Keynote Address by Mario Draghi, Vice Chairman and Managing Director, Goldman Sachs International

Introduction

I'd like to begin by commending the European Corporate Governance Institute and the American Law Institute, together with the European Commission and the US SEC, for taking the initiative to launch a transatlantic dialogue on corporate governance.

With corporate malfeasance scandals and regulatory responses in Europe as well as the United States, we should be learning from each others' mistakes and sharing perspectives on the optimal steps to restore confidence in corporates and in markets. We must work together to prevent mistrust from persisting and further dragging down the economy.

So I very much hope that this dialogue will prove beneficial, by helping to prevent future such extraterritorial disputes from arising and contributing to best practice in the area of corporate governance.

My remarks draw upon my public and private sector experience, as well as my firm's transatlantic pedigree. However, I hope you will forgive the fact that I am the only corporate speaker on today's programme, and so my remarks will focus more on representing the corporate perspective on corporate governance. And in doing so, I will not even try to suggest we should have a one size fits all model. The legal and structural differences between US and European corporate models are just too big to attempt this. Still I find some common pivotal elements where improvement is necessary on both sides of the Atlantic.

We all know that good corporate governance is fundamental for confidence in the market economy. As Alex Schaub pointed out, and unfortunately as recent experience shows, corporate governance failures can have significant economic consequences at macro and micro levels, for markets, economic growth and individual firm business, for investors, counterparties and consumers. Reputation and market confidence are crucial components of individual firms' profitability and contribute to our collective economic well being.

Enron, WorldCom, Parmalat, Ahold, Adecco, Adelphia became household names uttered with contempt, following corporate scandals that resulted in massive lost shareholder value and trust. At the time when owners' trust has been challenged by failures of the boards, executive management, auditors, brokers and advisors, it is not surprising that the symptoms of the malaise have been aggressively adddressed by policy makers.

Irate shareholders empowered politicians and the judiciary to take charge, producing impressively comprehensive volumes of legislation and regulation on both sides of the Atlantic.

But more recently, after the wave of legislative, regulatory and investigative activity, some have begun to question whether the cure for corporate malfeasance could be more lethal than the disease. So, where are we going? Are we on the way to achieving our goal, restoring trust and improving the health of the economy and the welfare of economic actors?

Critics of the reforms say:

1) legislation and regulation has been to a great extent a purely emotional and populist response that will only serve to shift responsibilities and incentives from investors to other parties, primarily companies and managers;
2) this legislation tries to cope with a wide variety of misbehaviour (for example fraud, conflict of interest, unanticipated and unintended accumulation of risks) in response to the particularities of the various successive scandals as they have emerged. Such legislation cannot be other than patchy, ineffective and badly conceived;
3) too much is being asked of the law, such as defining an “independent” director;
4) it is proving too costly to implement relative to what it stands to achieve;

the fragmented regulatory approach to global companies is not enhancing, but rather hampering international capital markets and investor interests.

Advocates of strong reforms say:

1) politicians’ response was not so much to the scandals as to shareholder demand for greater oversight;
2) the new rules are not bad, and what new legislation may have missed the Spitzers, Donaldsons of the world are fixing in court and through new legislation.
3) the European Commission and their counterparts in Europe together with US regulators have done a good job at patching up differences.
4) compliance costs are negligible compared to shareholders’ losses following the scandals, and this would certainly occur again in the absence of legislation;
5) so long as investor trust has not been restored, a tough, legislative approach to the problems is warranted and must continue.

Considering the regulators’ response to the scandals, and noting the growing negative corporate “response to the response”, which has been much debated in the press lately, I would be interested for this audience’s thoughts on whether or not we are entering a situation of “excessive” regulation, where the regulatory pendulum has swung too far.

The question is, to what extent can the problems underlying these scandals be “cured” via procedural means, rulemaking and enforcement? The tendency to over regulate in times of crisis is well established and much debated, and while in present circumstances there wouldn't have been any viable alternatives to regulation, I argue that regulation in itself is not enough when excessive can be counter productive.

Of course, much of the US legislation is new, and in the EU the Corporate Governance Action Plan is just beginning, so it is admittedly a bit early to pass judgement. A full evaluation will not be possible until after the rules have been operative for a time and we have a track record by which to measure them. But even so, I believe that there is a basis on which we can evaluate whether regulation is “excessive”, in terms of whether it is achieving its objectives of preventing fraud.

Jurisdictional Clashes Are Costly
One thing that is absolutely clear, as evidenced by the focus of this conference, is that the cost of trans jurisdictional regulatory clashes is high. In the US, the Sarbanes-Oxley Act was legislated as a swift and prescriptive response to Enron and WorldCom, and promptly raised thorny jurisdictional questions. Differential rules may create conflict of laws for firms operating across borders, establish opportunities for regulatory arbitrage or create level

playing field issues where standards are tougher in one jurisdiction than in another. At a minimum, even where they don't conflict, they create additional and potentially unnecessary costs. Some might argue that some regulatory competition may be beneficial in eventually leading to best practice, but surely the optimal way to achieve common best practice is via regulatory dialogue, preferably BEFORE anyone legislates.

We are learning from the Sarbanes Oxley experience. Following concerns in Europe and other jurisdictions regarding its extraterritorial provisions, accommodations have been reached that go a significant way toward addressing the issues.

In Europe a body similar to the PCAOB will be established, and greater coordination among audit supervisory bodies is being implemented. The EU and US are converging on independent public oversight, audit quality and assurance, auditors' rotation and rules governing conflict of interest for auditors (eg in supplying non-audit services). And now we have theTransatlantic Corporate Governance Dialogue. These are all welcome developments.

Implementation is Costly…

As companies implement Sarbanes-Oxley, however, its costs are only just becoming apparent. A recent Goldman Sachs research report noted a number of implications with market impact. The report stated that while companies and auditing firms are keenly focused on implementation of Sarbanes Oxley Section 404 (requiring a separate audit opinion), investors have not yet contemplated the following potential implications of the new audit requirements:

• asymmetric reactions to audits (clean audits go unnoticed, but qualified audits may be punished);
• implementation costs to companies;
• potential slowdown in acquisitions by highly acquisitive companies until after their audits;
• potential to drive foreign companies tapping the US markets elsewhere; and
• less time for corporate managers and board to focus on business strategy.

In addition, investors will have difficulty knowing in advance whether or not a company is on track for an unqualified audit.

We have seen a slew of recent complaints by companies in the press, such as:

• A January survey by Ernst & Young indicated that some large US companies expect to spend over 200,000 hours on Section 404 implementation;
• GE noted a cost of $30 million to implement Section 404 alone – this figure only includes measurable, not incremental costs;
• NYSE Chairman John Thain suggesting that the Sarbanes-Oxley Act's provisions are becoming a disincentive to non-US corporate listings, especially from European companies, that the NYSE is seeing a slowdown in growth of new listings by foreign companies from an average of 50 per year during 1996 – 2001 to 25 per year in 2002 and 2003, and only 1 European company listing so far in 2004.
• He cautioned, "American standards of corporate governance should not become the enemy of economic performance" and warned that regulatory burdens could harm US competitiveness and capital markets;
• Assertions by buy-out fund The Blackstone Group that many CEOs are contemplating taking their companies private or curtailing their careers.

And this is only the US regulatory impact. Corporate governance in Europe has largely been based around various voluntary codes, but this is now changing. With the EU Corporate Governance Action Plan and its component rules just taking shape, companies have not yet felt their implications. European policy makers should watch closely the impact of Sarbanes Oxley and other US governance reforms and draw upon any mistakes and best practices as the Action Plan moves forward.

With all the reputational pressure, some companies are going beyond legal requirements in corporate governance. Even private companies that are technically outside some of the requirements are being judged to the same standards (example: independence of directors, Marshall Cogan case), and investors and institutional lenders are increasingly evaluating private companies along the same lines as public companies.

But recent reports also suggest that some public companies may be contemplating going private – however, it is not clear that this will significantly reduce their compliance demands, given investor scrutiny and activism. And is this a good development?

But Worth It?
The main measure of "excessive" regulation should not be cost alone. We must consider to what extent regulation is successful in achieving its objectives: improving or removing corporate fraud. If the regulations prevent fraud that would otherwise have taken place, then one could persuasively argue that they are not excessive.

Well, from past experience one could conclude that it is unlikely that rules can ever fully prevent fraud, although items such as auditor rotation and disclosure can reduce its potential or enable earlier identification.

I believe much of the new conflict of interest regulation is being effective, but not so much directly as indirectly. It is difficult to conceive of all the possible crimes and address all of them, but we have increased awareness of conflicts and the importance of managing them. Bankers and corporates are questioning themselves or being questioned by investors about their policies and behaviour in this regard, as never before.

Reputational risk plays a critical self-policing role in financial institutions' incentives toward doing the right thing. Current FSA rules are principles based, helping to avoid narrow, legalistic interpretations that could defeat the rules' purpose. In addition to providing a context in which to analyze the detailed rules, the principles themselves are rules and can form the basis for disciplinary action, and it is this interaction that makes them so effective

Coming back to the risks of over prescription, in addition to the potential costs already mentioned, there is the risk of getting it wrong and incentivising the wrong behaviour, inducing moral hazard.

The example of new attempts to legislate the requirements to become a director show how problematic this can be. In attempting to prescribe the right characteristics of a director, how would you legally define concepts like, "competent".

If you devise a set of parameters that are too narrow and set the bar at a particular level, you risk reducing the talent pool to the same group of individuals – when it has long been recognised, in the Higgs Report among other studies, that the existing pool is too narrow, and

too integrated as a network, with “friendly” directors sitting on each others’ boards. A MORI survey conducted for the Higgs Report showed that nearly half the non-executive directors of UK listed companies had been appointed through personal contact with a board member, with only 4% going through a formal interview process.

Onerous requirements and liabilities for directors risk disincentivizing many legitimate, qualified individuals from accepting posts. A recent survey by Deloitte in Ireland, where requirements are considered to be more onerous than on average in the EU, showed that 63% of business people are less likely to take up an offer to become a non-executive director of a company than they were five years ago, due to the increased level of responsibility involved.

Attempts to regulate the behaviour of boards as entities are also problematic. Half of a board’s activities are hard objectives, and regulations can be used to further harden them. But half of what a board does is social interaction, much softer, and not desirable to regulate or to disincentivize.

High compliance costs bring their own opportunity costs and disincentives to business, but it seems to me that the biggest downside risk is that over reliance on rules could overload the system, result in more box ticking than proper thinking about the issues, and impede achievement of their underlying objectives. Rules can invite compliance with their letter, rather than their spirit. I believe a strain exists between continuous demands for more prescriptive legislation, and improving and enhancing self-regulation.

Comply or Explain

The real key to well functioning capital markets is the “comply or explain” principle, ie either compliance with agreed rules of behaviour or explanations for non-compliance. It is worth noting that financial legislation in most countries has long been based around this idea of comply or explain, which revolves around providing information to investors, who then make up their minds on that basis. The UK’s corporate governance codes are also based on this principle.

But this principle can break down in several situations:

1) First and most obviously, fraud;
2) Second, lack of shareholder activism – challenge and questioning is critical to make the “explain” part of the equation work;

When they comply or explain principle does break down due to fraud, or if investors are insufficiently active, then political pressures mount to do something more prescriptive, and we are bound to accept more regulation. In which case because of regulation, we may deprive the system of flexibility, and instead of comply or explain, we end up with comply or nothing.

There is a strong argument for retaining the comply or explain principle as the main basis for corporate governance. I believe this is the fundamental point without which no amount of legislation can be fully effective. I maintain that if comply or explain works, then further regulation is excessive, because investors will have the necessary information on which to base their decisions. But the real key to the effectiveness of comply or explain is shareholder activism. Parmalat shows clearly that comply or explain breaks down if no one asks questions where there is no compliance.

The amount of publicly available information about Parmalat's substantive non-compliance was staggering. The Board was mostly made up by friends of Mr Tanzi. The CFO chaired the audit committee making a mock of any pretence of independence. Research reports by major investment banks – incidentally Goldman Sachs was the only international bank that had nothing to do with Parmalat – had been indicating for months that there was something very wrong with the published balance sheet showing cash assets for roughly $3 billion and about an equivalent short term liabilities coming due in the next three years. A position that could be explained for a hedge fund but not for an industrial company. All of the research reported noted this and other anomalies yet came out with buy or hold recommendations. Even in this instance, all of the information was in the market, but nobody, not board members, not auditors, not shareholders, not the creditor banks, not the rating agencies, asked questions.

My view of where the dividing line should appropriately fall is that legislation and regulation should protect the interests of third parties, ie shareholders and investors and prescribe specific behaviours only where shareholders, investors and creditors' own due diligence cannot reach.Apart from that, it should aim to increase corporate transparency and to remove barriers to shareholder activism.

Therefore, I say yes to prescriptive legislation in the area of conflict of interest and yes to any form of legislation that makes companies' behaviour more readable to outsiders (including accounting); but no to legislation that prescribes in detail directors' prerequisites, compensation, etc.

Shareholder Activism

To enable comply or explain to work means that we need a stronger culture of shareholder activism. In our present situation, it is interesting that concurrent with the legislative approach, we are seeing a significant uptick in shareholder activism, which is playing an increasingly important role in governance issues in Europe, as well as in the US.

Examples abound:

- Dutch pension funds pressure led to changes at Ahold and Shell;
- In the US CalPERS and other public pension funds have witheld votes for director appointments and pressed for governance changes;
- France's CDC (state owned bank managing civil servants' pension funds) announced it will push for governance improvements in French companies in which it invests, including independent audit, nomination and remuneration committees and separating the positions of chief executive and chairman;
- Numerous disputes over golden parachutes and executive pay packages (Glaxo SmithKline, Tesco, Barclays, Reuters);
- Ouster or rejection of Chairman or CEO appointments (Ian Prosser at Sainsbury's, Michael Green at ITV, Michael Ovitz at Disney).

Corporate governance organisations are also increasing their influence and upping the pressure for example, European Corporate Governance Services and Institutional Shareholders Services track 900 of Europe's companies and rate companies on governance. Also, the three major rating agencies factor in governance (Standard & Poor's, Moody's, and Fitch).

US and EU companies are increasingly subject to legal action over governance failures.

The Role of Ethical Culture

In addition to creating the right shareholder culture to encourage companies' owners to properly exercise their authority, I'd like to address the importance of encouraging the right ethical culture within firms, to underpin proper management, director and officer behaviour within the company.

My starting point is that for developing ethical culture, rules are insufficient in themselves. They must be supplemented by firms' self-motivation in promoting the right internal best practices and ethical culture for their senior executives, as well as for responsible internal and external officers such as auditors. Ethical culture, creating the right "tone at the top" is vital – we can have the best rules in the world on paper, but if they are not applied in the right spirit, they will become worthless. I would argue that one of the chief benefits of the crises and debates is the work being done by firms on their own initiative – including private firms that are not subject to the rules.

Conclusion

In conclusion, there are 3 ingredients for a successful financial services industry:

a. measured prescriptive legislation of the type defined before. It may well be that such measure could be achieved by competition rather than by coordination. I prefer the second to the first, but the first to excessive prescription.
b. vibrant sharehold activism. Substantial barriers in some parts of Europe to real shareholder activism remain, and they will have to be removed.
c. creation and promotion of ethical culture by all actors of the industry.