Review the Structure of Securities Regulation in Canada: Research Studies, (Ottawa: Wise Persons’ Committee, 2003) 455 at 474 (A. Douglas Harris, ed.), online: <http://www.wise-averties.ca/reports/WPC_10.pdf> [the “Charles River Study”]. By contrast, of the four largest securities regulators in Canada, Alberta, Quebec, and Ontario all allocate between 15% and 20% of their budget to enforcement, while British Columbia allocates 13–14% of its budget to enforcement. In 2002, the actual enforcement budgets for these securities regulators were as follows (in Canadian currency): Alberta – $3.084 million; Quebec – $4.418 million; Ontario – $9.225 million; British Columbia – $3.456 million. See the Charles River Study at 468–469, 473.
Even under a mandatory system, compliance is not guaranteed, since firms may not be motivated by fear of penalties for non-compliance. Many may simply ignore the law and absorb the costs of non-compliance. In any case, if the firm is performing well, investors will be satisfied and deviations from corporate governance standards will likely be of secondary importance to them. Thus, unless the penalty is strict – such as an order cease trading the firm’s stock – non-compliance is a real option for firms that are performing well.

In capital markets regulation, a mandatory system can have the effect of repelling issuers, especially if it increases the firm’s costs of production. Since issuers are free to raise capital in a variety of markets worldwide, they may avoid those markets that impose comparatively costly regulation. In particular, though there is no hard data on the effect of SOX on cross-listings, there is anecdotal evidence that foreign firms are less willing to list in the United States after the implementation of Sarbanes-Oxley because of its extension to cross-listed firms with certain exceptions. Thus costly regulation can have the effect of decreasing competition by driving firms out of the market. This may not be a significant consideration in large capital markets such as the United States, but

52 Securities Act (Ontario), R.S.O. 1990, c. S.5, s. 56.
53 See discussion in Larry E. Ribstein, “Cross-listing and Regulatory Competition” (2005) 1:1 REVIEW OF LAW AND ECONOMICS at 127-128. However, we should recognize Coffee’s argument here that foreign issuers may cross-list in more onerous governance regimes such as the US in order to signal to investors their commitment to minority investor rights and fuller disclosure. See John C. Coffee Jr., “Racing Towards the Top?: The Impact of Cross-listings and Stock Market Competition on International Corporate Governance” 102 Columbia Law Review (2002) 1757 at 1780.
in Canada, Australia and possibly the UK, these cost considerations are important in terms of ensuring that they remain in the competition for capital. It is unlikely that Canada could implement Sarbanes-Oxley type reform if the US chose to implement an enabling or partially enabling governance regime.

Enabling regimes are also more effective in capital markets populated by business entities of different sizes and types. A requirement for an entirely independent board or audit committee may be onerous for the micro, small or mid-cap issuer, which may only have a few directors on its board to begin with. Similarly, if the issuer has a small number of shareholders, some of whom are insiders, the benefits of having the chair and CEO roles separated may not be as apparent as they are in a widely-held firm. As Romano states, “the more efficacious corporate and securities law regimes are the product of competitive legal systems, which permit legal innovations to percolate from the bottom up by trial and error, rather than being imposed from the top down by regulators or corporate governance entrepreneurs, who are far removed from the day-to-day operations of firms.”54 A one-size fits all approach seems both costly and unnecessary.

We have generalized that costs in an enabling regime will be lower than in a mandatory one. In the mandatory structure, the state bears design, implementation, and enforcement costs, while issuers bear compliance costs (direct or indirect). In an
enabling regime, aggregate compliance costs will be lower because firms can opt out of measures that are excessively costly for them. They can tailor their governance structures to their particular firm characteristics (e.g., size and capital structure) and refrain from incurring excessive compliance costs. In an enabling regime, the state does not incur surveillance and enforcement costs to the same extent.

Thus from the firm’s perspective, enabling or voluntary regimes seem less costly than mandatory regimes. It is likely that regulators have a bias in favor of mandatory regimes because they establish a baseline of consistent rules with the assumption that issuers will abide by them. However, this means increased costs for issuers, undermining the efficiency with which their businesses operate. Thus, if a less costly regime can achieve an equivalent level of investor protection at lower costs to issuers, then this policy alternative should surely be explored.

IV. Choosing a Governance Structure

If firms are prepared to adopt corporate governance practices voluntarily – and we have seen that they have incentives to do so – then, presumably, implementing a mandatory legal regime that compels them to adopt such practices is unnecessary. But compliance in an enabling regime may be difficult to achieve with certainty. It is true that market forces can occasion greater compliance. However, there is no guarantee that

54 Roberta Romano, supra note 49 at 1529.
compliance will in fact increase, and it could certainly also decrease, depending on market conditions.

Thus, the tradeoff may be lower costs in an enabling structure but also lower compliance, while a mandatory structure is characterized by higher costs and perhaps higher compliance overall. Because of potential difficulties regarding compliance in a purely enabling regime, I here argue in favor of a partially enabling or hybrid structure where, like the regimes in Canada, the U.K. and Australia, the adoption of governance practices is optional but disclosure regarding governance practices is mandatory. I contend that this structure is likely to yield a high level of compliance at a lower direct cost than a wholly mandatory regime.

Mandatory disclosure heightens compliance with an otherwise voluntary regime by attaching consequences to firms’ decisions not to disclose negative information. If a firm knows that the market is watching its governance practices, it will have a greater incentive to comply with the voluntary guidelines that investors deem desirable. A

55 See Frank H. Easterbrook & Daniel R. Fischel, “Mandatory Disclosure and the Protection of Investors” (1984) 70 VA. L. REV. 669 at 680 [Easterbrook & Fischel, “Mandatory Disclosure and the Protection of Investors”] who state, “In a world with an anti-fraud rule but no mandatory disclosure system, firms could remain silent with impunity. If they disclosed, they could do so in any way they wished, provided they did not lie. … A mandatory disclosure system substantially limits firms’ ability to remain silent.”

56 Each year, one of Canada’s leading national newspapers, the Globe and Mail, conducts a review of corporate governance practices for companies listed in the benchmark S&P/TSX index, based on a ranking of its own devising, in the “Board Games” series. The 2004 Board Games series suggests that firms’ voluntary adoption of corporate governance practices is, in part, a response to the previous Board Games rankings. See Elizabeth Church & Janet McFarland, “Board Games” THE GLOBE & MAIL (12–15 October 2004). See also these authors in “Board Games: Canada’s Definite Corporate Governance Rankin”
Disclosure requirement reduces information asymmetries by giving investors a minimum amount of information on which to base their investment decisions.\textsuperscript{57} It also controls other variables, such as the time, place, and manner of the disclosure,\textsuperscript{58} thereby ensuring that information will be conveyed to investors in a standardized manner.\textsuperscript{59} Mandatory disclosure also can reduce conflicts between directors, managers, and other agents\textsuperscript{60} since they likely all have an interest in avoiding negative disclosure that may hurt the company as a whole. Finally, it solves the credibility problem whereby managers make only self-serving voluntary disclosures.\textsuperscript{61}


\textsuperscript{58} Easterbrook \& Fischel, “Mandatory Disclosure and the Protection of Investors,” \textit{supra} note 55 at 680.

\textsuperscript{59} In Canada, for example, investors can turn to the “Statement of Corporate Governance Practices” in the annual report or information circular for information concerning the number of independent directors and the composition of the various committees.

\textsuperscript{60} Paul G. Mahoney, “Mandatory Disclosure as a Solution to Agency Problems” (1995) 62 U. CHI. L. REV. 1047 at 1051.

While we can accept the positive effects of mandatory disclosure generally, we must question whether ever-increasing disclosure requirements have similar positive effects. In light of the arguments raised here, it may seem that non-repetitive disclosure has valuable effects in enhancing market efficiency by reducing information asymmetries. In other words, if the disclosure requirements provide relevant information which investors do not already have pursuant to another disclosure rule, the disclosure would be worthwhile since it ensures that insiders do not possess information that is not generally known. However, we should not sanction all disclosure requirements simply because they may have the effect of reducing information asymmetries. Because disclosure is not costless, in each case we must ask whether the costs of the disclosure outweigh the benefits that arise from the additional disclosure that will be made. If, for example, only 2% of investors are interested in the information in question while the other 98% would deem it irrelevant to their investment decisions and there is a cost associated with the issuer’s disclosure, it would seem that the aggregate benefits of the increased disclosure would likely not outweigh the costs of producing it.

62 On this point, Ferrell has examined the extension of mandatory disclosure requirements to over-the-counter stocks in 1964, citing this legal change as the “only fundamental change in disclosure regulation other than the initial 1930s securities acts.” He finds that mandatory disclosure is associated with a reduced volatility in OTC stock returns. See Allen Ferrell, “Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter-market”, Harvard John M. Olin Center for Law, Economics and Business, Discussion Paper No. 453, online: <http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/No453.04.Ferrell.pdf>.

Thus, because of mandatory disclosure in the partially enabling regime, there will be a higher rate of compliance with best practices at lower aggregate costs to market participants. But if we can rely on market forces to compel issuers to follow best practice guidelines, why are we unable to rely on market forces to compel them to choose the appropriate amount of disclosure? To begin, there are powerful disincentives that inhibit voluntary disclosure. Issuers have an incentive to disclose only the minimum amount of information that they are required to disclose, and they will be disinclined to disclose information that the market views as “bad news.” Market pressure to disclose will be weak if an issuer’s competitors choose not to disclose similar information. Therefore, investors may not be able to rely on voluntary behavior with respect to this (often important) news.

Furthermore, once disclosure is required, firms will come under greater public/market scrutiny if they do not comply with existing corporate governance guidelines. They will have to provide a compelling, rational explanation for their decision not to comply. Mandatory disclosure is more effective than voluntary disclosure here because it ensures that all firms provide information that investors can use in their investment decisions and also because it provides a baseline against which all issuers can readily be evaluated. The disclosure enables investors to react to governance choices on the basis of full information.
In all, there may be a number of reasons for non-disclosure or ambiguous disclosure of governance choices (such as bad news or a mere desire not to be transparent about governance structures). Investors cannot simply conclude that non-disclosure is due to a problem with the governance structure, or they may forgo a valuable investment opportunity. It is difficult for investors to make informed decisions if there is no disclosure requirement, since firms may choose not to disclose information relating to governance in which investors are interested. By contrast, if there is a rule requiring explanation of the governance choices (i.e., mandatory disclosure), investors need not draw conclusions from ambiguous or non-disclosure; they know specifically why a firm has made the particular governance choice it has. Thus, mandatory disclosure prevents investors from having to draw inferences about governance choices, and the reasons for such choices, when firms choose to be silent.

Admittedly, one could argue that compelling disclosure where it is not forthcoming must entail penalties and an otherwise enabling system is in effect rendered mandatory in this system. It is true that a disclosure requirement does indeed necessitate regulatory enforcement action (or at least the threat of enforcement action) of some sort. However, the costs to the state (or regulator) of ensuring that disclosure is adequate are surely less than the costs of monitoring whether a firm has complied with corporate governance standards across the board. The regulator still has a role in ensuring that disclosure is accurate and complete, but the costs of this process will likely be less than those of examining firms’ governance regimes as a whole. Thus, my
contention is that a partially enabling structure lessens but does not eradicate the need for monitoring and enforcement activities by regulators.64

In sum, this argument in favor of a partially enabling regime stems from a belief that the market mechanism is not sufficient, in and of itself, to encourage compliance with a voluntary code of corporate governance practices. Unless disclosure is mandatory, firms will have a bias to disclose only positive information (i.e. this is the credibility problem discussed above). In addition, mandatory disclosure ensures transparency, creating a level playing field among investors in terms of the information they have about the firm’s governance practices. Thus, low compliance combined with the credibility problem constitutes a major drawback of an enabling system, while direct costs are a significant disadvantage of a mandatory regime. The partially enabling structure lessens the need for penalties for non-compliance (a main feature of the mandatory system) because the disclosure itself is mandatory, compelling firms to comply with the voluntary guidelines or suffer investor repulsion.

We could argue that the only reason that some jurisdictions, such as Canada, can function effectively under a partially enabling regime is that one jurisdiction has

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64 It is true that firms may not comply with disclosure requirements. But this is not an issue specific to partially enabling regimes. Rather it is one that plagues the enforcement of securities violations generally: How does the state ensure that those who do not comply with the law are penalized for the market abuse they occasion? In my view, the issue relates to the severity of the penalties for non-compliance. If firms are not complying because it is more cost-effective for them to absorb the penalty for non-compliance, then clearly the penalty itself is not harsh enough. The deterrence mechanism is not there.
adopted a wholly mandatory approach (i.e., the United States with Sarbanes-Oxley). Issuers will be compliant under a partially enabling regime because they seek to remain competitive with their peers in other jurisdictions. They are also aware of the heightened costs that could come with a mandatory – and potentially more costly and less flexible – regime.

On the one hand, it is not clear whether an entirely mandatory regime must be established in order for issuers to understand that their current governance regime could become stricter; the Canadian and U.K. partially enabling governance regimes, for example, were in place long before Sarbanes-Oxley.\(^{65}\) On the other hand, onerous legislation in another jurisdiction no doubt influences the behavior of firms outside that jurisdiction, for reasons relating to competition.\(^{66}\) Arguably, the US sets the default standard against which firms believe they will be judged by analysts, shareholders, potential acquirors etc.

\(^{65}\) The TSX regime has been in place since the 1995 adoption of the Dey Report. See TSX COMPANY MANUAL, supra note 6 at § 472. As for the U.K. regime, the 1998 Combined Code created by the Hampel Committee was actually an update of the CODE OF BEST PRACTICE drafted by the Cadbury Committee in 1992. See Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice (Cadbury Code), Dec. 1, 1992. Although the NYSE did have some corporate governance listing requirements prior to the enactment of SOX, those requirements were relatively minor, relating primarily to audit committees. See New York Stock Exchange, Listed Company Manual, online: <http://www.nyse.com/Frameset.html?displayPage=/about/listed/102221393251.html> at § 303.

\(^{66}\) For example, in “Voluntary vs. Mandatory Corporate Governance Legislation: Theory and Evidence,” Anand, Milne, and Purda have found that Canadian companies express their awareness of SOX in annual disclosure documents and that they have adopted reforms to comply with SOX in the absence of a legal requirement to do so. [paper on file with author]
These questions, and the present theoretical argument in favor of partially enabling governance regimes, establish the groundwork for future empirical research. Such research should examine the success of enabling and partially enabling regimes and the propensity of firms to adopt governance practices voluntarily. It is possible that firms not subject to the Sarbanes-Oxley Act will voluntarily comply with this legislation. In fact, in another paper, Purda, Milne and I document a general increase in the adoption of governance practices following the implementation of a partially enabling regime in Canada. Our empirical results show that between the years 1999-2003, Canadian firms voluntarily implemented Canadian best practice standards as well as SOX-like governance mechanisms. It appears that compliance with best practices has increased since introduction of Sarbanes-Oxley. These results bear out the postulation that firms act voluntarily with regards to corporate governance and that entirely mandatory governance legislation may not be necessary, at least where certain incentives exist.  

V. Conclusion

There is no shortage of critics of Sarbanes Oxley and, among the academic community, many of these critics have sanctioned an enabling governance regime. I am not jumping on this bandwagon but rather, am making a reasoned case for another alternative. Legislators and regulators do not uniformly recognize that firms have

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67 Anand, Milne & Purda, *ibid.*
incentives for voluntary behavior in corporate governance. It is possible for the state to take advantage of these incentives by creating a governance regime that is less costly for firms yet still protects investors. In particular, a partially enabling structure has the effect of minimizing costs but at the same time encouraging compliance. Mandatory disclosure seems a good policy choice in an otherwise enabling governance regime. It solves the credibility problem and also compels the disclosure of positive and negative news.

Critics may argue that I have no evidence that an enabling regime is superior to a mandatory structure and that there is little proof of the benefits of mandatory disclosure in this context. But the analysis of potential governance choices contained here paves the ground for future empirical studies in this area. It also broadens existing literature in the comparative corporate governance domain. Until now, the literature has been dominated by path dependency theorists and their critics on the one hand and shareholder primacy proponents and their critics on the other. I have tried to push the bounds of existing scholarship by arguing that the enabling-mandatory typology can inform our comparisons of international legal regimes as well as state corporate law. In elucidating the concept of a partially enabling regime, I have also developed another facet of this typology. Academic literature has lagged behind policy initiatives by not yet examining the implications of this subtlety.

68 Romano, supra note 49.