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Corporate Governance: Codification or Self-Regulation?

Is SOX a Viable Solution for New Zealand?

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Corporate Governance: Codification or Self-Regulation? – Is SOX a Viable Solution for New Zealand?

I. INTRODUCTION

The stock market has gained extraordinary significance over recent years. Large proportions of society invest in equity markets in order to save for their retirement. Various bodies exist to fight abuses by executives of publicly owned companies. Parliament has created the New Zealand Securities Commission (SEC), an independent Crown entity in terms of the Crown Entities Act 2004, to fight ‘white collar fraud’ and the abuse of business ethics and the law.¹ Numerous scandals worldwide but especially the Enron case in the United States of America (USA) at the beginning of this decade shocked investors and led to a decrease in shareholder confidence. Investors lost their trust in corporate governance techniques and the credibility of managements.

In the 1930s, in the aftermath of the 1929 stock exchange crash in the USA, Berle and Means ascertained the underlying problem of corporate governance as the separation of ownership and power.² In accordance with Adam Smith,³ they explained that, as a basic human trait, executives never apply the same diligence when running a company as the owner of the same company might apply.⁴ This fundamental understanding is the reason for the necessity of corporate governance rules. As a protection of shareholder interests, the interests of the owners of the company, the regulator tries to set standards which create investor confidence and security.

By now the large majority of nations have implemented some form of corporate governance regime. The US government has tried to counter fraud and investor scepticism by adopting a statutory corporate governance code called the Sarbanes-Oxley Act 2002 (SOX).⁵ New Zealand, on the other hand, opted for a more voluntary approach to governance regulation based on principles rather than legal norms, which

¹ Securities Commission, *About: Who We Are*, <<http://www.sec-com.govt.nz/about/>> at 05 July 2006.

² Berle A & Means G, *The Modern Corporation and Private Property* (1932).

³ Smith A, *An Inquiry Into The Nature And Causes Of The Wealth Of Nations* (Glasgow ed, 1976).

⁴ Ribstein L, *SARBOX: The Road to Nirvana*, 2004 Mich. St. L. Rev. 279, 280.

⁵ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

impose no legal obligation on affected parties.⁶ Farrar disapproves of his approach and calls New Zealand's principles "bland provisions".⁷ He fears a decrease of investments in the New Zealand market if it does not follow the US lead quickly.⁸

This paper tries to evaluate Farrar's proposal of imitating the US example. Section II portrays corporate governance regulations currently in place in New Zealand. It focuses predominantly on listed public companies and shows shortfalls in this area. Section III illuminates SOX and its provisions. The paper provides explanations major fraud scandals in the USA and discusses in the light of these findings the effectuality of SOX. It concludes that the US legislation has numerous pitfalls and fails to achieve necessary fraud prevention. Based on this understanding, Section IV discusses the advantages and disadvantages of a principle-based approach to corporate governance regulation. It is shown how self-regulation paired with a strong legal framework provides sufficient protection for investors and how such an approach values the theory of free markets. This author believes strongly in the efficiency of free, unregulated markets and eventually concludes with a few humble suggestions on how New Zealand might change their corporate governance regime.

II. NEW ZEALAND'S APPROACH TO THE CODIFICATION OF CORPORATE GOVERNANCE

A. The New Zealand Corporate Market

New Zealand's corporate regime is a mixture of statute and common law principles.⁹ The underlying framework is given by the Companies Act 1993 which defines director duties, board responsibilities and shareholder control.¹⁰ The New Zealand economy is dominated by small to medium-sized companies with 96.3 per cent of com-

⁶ Securities Commission, *Corporate Governance in New Zealand: Principles and Guidelines – A Handbook for Directors, Executives, and Advisers*, <<http://www.sec-com-gov.nz>>, at 18 June 2006, p 28.

⁷ Farrar J, *Enforcement: A Trans-Tasman Comparison*, Corporate Governance at the Cross Roads (14 February 2005), p 10.

⁸ Farrar, above n 7, 10 & 11.

⁹ Gilberton B & Brown A, *Corporate governance in New Zealand*, <<http://www.iflr.com>>, at 18 June 2006, p 51.

¹⁰ Ibid.

panies falling within this category.¹¹ Consequently, corporate governance regulations must match New Zealand's unique economic circumstances.

There are currently two types of companies¹² in place in New Zealand: companies and listed companies.¹³ The term "listed companies" describes those entities that are listed with the New Zealand Stock Exchange (NZX).¹⁴ Each form of company needs to have at least one or more shareholders as well as one or more director.¹⁵ In the year 2001, there were 270,000 registered companies in New Zealand but only 216 of these were listed with the New Zealand Stock exchange and only 139 of these were original New Zealand companies.¹⁶ Notwithstanding the minor share of listed public companies in the overall number of domestic companies, it has been estimated that "the total market capitalisation of the domestic equities market was approximately NZ\$44 billion in 2001".¹⁷ Between 1985 and 2001 market capitalisation almost tripled and in June 2000, 44 per cent of all New Zealanders owned shares.¹⁸

Nonetheless, there is evidence that specifically large New Zealand companies have underperformed in recent years.¹⁹ Large companies, however, significantly shape the reputation of country's economy.²⁰ American but also European investors heavily rely on corporate governance practices nowadays. It casts a bad light on a country's entire economy if large companies, which are internationally noticeable, show weak performance. In times of global equity markets, New Zealand cannot afford to have a bad international reputation.²¹ A survey conducted by McKinsey in 2000 showed that three quarters of the questioned investors found that good corporate governance was

¹¹ Ministry of Economic Development, *Small & Medium Enterprises*, <http://www.med.govt.nz/templates/MultipageDocumentPage_202149spx#P47_5065> at 05 July 2006.

¹² Companies being defined as artificial legal entities with separate legal personality (Walker G, Reid T, Hanrahan P, Ramsay I & Stapledon G, *commercial applications of company law in new zealand*, p 5 [§103]).

¹³ *Ibid*, p 18 (§113).

¹⁴ *Ibid*.

¹⁵ *Ibid*, p 16 (§113).

¹⁶ *Ibid*.

¹⁷ *Ibid*, P 7 (§105).

¹⁸ *Ibid*, p 8 (§105); NZSE, *Share Ownership Survey 2000*, (2000).

¹⁹ Krackhardt O, *New Rules for Corporate Governance in the United States and Germany – A Model for New Zealand?*, 36 VUWLR 319, 327.

²⁰ Fox M & Walker G, *Evidence on the Corporate Governance of New Zealand Listed Companies*, 8 Otago L. R. 317, 327-328.

²¹ Krackhardt, above n 19, 329.

as important as the financial performance when evaluating an investment.²² Focusing on good corporate governance is important in order to “inspire confidence in ... international investors”, to retain a strong equity market and to support underperforming large corporations.²³ In Australia, New Zealand’s biggest rival, medium to large-size companies have been 2.5 times more successful in developing growth than their New Zealand counterparts.²⁴ Considering that the NZX market capitalisation has, notwithstanding its overall success during the last two decades, only grown by \$0.7 billion between 1994 and 2001,²⁵ whereas the Australian market grew from \$282 billion to \$733 billion during the same period of time,²⁶ New Zealand not only needs to be aware of its comparably less attractive market for international investors but also of the possibility that local investors might find it more profitable to invest overseas.

The slow growth between 1994 and 2001, after such severe progress in the preceding decade, might arguably be seen as an indicator that less and less local investors obtain equity of New Zealand companies and invest somewhere else instead. In the light of the fact that almost half of the population owns equity; such assumption does not appear to be absolutely far-fetched, in the author’s opinion. The words of Jane Diplock, Chairman of the SEC, that “corporate governance [in New Zealand needs to be] world-class” are, therefore, more than just a slogan.²⁷ Good corporate governance can improve a company’s financial performance and its attractiveness to investors. Only through superior corporate governance can New Zealand, in the author’s view, overcome its recent capital underperformance and raise itself to one of the leading investment markets worldwide.²⁸

²² McKinsey and Company, <<http://www.mckinsey.com>>, at 15 June 2006.

²³ Securities Commission, *Corporate Governance in New Zealand – Consultation on Issues and Principles* (September 2003), <http://www.ecgi.org/codes/documents/cg_nz_consult2003.pdf>, at 18 June 2006, p 3.

²⁴ Krackhardt, above n 19, 329.

²⁵ New Zealand Stock Exchange, *Annual Report 2001*.

²⁶ Krackhardt, above n 19, 329.

²⁷ Securities Commission, above n 23, 3.

²⁸ Krackhardt states also that “the small size of an economy does not prevent its producing internationally successful large companies” (Krackhardt, above n 19, 327).

B. Corporate Governance in New Zealand: Principles and Guidelines

The SEC published on 16 February 2004 its report *Corporate Governance in New Zealand: Principles and Guidelines* (Code).²⁹ Beforehand the SEC had conducted a survey among all interested parties accumulating their opinions on nine key areas relevant to corporate governance in New Zealand.³⁰ These nine issues later became an integral part of the Code. The SEC issued nine principles supplemented by numerous explanatory guidelines. The Principles apply to every business equally and determine how the business is run,³¹ whereas the Guidelines are literally intended to give guidance. The principles are, stated in numerical order in the Code:

- Ethical Conduct
- Board Composition and Performance
- Board Committees
- Reporting and Disclosure
- Remuneration
- Risk Management
- Auditors
- Shareholder Relations
- Stakeholder Interests.

The SEC decided to apply the principles-based approach to corporate governance as demonstrated by the Combined Code of the United Kingdom (UK).³² This approach inquires guidelines on proper business behaviour and detailed disclosure upon compliance.³³ SOX, on the other hand, represents a rule based approach demanding more detailed statutory prescription.³⁴ The SEC deliberately refrained from the rule-based approach in order to meet New Zealand specific circumstances.³⁵ The SEC assured New Zealand businesses that the Code would not cause any law reform or any revision of the existing law.³⁶ It was agreed that a “tick-in-the-box” approach to corpo-

²⁹ Securities Commission, *Corporate Governance in New Zealand: Principles and Guidelines*, <<http://www.sec-com-gov.nz>>, at 18 June 2006, 1.

³⁰ Securities Commission, above n 23, 3.

³¹ Krackhardt, above n 19, 330.

³² Securities Commission, above n 23, 8.

³³ Ibid.

³⁴ Ibid.

³⁵ Ibid, 4.

³⁶ Ibid, 3.

rate governance would not achieve the intended corporate improvements and investor confidence.³⁷ Contrary to the rule-based approach, which heavily relies on sanctions, the code is not enforced. Companies are *expected* to disclose but this is not mandatory.³⁸ This is arguably the biggest flaw of the system.

Principles in the Code are kept very brief, consisting of only one sentence each. Already shortly after its promulgation the Principles of the Code were criticised as “commonsense” and “self-evident”.³⁹ The Principles sound more like slogans than actual rules. Diplock emphasizes that directors and managers “step up and take responsibility for good corporate governance” mainly by establishing a boardroom culture which embraces corporate governance as the “driver for good financial performance and for success in the capital market”.⁴⁰ In sum, the SEC tried to establish an environment in which businesses are free to decide themselves how to define good corporate governance exactly. The SEC has only given vague orientation points. More descriptive and detailed are the Guidelines, sometimes filling an entire page with recommendations. Nevertheless, companies are not expected to report specifically against the Guidelines.⁴¹

Reporting against the Principles *should* be conducted by explaining how the entity achieved them comprehensively displaying the entity’s policies and practices.⁴² The SEC does not ask for a particular format, however.⁴³ The implementation of the Guidelines is optional and even though the SEC finds explanations for variations from the Guidelines useful, it does not require them.⁴⁴ Krackhardt evaluates the current New Zealand version of the Principles as a “weak system” and “insufficient”.⁴⁵ He recommends a more comprehensive code of principles based on a mandatory comply-or-explain enforcement.⁴⁶

³⁷ Securiteis Commission, above n 6, 5.

³⁸ Securities Commission, above n 6, 28; Diplock rejects the “comply-or-explain” enforcement vehicle, which makes disclosure mandatory (Diplock J, *Corporate Governance: The Role of the Regulator*, Legal Research Foundation Conference 2005, (18.02.2005), p 6).

³⁹ Panckhurst R, *Guiding Rules For Directors Sit Well* (20 February 2004), The New Zealand Herald Auckland, at C3.

⁴⁰ Diplock, above n 38, 7; Securities Commission, above n 6, 4.

⁴¹ Securities Commission, *ibid*, 5.

⁴² *Ibid*; Diplock, above n 38, 6 [emphasis added].

⁴³ *Ibid*, 7.

⁴⁴ *Ibid*.

⁴⁵ Krackhardt, above n 19, 333.

⁴⁶ *Ibid*.

C. NZX Corporate Governance Best Practice Code

Due to New Zealand's unique market of predominantly small-size corporations, the Code applies to any kind of entity. All companies apply the Code but only issuers listed with the NZX additionally have to fulfil the requirements of the *NZX Corporate Governance Best Practice Code* (NZX BPC).⁴⁷

The NZX BPC sets principles for four main issues: Ethics, Directors, Board Committees, and the Relationship with Independent Auditors.⁴⁸ Although fundamentally similar to the Principles of the Code,⁴⁹ the rules laid down by the NZX PBC are by far more detailed and provide more prescriptive guidance. Nevertheless, they do not contradict the Code and are therefore similarly accepted by the SEC.⁵⁰ The four main principles of the NZX PBC are divided in a number of subcategories dealing with main issues affecting current corporate governance. The NZX intends to enhance investor confidence through accountability.⁵¹ The NZX PBC provides, as the NZX gauges, "flexible principles which recognise differences in corporate size and culture".⁵² Pursuant to NZX Listing Rule 10.5.3(i) issuers are held to disclose in their annual report "the extent to which their corporate governance structure *materially* differs from the NZX PBC".⁵³ Problematic is the term "material". Neither the NZX Listing Rules nor the NZX PBC defines the term. The terminology seems relatively vague and subject to issuer assessment. Issuers might define "material" differently weighting specific variations from the NZX PBC differently. The vagueness of this terminology might lead to an unexpected and unwelcome diversity of corporate governance reporting. Although more comprehensive than the Code the NZX PBC is because of this terminology open to self-evaluation. By deciding if variations from the NZX PBC are material, the accountability of corporate conduct suffers, defeating the purpose of the code.

⁴⁷ Securities Commission, above n 6, 9.

⁴⁸ New Zealand Stock Exchange, *NZX Corporate Governance Best Practice Code* (August 2003), <<http://www.nzx.com>> at 18 June 2006, p 3.

⁴⁹ Thereby making double-reporting unnecessary (Securities Commission, above n 61, 8).

⁵⁰ See Securities Commission, above n 6, 6.

⁵¹ Ibid, 8.

⁵² Ibid.

D. Attracting International Investments

International private investors might arguably look for a comprehensive unified code of principles to which every entity adheres in a formatted manner. Diplock has to admit that not a single company in New Zealand has reported by the nine Principle format.⁵⁴ The New Zealand approach, from the author's point of view, might be very flexible in suiting all sizes of firms but it indubitable lacks necessary unification to attract overseas capital. Investors are not willing to learn about a country's legal system, the economic structure or the precise listing rules of a market. They take annual reports for granted and easily regard a market as chaotic when disclosure turns out to be inaccurate and merely a result of corporate assessment and lax principle enforcement. The main advantage of strict rules to corporate governance is its inherent clarity.⁵⁵ The risk of loopholes, deriving from a system which allows companies themselves to decide what they would like to report on, can be eliminated through mandatory rules.⁵⁶ Additionally, the State can control compliance and thereby guarantee good corporate governance.⁵⁷ In the light of the pressure the US government and the US market imposes on other legislations to follow their lead, it has become necessary to re-think New Zealand's approach to corporate governance, revise the US legislation and assess if SOX regulations truly meet the governmental intention behind it. Only if SOX appears to be a successful and appropriate piece of legislation it is worth to consider adoption. It is vital in this process to consider the chain of reasons leading to SOX and to analyse them.

III. THE SARBANES-OXLEY ACT 2002 – PRIME EXAMPLE OF THE STRICT RULE-BASED APPROACH

A. Introduction

In 2002 the US legislature passed SOX in the aftermath of the most dramatic corporate scandals in US history: Enron and WorldCom. SOX is the most comprehensive

⁵³ Ibid; NZX Listing Rule 10.5.3(i) [emphasis added].

⁵⁴ Diplock, above n 38, 8; it needs mentioning that they are not required by law to use this format either.

⁵⁵ Krackhardt, above n 19, 331.

⁵⁶ Ibid.

⁵⁷ Kim B, *Sarbanes-Oxley Act*, 40 Harv. J. Legis. 235, 252.

securities legislation in the USA since the 1930s⁵⁸ and it regulates a field of law that, up to this point, had only been subject to state law and the state jurisprudence.⁵⁹ The federal government thereby followed the long-time call of many legal scholars.⁶⁰

B. Historical Context

SOX is the prime example of the strict rule-based approach.⁶¹ It was passed without the involvement of the business community.⁶² Driving force behind the regulation process in the USA were the recent corporate scandals of Enron and WorldCom.

The Enron Corporation was a multi-billion dollar enterprise in the energy and communication sector.⁶³ The Fortune Magazine put it on its “100 Best Companies to Work for in America” list in 2000.⁶⁴ The Chief Executive Officer (CEO) Kenneth Lay and Enron’s Chief Financial Officer (CFO) Andrew Fastow engaged in numerous accounting frauds which resulted in a deception of the firm’s financial status. They had created “special purpose entities” (SPE)⁶⁵ in order to shift debts from Enron’s books to these bogus enterprises.⁶⁶ In 2000, Enron’s share value was extremely high at \$90-per-share value and investors thought prices would rise indefinitely.⁶⁷ This assumption was solely based on Lay’s and Fastow’s assertion that Enron would “earn returns on equity of 25 per cent *forever*”, a statement investors, due to Enron’s previous unstoppable ‘success’, believed unquestioningly.⁶⁸ Eventually, Lay and Fastow encouraged shareholders to buy stock while they sold their shares at horrendous prices.⁶⁹ In October 2001, the swindle was discovered and Enron’s executives were charged on accounts of fraud. The jury reached a verdict in May 2006 holding

⁵⁸ Lehman K, *Executive Compensation Following the Sarbanes-Oxley Act of 2002*, 18 NCLR 2115, 2117.

⁵⁹ Branson D, *Enron – When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?*, 48 Vill. L. Rev. 989.

⁶⁰ Berle and Means first asked for federal legislation on securities law in 1932 (see Ribstein L, *Bubble Laws*, 40 Hous. L. Rev. 77, 87).

⁶¹ Kim, above n 57, 236.

⁶² Hamilton R, *The Crisis in Corporate Governance: 2002 Style*, 40 Hous. L. Rev. 1, 46.

⁶³ Ruder D, *Lessons from Enron: Director and Lawyer Monitoring Responsibilities* (2002), (< http://www.law.northwestern.edu/contextec/documents/Ruder_Lessons_Enron.pdf> at 10 April 2006).

⁶⁴ Wikipedia, *Enron Corporation*, (<http://en.wikipedia.org/wiki/Enron_Corporation> at 07 April 2006).

⁶⁵ Limited partnerships controlled by the Enron Corporation.

⁶⁶ Ruder, above n 63.

⁶⁷ Ribstein, above n 60, 84.

⁶⁸ Ibid [emphasis added].

⁶⁹ Wikipedia, above n 64.

Lay liable on all charges; sentencing is going to take place in September 2006.⁷⁰ Maximum sentence estimates range from 45 to 165 years.⁷¹ Thousands of Enron employees lost their jobs and pensions and shareholders lost their investments when Enron declared bankruptcy in December 2001.⁷²

After the Enron scandal had become public in 2001 regulatory moves appeared to languish in early 2002.⁷³ However, in June 2002, WorldCom, America's second largest long distance telecommunication company, announced that it has had overstated earnings by US \$3.8 billion in the previous year.⁷⁴ Investigations proved that WorldCom executives had counterfeited the company's books through bogus entries inflating revenues this way.⁷⁵ The company's market capitalisation dropped considerably from US \$115 billion to less than US \$1 billion.⁷⁶ Shareholders lost two thirds of their investments in stock value.⁷⁷

As a result of this second major accounting scandal within one year, the US Congress felt obligated to pass SOX on 30 July 2002.⁷⁸ US President George W Bush described the law as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt".⁷⁹ The regulations were intended to hold affiliates in monitoring positions liable to execute their duties properly.⁸⁰ The intention of SOX, as set down in its preamble, is "to protect by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws, and for other purposes".⁸¹ The US securities market suffered severely from recent scandals. Patrick McGeehan, CEO of Goldman Sachs, for example, described the post-Enron

⁷⁰ RAW Story, *Enron jury reaches a verdict in fraud and conspiracy case*, <http://www.rawstory.com/news/2006/Enron_jury_reaches_verdict_in_fraud_0525.html> at 29 May 2006.

⁷¹ Ibid.

⁷² Wikipedia, above n 64.

⁷³ Ribstein, above n 60, 86.

⁷⁴ Owen C, *Board Games: Germany's Monopoly on the Two-Tier-System of Corporate Governance and Why the Post-Enron United States Would Benefit From Its Adoption*, 22 Penn St. Int'l L.Rev. 169.

⁷⁵ Wikipedia, *MCI*, <<http://en.wikipedia.org/wiki/WorldCom>> at 07 April 2006).

⁷⁶ Owen, above n 74, 169.

⁷⁷ Wikipedia, above n 75.

⁷⁸ Ribstein, above n 60, 86.

⁷⁹ US Gov't, *Remarks on Signing the Sarbanes-Oxley Act of 2002*, 38 Weekly Comp. Pres. Doc. 1284 (30 July 2002), <<http://www.whitehouse.gov/news/releases/2002/07/20020730-1.html>> at 29 May 2006.

⁸⁰ Ibid.

⁸¹ Ibid.

era as “a time when business has never been held in less repute”.⁸² Consequently, SOX might be seen as an attempt of the US legislature to satisfy the desires of startled investors for strict regulation and to improve the overall confidence in the US securities market.⁸³

C. Causes of the Market Failure

1. Introduction

According to Ribstein there are three reasons for the 2001/02 market failures. He describes them as agency costs, a “bubble atmosphere”, and a gatekeeper failure.⁸⁴ This subsection explains these terms and their severe effect on the US securities market which made Enron and WorldCom inevitable.

2. Agency Costs

The separation of ownership and control leads to so-called “agency costs”.⁸⁵ Corporate managers function as agents of the shareholders who own the company.⁸⁶ The main benefit of having non-owner managers is that passive owners are able to invest in diversified portfolios, leaving the risk of failure to the specific agent.⁸⁷ These agents have, as Ribstein observes, “incentives to use their control [over the company] to benefit themselves rather than the owners”.⁸⁸ Costs arising from supervising management and protecting owners as well as residual losses caused thereby are called “agency costs”.⁸⁹ Since ownership is highly dispersed in most securities markets, the monitoring process is particularly impractical in listed public companies raising agency costs substantially.⁹⁰ These costs are exacerbated by the “free-rider” mentality of minor shareholders who are either unwilling or unable to invest money and

⁸² McGeehan P, *Goldman Chief Urges Reforms in Corporations*, N.Y. Times, 6 June 2002 quoted in Owen, above n 74, fn 9.

⁸³ Kim, above n 57, 236.

⁸⁴ Ribstein, above n 4, 280.

⁸⁵ Ibid; see Jensen M & Meckling W, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (defining agency costs).

⁸⁶ Beck A & Borrowdale A, *Guidebook to New Zealand – Companies and Securities Law*, (7th ed.), p 90, §407, §408.

⁸⁷ Ribstein L, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1, 36.

⁸⁸ Ibid..

⁸⁹ Ibid.

⁹⁰ Ribstein, above n 4, 280.

time in monitoring management.⁹¹ The Enron as well as the WorldCom case show indubitably the dilemma that may arise when owners put too much trust in their agents and lose their natural scepticism. Large-scale managerial fraud paired with an indistinguishable cleverness of masking such misdeeds made effective supervision difficult, if not impossible.⁹² Fostered by the size and complexity of the business, agency costs rose to an unbearable degree. The nature of agency costs disallows constant and thorough supervision in such an environment.

3. Bubble Atmosphere

The mood prevalent in the securities market after Enron and WorldCom may be described as ‘panic’, a panic that derived from absolute disillusionment.⁹³ Investors had lost their healthy scepticism for the “new market”.⁹⁴ A sheer abundance of business opportunities and deregulations of numerous industries paired with seemingly inexhaustible amounts of capital resulting from an increasing number of private investors entering the securities market led to an unrealistic optimism shared by all market participants.⁹⁵ Investors had gotten used to believing stories about expected yet unrealistic earnings.⁹⁶

Moreover, a “new breed of corporate managers” found themselves in a new, highly-competitive market, in which only the most confident and deceptive participants could survive.⁹⁷ It might be assumed that high market expectations and tough competition spurred managers to fraudulent actions. Investors continuously expected news of even higher earnings and there was always someone as competent as oneself waiting to replace the CEO. There were also new business techniques, such as Enron’s SPEs, which made financial statements opaque.⁹⁸ In particular small-scale investors, but also some institutional investors, lacked the expertise to understand the company’s accounts and its actual financial status.⁹⁹ Consequently, many executives dis-

⁹¹ Ribstein L, *Sizing Up SOX*, Legal Research Foundation – Seminar *Corporate Governance At The Crossroads* (18 January 2005), p 4.

⁹² Ribstein, above n 4, 281.

⁹³ Ribstein remarks that Congress *hurriedly* passed SOX (Ribstein, above n 4, 282 [emphasis added]).

⁹⁴ Ribstein, above n 87, 10.

⁹⁵ Ribstein, above n 60, 83, 84.

⁹⁶ *Ibid*, 85.

⁹⁷ Ribstein, above n 87, 9.

⁹⁸ Ribstein, above n 4, 281.

⁹⁹ See references in Ribstein, above n 4, ftn 10.

regarded all ethical measures of the ‘old economy’ and enriched themselves on the way up and lied in order to cover up their crimes on the way down.¹⁰⁰

Ribstein regards these corporate frauds as a logical consequence of the stock-market boom of the 1980s and 1990s. He states that every economic boom is followed by a crash and strict regulations.¹⁰¹ Certain groups within society including well-established corporations as well as numerous forms of legal advisers favour harsh regulation whereas marginal firms and start-ups might be infringed by regulatory attempts.¹⁰² During a phase of economic boom, equilibrium between these interest groups prevails because “those who might shift the balance, such as consumers or investors, do not see a need for new regulation while they are riding a rising market”.¹⁰³ In case of an economic crash, this equilibrium shifts in favour of those preferring stricter regulations for its negative effect on weaker market participants.¹⁰⁴ Ribstein calls this the “Cycle of Financial Regulation” and claims that this has also happened after the 1929 crash of the New York Stock Market with the so-called New Deal.¹⁰⁵ In sum, a market thrives and expands in such a way that investors lose their scepticism and start to believe lies about inexhaustible earnings. All market participants find themselves in a euphoric state that is based on unrealistic optimism. This “bubble”¹⁰⁶ atmosphere expands until it bursts.

During its expansion, it has provided a situation in which fraud could easily flourish.¹⁰⁷ Nonetheless, Ribstein claims, it is not the discovery of such frauds which cause a decline in the stock market.¹⁰⁸ Statistics of the New York Stock Exchange prove, as he says, that stock values were already decreasing in 2001 and that the

¹⁰⁰ Ribstein, above n 87, 9.

¹⁰¹ Ribstein, above n 60, 78; *see also* Coffee J, *Rise of Dispersed Ownership*, 111 Yale L. J. 1, 66 (calling it the “crash-then-law” cycle).

¹⁰² *Ibid*, 79.

¹⁰³ *Ibid*.

¹⁰⁴ *Ibid*.

¹⁰⁵ *Ibid*, 79 & 90; *see* APPENDIX A for graph of the 1929 crash.

¹⁰⁶ When Ribstein talks about the “bubble atmosphere”, he actually refers to an Act passed after the Spanish War, which intended to secure royal rights by regulating speculations and is now known as the Bubble Act derived from the economic term “speculative bubble” (*see* Ribstein, above n 60, 95 & 96). In the author’s opinion, the term bubble can also be understood metaphorically, picturing a market which expands, similar to a balloon or bubble, until it succumbs to inherent pressures and its fragile construction and bursts (*see* Wikipedia, *Economic Bubble*, <http://www.en.wikipedia.org/wiki/Economic_bubbles> at 30 June 2006).

¹⁰⁷ Ribstein, above n 4, 281.

¹⁰⁸ Ribstein, above n 60, 86.

phase of economic boom had already ceased.¹⁰⁹ Scandals such as Enron and World-Com merely coincided with this phase.¹¹⁰ Managers had gotten too greedy and made mistakes while trying to cover up their previous crimes as they realised that their company's bad financial situation became increasingly apparent. Investor expectations were built on lies which had become too extensive to hide. Securities prices cannot rise indefinitely and too much market optimism results in uncontrollable managerial conduct.¹¹¹ Accordingly, a boom phase necessarily leads to a phase of strict regulation, such as the one taking place in the USA at present, as investors lose confidence in the market and governments need to react. All market participants have by then reverted from extreme optimism of the bubble atmosphere to extreme pessimism.¹¹²

4. Gatekeeper Failure

Shareholders are, due to the high diversity of ownership, unable to monitor management themselves. Therefore, they delegate such tasks to the directors, auditors and other supervisors, often referred to as "gatekeepers".¹¹³ At Enron, gatekeepers were oblivious to the scandals within the company although evidence of the manipulations that took place would have been available to sophisticated supervising bodies.¹¹⁴ As Ribstein analyses that gatekeepers are either "too remote from the misconduct to be able to spot it" or "conflicting loyalties [makes them] overlook ... misconduct".¹¹⁵

The example of Arthur Anderson LLP, formerly considered to be one of the 'Big Five' international accounting firms, shows this inadequacy. In highly competitive markets with an increasing number of auditing firms, supervising bodies were willing to sacrifice ethics and even valuable reputation for the sake of business relationships and profit maximisation within the firm.¹¹⁶ Arthur Anderson was the auditor of Enron and WorldCom. It was convicted of obstruction of justice for destroying En-

¹⁰⁹ See Ibid, ftn 39; Coffee, above n 101, 19.

¹¹⁰ Ibid.

¹¹¹ Ibid, 77 & 81.

¹¹² Ribstein, above n 87, 49.

¹¹³ Kraakman R, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. Econ. & Org. 53, 61.

¹¹⁴ Report of the Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., February 1, 2002, <<http://news.findlaw.com/hdocs/docs/enron/sicreport/>> at 10 April 2006, p 23 ; Catanach A & Rhoades-Catanach S, *Enron: A Financial Reporting Failure?*, 48 Vill. L. Rev. 1057.

¹¹⁵ Ribstein, above n 91, 4.

ron-related documents.¹¹⁷ In this case, the auditor not only overlooked misconduct but also assisted it. It is unclear, if Arthur Anderson personal was aware of the fraudulent behaviour of WorldCom executives, as well. Nonetheless, in the bubble atmosphere fraud prospered because auditors were either unwilling to spot misconduct or they were caught up in this surge of optimism just as anyone else and therefore unable to apprehend complex concealments. Anyway, even gatekeeper failures may be seen, in the author's perspective, as a result of the economic boom phase and people's irrevocable belief in an unstoppable market growth.

D. Brief Account of Regulations

1. Introduction

SOX focuses primarily on corporate control. Instead of strengthening the position of the shareholders, it amplifies management responsibilities and determines internal organisational structures.¹¹⁸ Congress intended to combat fraud, improve the reliability of financial reporting, and restoring investor confidence.¹¹⁹ SOX might consequently be called an investor-protection law.¹²⁰ SOX's regulations handle:

- Internal Monitoring,
- Gatekeeper Regulation,
- Regulation of Insider Misconduct,
- Financial Disclosure, and
- Fraud Liability.

2. Scope of Application

Some of SOX's regulations take effect without any further legislative act.¹²¹ However, partly, Congress ordered the United States Securities and Exchange Commis-

¹¹⁶ Bazerman M, *The Impossibility of Auditor Independence*, Sloan Mgmt Rev. 88, 91.

¹¹⁷ Gutman H, *Dishonesty, Greed and Hypocrisy on Corporate America* (14 July 2002), <<http://www.commondreams.org/views02/0712-02.htm>> at 30 May 2006.

¹¹⁸ Gruson M & Kubicek M, *Der Sarbanes-Oxley Act, Corporate Governance und das Deutsche Aktienrecht (The Sarbanes-Oxley Act, Corporate Governance and the German Securities Law)*, <www.web.uni-frankfurt.de/fb01/baums/files/paper113.pdf> at 30 May 2006, p 3.

¹¹⁹ Wagner S & Dittmar L, *The Unexpected Benefits of Sarbanes-Oxley*, 84 Harv. Bus. Rev. (April 2006), 133.

¹²⁰ Ibid.

¹²¹ See SOX ss 304, 305, 402, 408, 906, 1103.

sion (US SEC) to find means of implementation.¹²² The regulations of SOX apply to publicly held corporations, which are enlisted with the US stock exchanges. SOX affects all companies listed with the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX) and NASDAQ as well as any corporation registered with the US SEC.¹²³ This includes foreign firms which seek to register with one of the US stock exchanges. There are no exceptions for foreign corporations and previous appeals to the US SEC to change this have been rejected.¹²⁴ New Zealand companies registered with the US SEC, such as Telecom New Zealand, must also comply with SOX regulations if they want to remain registered and enlisted in the USA.¹²⁵

3. Regulations

The main focus of SOX is place on control through independent monitoring and protecting monitoring parties. The following subsections briefly describe regulations according to this goal.

a. Internal Monitoring

The US legislature, due to the ignorance of Enron's directors, wanted to strengthen supervision within the company in order to improve overall corporate control.

aa. Independent Directors

Under Section 301 of SOX,¹²⁶ the US SEC is required to de-list, or prohibited from enlisting, any company which does not prove to have established an audit committee which consists solely of independent directors. Every member of the audit committee has to be on the company's board of directors.¹²⁷ Section 301(3)(B) defines independent director as a person who does not accept any consulting, advisory, or compensatory fee from the entity and who is not affiliated to the company or any subsidiary in any way. The audit committee is supposed to monitor management without the interferences of executives, a task impossible for the board of directors due to the

¹²² Gruson & Kubicek, above n 118, p 11.

¹²³ Most regulations refer to the term Issuer. SOX s 2(a)(7) defines this term as any issuer who is registered under section 12 of the Securities Exchange Act of 1934 (SEA) or who is required to file under section 15(d) of the SEA, or files or has filed a registration statement which has not yet become effective under the Securities Act of 1933 and has not been withdrawn; *ibid*, 12.

¹²⁴ *Ibid*.

¹²⁵ Price-Waterhouse-Coopers, *What has Sarbanes-Oxley Meant for New Zealand Companies?* (January 2005), Legal Research Foundation – Seminar *Corporate Governance At The Crossroads*, p 1.

¹²⁶ SOX s 301, 15 U.S.C.A. s 78f (2002).

¹²⁷ SOX s 301(3)(A).

presents of executives at meetings.¹²⁸ It is responsible for hiring the accounting firm and will receive its reports.¹²⁹ By rule of Section 407 one member of the audit committee needs to be a financial expert who is able to understand the company's books.¹³⁰

bb. Whistleblowers

Theoretically, it is assumed that once senior executives are given sufficient financial incentive they exert proper corporate control over both each other and subordinates.¹³¹ Enron and WorldCom have shown, however, that senior executives can be involved in the frauds, which makes discovering the wrongdoings exceptionally difficult. Often the authorities might not be able to detect such actions without inside help. In case of WorldCom, an employee discovered the fraud.¹³² In all major US scandals internal staff had voiced concerns but managements affectively suppressed or allayed concerns.¹³³ In order to prevent intimidation, SOX section 806 protects whistleblowers, meaning employees informing authorities on corporate misconduct, from reprisals.

cc. Internal Control Disclosure

The most controversial rule incorporated in SOX is Section 404.¹³⁴ In order to provide investors with useful information, management is required to evaluate and report on the company's internal control structures and procedures for financial reporting.¹³⁵ The company's external auditor is also required by Section 404 to examine and report on the assessment of internal controls as well as its effectiveness.¹³⁶

As part of corporate responsibility, Section 302 of SOX requires management to certify the accuracy of financial statements and disclosures in periodic reports.¹³⁷ Similar to Section 404, they also have to certify that financial controls and procedures

¹²⁸ Krackhardt, above n 19, 345.

¹²⁹ Hamilton, above n 62, 59.

¹³⁰ Defined in SOX s 407(b).

¹³¹ Ribstein, above n 87, 13.

¹³² Ribstein, above n 91, 7.

¹³³ Price-Waterhouse-Coopers, above n 125, 2.

¹³⁴ See *ibid*, 1 (for discussion on the effect of this regulation on New Zealand companies).

¹³⁵ Ribstein, above n 91, 7.

¹³⁶ Wagner & Dittmar, above n 119, 137.

¹³⁷ *Ibid*.

have been implemented and evaluated, and that any changes to the system of internal control since the previous report have been noted.¹³⁸

In sum, Section 404 and 302 hold management to their duties of monitoring financial reports and investor information. By having them sign and approve disclosures, the regulator expects more honesty and appropriate conduct. If a person has to sign a statement, this person might be more induced to double-check the paper's accuracy. Accounting slacks due to time constraints or disinterest might arguably be avoided this way.

b. Gatekeeper Regulation

The case of Enron and Arthur Anderson proved that gatekeepers are not as independent as necessary. Before Enron, auditors' independence was expected because of two reasons: Firstly, major auditing firms are busy in such a diverse market that they never become dependent of one client.¹³⁹ Secondly, they have usually established a valuable reputation that they would not want to lose.¹⁴⁰ In the "bubble atmosphere" of the late 1990s, these values have lost importance and interweaving relationships had become common.

The independence of gatekeepers is achieved by four means: auditors are barred from non-audit work for the company;¹⁴¹ auditors are only allowed to audit the same company for five years in a row;¹⁴² auditors are selected by the audit committee, which itself is independent;¹⁴³ and restricting auditing of a firm by a member whose senior management was employed by the auditor during anytime of the previous year.¹⁴⁴

In order to unite external and internal supervision, SOX s 204 demands that the auditing firm reports more detailed to the auditing committee on a periodic basis. SOX

¹³⁸ Ibid.

¹³⁹ Ribstein, above n 87, 13.

¹⁴⁰ Ibid.

¹⁴¹ SOX s 201.

¹⁴² SOX s 203 (demanding a rotation of auditing firms).

¹⁴³ SOX s 202.

¹⁴⁴ SOX s 206.

also provides for US SEC rules which prevent fraudulent misleading and influencing of auditing firms.¹⁴⁵

An appropriate standard of corporate auditing is expected through the implementation of the Public Company Accounting Oversight Board (PCAOB), a public agency under the oversight of the US SEC, which duty it is to register, inspect, and investigate public accounting firms.¹⁴⁶ It establishes audit quality, control standards and professional as well as ethical monitoring standards.¹⁴⁷ Firms with more than 100 public clients are inspected annually and others triennially.¹⁴⁸

Other gatekeepers, such as attorneys, are not covered to the same extent as auditing firms by the regulations of SOX. In the author's opinion, this is the case because neither Enron nor WorldCom revealed failures of any other monitoring entity than auditors. SOX s 307 merely establishes that attorneys have to report on evidence of fraud to either the chief executive counsel or the auditing committee.

c. Regulation of Insider Misconduct

Insider misconduct is handled by limiting executive compensation. WorldCom had given loans to its long-time leader Bernard Ebbers, which he never returned; Enron executives had sold large amounts of their shares and had enriched themselves thereby and Kenneth Lay of Enron was able to purchase stock options through company credits that resulted in personal gains of US \$100 million in the year of Enron's collapse.¹⁴⁹ As a result, SOX prohibits insider loans and requires returns of incentive-based compensation as well as profits from stock sales following accounting restatements.¹⁵⁰ This way, the legislature does not only attempt to minimise incentives of frauds but also intends to ensure that executives adhere to their duties of proper accounting.¹⁵¹ The return of incentive-based compensations is intended to be a method of penalizing frauds.¹⁵² SOX allows credits and loans as long as they are given for

¹⁴⁵ SOX s 307.

¹⁴⁶ SOX s 101-109.

¹⁴⁷ Price-Waterhouse-Coopers, above n 125, 2.

¹⁴⁸ Ibid.

¹⁴⁹ Ribstein, above n 87, 15; Krackhardt, above n 19, 352.

¹⁵⁰ SOX s 402, 304.

¹⁵¹ Ribstein, above n 87, 16.

¹⁵² Ibid.

company-related relocations and if they are on “market terms”, meaning not a specifically subsidised bonus.¹⁵³

4. Increase in Financial Disclosure

A loophole of the law preceding Enron were the infrequency by which companies were obliged to give disclosure. Kenneth Lay was able to sell personal stock back to the company without disclosure because disclosures were only required annually.¹⁵⁴ This way, his fraudulent sale of major amounts of personal shares was unnoticed by other investors.

The rules of Title IV of the Act address pro forma earnings and immediate disclosure of material changes in financial activities.¹⁵⁵ SOX requires “real time disclosure in plain English on a rapid and current base”.¹⁵⁶ Companies have to provide reports on a quarterly basis in order to keep investors up-to-date.¹⁵⁷ In a set of detailed rules, Title IV SOX regulates precisely responsibilities of all forms of financial disclosure within the firm.¹⁵⁸ Financial disclosure is at the heart of US corporate governance regulations because such reports are necessary in order to retain investor confidence. Since Enron’s CFO had hidden major debts through off-balance sheet accounts generated by means SPEs, Congress tries to fight these financial techniques by stricter regulation and increased disclosure.

As required by Section 408 of SOX, the SEC is also urged to increase their reviews of public corporation filings. In order to comply, SEC’s funding has been increased.¹⁵⁹ Additionally, truthful certification of financial statements and disclosures by a company’s CEO and CFO is assured by means of criminal penalties in case of “wilful failure” to portray true conditions.¹⁶⁰ CEO and CFO must confirm that the document complies with US SEC reporting requirements and represents the com-

¹⁵³ Krakhardt, above n 19, 352.

¹⁵⁴ Ibid, 347; *see* SOX s 401, 409.

¹⁵⁵ Ribstein, above n 4, 283.

¹⁵⁶ Ibid.

¹⁵⁷ Ibid.

¹⁵⁸ Title IV is headlined “enhanced financial disclosure”.

¹⁵⁹ *See* SOX s 604.

¹⁶⁰ Wagner & Dittmar, above n 119, 137.

pany's financial standing.¹⁶¹ Non-compliance results in either a US \$5 million fine or imprisonment of up to 20 years.¹⁶²

5. Fraud Liability

Previous to SOX, US securities law and antifraud provisions had been liberalised reducing liabilities.¹⁶³ Numerous states had introduced limited liability partnerships (LLP) laws which abetted accounting firms, such as Arthur Anderson, by eliminating vicarious liability provisions for these gatekeepers.¹⁶⁴ Arguably fraud might have been encouraged by these rules.

Titles VII to XI of SOX explicitly address frauds, penalties and tax evasion. It is more than apparent, from the author's point of view, that Congress was contemplating Enron and WorldCom frauds when framing Titles VII-XI.¹⁶⁵ Criminal penalties are increased and liabilities rank from securities fraud to more unusual crimes, such as the "violation of the Employee Retirement Income Securities Act of 1974", a provision most likely related to what happened to the pensions of Enron employees.¹⁶⁶ Besides these criminal charges,¹⁶⁷ Section 304 of SOX demands that managers have to reimburse the corporation in case of restatements. The interplay of these criminal and financial liabilities is intended to improve managerial monitoring.

By law, certain criteria also cause people to be barred from exerting director positions and others can be barred from practicing professionally before the US SEC.¹⁶⁸ Authorities are able to 'weed out the black sheep'.

¹⁶¹ SOX s 906.

¹⁶² Ibid.

¹⁶³ Ribstein, above n 87, 17.

¹⁶⁴ Ibid.

¹⁶⁵ Concerning the tax evasion provisions it is referred to the case of Tyco International, another corporate scandal that occurred in 2002. The former CEO of Tyco International, Dennis Kozlowski, was indicted, among other more severe charges, for sales tax evasion (*see* USA Today, *Timeline of the Tyco International Scandal*, <http://www.usatoday.com/money/industries/manufacturing/2005-06-17-tyco-timeline_x.htm> at 07 April 2006 for more information).

¹⁶⁶ *See* SOX s 807, 903, 904-906.

¹⁶⁷ For example SOX s 807 encompasses imprisonment of up to 25 years.

¹⁶⁸ SOX s 1105, 602.

E. Evaluation of SOX

1. Introduction

The following subsections show that although SOX has caused positive effects in terms of corporate control structures and internal monitoring, the overall impact is counter-productive and defeats its purpose of fraud prevention and enhancing investor confidence.

2. Effectiveness of Regulations

Although greed might have played a large part, especially in the Enron case, it was not the main driving force behind major US scandals. This may rather be attributed to a market of over-enthusiasm. It is arguable that stronger codification might be necessary under such circumstances.¹⁶⁹ Strong mandatory rules paired with sanctions may incite managers to honour the law. However, the following subsections demonstrate that the US legislature failed at creating effective rules. Roe explains in a similar context that intensifying regulation is unlikely to be effective to counter fraud.¹⁷⁰ The mandatory rules incorporated in SOX are a prime example of over-reaction and inefficiency.¹⁷¹

a. Independent Directors

The standard solution to recent corporate problems was that directors on a company's board of directors are independent.¹⁷² Advocates of this approach claim that a board solely consisting of independent directors would lead to an improved supervision of a company's financial disclosure and its relationships with auditors.¹⁷³

Nonetheless, there is substantial data collected over the last 20 years which indicate that regulations of the composition of the board of directors is no solution to corpo-

¹⁶⁹ See Langevoort D, *Seeking Sunlight In Santa Fee's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 Wash. U. L.Q. 449, 450.

¹⁷⁰ Roe M, *Corporate Law's Limits*, 31 *J. Legal Stud.* 233.

¹⁷¹ Farrar, above n 7, 9.

¹⁷² Gelb H, *Corporate Governance Guidelines – A Delaware Response*, 1WYLR 523, 550; Delga J, *Corporate Governance and the Independent Director: The Independent Director in France*, 15 ICCLR 1, 1.

¹⁷³ *Ibid.*

rate frauds.¹⁷⁴ Independent, outside directors may be better at removing inefficient executives¹⁷⁵ but there is also evidence that they are correlated with poor corporate performance.¹⁷⁶ Relying on independent, unrelated directors interferes with value creation because such a directorate is, unlike entrepreneurs, risk-averse.¹⁷⁷ Independent directors do not gain from risky business transactions. They do not hold any equity in the firm and usually receive no incentives based on their performance. Perry, therefore, raises the idea of providing directors with stock of their own in order to avoid the old problem of separation of ownership and power which would otherwise take full effect in the shareholder-director relationship as well.¹⁷⁸ Contrarily, WorldCom directors held equity shares which did not help prevent fraud there.¹⁷⁹

Outside directors are usually chosen by insiders and hence are unlikely to second guess their decisions.¹⁸⁰ It is also questionable if they devote enough time to the job.¹⁸¹ Outside directors lack time to do more than just reviewing business decisions. They are normally ignorant of the company's business, thus rely on information provided by the company's executives.¹⁸² Consequently, their lack of business expertise and sophistication might disable them to detect financial loopholes and internal frauds.¹⁸³

b. Whistleblowers

In case of WorldCom it was an internal auditor who discovered the fraudulent actions of the management. Only the comprehensive sophistication of the accounting department helped these internals to uncover the bogus entries and preparations of

¹⁷⁴ Bainbridge, for example, shows by looking at the New York Stock Exchange listing rules that this already strict regulatory body did not hinder Enron officials or any other business figure involved in a similar fraud case from committing such crime (Bainbridge S, *A Critique of the NYSE's Director Independence Listing Standards*, UCLA School of Law, Research Paper No. 02-15, June 2002, <http://papers.ssrn.com/paper.taf?abstract_id=317121> at 14 June 2006).

¹⁷⁵ Weisbach M, *Outside Directors and CEO Turnover*, 20 J. Fin. Econ. 431.

¹⁷⁶ Bhagat S & Black B, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. Corp. L. 231.

¹⁷⁷ Ribstein, above n 4, 285.

¹⁷⁸ Perry T, *Incentive Compensation for Outside Directors and CEO Turnover*, SSRN Elec. Library, Working Paper, June 2000, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236033> at 15 June 2006.

¹⁷⁹ See Sandberg J & Lublin J, *Questioning the Books: WorldCom's Travails Could Affect Its Directors*, WALL ST. J., 28 June 2002, at A9.

¹⁸⁰ Ribstein, above n 87, 26.

¹⁸¹ Rees W & Sheikh S, *Corporate Governance and Corporate Control: Self Regulation or Statutory Codification*, 3 ICCLR 370, 373.

¹⁸² Sheikh S, *Non-Directors: Self-Regulation or Codification*, 23 Comp. Law 296, 298.

the company's books.¹⁸⁴ SOX tries to improve monitoring *by* these lower-level employees but opens doors for, what Ribstein calls, "shirking or even defrauding employees masquerading as whistleblowers" who may avoid being monitored themselves this way.¹⁸⁵ These employees might 'sell' a fraud they have committed themselves as a something under the responsibility of the firm's management. Although this is, in the author's view, a far-fetched scenario, Ribstein believes it is an "obvious problem".¹⁸⁶

Moreover, SOX makes no distinction between reporting about fraud before it occurs and afterwards. Arguably, there is a significant distinction between the two. The first scenario prevents vital communication within the company. If employees are afraid of 'telly-tales' eavesdropping within the firm necessary information does not flow.¹⁸⁷ In the latter case, such flow of information is not impaired similarly and the benefits of the report may outweigh the impact of discouraged communication for the firm, which can react and rescue its reputation.¹⁸⁸

From the writer's perspective, it must not be forgotten that even though whistleblowers cannot be dismissed from their positions within the firm and cannot be subject to any other *obvious* reprisal, they will always be known as the person who informed the authorities, the board or any other institution. In the future superiors might try to avoid this person and cut this person out of the communication line as far as possible. Working with someone who evidently reports on superiors may create an atmosphere of distrust and nervousness.¹⁸⁹ In such an environment productive value creation might arguably be impossible. Eventually whistleblowers might leave voluntarily because they cannot survive in such an environment.¹⁹⁰ The company might not only lose good employees this way but might also lose in terms of profits as the labour

¹⁸³ Ribstein, above n 87, 27.

¹⁸⁴ Ribstein, above n 4, 286.

¹⁸⁵ Ibid.

¹⁸⁶ Ibid.

¹⁸⁷ Ibid.

¹⁸⁸ See Koniak S, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 Colum. L. Rev. 1236; Kaplow L & Shavell S, *Legal Advice About Information to Present in Litigation: Its Effects and Social Desirability*, 102 Harv. L. Rev. 565.

¹⁸⁹ Ribstein, above n 87, 42.

¹⁹⁰ Ernst&Young has found out that approximately 97 per cent of all whistleblower complaints against discrimination filed with the US Department of Labour under the SOX provisions are dismissed (Ernst&Young, 9th *Global Fraud Survey – The Risk in Emerging Markets*,

machinery does not function properly anymore. SOX only provides for a broad, undefined and incomprehensive vehicle of protecting whistleblowers, inappropriate for fostering internal monitoring. Employees willing to ‘blow the whistle’ might refrain from doing so if they are aware that, besides legal job protection, there are no means to save their reputation within the same firm and any future employer.

c. Gatekeeper Regulations

Biggest shortcoming of the gatekeeper regulations of SOX is the fact that, although induced to report on frauds, auditors are not required to forensic audits. Many commentators have pointed this out but agreed that such auditing would be too expensive.¹⁹¹ Auditors are outsiders, and without forensic research, are unable to fully monitor transactions within the firm and wrongdoings that have been taken off the books. Such thorough research would easily develop into a “fulltime job” increasing costs and auditing prices even more.¹⁹² The prohibition of non-audit work during the auditing process¹⁹³ bears two risks, though: Firstly, and in connection with the previous argument, the auditor’s scope of overview is restricted to checking the books. Even though this might be in alignment with Congress’ goal of more financial supervision, other, well-planned wrongdoings might possibly remain undetected. Without information coming from all corners of the company a detection of illegal behaviour is tough.¹⁹⁴ Consequently, auditors are bound to either conduct forensic check-ups charging higher prices in order to match their expenditures¹⁹⁵ or risk liability charges in case of undetected wrongdoings.

The example of Arthur Anderson shows that auditors may be willing to risk the second alternative. Shortly before the Enron debacle became public, the firm was fined a US \$7 million for its mishandling of Waste Management Inc.¹⁹⁶ Enron proves that

<[http://www.ey.com/global/download.nsf/International/FIDS_-9th_Global_Fraud_Survey_2006/\\$file/EY_Fraud_Survey_June2006.pdf](http://www.ey.com/global/download.nsf/International/FIDS_-9th_Global_Fraud_Survey_2006/$file/EY_Fraud_Survey_June2006.pdf)> at 21 June 2006, p 10).

¹⁹¹ Hamdani A, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53, 121; Coffee J, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=447940> at 16 June 2006.

¹⁹² Krackhardt, above n 19, 343.

¹⁹³ Studies show that many US firms actually cancel all non-audit services with their auditors, even those which are not forbidden by law (Wagner & Dittmar, above n 119, 138).

¹⁹⁴ See also Solomon D & Berman D, *Questioning the Books: Experts Say WorldCom Auditors Should Have Found Hidden Costs*, WALL St. J., 28 June 2002, at A9.

¹⁹⁵ See Ribstein, above n 4, 287.

¹⁹⁶ The Houston-based Waste Management Inc. was also part of public prosecution for “questionable accounting practices”. Arthur Anderson agreed to pay a \$7 million civil fine after the Securities and

this sentence did not encourage Arthur Anderson to significantly change its practice. It is questionable if higher liability, as the one imposed by SOX, can possibly change the forces facing them by a highly competitive market. SOX is not able to reverse the strong profit-oriented culture of auditors.¹⁹⁷ Non-auditing services are only prohibited “contemporaneously” and auditors will try to keep clients happy for future business risking not only fines but also losing their reputation.¹⁹⁸

The same applies to lawyers. Law firms are outsiders and without the necessary lawyer-client confidentiality protection wrongdoers are unlikely to discuss their fraud with them for they are non-participants and as a matter of common sense criminals always try to limit the group of those who know of the crime. This process is reinforced by the new rules which infringe those criminals’ rights of confiding in their lawyer.¹⁹⁹ In addition, the wording of Sections 307 of SOX appears to be vague. The term “evidence” is not further specified. It is to the attorney’s discretion to determine “whether or not a wrongdoing has occurred”.²⁰⁰ Some law firms, as a private entity, might be inclined to interpret “evidence” conservatively in order to please their clients. Others might approach it rather liberally afraid of losing their privilege to practice before the US SEC.²⁰¹ The latter firms rather increase consultation prices if the firm is primarily focused on US SEC work.²⁰² Either way balanced monitoring seems impossible since either kind of firm tries to please who they consider more vital to their business.

d. Increased Disclosure

Enron and WorldCom frauds were attributed to false disclosures – not less.²⁰³ Nonetheless, SOX solely increases the occasions on which financial statements need to be

Exchange Commission accused it of "knowingly or recklessly" issuing false and misleading audit reports for Waste Management for the years 1993 through 1996 that inflated the company's earnings by more than \$1 billion (CNN Money, *Waste Management Settles*, 11 November 2001, <http://money.cnn.com/2001/11/07/news/waste_mgt/index.htm> at 16 June 2006).

¹⁹⁷ Although it needs to be mentioned that there is anecdotal evidence of CFOs and *audit committees* applying more attention and time to working with their auditors since SOX, this might be interpreted as a first step of an improving companies support to auditors and enhanced objectivity in the auditing process (Wagner & Dittmar, above n 119, 138).

¹⁹⁸ Ribstein, above n 87, 30.

¹⁹⁹ Ibid, 32.

²⁰⁰ Ibid, 44.

²⁰¹ Ibid.

²⁰² Ibid.

²⁰³ Ibid, 32.

reported.²⁰⁴ Additionally, managers are held to evaluate internal control structures of their enterprise. A recent survey conducted by Ernst&Young among 500 top corporations worldwide on the prevention of fraud revealed that over 70 per cent of the surveyees regarded good internal control structures as the key to fraud prevention.²⁰⁵ Section 404 of SOX, which serves the goal of more disclosure on the firm's structure, is consequently well at the core of the fight against corporate fraud. Encouraging managers to rethink, evaluate and maybe even rebuild their firm's control structures may be beneficial. Wagner and Dittmar illustrate in an article for the *Harvard Business Review* broad areas in which SOX compliance benefited firms' governance, management, and investors.²⁰⁶ They give practical examples of numerous US firms which, instead of resisting the new legislation, took it as an opportunity of reviewing and reshaping internal control structures saving budget, improving employee understanding and implementing foolproof mechanisms of control through cross-checking.²⁰⁷ SOX has, from their perspective, led to more standardized control processes and reduced its inherent complexity.²⁰⁸ Still a year after the implementation of section 404, SOX inspires fear in boards and top executives creating a "strong control environment".²⁰⁹

Milstein, on the other hand, believes that the US Congress failed to comprehend that inappropriate earnings can also occur in sound networks of internal control.²¹⁰ He refers to recent restatements of well-known US companies and the increase in fraud-related enforcement actions and derives from it that "accounting irregularities are still relatively commonplace".²¹¹ A study conducted by Ernst & Young has also shown that the implementation of anti-fraud policies is not significantly increasing among US corporations.²¹² Although Ernst&Young is reluctant to make this statement, there seems to be strong correlation between this trend and recent requirements

²⁰⁴ Ibid.

²⁰⁵ See APPENIDX B.

²⁰⁶ Wagner & Dittmar, above n 119, 133.

²⁰⁷ Ibid, 137, 138, 140; true as these findings might be, Ernst&Young has found out in a global survey including also 60 US firms that alarmingly 72 per cent of the surveyed companies do not train their employees in understanding and implementing the firm's anti-fraud policies (see APPENDIX C).

²⁰⁸ Ibid, 139, 140.

²⁰⁹ Ibid, 136, 142.

²¹⁰ Milstein is, among other professional positions, chairman of the private sector advisory group of the Global Corporate Governance Forum founded by the World Bank and the OECD (Milstein I, *When earnings management becomes cooking the books*, FT Corporate Governance, <<http://www-ft.com/masteringcorporategovernance>> at 15 May 2006, p 1.

²¹¹ Ibid, 2.

of Section 404 of SOX.²¹³ Meeting requirements of internal control seems to preoccupy managers' focus leaving anti-fraud policies untouched although Ernst&Young finds that these policies are most important in combating fraud and attaining investor confidence.²¹⁴

Even more dramatic is the effect Section 404 has on stock prices. Amazon and ebay lost ground in terms of share value by 16 and 19 per cent respectively after they did not match the forecasts.²¹⁵ This may not only be because they did not "make the numbers" which in itself might be related to a situation in which too much focus is put on meeting financial disclosure requirements than actual business.²¹⁶ Milstein concludes that "it is important to bring back attention to the substance of financial reporting or risk even more regulation".²¹⁷

Requirements of enhanced financial disclosure as well as structural disclosure may help institutional investors who own comprehensive knowledge of the market and enough sophistication to detect irregularities but individual, private investors might still be unable to completely comprehend misstatements.²¹⁸ Therefore, it seems unrealistic to expect that investor confidence can truly be regained this way. Maybe, with time, private investors will start to believe in the market again but, in the author's opinion, this will not be because they understand the business but because new markets create new unsubstantiated euphoria. Ribstein is of the opinion that SOX "deals more with yesterday's problems" than with future ones.²¹⁹ He suspects that the next big fraud will appear somewhere else as the market is watching disclosures more closely anyways.²²⁰

e. Increased Liability

Even without securities liability there has always been state law liability for all forms of corporate misconduct. One might consequently question the purpose of SOX's

²¹² Ernst&Young, above n 190, p 9.

²¹³ Ibid.

²¹⁴ Ibid, 8; *see also* APPENDIX: D.

²¹⁵ Milstein, above n 210, 2.

²¹⁶ Ibid.

²¹⁷ Ibid.

²¹⁸ Ribstein, above n 87, 33.

²¹⁹ Ibid, 32.

²²⁰ Ibid.

federal liability regulations.²²¹ Some argue state law did not stop Enron – a plausible and correct assumption that cannot be dismissed.²²² Even so, Enron and WorldCom can be identified as a psychological problem because Lay, and the other executives did not realise the threat of reputational loss and legal sanctions back then. The question may be asked why they should act differently now under federal regulation. In the author’s opinion, they would act differently but not because of the federal regulation but because of a more watchful market that constantly imposes sanctions through loss of reputation.²²³ Reputation is highly important throughout the business world. Companies spend billions of dollars on good public relations. Particularly listed public companies have an incentive to remain reputable in order to attract a high level of equity capital. The effect of losing one’s reputation is proven to be higher than criminal charges.²²⁴

Stiff regulation and penalties may also deter innovation as managers avoid profitable but risky transactions in fear of liability charges to the detriment of investors. Such conservative behaviour is unfavourable because corporate growth may slow down - a scenario rather appalling than appealing to investors.²²⁵

3. Higher Costs

Since high agency costs have been identified as a fundamental cause for recent scandals, it is vital to consider the costs arising from SOX.

a. Agency Costs

Excessive risk-aversion is always a problem because agents invest, unlike shareholders, their undiversifiable human capital in the firm.²²⁶ This effect might be worsened by SOX’s provisions. Sections 302 and 304 of SOX shift the liability for frauds from the entity to the executives. This extra risk might cause many managers, who are

²²¹ Ibid, 33.

²²² Schneyer T, *Reputational Bonding, Ethics Rules, and Law Firm Structure: The Economist as Story Teller*, 84 Va. L. Rev. 1777.

²²³ Although it needs to be mentioned that Schneyer disagrees with the idea of corporate control through a loss in reputation. Schneyer is, however, referring to large law firms, not listed public companies. Nonetheless, one might argue that similar disbelief might be appropriate for those firms (Ibid, 1783).

²²⁴ See Bhagat S & Romano R, *Event Studies and the Law: Part I: Technique and Corporate Litigation*, 4 Am. L. & Econ. Rev. 141 (finding that markets imposed penalties on firms that were higher than criminal sanctions).

²²⁵ Ribstein, above n 4, 290.

often in no position to effectively monitor all processes within the firm, to become overly cautious.²²⁷ The new corporate governance system introduced by SOX does not benefit executives in any way for minimizing disclosure costs but imposes the risk of disclosure liability on them. As a possible result, they might be induced to under-report financial statements in order to be ‘on the safe side’. In order to protect themselves from unbearable liability charges, executives might arguably be inclined to implement costly information procurement.²²⁸ Increased reporting costs and understatements are, from an investor’s perspective, by no means better than inattention to fraud.²²⁹ Higher costs arising from financial reports and extreme caution in preparing and filing these reports might lead to overall higher expenditures, a scenario imaginable considering the bureaucracy involved in the administration of most major US listed public firms. It should not be forgotten that companies try to run down any possible costs in order to enhance their profits which again determine the share price as well as dividends. Higher reporting costs minimize the company’s profits, the share price and dividends. Consequently, an overall reduction of profits is unlikely to induce the public to invest in the securities market.

Additionally, the regulation of stock-based compensation and the restriction of loans, as ruled by Sections 402 and 304 of SOX, impair the alignment of management and shareholder interests.²³⁰ The fundamental problem of the separation of ownership and power might be overcome by means of loans and stock-based incentives because this way, agents have the same aim as their principals: increasing share value. Ribstein believes that regulating such compensation does not only destroy possible alignment but might also contribute to the effect caused by increased liability risks.²³¹ By reducing their incentives to “work hard [which] would pay off for the firm” managers might be turned from entrepreneurs into “bureaucrats”.²³²

²²⁶ Haddock D, *Propoerty Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701, 714.

²²⁷ Healy P & Palepu K, *Governance and Intermediation Problems in Capital Markets: Evidence from the Fall of Enron*, Harvard NOM, Working Paper No. 02-27, 15 August, <http://www.papers.ssrn.com/sol3/papers.cfm?abstract_id=325440 at 23 June 2006, p 37.

²²⁸ Ribstein, above n 87, 38.

²²⁹ *Ibid.*

²³⁰ *Ibid.*

²³¹ *Ibid.*

²³² *Ibid.*

b. The Effect of Stricter Liability

Ribstein claims that the increased liability risk will have a negative effect on the “flow of human capital”.²³³ Since the reward remains put while the risk increases, executive positions attract more risk-averse personal.²³⁴ Price-Waterhouse-Coopers has shown that the threat of civil as well as criminal liability has induced some CEOs and CFOs in the USA to retire, privatise their firm, or resign and change to a private firm instead.²³⁵

Costs related to increased disclosure and liability risks have also diminished cross-listing. Cross-listing means that foreign companies enlist with the respective stock exchange. Cross-listing at the NYSE has slowed down from 50 companies enlisting per year during the period of 1996 to 2001 to merely 25 per annum in 2002 and 2003, with only one European company enlisting in 2004.²³⁶ It appears as if especially European issuers are avoiding the usually lucrative US market. It seems questionable if SOX supports the securities market when fewer firms are willing to enlist and more try to de-list. This may be a matter of convenience as the total listing numbers for 2004 went up by 40 per cent.²³⁷ Nevertheless, it seems remarkable that foreign companies, which have a choice of selecting a securities market to enlist in, abandon the US market since SOX has been implemented. Losing possible investments is, from the author’s point of view, unlikely to benefit the market or investors.

Moreover, liability pressure is not only imposed on managers but also on external auditors. This risk might increase prices for auditing service, a side-affect exacerbated by the prohibition of non-auditing services.²³⁸ As a result, companies might employ smaller, less qualified auditors, thereby, lowering the overall auditing standard.²³⁹ Similar to their clients, auditing firms are profit-oriented. Until now, most companies used one of the big four accountancy firms ensuring that auditing standards remain high.²⁴⁰ A competition with smaller, more flexible firms can only be

²³³ Ibid, 39.

²³⁴ Ibid.

²³⁵ Price-Waterhouse-Coopers, above n 125, p 5.

²³⁶ Ibid, p 2.

²³⁷ Ibid.

²³⁸ Ribstein, above n 87, 40.

²³⁹ Ibid.

²⁴⁰ Remarkably, in New Zealand 95 per cent of all audits are performed by one of these auditors (Price-Waterhouse-Coopers, above n 125, p 14).

won by lowering overall standards. Forgetting market forces and the underlying free-market theory of self-regulating markets, SOX triggers exactly the opposite effect of what it was intended to do. By lowering auditing standards, fraud becomes more realistic and investor confidence less likely.

c. Information Costs

Additionally to the ineffectiveness of requiring independent directors and auditors, this legislation expands costs these parties incur in the process of obtaining necessary information.²⁴¹ Liability and ignorance of the firm's business might cause more forensic work which is always related with higher expenditures. Such costs could be avoided if, at least partly, insiders would be allowed to participate.²⁴² In a competitive market environment, directors but also auditors have to minimise costs and in order to do so, they might not obtain all the information necessary to make appropriate evaluations. Again, there is a risk that SOX regulations which are intended to foster monitoring obstruct such.

4. Conclusion

SOX regulations are incapable of providing solutions to corporate fraud and 'slack periods' in investments. Although some companies might have found a way of improving corporate governance within their firm, there is little evidence that the regulation itself caused this phenomenon. The sanctions provided may threaten managers and directors but they surely do not lead to better corporate governance. It has been shown that the rules are ineffective and rather obstructive. As a result of panic and scepticism, they lack the superior understanding necessary to prevent future malfunctions. Coffee explains that as a result of a "crash-then-law" cycle such legislation is always responsive and never preventive.²⁴³ SOX is not a good antidote to New Zealand's corporate governance regulation problem. Strict regulation by its example would rather deteriorate the corporate governance situation than improve it. The following section discusses the possibility of principle-based regulations and its enforcement.

²⁴¹ Ribstein, above n 87, 40.

²⁴² Ibid, 41.

²⁴³ Coffee, above n 101, 66.

IV. WHY COMPLY-OR-EXPLAIN – REASONS BEHIND THE SPATE OF INCORPORATIONS

A. Introduction

From the European Union to Hong Kong and Singapore, the majority of countries worldwide have opted for the principle-based approach to corporate governance.²⁴⁴ Self-regulation supported by strong market control is viewed as the key to good corporate governance. It has often been noted that a “one size fits all approach” as conducted by SOX is no solution to current problems.²⁴⁵ The diversity of different-size corporations forbids any stringent regulation which disregards such differences. Key advantage of any principle-based code is consequently the flexibility inherent in this system.²⁴⁶ Krackhardt finds it “hard to believe that rules [concerning the way] business is run [is] equally applicable to every company” and concludes that a principle-based approach delivers the necessary flexibility to serve every company within its jurisdiction.²⁴⁷

The approaches are substantially different. By imposing a statutory body of governance rules, the USA intends to regulate disclosure on the “source”, thus assuring that information is accurate.²⁴⁸ Corporate governance codes under the “comply-or-explain” rule, on the other hand, do not address the accuracy of the information itself, but widens the array of issues which have to be disclosed.²⁴⁹ Since self-regulation under the “comply-or-explain” rule may only impose further disclosure requirements and not particular substantive requirements, de Espinosa explains, “all self-regulation means is full disclosure” given by listed companies to the public.²⁵⁰ Instead of constantly enforcing legal standards through sanctions, a measure SOX utilizes, in nations implementing principle-based codes the law naturally operates only when a

²⁴⁴ All European countries, for example, have implemented a principle-based code with a “comply-or-explain” vehicle for enforcement reasons (De Espinosa M, *The Need for Substantive Regulation on Investor Protection and Corporate Governance in Europe: Does Europe Need Sarbanes-Oxley*, J.I.B.L.R. 2004, 19(11), 419, 425).

²⁴⁵ Diplock, above n 38, 6; Draghi M, *Speech: Keynote Address – Trans-Atlantic Corporate Governance Seminar 2004*, <http://www.ecgi.org/tcgd/launch/draghi_speech.php> at 19 April 2006.

²⁴⁶ Hirt H, *Germany: The German Corporate Governance Code: Co-Determination and Corporate Governance Reform*, 23 Comp Law, 349, 351.

²⁴⁷ Krakhardt, above n 19, 331.

²⁴⁸ De Espinosa, above n 244, 431.

²⁴⁹ Ibid.

²⁵⁰ Ibid, 424.

company lacks explanation for non-compliance.²⁵¹ While SOX penalizes non-compliance itself, most states following the “comply-or-explain” rule impose sanctions only on failures to explain. The difference is apparent, the latter relies fundamentally on the forces of the market and sets only a regulatory framework in which companies can freely operate. Strenger explains that it is “obvious that any deviation [from the code] will negatively impact the standing of the company in the capital market”.²⁵² This is the main idea behind the “comply-or-explain” enforcement tool. Consequently, the European Corporate Governance Forum laid down prerequisites necessary for a code of best practice to be successful.²⁵³

- a real obligation to comply-or-explain; either by company law or listing standards
- a high level of transparency, with coherent and focused disclosure
- a way for shareholders to hold company boards accountable for their decisions to comply-or-explain and the quality of the disclosure.

Key components of an efficient principle-based code, therefore, are an appropriate regulatory framework and the existence and practice of sufficient shareholder rights.²⁵⁴

The following subsections discuss reasons for substantive regulations opposed to self-regulation as well as the intentions various regulators followed when constructing the codes. The section concludes that, besides the flaws accompanying self-regulation, stringent mandatory regulation is no real solution. There might be examples which might indicate that strict rules serve the market better than reliance on market forces but, as the Chicago School of Economics have shown at the beginning

²⁵¹ Ibid, 422.

²⁵² Strenger C, *Speech: Corporate Governance Standards: The Importance of Compliance and Main Issues in Germany*, The Global Corporate Governance Forum – 5th Meeting of the Eurasian Corporate Governance Roundtable (Kiev, 18 May 2004), <http://www.oecd.org/document/10/0,2340,en_2649_34813_31916554_1_1_1_1,00.html> at 26 June 2006, p 5.

²⁵³ European Corporate Governance Forum, *Statement of the European Corporate Governance Forum on the comply-or-explain principle (22 February 2006)*, <http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf> at 27 June 2006, p 1.

²⁵⁴ Ibid.

of the last century, unrestrained markets are best at regulating themselves for various reasons illuminated below.²⁵⁵

B. Reasons for Substantive Regulation

Some commentators advocate the opinion that successful stock markets might develop without legal regulation, solely relying on self-regulation, but “neither function optimally nor develop to their potential in the absence of mandatory law that seeks to mitigate the risks of crashes”.²⁵⁶ An argument for strict regulation arises from the fact that self-regulatory standards are usually provided by non-governmental regulators, such as the NZX for example.²⁵⁷ A shortfall in this matter would reversely be an argument for stricter legislation which might be able to prevent sluggish enforcement. A report by Fox on the NYSE gives evidence that the enforcement of de-listing rules by the stock exchange is lax, either because it is unable or unwilling to de-list in case of non-compliance with listing standards.²⁵⁸ Coffee provides four reasons for this shortfall:

Firstly, evidence of slacking disciplinary regime enforcement argues that “a private body has weak incentives to enforce rules protecting third parties against its own members and clients”.²⁵⁹ Werner and Smith found out that the NYSE seldomly enforced its own disciplinary rules against its issuers for market manipulation in the 1990s.²⁶⁰ Stock exchanges, although lacking ‘real’ domestic competition have a disincentive to enforce their rules in a manner which restricts trading volume and reduces listings.²⁶¹ They profit from good trading and may therefore feel encouraged to overlook little wrongs for the sake of keeping the issuer and stabilizing its trade with the exchange. On the other hand, stock exchanges are highly reliable on investor confidence. Since the stock exchange is a business, it is subject to market forces. Without a large enough investor group, trading issuers will avoid a stock exchange and try

²⁵⁵ See Wikipedia, *Chicago School (Economics)*,

<http://en.wikipedia.org/wiki/Chicago_School_of_Economics> at 27 June 2006.

²⁵⁶ Coffee J, above n 101, 66.

²⁵⁷ Although the NZX is obliged to enact listing rules by Section 7 of the Sharebrokers Amendment Act 1981, it is not endowed with the legal power to enforce these rules.

²⁵⁸ See Fox M, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 Va. L. Rev. 1369, 1376-79.

²⁵⁹ Coffee, above n 101, 67 & 68.

²⁶⁰ Werner W & Smith S, “Wall Street” (1991), 133-140, cited in Coffee, above 312, fn 254.

²⁶¹ Banner S, *The Origin of the New York Stock Exchange, 1791-1860*, 27 J. Legal Stud. 113, 138-139; Kahan M, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 Va. L. Rev. 1509.

to attain necessary equity by other means. Sloppy oversight execution might cost them their reputation and investors use other stock exchanges. Consequently, stock exchanges are urged to maintain a high reputation combined with sufficient rule enforcement.

As a second reason for market shortcomings, Coffee explains that “a private body has little ability to enforce its rules against non-members”.²⁶² He does not define non-members but it needs to be assumed that he means executives and directors of the entity because the entity itself, not its employees is enlisted and thereby subject to listing regulations.²⁶³ Although occurred after the publication of his comment, he neatly describes the wrongdoings involving Enron and WorldCom executives.

The stock exchange as a private entity does not have any sovereignty over private actors legally unrelated to them.²⁶⁴ It might be able to discipline the corporation through de-listing or other measures but it lacks the legal ability to proceed against company affiliates who are not bound by contract. Coffee analyzes that without a public regulatory body, victims of fraud would have to rely on private litigation, a costly undertaking which would be deterred in court system that imposes all litigation costs on the losing party as the case in the UK or New Zealand.²⁶⁵ He therefore highlights the necessity of the SEC in order to fight fraud through state enforcement of practice rules.²⁶⁶ In New Zealand, the SEC has the legal duty and responsibility to monitor the securities market and enforce legal regulations battling fraudulent misconduct. By its own definition the SEC:

Inquires into, and can take enforcement action on misleading and illegal investment schemes, offer documents and advertisements for securities. The Commission oversees the operations of the stock exchange, and disclosure and practices of listed companies. [It] also inquire[s] into practices of investment advisers and fund managers.²⁶⁷

²⁶² Coffee, above n 101, 68.

²⁶³ Coffee explains that “non-members may often be the parties most likely to engage in insider trading or other manipulative practices” (ibid); see also Walker et al, above n 12, p 47 (§302) (pointing out the separate legal personality of corporations).

²⁶⁴ Walker et al, ibid, p 41 (§220); see also *NZ Stock Exchange v Listed Companies Association International & NZ Forest Products C* (1984) 2 NZ CLC 99, 159; 1 NZLR 699 (CA).

²⁶⁵ Coffee, above n 101, 68 & fn 256; similar to the UK, in New Zealand civil proceedings, as a general rule, the losing party has to pay all costs, even though this is in the discretion of the Court (High Court Rule – Part I, r 46[1]).

²⁶⁶ Ibid, 68.

²⁶⁷ Securities Commission, above n 1.

The Securities Markets and Institutions Bill adopted a penalties and remedies regime which provides the SEC with the authority necessary to sue possible offenders of insider trading, market manipulation and breaches of continuous disclosure requirements.²⁶⁸ Penalties include imprisonment, fines and the banning from management position.²⁶⁹ Consequently, non-members can and are held liable for wrongdoings at present. Although these provisions are formally independent of the corporate governance principles of the Code and the NZX PBC, it is correlated. In terms of enforcing the Code or the NZX PBC, New Zealand has a public authority which is able to prevent frauds and would be able to provide enforcement measures for non-compliance.²⁷⁰ The authority provided by the Securities Markets and Institutions Bill may only deal with actual charges and not directly with the non-compliance issue related to the Code and the NZX PBC but it is a start. It proves that the regulatory body could be trusted with the enforcement of the “comply-or-explain” provision which would also hold non-members liable to explain.

Thirdly and fourthly, enforcement might be both too cost-intensive for a solely private entity and impossible in the sense that private bodies lack the investigative tools and punitive sanctions that the state has at its disposal.²⁷¹ Private bodies might find it hard to prove fraudulent behaviour as conspiracies by nature do not “reveal themselves to the observer”.²⁷² The state with seemingly inexhaustible financial resources is not driven by profit maximisation and market demands whereas private bodies are subject to these matters and have only access to limited budgets. Hence, the public enforcer is better at conducting investigations. Public bodies also possess the necessary means to threaten criminals, such as criminal penalties and punitive civil fines.²⁷³ The Securities Markets and Institutions Bill provides necessary enforcement power for the SEC. Therefore, self-regulation, as conducted by the NZX and the SEC complement each other. The Code and the NZX PBC provide guidelines for managers by means of which the SEC can find orientation in terms of disclosures and business conduct. The SEC’s persecutorial rights, on the other hand, provide a frame-

²⁶⁸ Farrar, above n 7, 7.

²⁶⁹ *Ibid.*, 7 & 8.

²⁷⁰ Walker *et al.*, above n 12, p 506-507 (§2621-2622).

²⁷¹ Coffee, above n 101, 68.

²⁷² *Ibid.*

²⁷³ *Ibid.*

work which supports corporate good behaviour, even if it might not support compliance.

New Zealand as well as most other nations does not have a purely self-regulating system. Certain standards are enforced by a public body. Although standards are created and somehow enforced by the market, not any supervision is left to private bodies. Although there is partly a legal framework for corporate governance as crimes, for example, are prosecuted by state agencies, the Code or the NZX PBC are not enforced. Therefore, Krackhardt annotates that New Zealand lacks a sufficient legal framework enforcing the Code.²⁷⁴ The “comply-or-explain” rule, as in place in Germany, provides the essential legal back-up.²⁷⁵ By German law, executives of corporations which do not explain their non-compliance can be forced by criminal penalties and punitive civil fines.²⁷⁶ This way, it is assured that every member of the market plays by the rules. A similar legislation might be needed in New Zealand.

C. Advantages of Self-Regulation

Ribstein proposes that "before adopting regulatory solutions it is necessary to consider the feasibility of market based responses" and "although market responses are likely to be imperfect, it is necessary to compare market with regulatory imperfections, rather than unrealistically assuming that only markets are flawed".²⁷⁷ In the light of the above analysis on SOX, it becomes apparent that strict regulations as exerted by SOX can easily be deficient lacking the potential to achieve the intention behind the law. The intention behind SOX might be attained more effectively through market forces. The subsequent subsections explain the theory of free markets and demonstrate, by pointing out the correlation of the theories, that in order to sustain and enhance market growth and market security it is vital to adhere to the principle-based corporate governance approach.

²⁷⁴ Krackhardt, above n 19, 332.

²⁷⁵ Krackhardt refers to Germany in his comparison of corporate governance regulation with the USA (Krackhardt, *ibid*).

²⁷⁶ Aktiengesetz § 161 & Strafgesetzbuch § 283b 2j.

²⁷⁷ Ribstein, above n 87, 48.

1. The Theory of Free Markets

The USA and New Zealand share the common-law legal tradition derived from the British legal system with its market-based (contractarian) corporate environment.²⁷⁸

When announcing her government's intention to foster the New Zealand market through a new regulatory framework in 2002, Prime Minister Helen Clark made clear that, besides the necessity of a regulatory standard, the reforms were "a market led approach to economic development, not one that is centrally planned" motivated by the objective to "unleash the potential of the private sector and not to replace it".²⁷⁹

In 2006, Mrs Lianne Dalziel, Minister of Commerce, reaffirmed this objective for the new legislation period.²⁸⁰ The new government favours flexible legislation which is achieved in co-operation with New Zealand businesses.²⁸¹ This shows the inclination of the New Zealand government to keep regulations down allowing the forces of the market to take effect. This kind of market-based economy is called a free-market economy. A free market is defined as a market where trades are morally voluntary and therefore free from the interference of force.²⁸² Associated with the free-market theory is the laissez-faire economic philosophy, which advocates confining government intervention.²⁸³

Milton Friedman, the originator of this theory, imagined an economic market free of any regulations completely reliant on the "supply-and-demand" maxim.²⁸⁴ Without outside (state) intervention the market "will dispense with inefficiencies in a more deliberate and quick manner than any legislating body could".²⁸⁵ Adam Smith called it the "invisible hand of the market" which leads people to serving the public interest

²⁷⁸ Bradley M, *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at Crossroads*, 62 Law & Contemp. Probs. 9, 35-40, 51; other countries with an Anglo-American legal tradition are Australia and Canada; see Grantham R & Rickett C, *Company and Securities Law – Commentary and Materials* (2002), p 45-107 (giving a comprehensive account of the opposing economic theories on the nature of company law); see also Bratton W, *The "Nexus Of Contracts" Corporation: A Critical Appraisal*, 74 Cornell L. Rev. 407 (for an explanation of the Contractarian Theory).

²⁷⁹ Clark Helen, *Growing an Innovative New Zealand* (February 2002),

<<http://www.executive.govt.nz/minister/clark/innovate/innovative.pdf>> at 30 June 2006, p 22.

²⁸⁰ Dalziel L, *Speech notes for address to Vector Winter Series: Taking a Fresh Approach to Regulation* (22 March 2006), <<http://www.beehive.govt.nz/ViewDocument.aspx?DocumentID=25881>> at 30 June 2006.

²⁸¹ Ibid.

²⁸² Foldvary F, *Has Deregulation Failed? - The Progress Report 2002*,

<<http://www.progress.org/archive/fold253.htm>>, at 30 June 2006.

²⁸³ Wikipedia, *Free Market*, <http://en.wikipedia.org/wiki/Free_Market> at 30 June 2006.

²⁸⁴ See Friedman M & R, *Free to Choose: A Personal Statement* (1980).

²⁸⁵ Wikipedia, *Laissez-Faire*, <<http://en.wikipedia.org/wiki/Laissez-faire>> at 30 June 2006.

by following their own self-interest.²⁸⁶ Taking the example of securities markets, stock exchanges have incentive to maintain high market control and issuer to comply with best practice rules in order to attract investors who are looking for safe markets. Investors ‘demand’ and markets ‘supply’. Stock exchanges and issuers, due to a much less complex decision process, are able to respond quicker to scandals and inefficiencies than legislatures which are bound to certain legislative processes.

Market intervention by immoderate regulation can result in a hampered transmission of information necessary to allow the market to operate.²⁸⁷ This may result in inflation, deflation, recession, and depression.²⁸⁸ In sum, the market ‘derails’. Out of this reason, governments should be limited to providing regulations aimed at merely protecting the property of individuals and maintaining a peaceful environment for the market to function.²⁸⁹

Among other commentators, Friedman proposed that there was a direct relationship between economic freedom and economic growth.²⁹⁰ In a computer simulation called “Sugarscape” the economists Epstein and Axtell evaluated the properties of free markets under ideal situations and concluded that free markets lead to a Pareto Distribution of wealth meaning that with increasing wealth the number of people benefiting from the wealth decreases.²⁹¹ This allocation of wealth is actually optimal for a functioning society as, by theory, one person can only attain more wealth at the expense of another person.²⁹² A Pareto Distribution causes equilibrium of wealth within society which again balances demands against supplies preventing speculation bubbles such as the one of the late 1990s.²⁹³

2. Free Markets in the Common Law World

The USA but also the UK and New Zealand are traditionally advocates of the free-market theory. Contrary to Civil Law countries which derived their legal system

²⁸⁶ See Smith, above n 3.

²⁸⁷ Friedman, above n 284, 2.

²⁸⁸ Ibid.

²⁸⁹ Wikipedia, above n 283.

²⁹⁰ Friedman, above n 284.

²⁹¹ Epstein J & Axtell R, *Growing Artificial Societies: Social Science from the Bottom Up*, (1996); see also APPENDIX E for graph.

²⁹² Wikipedia, *Pareto Efficiency*, <http://en.wikipedia.org/wiki/Pareto_efficiency> at 30 June 2006.

²⁹³ Wikipedia, above n 283.

from Roman Law, Common Law countries derived their legal understanding from their Germanic ancestry which was less codified and consistent.²⁹⁴ The English legal system was always characterized by decentralised governmental institutions. Lacking comprehensive regulation, in the UK but also in the USA, small interest groups quickly formed in order to self-regulate their field of interest.²⁹⁵ In a federation of 50 different jurisdictions with different, inconsistent laws,²⁹⁶ the US stock markets early on realised that they had to regulate their market themselves in order to attract foreign investments by creating necessary confidence in the market as legal protection was (and is) without federal regulations merely impossible.²⁹⁷ Early in the nineteenth century, the NYSE became the most active stock exchange worldwide in terms of self-regulation. Corporate governance, as known today, needs to be attributed to these early attempts of guaranteeing sufficient control practices for private investors.²⁹⁸ This might arguably be the reason why at present investment advisers as Martin Whitman of Third Avenue Value Fund call the US market “the best, most efficient, most *honest*, and deepest capital market [...] in the history of mankind”.²⁹⁹ Although slightly overstated in the light of recent scandals, it shows the confidence many advisers have in the self-regulating US stock market. In case of the UK, mandatory securities market legislation was in place early on but the London Stock Exchange (LSE) always provided additional substitutional self-regulation in order to provide higher shareholder protection to enhance its reputation as, similar to Enron and WorldCom, the LSE had to react to large scandals in the first two decades of the twentieth century after legislative attempts had failed.³⁰⁰ Consequently, it can be assumed that legal ‘protection’ through self-regulation is a common means of market control and shareholder protection in the Common Law world.³⁰¹ By interfering less with the market, legislatures create, maybe unconsciously, a free market.

²⁹⁴ Coffee, above n 101, 61.

²⁹⁵ Ibid, 27 & 28.

²⁹⁶ Coffee describes a case commonly referred to as the “Erie War” in which large shareholders could “nullify legal protection” by moving from “jurisdiction to jurisdiction, seducing courts and legislatures” (ibid, 28).

²⁹⁷ Coffee, ibid, 29; similar argumentation might be applied to New Zealand which due to its remote geographic location might arguably seem unattractive to foreign investors.

²⁹⁸ Ibid, 34.

²⁹⁹ Whitman M, *Letters to our Shareholders* (31 July 2004), <<http://www.thirdavenuefunds.com/taf/>> at 30 June 2006 (emphasis added).

³⁰⁰ Coffee, above n 101, 41.

Although not necessarily intended by the legislature, geographic circumstances and inconsistencies in the legal system provided a sublime environment for free-market provisions to take place. The legislature left market regulation mostly to private bodies, namely the respective stock exchanges, which were able to react quicker and more appropriately on a case-to-case basis to scandals because of their superior knowledge of the market and its functionalities.

3. Evaluation of the Principle-Based Approach in the light of the Free-Market Theory

a. Flexibility

Regulators worldwide praise the flexibility aspect of the principle-based corporate governance code.³⁰² Consistent with the free-market idea, markets are believed to regulate themselves through competition for investment funds.³⁰³ Prentice advocates the theory that regulation is unnecessary as long as investors are sufficiently informed by privately provided “information on the risks and returns” of their investment.³⁰⁴ Provided that investors, based on this information, pay higher rates for “securities of issuers offering valued [investor] protection”, issuers are incited to provide higher security when the increase in value exceeds the costs of the protection.³⁰⁵ Considering the Coase Theorem which explains that two parties can find consent upon a controversial topic by bargaining,³⁰⁶ Prentice’s understanding of the market forces seems, in the author’s opinion, realistic. In a free, undisturbed market, investors are able to ‘demand’ certain standards which are ‘supplied’ by the issuer as long as the latter receives some form of compensation, naturally higher profits. Through this constant bargaining process, which is apparently executed non-verbally, the securities market is able to react to events self-reliably. Precondition is, however, that investors are sufficiently informed. A principle-based code of practice accompanied

³⁰¹ Oppositely, Civil Law countries, such as France, due to different economic and monarchical structures, were, telling from Coffee’s analysis, unlikely to develop self-regulatory means, even in the light of more competition (Coffee, above n 101, 50).

³⁰² NZ SEC: Diplock, above n 38, 6; Brown D, *Corporate Governance: An Opportunity for Positive Change*, CFO Summit Ontario, Canada (21 June 2004), p 5; EU: see de Espinosa, above n 244, 424.

³⁰³ Ibid.

³⁰⁴ Prentice R, *Whither Securities Regulation? Some Behavioural Observations Regarding Proposals for Its Future*, 51 Duke L.J. 1397.

³⁰⁵ Ibid.

³⁰⁶ See Coase R, *The Problem of Social Cost*, 3 J.L. & Econ. 1.

by a “comply-or-explain” enforcement tool may be able to deliver the necessary disclosure.

Judging from recent corporate governance proposals by the European Union, de Espinosa derives two fundamental assumption: (a) market participants are generally better informed and motivated than regulators, and (b) market reactions may lead to a variety of solutions,³⁰⁷ whereas strict legislation naturally leads to only one general solution which might be appropriate for the majority of firms, but at the same time ineffective for others. The example of SOX has proved that strict regulation often is flawed and ineffective – a mere attempt to lull investors in a false sense of security. Coffee explains that “codification naturally adopts bright-line and prophylactic rules that leave less room for flexibility or innovation”.³⁰⁸ Unlike its Common Law tradition, the US government decided to take on the role of an interventionist who favours policy-implementing over dispute-resolving. The most remarkable feature of the Common Law legal system, however, is to resolve disputes on a case-to-case basis as traditionally the system is more reliable on judge-made law than legislative acts.³⁰⁹ This way, case specific circumstances, such as local variations or dissimilar company sizes, are considered. Not only does this approach foster an innovative legal system, but it also supports a tolerant market atmosphere that provides perfect conditions for innovative corporate governance necessary for larger profits.³¹⁰ Judging from the previous superiority of the market performance of US companies compared to their Continental European counterparts, who are well known for their comprehensive codification, less codification and more market reliance appears to be preferable.

In order to compete with each other, publicly owned companies have to signal quality to potential investors.³¹¹ Compliance with principles which are voluntary instead of obligational may be the essential means to signal this quality. Mandatory government rules reduce firms’ ability to signal for they are required to comply.³¹² However, de Espinosa is of the opinion that strong governance regulations are necessary in order to create investor confidence as minority shareholders lack the incentive as

³⁰⁷ De Espinosa, above n 244, 424.

³⁰⁸ Coffee, above n 101, 62.

³⁰⁹ *Ibid.*

³¹⁰ *See ibid.*, 63.

³¹¹ Ribstein, above n 87, 55.

³¹² *Ibid.*

well as the capability of reacting properly to provided disclosure.³¹³ Rigid, state-controlled compliance regulation guarantees good standards that investors can easily understand.³¹⁴ Even though this assumption seems realistic, de Espinosa fails to realise that SOX cannot provide any more protection for minority shareholders than a “comply-or-explain” approach. Shown before, SOX relies heavily on broader disclosure. Similar to most European codes,³¹⁵ SOX demands detailed information on corporate structures and accounts. It is beyond the comprehension of this author why minor shareholders would feel more inclined to base their investment decisions on information provided due to SOX than on information provided and *explained* because of a principle-based code. The possibility of explaining one’s non-compliance should not be underestimated. By virtue of this means, companies can again signal quality. They distribute information on the corporate structure of their firm. Thereby investors learn more about the entity, its business conduct and its financial situation than it would through statements that follow rigid statutory standards.

b. Investor Education

Ribstein stresses the need for more investor education on the functionality of securities markets.³¹⁶ A properly executed “comply-or-explain” code would eventually lead to a better understanding among investors. Issuers in more diversified markets want to attract as many investors as possible. In the light of recent scandals, minor investors are paralysed. The fear of losing one’s investments because of ill-information is deep.³¹⁷ Consequently, private investors who are still willing to engage in stock trade are more likely than ever to pay close attention to corporate statements. Companies, on the other hand, are aware of this and try to survive through superior self-presentation.³¹⁸ They want to signal quality by providing good explanations and profound financial and structural statements. This author assumes that there has not been a better time for investor education than at present. Companies are willing to supply and investors are sceptical and therefore attentive. For the same reasons, stock exchanges are inclined to do their share of shareholder education

³¹³ De Espinosa, above n 244, 425.

³¹⁴ Kim, above n 57, 252.

³¹⁵ I.e. the German Corporate Governance Code.

³¹⁶ Ribstein, above n 87, 49.

³¹⁷ Ibid.

³¹⁸ Wagner & Dittmar, above n 119, 133.

as the NZX PBC with its high standards and relatively strict “comply-or-explain” provision, for example, proves.

c. Considering New Zealand Circumstances

In case of the New Zealand market, it should not be forgotten that institutional investors dominate the securities market.³¹⁹ Consequently, confusing disclosure can be more easily detected. By means of their blockholding power institutional shareholders can assert control on issuing companies and improve disclosures this way.³²⁰ However, some 44 per cent of the New Zealand population own stock. Proper education is therefore vital. Mandatory “comply-or-explain” standards, more detailed principles which portray the regulators wish for comprehensive disclosure, and more public awareness of possible malfunctions are necessary means to support these investors in their decision-making and to prevent similar frauds to Enron from happening in the local market.

Outruling the adoption of SOX and strict regulation are the words of David Brown, Chairman of the Ontario Securities Commission, who stated that in Canada companies tend to go public at lower levels of capitalization.³²¹ A similar argument can be made for the New Zealand securities market. The New Zealand capital market is small and the large majority of companies are SMEs with little capitalization. High costs arising from strict regulation would therefore be unbearable for most of New Zealand’s publicly owned companies. De Espinosa refers to the example of the former German Daimler-Benz AG which had to comply with much stronger legislation when enlisting with the NYSE compared to its home market.³²² Apparently, as a result of different disclosing standards, the company was forced to disclose much higher losses than before in Germany. Nevertheless, the firm’s stock performed better than the average by five per cent that year.³²³ De Espinosa concludes that stricter regulations which improve investor protection are viewed positively by the market and that the increase in profit outweighs the costs of compliance.³²⁴

³¹⁹ Walker *et al*, above n 12, p 8 (§105).

³²⁰ Ribstein, above n 87, 61.

³²¹ Brown, above n 302, 2.

³²² See de Espinosa, above n 244, 426.

³²³ Ibid.

³²⁴ Ibid, 427.

A similar statement cannot be made for the New Zealand market because even the biggest, most successful companies do not match the capitalization of a global tycoon such as Daimler-Benz AG.³²⁵ In case of New Zealand, the costs of compliance would outweigh the possible profits.

d. Comply-or-Explain in New Zealand

In summary, it can be said that New Zealand should refrain from adopting an US-inspired rule-based approach to corporate governance. Ribstein notes that the recent stock exchange crash might possibly be attributable to strict legislation already in place by then. With strict takeover legislation intended to protect labour forces against dismissal, the US legislature had taken away a standard tool of corporate control in free markets.³²⁶ Without the risk of hostile takeovers, managers felt undisciplined and unstoppable.³²⁷ To prevent this, the US legislature enacted SOX which shows severe weaknesses and might eventually lead to even more legislative acts. Like a vicious circle, regulation causes further regulation. The New Zealand legislature should (and is) aware of this problem and tries to minimise market intervention.

Undeniably scholars agree that some regulation is necessary in order to secure shareholder protection and investor diversity.³²⁸ Self-regulators such as the NYSE or the NZX are not persistent in their activist role and without competition lose their drive for rule enforcement against their members.³²⁹ Issuers may also lose their spur to comply effectively once noises of corporate scandals have silenced. Diplock may be able to report high percentages of participation for the 2004 annual report of listed companies,³³⁰ but it should not be forgotten that the Code had just recently been introduced to the New Zealand securities market. Expectations were high and investors most likely watched company reactions closely. Investors here and abroad are aware of the Enron debacle and want to see some effort from their investments. With time, such compliance may wither, though. Voluntary compliance just as well as sole self-regulation by the stock exchange may for that reason be inappropriate. The SEC

³²⁵ Disregarding the apparent cut-back Mercedes had take after the acquisition of Chrysler Motors.

³²⁶ Macey J & Miller G, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 Stan. L. Rev. 73, 112.

³²⁷ Coffee, above n 101, 20.

³²⁸ Ibid, 65.

³²⁹ Ibid.

³³⁰ Numbers are ranging between 70 and 95 per cent of companies reporting on topics implied by the Code (see Diplock, above n 38, 7-9).

should redevelop the Code, filling the principles with more contents. A smart approach might be to use the NZX PBC as an example as it is more comprehensive than the Code but by international standards short and clear.³³¹ Additionally, it is important to notice that enforcement and regulation cannot be left to the NZX. Rather, the SEC has to continue its efforts. In terms of enforcement, it is vital to back up the “comply-or-explain” tool by mandatory legislation.³³² Without legal sanctions in case of non-compliance, companies might in times of low competition feel inclined to avoid compliance costs or thorough explanation to the debit of minor shareholders. Political and/or economic pressure might not suffice under such circumstances. Making explanation mandatory as in Germany or the UK cannot be seen as severe market intervention. The forces of the free market still take hold. Companies comply to signal quality or explain their non-compliance. Holding them liable if they disregard this system is solely a necessity in times of new market euphoria which, from an economic point of view, will most likely reappear.³³³

V. SUMMARY AND CONCLUDING REMARKS

This paper analysed that, in terms of corporate governance regulation, New Zealand follows a voluntary approach that lacks mandatory compliance of the Code or the NZX PBC. There is a risk that once the Code has become ‘old news’ companies will slack off in reporting and compliance. In the course of this paper, it was determined that strict regulation of corporate governance constructed around the example of SOX is ineffective. New Zealand should not adopt mandatory regulation based on the US example. Rather, it is preferable to maintain the principle-based approach in place at present and supply a mandatory enforcement tool. By means of the “comply-or-explain” tool companies are less restricted in running their business and allocating resources. Board of directors actually debate about an improvement of corporate governance principles and investors might be educated and learn about their investments because of its comprehensive explanations. This way, free-market forces can take place and the securities market can live up to its full potential. When provided

³³¹ For suggestions refer to Krackhardt who has attempted to formulate essential parts of an effective and internationally recognised corporate governance code for New Zealand (Krackhardt, above n 19).

³³² Such legislation would have to be enacted by the legislature as the SEC lacks necessary sovereignty (*see Walker et al*, above n 12, p 39-41 [§219]). The statute might be included in the Companies Act 1993 as it does not need more than a single paragraph.

³³³ Even if Farrar reports that in the UK and Germany compliance with the codes is low, investors still know the reasons for such non-compliance and are able to base their decision on this reasoning.

with explanations, investors have more confidence in their investments and the market flourishes. It is therefore necessary that New Zealand authorities prevent market euphoria through education of market participants and that the legislature refrains from excessive market regulation. A free securities market which is based on a strong mandatory framework, such as the “comply-or-explain” vehicle, may help the New Zealand market to become world-class.

As mentioned before, this paper is not exhaustive, and it is recommended that further research is undertaken. Due to word limitations an exact proposal of corporate governance regulations cannot be made. Others have provided thorough analyses on this topic and it is recommended to revert to their work for necessary guidance. Corporate governance and its regulation and enforcement are a hot topic at present and new insights to the matter are reached almost daily. It is therefore worthwhile to conduct further research on different international approaches to corporate governance. It may prove even valuable to take a look at relatively unspectacular, less successful, and maybe less obvious economies in order to make findings which may serve the New Zealand market and its unique business structure better than the US approach.

APPENDIX A: GRAPH OF THE 1929 CRASH OF THE US STOCK MARKET

The 1929 crash was spectacular by any measure. It followed a spectacular bull market that had been going on for the better part of a decade. The Dow Industrials hit a high of 386 in September, 1929. It did not get back to that level until November, 1954. At its worst level, the Dow dropped to 40.56 in July, 1932. That is a drop of 89%.



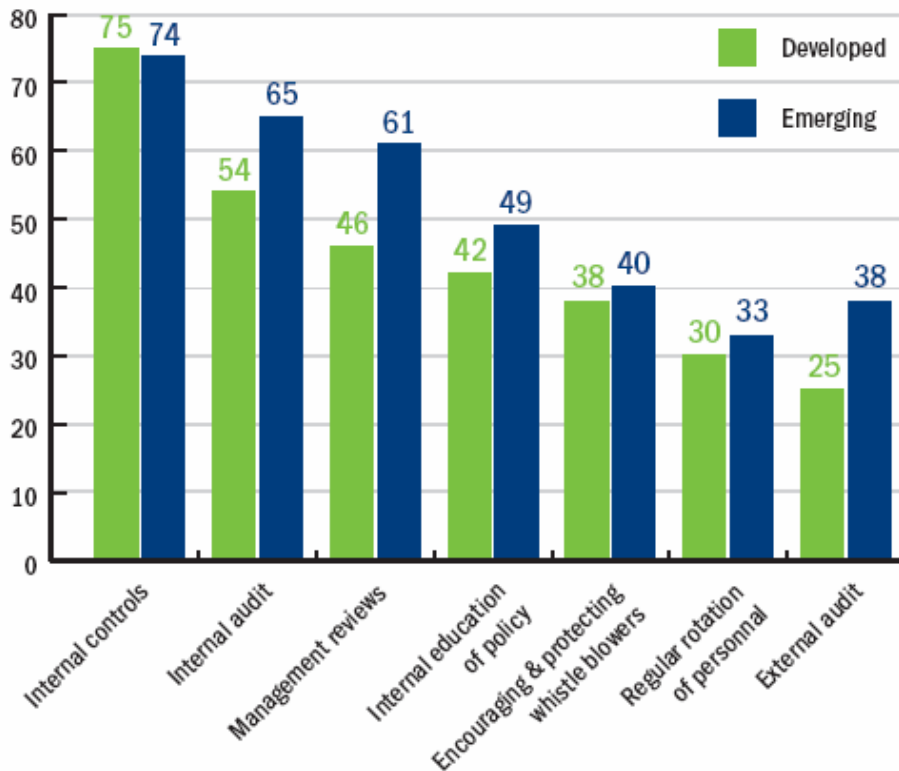
Source: Walker J, *1929 Crash*, <<http://www.lowrisk.com/29crash.htm>> at 30 May 2006

In 1933, this dramatic decline of share value caused the implementation of what is commonly referred to as the “New Deal”, a comprehensive set of regulations which was intended to protect investors and stabilize the overall confidence in the stock market.³³⁴

³³⁴ See Wikipedia, *New Deal*, <http://en.wikipedia.org/wiki/New_Deal> at 30 May 2006.

APPENDIX B: 9th GLOBAL FRAUD SURVEY AMONG 500 TOP CORPORATIONS CONDUCTED BY ERNST&YOUNG

Figure 1 Companies see internal controls as key to fraud prevention



Q: How likely are each of the following factors to prevent fraud? (High rating – % respondents giving 8, 9 or 10 on a 1-10 scale)

Sample Base: Respondents in Developed Markets (360), respondents in Emerging Markets (226)

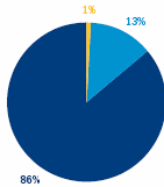
Source: Ernst&Young, 9th Global Fraud Survey – *The Risk in Emerging Markets*,

< [http://www.ey.com/global/download.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/\\$file/EY_Fraud_Survey_June2006.pdf](http://www.ey.com/global/download.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/$file/EY_Fraud_Survey_June2006.pdf)> at 21 June 2006, p 7.

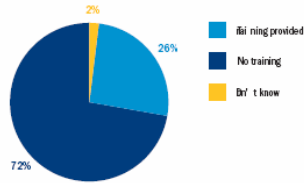
APENDIX C: EMPLOYEE TRAINING ON ANTI-FRAUD POLICIES

Figure 6

Are all employees trained on the difference between facilitation fees and corrupt payments?



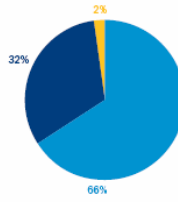
Are all employees educated on anti-fraud policies?



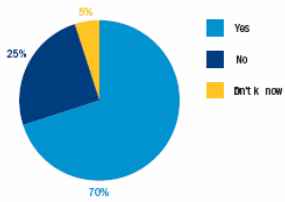
Q: Are employees within your organization trained on the difference between facilitation fees and corrupt payments? (% of all respondents, 586)
 Q: Are employees provided with formal training to help understand and implement the organization's fraud policies? (% of respondents with international links, 531)

Figure 7

Where facilitation fees are common practice, do employees receive anti-fraud training?



Where organizations communicate anti-fraud policies to their people, do they also provide training on how to implement them?

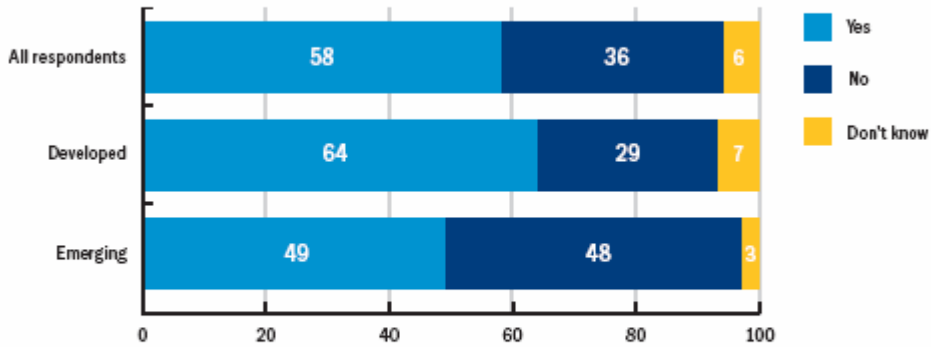


Q: Are employees trained on the difference between facilitation fees and corrupt payments (% respondents where facilitation fees are common, 117)
 Q: Are employees provided with formal training to help understand and implement the organization's anti-fraud policies? (% of respondents communicating policies to local management and staff, 200)

Source: Ernst&Young, 9th *Global Fraud Survey – The Risk in Emerging Markets*,
 < [http://www.ey.com/global/download.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/\\$file/EY_Fraud_Survey_June2006.pdf](http://www.ey.com/global/download.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/$file/EY_Fraud_Survey_June2006.pdf)> at 21 June 2006, p 15.

APPENDIX D: NOT SIGNIFICANTLY INCREASING NUMBER OF ANTI-FRAUD POLICIES

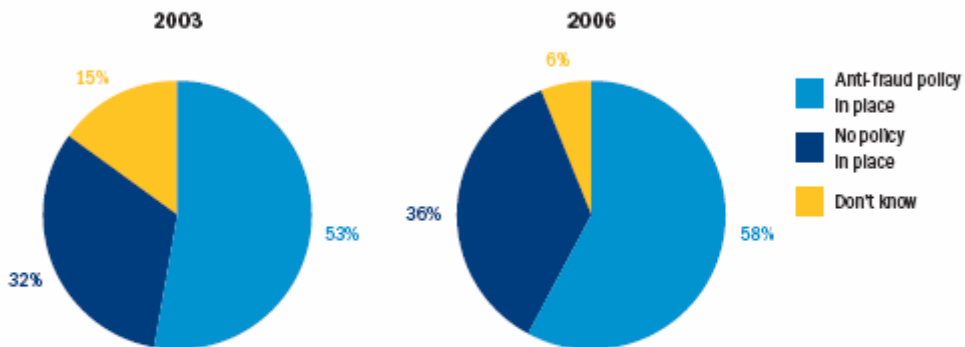
Figure 2 Do companies have a formal anti-fraud policy?



Q: Does your organization have a formal or documented anti-fraud policy?
(% respondents)

Sample Base: All respondents (586), respondents in Developed Markets (360), respondents in Emerging Markets (226)

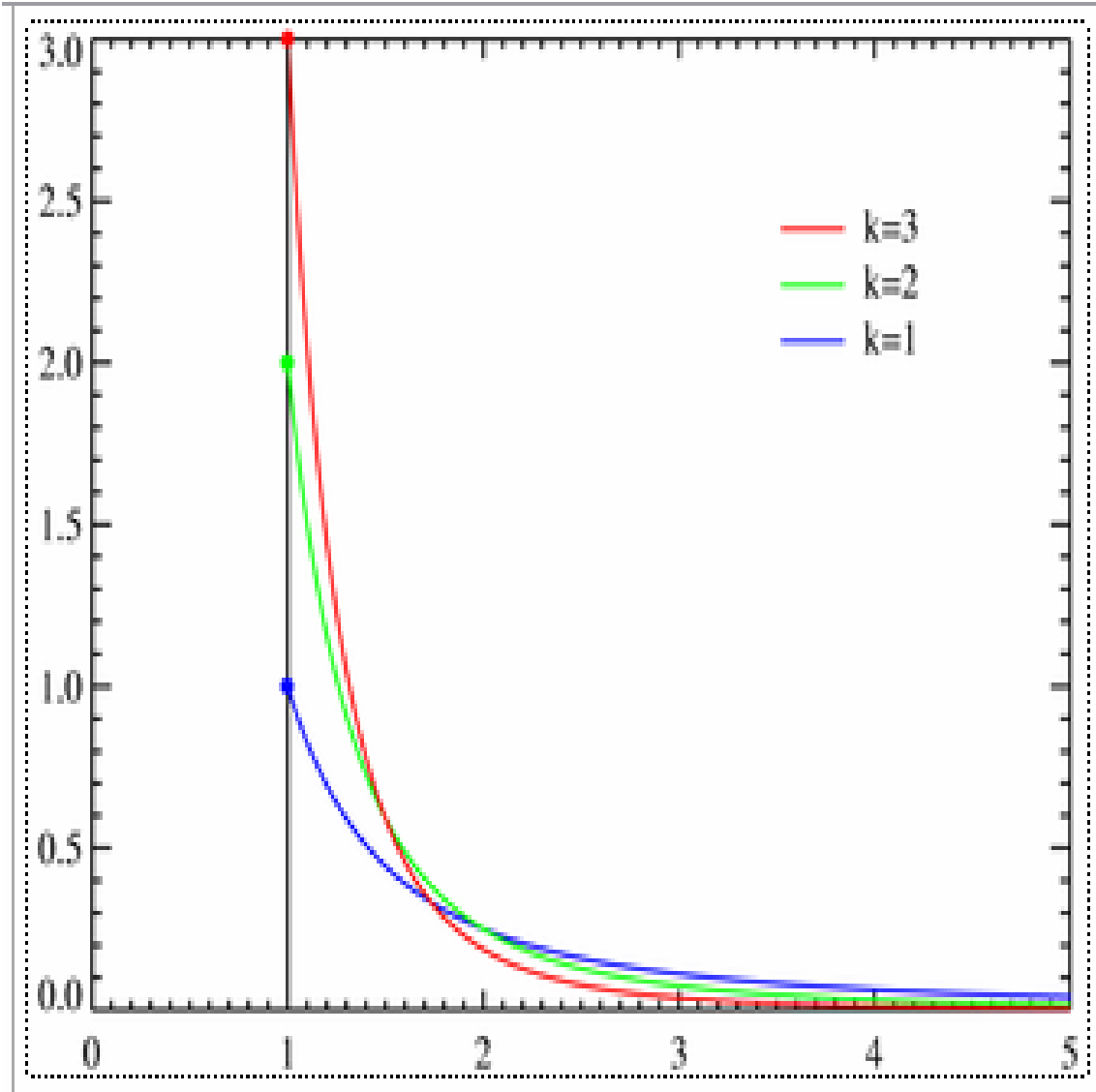
Figure 3 Change in prevalence of anti-fraud policies over three year period



Q: Does your organization have a formal or documented anti-fraud policy?
Percentage of all respondents

Source: Ernst&Young, 9th Global Fraud Survey – The Risk in Emerging Markets,
< [http://www.ey.com/global/download.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/\\$file/EY_Fraud_Survey_June2006.pdf](http://www.ey.com/global/download.nsf/International/FIDS_-_9th_Global_Fraud_Survey_2006/$file/EY_Fraud_Survey_June2006.pdf)> at 21 June 2006, p 9.

APPENDIX E: GRAPH OF PARETO DISTRIBUTION



Source: Wikipedia, *Pareto Distribution*, <http://en.wikipedia.org/wiki/Pareto_distribution> at 30 June 2006.

Note that the vertical axis represents the wealth whereas the horizontal axis represents the number of people participating from the wealth.

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