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

BY ANITA INDIRA ANAND* 

ABSTRACT 

Firms have incentives to adopt corporate governance practices in the absence of a legal requirement to do so. An enabling governance regime coupled with mandatory disclosure of a firm's governance practices is likely to yield a high level of compliance at lower direct costs to the issuer than a wholly mandatory regime. While a wholly mandatory structure may yield slightly better compliance, its other benefits are uncertain and its costs are likely much higher. Pushing the boundaries of existing comparative corporate governance scholarship, it will be argued that the enabling/mandatory dichotomy informs analyses of corporate governance regimes worldwide. 

I. INTRODUCTION 

In the United States, certain aspects of corporate governance have become the subject of mandatory regulation under the Sarbanes-Oxley Act. 1 Other major common law jurisdictions, such as the United Kingdom, Australia, and Canada, have rejected mandatory corporate governance legislation of this nature. These countries have opted for an enabling, or partially enabling, regime under which firms can choose governance practices they will adopt from a list of best practices, but they must disclose 

*Visiting Olin Scholar in Law and Economics and Visiting Lecturer in Law, Yale Law School (2005-2006); Associate Professor, Faculty of Law, Queen's University, Kingston, Ontario, Canada, e-mail: anita.anand@yale.edu. Thanks to Bernard Black, Kim Brooks, Doug Harris, Edward Iacobucci, Lewis Johnson, John Knowlton, Kate Litvak, Niamh Maloney, Marc Paulez, Jessie Penley, Larry Ribstein, Arthur Sweetman, and Michael Trebilcock for their very helpful comments, as well as to the Social Sciences and Humanities Research Council of Canada for providing comments of an anonymous reviewer. Thanks also to Jessie Penley, Ryan Sheahan, and Nicole Stephenson for their excellent research assistance. Thanks to participants in the Queen's Law and Economics Discussion Group, the annual conference of the Canadian Law and Economics Association (2004), and the annual meeting of Law and Society (Canada) (2005) for their helpful comments. I extend my appreciation to the Queen's University Advisory Research Council, the Foundation for Legal Research, and the Social Sciences and Humanities Research Council of Canada for assistance in funding research underlying this project. 

their choices and the resulting governance structure of the firm. This article examines whether an enabling structure gives rise to the benefits of a mandatory governance regime, but at less cost.

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

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

I do not seek to slot entire governance regimes into either the mandatory or the enabling category: most regimes exhibit characteristics of both. State corporate law in the United States in particular is largely enabling at the state level, providing default rules to which corporations must adhere if they do not choose an alternative arrangement that will govern them.2 Despite the enabling character of state corporate law, most would agree that Sarbanes-Oxley cannot be characterized as enabling legislation.3 Thus, this article addresses the conspicuous aspect of U.S.

---


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

While the U.S. regime under SOX is largely mandatory, other jurisdictions have adopted a different governance model. Canada's regime dates back to 1995 when the Toronto Stock Exchange (TSX) issued a list of best practices that Canadian listed firms could voluntarily follow. Disclosure regarding the extent of a firm's compliance with the best practices was required in the firm's proxy circular or annual report. Provincial securities commissions now bear the responsibility for formulating and administering the corporate governance guidelines. They too have issued a voluntary code of best practices coupled with a mandatory disclosure requirement.

Jan. 23, 2006) ("The most recent cycle of U.S. corporate governance reform ... both through Sarbanes-Oxley and the recent New York Stock Exchange and Nasdaq rules, are mandatory, especially with respect to board composition and committee structure.").

4See SOX, supra note 1, §§ 302 (requiring CEO and CFO signatures on reports), 304 (requiring CEO and CFO to reimburse the company for any bonus or profit on the sale of the company's securities that were made for a year before the accounting restatement due to that officer's misconduct), 401 (requiring financial statements to be prepared with or reconciled to GAAP), 403 (requiring officers and directors to report sales of stock), 404 (requiring management to establish internal controls on financial reporting).


6TSX COMPANY MANUAL, supra note 5, § 473 (stating that a listed company must make disclosure regarding its corporate governance practices with reference to the guidelines, and where its governance system differs from the guidelines, it must explain the differences). Note that the rule is unclear as to what explanation of the differences is required.

The U.K. regime is also partially enabling under the 1998 Combined Code which creates best practice guidelines.\textsuperscript{8} Compliance with these guidelines is voluntary, but companies listed on the London Stock Exchange are required to include in their annual report a statement indicating how the company applies the Combined Code's principles.\textsuperscript{9} Similarly, the Australian corporate governance regime revolves around the Australia Stock Exchange (ASX) guidance,\textsuperscript{10} which presents recommendations on how to achieve best practice in governance.\textsuperscript{11} The ASX guidance requires each listed company to provide a corporate governance statement containing disclosure of noncompliance in its annual report.\textsuperscript{12}

Thus, in three major common law jurisdictions outside the United States, corporate governance law can be called "partially enabling" where a code of best practices is coupled with a mandatory disclosure obligation. This is distinct from state corporate law, which is, as discussed above, enabling. The seeming popularity of the partially enabling or "best practices" structure presents a puzzle as to why these jurisdictions have adopted a hybrid governance regime and, in particular, what are the benefits and costs of such a regime. This puzzle is the starting point for this article.

Up to this point, the "mandatory" versus "voluntary" or "enabling" typology has infrequently been used in studies of comparative corporate


\textsuperscript{9}This requirement is found in the Preamble of both versions of the Combined Code, ¶ 4.


\textsuperscript{11}Id. at 5.

\textsuperscript{12}Id. The ASX regime takes an "if not, why not?" approach: it does not usually require disclosure of compliance; rather, it requires disclosure of noncompliance, with an explanation of why the company's board believes that noncompliance is appropriate. See Press Release, ASX, Corporate Governance—Implementation Review Group Delivers Report (Mar. 31, 2004), available at http://www.asx.com.au/about/pdf/CGCreview310304.pdf (last visited Oct. 22, 2005).
governance,\textsuperscript{13} although it has certainly been the subject of academic discussion in the context of state corporate law.\textsuperscript{14} Existing comparative corporate governance literature appears to be divisible into two broad categories. One focuses on the differences between the dispersed ownership model found in the United States and concentrated ownership models, such as those found in Germany and Japan.\textsuperscript{15} This stream of the literature has examined whether the end of corporate law is here, since shareholder primacy has prevailed,\textsuperscript{16} or whether path dependencies exist that prevent convergence in corporate governance systems. The other category stems from empirical work that examines the impact of a country's legal system (common versus civil law) on corporate governance\textsuperscript{17} and corporate performance.\textsuperscript{18} A main issue in this strand of the debate is the importance of corporate governance practices, such as minority protections, in enhancing capital markets and firm value. By exploring differences

\textsuperscript{13}But see Gilson & Milhaupt, supra note 3.

\textsuperscript{14}See, e.g., Bebchuk & Hamdani, supra note 2 (examining default rules governing publicly traded companies); Black, supra note 2 (examining importance of state corporate law, where defaults can be changed); Gordon, supra note 2 (examining limits to flexibility of corporate law).

\textsuperscript{15}See, e.g., Ronald J. Gilson & Mark J. Roe, Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 YALE L.J. 871 (1993) (examining the concentrated holders of Japanese stock, arguing that other corporations, as well as banks, hold significant portions of Japanese companies); Mark J. Roe, Some Differences in Corporate Governance in Germany, Japan, and the United States, 102 YALE L.J. 1927(1993) (describing difference in power of managers and stock ownership in different countries); Klaus J. Hopt, The German Two-Tier Board in COMPARATIVE CORPORATE GOVERNANCE, ESSAYS AND MATERIALS 227 (Klaus J. Hopt & Eddy Wymeersh, eds., New York, Clarendon, 1998) (discussing the history structure and future of the German two-tiered board).

\textsuperscript{16}See, e.g., Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 GEO. L.J. 439 (2001) (asserting that the dominance of the view that corporate law primarily serves long-term shareholder value will eventually cause reform in corporate law).

\textsuperscript{17}See generally Rafael La Porta et al., Corporate Ownership Around the World, 54 J.FIN. 471 (1999) (showing correlation between shareholder protection and economies with widely distributed shareholders); Rafael La Porta et al., Investor Protection and Corporate Governance, 58 J. FIN. ECON. 3 (2000) (discussing implications of correlation between legal effectiveness and breadth or shareholder control); Rafael La Porta et al., Legal Determinants of External Finance, 52 J. FIN. 1131 (1997) (arguing countries with inferior legal rules and enforcement have smaller capital markets).

between enabling vs. mandatory corporate governance regimes among countries, this article seeks to add a third category to the comparative corporate governance debate.

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

In Part II, this article contends that there are powerful incentives for voluntary behavior in the area of corporate governance. Part III examines the policy implications of recognizing that firms have incentives to voluntarily adopt governance practices. It presents an argument in favor of a partially enabling structure in which firms have the flexibility to design their own corporate governance regime, but must also disclose the compliance with suggested best practices. Finally, Part IV explores the need for mandatory disclosure in an otherwise enabling system of corporate governance.

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

II. Incentives for Voluntary Behavior

One way to maintain a high level of investor protection without creating excessive costs to issuers is to take advantage of firms' incentives

---

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

20 See, e.g., TSX COMPANY MANUAL, § 474, supra note 5.

21 See, e.g., NI 58-101, supra note 7.
to voluntarily adopt recommended corporate governance practices. These practices may be contained in a list of best practices or other guidelines issued by securities regulators or stock exchanges. But, if we are to favor this or any other system of voluntary corporate governance, we must be certain that these incentives for voluntary behavior exist: Why would a firm adopt corporate governance practices in the absence of a legal requirement to do so? In this section, we will see that there are incentives to adopt corporate governance practices voluntarily and to disclose whether these practices have been adopted. Firms will likely assess the costs and benefits of a proposed course of action and will adopt practices that result in net benefits to them.

To begin, firms may seek to preempt government regulation by adopting governance practices in advance of legal rules compelling them to do so.\(^2\) In the environmental area, empirical analysis has been conducted on the willingness of firms to adopt cleaner products or processes.\(^3\) Several studies show that the threat of mandatory environmental regulation can be a motivating factor in a firm's decision to reduce its pollution levels.\(^4\) For example, Khanna and Damon demonstrate that voluntary programs to control pollution are likely to be successful because firms participate out of rational economic self-interest, seeking to avoid high costs of mandatory compliance in the future.\(^5\) Voluntary programs can thus be considered as a means to forestall more costly mandatory regulation.

Even if firms see proposed regulation as a fait accompli, they may move to implement the proposed rules in advance of the regulations becoming law. As discussed below, firms will still be unlikely to implement standards voluntarily if the costs of doing so exceed the net benefits. Thus, attempting to comply with regulation that may or may not be implemented seems a plausible, but insufficient, explanation of firms' voluntary behavior.

Firms may also adopt voluntary practices to deter investors from devaluing them. To begin, managers may believe that if they withhold information, investors are likely to conclude that the information is bad

---


\(^4\)Id.

\(^5\)Id. at 23; Maxwell et al., supra note 22, at 584 (explaining "self-regulation" may be motivated by a desire to avoid mandatory regulation).
news.\textsuperscript{26} Withholding information increases market noise due to the range of possible interpretations of the withheld information. As a result, the expected cost of investors discounting the value of the firm is so high that the manager is better served by making a disclosure.\textsuperscript{27} Thus, disclosure assists in preventing devaluation of the firm by the market. In addition, firms will seek to prevent network externalities that could occur if they do not adopt governance practices, including disclosures, that are otherwise the norm. They will seek to ensure that they do not support a governance structure that is unfamiliar to investors. Otherwise they risk being seen as an outlier and raising capital may be difficult.

Admittedly, investors will not always discount the value of a firm if they do not have information about its corporate governance practices. Investor skepticism will depend on many factors—for example, the disclosure history of the firm and the firm's performance, including its share price. If the return on equity is high, investors will be less inclined to analyze and evaluate the firm's governance structure. If the firm is underperforming, analysts and investors will search for reasons why this may be so. Such inquiries may lead analysts and investors to conclude that the firm has a weak governance structure and, indeed, that the firm's performance might experience a turnaround if its governance structure were enhanced.

Firms may have specific incentives to disclose their governance practices. Assuming that investors are primarily concerned with obtaining information for the purpose of purchasing securities and maintaining their investment portfolios,\textsuperscript{28} it stands to reason that management will disclose information, believing that investors require it prior to making the decision to invest or remain invested. Thus, the competition for capital among firms determines the optimal level of disclosure.\textsuperscript{29} Firms are likely to respond to investors' desire for information in order to remain competitive.\textsuperscript{30}

\textsuperscript{26}This is the "no news is bad news" hypothesis. See Stephen A. Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory in ISSUES IN FINANCIAL REGULATION: REGULATION OF AMERICAN BUSINESS AND INDUSTRY 177, 185 (Franklin R. Edwards ed., McGraw-Hill 1979).


\textsuperscript{30}See id.
By the same token, voluntary disclosures can also create competitive disadvantages for the firm.\textsuperscript{31} Firms may be reluctant to disclose information that may benefit their competitors. If a firm's rivals can use voluntary disclosure to become more competitive, the benefits of the disclosure are reduced.\textsuperscript{32} Companies, for example, are especially sensitive to the costs of disclosing future-oriented financial information that may put them at risk of increased competition or "encourage political intervention" in their marketplace.\textsuperscript{33} In addition, incentives for voluntary disclosure of information relating to corporate governance practices will be stronger if a firm has positive rather than negative news to report about its governance.\textsuperscript{34}

This is all to say that although firms may have incentives to behave voluntarily, voluntary disclosures in particular can be costly. For example, pre-dissemination costs associated with disclosure include the cost of gathering, organizing, and preparing the information. Further costs arise in disseminating the information, including mailings to shareholders and other market participants, as well as press releases, website updates, and analyst conferences.

Certain other costs affect firms disclosing information, such as costs associated with updating and revising disclosure, as well as "proprietary costs," or costs associated with disclosing negative information.\textsuperscript{35} Proprietary costs arise, for example, when a firm issues unfavorable information and a bank then asks for its loan to be repaid.\textsuperscript{36} Proprietary costs could also conceivably arise if a firm disclosed that its audit committee members were not financially literate, thereby subjecting the firm to greater scrutiny by rating agencies and lenders.

In sum, firms will assess the costs and benefits of possible governance practices and will voluntarily adopt practices, including making disclosures, that are likely to result in the highest net benefit to the firm.\textsuperscript{37} The costs and benefits will vary depending on the particular pressure giving

\textsuperscript{31}This is a type of "proprietary cost." See Verrecchia, supra note 27, at 182. See also Réal Labelle, The Statement of Corporate Governance Practices (SCGP), A Voluntary Disclosure and Corporate Governance Perspective 10 (June 2002), available at http://ssrn.com/abstract=317519 (last visited Oct. 22, 2005) (citing Verrecchia as saying that because governance procedures are not of great value to competition, disclosure costs are minimal).

\textsuperscript{32}Verrecchia, supra note 27, at 181-82.


\textsuperscript{34}Id.

\textsuperscript{35}Verrecchia, supra note 27, at 181.

\textsuperscript{36}Id.

\textsuperscript{37}Gray & Roberts, supra note 33, at 118.
rise to the perceived need for the practice. In the disclosure context, costs will also depend on the information being disclosed. Because of certain disincentives to voluntary disclosure, it seems necessary to consider the potential usefulness of a mandatory disclosure regime in the corporate governance context. But we will first analyze whether we can structure a regime that takes into account a firm's incentives to implement governance changes voluntarily.

III. IMPLICATIONS FOR DEVISING A LEGAL REGIME

Part II of this article argued that firms have incentives to voluntarily adopt governance practices and disclose their adoption of such practices. In this section, we take the examination one step further by comparing enabling to mandatory governance regimes using certain costs and benefits as points of reference, including: direct costs (costs to regulators of designing, monitoring and enforcing regulations); compliance costs (costs to firms, including internal and external expenditures); costs of production (including increases or decreases in quantity of goods produced); and, efficiency of competition (market competition maximizes social welfare where sellers compete on the basis of price and quality rather than trying to dupe consumers). 38

We should note that if the state accords primary importance to a certain objective, such as investor protection, it will likely seek to ensure that this objective is achieved through mandatory legislation. The assumption is that mandatory law is a means to achieve the goal directly because market participants will be compelled to comply with the law, not wishing to face the regulatory penalties of noncompliance. Mandatory laws with penalties thus act as a deterrent.

But do investors benefit from a mandatory system? La Porta et al. have found that in countries with better legal protections for investors, financial markets are more developed. Analyzing securities laws of forty-nine countries, they found that both disclosure rights and liability standards

---

38 This list is derived from the Financial Services Authority, which recommends that regulators focus on six "impact categories" in calculating the cost-benefit effects of their policies. The FSA also examines two other categories, which are: quality of goods offered (increase in consumer surplus that results from regulations that improve the quality of the goods offered) and variety of products offered (increase in consumer choices). These are, however, difficult to quantify and may have less relevance than the others in the corporate governance context. These categories have been excluded from this discussion. For further discussion of the FSA policy, see also Edwin Sherwin, Cost-Benefit Analysis of Financial Regulation: Why Dollars Don't Always Make Sense in SEC Rulemaking at 38-44, available at http://www.law.harvard.edu/faculty/hjackson/pdfs/Sherwin.Cost.Benefit.Paper.April.2005.pdf (last visited Jan. 10, 2006).
were positively correlated with larger stock markets. In short, mandatory law matters because it leads to strong markets by facilitating private contracting.\textsuperscript{39}

While mandatory law may matter as a general proposition, there may be a threshold above which additional investor protection laws do not enhance capital markets, or at least do not do so at the same rate (a diminishing returns argument). In advanced economies where investor protection laws are strong, such as the United States, it stands to reason that an ever-increasing volume of investor protection law, including so-called corporate governance law, will not always result in a corresponding efficiency gain.\textsuperscript{40} As Winter explains, "[I]nterventionist legal rules may reduce the yield to shareholders generally and this cost must be weighed against the benefits to be gained by the reduction of self-dealing or mismanagement."\textsuperscript{41} Thus, additional regulation may not lead to better protection for investors.

Further, it will be difficult to measure whether the appropriate level of protection has been achieved. It seems impossible to measure the benefit of moving investors from some (presumably) lower level of protection to a higher level of protection.\textsuperscript{42} It is true that one could attempt to aggregate and compare utility across investors with and without the regulation. But, apart from being vague, this calculus probably neglects individual preferences in favor of paternalistic choices.

Thus, some ostensible benefits of a mandatory corporate governance regime seem hard to quantify. But we can reason that compliance under mandatory rules may be relatively high, especially if the penalties for noncompliance are onerous. Further, if the regime has been in place for a number of years, and market participants are aware of the "rules of the

\textsuperscript{39}Raphael La Porta et al., \textit{What Works in Securities Laws?} 12-13 (2004), available at http://post.economics.harvard.edu/faculty/shleifer/papers/securities_final.pdf (last visited Oct. 25, 2005). \textit{See also} La Porta et al., \textit{Legal Determinants}, supra note 17 (arguing that countries with poorer investor protection have smaller and narrower capital markets; French civil law countries and the less developed capital markets have significantly weaker investor protection than common law countries).

\textsuperscript{40}See Mark J. Roe, \textit{Political Determinants of Corporate Governance: Political Context, Corporate Impact} 18-20 (Oxford: Oxford University Press, 2003) (asserting that the La Porta et al. model may explain the economies of less developed countries, but not developed economies such as the United States).

\textsuperscript{41}Ralph K. Winter, Jr., \textit{State Law, Shareholder Protection, and the Theory of the Corporation}, 6 J. LEGAL STUD. 251, 261 (1977). Winter also states, "[A]t some point the exercise of control by general rules of law may impose costs on investors which damage them in both quantity and quality quite as much as self-dealing or fraud." \textit{Id.} at 259.

game," including punishments in the case of breach, the regime exhibits a certain predictability. The assumption is that once the regime is implemented, the number of actors who deviate from the regime will be much smaller than the number of actors that comply.43

In an enabling regime, if the state establishes a set of guidelines or best practices to be followed, there is less assurance that market actors will abide by them, since no penalty attaches to those who fail to comply. Furthermore, rates of compliance are likely inconsistent in these regimes. This may occasion other costs associated with an enabling system, including information costs incurred by investors to determine the governance practices of a firm and to assess them in relation to other firms' practices. Conversely, it stands to reason that mandatory rules achieve their objectives more directly: If the state wants to achieve a certain objective, it need only set forth the legal rule and, provided that the rule is made known and has a penalty attached to it, it will likely be followed. Of course, the extent to which regulators enforce the rule in question will also affect compliance rates.

Enabling regimes can encourage compliance in the long term. As more and more firms adopt corporate governance practices, over time these voluntary practices can become the norm among a majority of firms. In year one of its inception, relatively few firms may comply with a voluntary code. Over time more and more firms may comply, believing that they will lose investors or be outdone by their competitors (i.e., because of "peer pressure") if they do not. Thus, compliance in the voluntary regime increases in year two and can continue to do so thereafter. This peer pressure effect is a pure market mechanism that can occur without mandatory legal rules.44

Thus, it is not the case that compliance is necessarily low, or does not increase, under a voluntary regime. Some may question whether peer pressure from firms to adopt additional governance practices effectively renders these practices mandatory. This is the idea that "we have to adopt

---

43See Darren Sinclair, Self-Regulation Versus Command and Control? Beyond False Dichotomies, 19 LAW & POLY 529, 534 (1997). This is an assumption for which no empirical support has been found.

44An example of the effects of this peer pressure is the separation of the roles of chair of the board and CEO. See Dey Report, supra note 5. Sixty-five percent of companies in the S&P/TSX index had separated the roles of chair of the board and CEO. See Board Games, The Globe and Mail, Oct. 7, 2002, at B1, available at The Globe & Mail http://www.theglobeandmail.com/series/boardgames/stories/20021007main.html (last visited Oct. 25, 2005). See also Phyllis Plitch, Post of Lead Director Is Catching On, WALLST. J., July 7, 2004, at B2A (stating that more U.S. companies are not only separating the roles of chair and CEO, but also that "[m]ore and more U.S. companies are naming lead directors, embracing the increasingly popular board position as a palatable alternative to separating the chairman and chief executive jobs").
this practice because our competitors are doing so." Industry pressure is a
market-driven incentive to act voluntarily. But a mandatory rule is
mandatory because it carries with it legal, not financial or competitive,
pressures or sanctions. Where a firm chooses to adopt a practice in the
absence of a legal requirement to do so, this is an example of voluntary
behavior as defined above.

Some may retort that if a firm is adopting practices that would have
been mandatory, then there is no difference in cost from the firm's
perspective. But micro, small and mid-cap issuers will bear costs of a
mandatory regime disproportionately and may choose to not follow
suggested best practices. The enabling structure is more flexible in this
regard and is especially important in jurisdictions such as Canada and
Australia given the preponderance of small to mid-size public companies
in capital markets of these countries. It is instructive that the SEC Advisory
Committee on Smaller Public Companies will likely recommend exempting
microcap companies from SOX Section 404, subject to certain conditions.
The Committee stated that smaller public companies "have been
disproportionately subject to the burdens" arising from Section 404
compliance.45

A mandatory governance system may benefit investors by decreasing
the cost of becoming informed. An informed investor may like to know the
governance practices of Company X and how they compare with those of
Company Y. Under a mandatory governance system, assessing the relative
strength of companies' governance practices is straightforward: Since each
company's governance practices are based on the legal regime, a rational
investor can use the same terms of reference—namely, the rules embodied
in that legal regime—to assess all potential investments. The law thus
constitutes a standard form. The costs of learning the terms of the standard
form can be spread out among as many companies as the investor assesses.

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

45See Final Report of the Advisory Committee on Smaller Public Companies to
the U.S. Securities and Exchange Commission (draft dated Apr. 23, 2006), available at
http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf at 19-20 (last visited Mar. 4,
2006).
spread the costs of becoming informed because she is unaware of the particular governance regime that any one firm has adopted. This will not be the case if disclosure about a firm's governance regime is mandatory.46

We should recognize that from a practical standpoint, a firm's governance structure may be a relatively minor aspect in the overall investment decision. That is, when an investor is considering making an investment, the firm's governance structure is only one of a number of factors she may evaluate. Furthermore, even an enabling regime may be viewed as a standard form if recommended best practices are set down in a code or policy statement. The regime may also compel disclosure of whether and to what extent a firm has complied with the governance guidelines. This is the partially voluntary system that has been in place in Canada since 1995, when the Toronto Stock Exchange began requiring that listed firms disclose their compliance with the voluntary guidelines.47 Under this type of regime, voluntary codes can exist as a standard form and investors can refer to standardized disclosure regarding a firm's compliance with a list of best practices.

In terms of direct costs, the enabling structure is less costly for the state and for the firm. In implementing any governance regime, the state will bear policy design costs, implementation costs, and enforcement costs (including the costs of monitoring the market for abuses). In addition, costs to firms arise from monitoring and assessing their own practices (e.g., conducting internal control reviews); implementing new governance structures; producing disclosure and reports; and distributing required and other disclosures. There may be ex post hidden costs that will be particularly significant in a mandatory structure, such as increased insurance premiums for directors or officers who are required to certify financial statements.48 Of course, the presence and extent of each of these

46See infra Part IV. Note, however, that even under a hybrid system, the investor must still assess the impact of different (disclosed) governance practices on investor protection, and whether they are "efficient" for the particular firm.

47See supra note 5.

48Most would agree that SOX is an example of costly mandatory legislation. A recent survey found that compliance costs will be US$5.5 billion in 2004. Costs of this legislation now include restructuring the board and finding CEOs and CFOs who will be prepared to certify financial statements. FileNet Corporation, Corporate Transparency: Addressing Sarbanes-Oxley in Today's Insurance Industry 3 (Sept. 2003), available at http://www.filenet.com/english/industry_solutions/white_papers/033020107.pdf (last visited Oct. 25, 2005). Management time will be spent on assessing internal controls and disclosing their effectiveness. Id. A hidden cost of these and other provisions is a dramatic increase in insurance premiums. Id. at 4. "Gartner, Inc. [reports] that, in early 2003, director and officer insurance premiums had exploded by 300% to 900% over 2001 levels. Professional liability insurance costs for accountants have risen similarly, increasing the cost of outside auditing services." Id. (citing Compliance With the Sarbanes-Oxley Act Requires Real-Time Data (Gartner, Inc. 2003)).
costs will depend on the content of the mandatory legislation itself (i.e., what does the law require?).

While all of these costs arise in a mandatory structure, some exist under an enabling governance regime. Presumably, the state will continue to monitor the activities of capital market participants. But two costs in particular will be reduced (though not necessarily eliminated) under an enabling structure. First, the issuer’s compliance costs are reduced. Compliance costs can be divided into direct and indirect categories. Direct compliance costs include fees that must be filed prior to or following a transaction, while indirect costs are costs that the issuer bears because of a legal rule but which are not paid directly to the regulator. Indirect costs include internal management costs, or the internal costs that an actor bears to organize itself to comply with a legal rule. For example, under the SOX internal control requirement, the firm will incur significant costs not only in establishing and maintaining the internal controls but also in drafting and issuing the appropriate disclosure. These costs will not necessarily arise under an enabling structure, since firms can decide which costs they wish to incur and when.

Again one may question whether compliance costs are decreased if firms are complying with best practices that are identical to what would be required under a mandatory rule. The difference is that under an enabling system, firms can elect whether or not to comply. It will often make sense for small or mid-cap firms not to comply because in their individual calculations, the aggregate costs of the governance practices outweigh the net benefits. These firms bear the costs of the regulation disproportionately. In any case, if investors value the particular governance practice at issue, firms (small and large) will face market discipline for noncompliance.

---

49SOX, supra note 1, § 404.


51Under a voluntary system, firms may have to incur the costs of monitoring a developing legal system and ensuring that their governance structures and disclosure comply with the existing legal regime. It is true that the market may demand equally costly measures, but as long as these are not legally required, they do not fall under the common understanding of the term "mandatory" and the definition of the term used here. See supra Part III.
Second, there are enforcement costs. In any regulatory system, enforcement costs can be significant.52 Under a purely voluntary code, however, enforcement and market surveillance costs will be less. It is true that regulators will still need to ensure that firms are making full, true, and plain disclosure of all material facts in respect of certain documents, such as the prospectus.53 But where there is no requirement for implementing governance practices and no corresponding remedy for failure to implement governance practices per se, enforcement costs, including investigation costs, must be less than if the requirement and accompanying remedy existed.

Overall, the costs to firms in an enabling regime are likely less than the costs of a mandatory system. This is mainly because of reduced compliance costs on the issuer's side and reduced enforcement costs on the regulator's side. Benefits of a mandatory system, such as establishment of minimum standards, enhanced compliance, and reduced information costs for investors, can also be realized under an enabling system. For example, information costs can be relatively low for investors where a list of best practices has been issued. In this case, the voluntary code serves the same function as a standard form legal instrument by setting out minimum standards for good behavior.

Even under a mandatory system, compliance is not guaranteed, since firms may not be motivated by fear of penalties for noncompliance. Many may simply ignore the law and absorb the costs of noncompliance. And, if the firm is performing well, investors will be satisfied and deviations from corporate governance standards will likely be of secondary importance to them. Thus, unless the penalty is strict—such as an order cease trading the firm's stock—noncompliance is a real option for firms that are performing well.

A mandatory system can have the effect of repelling issuers, especially if it increases the firm's costs of production. Since issuers are free to raise capital in a variety of markets worldwide, they may avoid those

52For example, in a recent study, Charles River Associates found that approximately 30% of the U.S. Securities and Exchange Commission's budget is spent on enforcement. See Charles River Associates, Securities Enforcement in Canada: The Effect of Multiple Regulators in WISE PERSONS' COMMITTEE—COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA: RESEARCH STUDIES 457, 474 (A. Douglas Harris ed., Ottawa: Wise Persons' Committee, 2003), available at http://www.wise-averties.ca/reports/WPC_10.pdf (last visited Aug. 30, 2005). By contrast, of the four largest securities regulators in Canada, Alberta, Quebec, and Ontario all allocate between 15% and 20% of their budgets to enforcement, while British Columbia allocates 13–14% of its budget to enforcement. In 2002, the actual enforcement budgets for these securities regulators were as follows (in Canadian currency): Alberta—$3.084 million; Quebec—$4.418 million; Ontario—$9.225 million; British Columbia—$3.456 million. See id. at 468–69, 473.

markets that impose comparatively costly regulation. Although there is no hard data on the effect of SOX on cross-listings, there is anecdotal evidence that foreign firms are less willing to list in the United States after the implementation of Sarbanes-Oxley because of its extension to cross-listed firms.\footnote{See Larry E. Ribstein, \textit{Cross-Listing and Regulatory Competition}, 1 \textit{REV. OF LAW \\& ECON.} 97, 127-28 (2005). We, however, should recognize Coffee's argument that foreign issuers may cross-list in more onerous governance regimes such as the U.S. in order to signal to investors their commitment to minority investor rights and fuller disclosure. \textit{See} John C. Coffee Jr., \textit{Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance}, 102 COLUM. L. REV. 1757, 1780 (2002).} Costly regulation can have the effect of decreasing competition by driving firms out of the market.

Enabling regimes are also more effective in capital markets populated by business entities of different sizes and types. A requirement for an entirely independent board or audit committee may be onerous for the micro, small or mid-cap issuer, which may only have a few directors on its board to begin with. Similarly, if the issuer has a small number of shareholders, some of whom are insiders, the benefits of having the chair and CEO roles separated may not be apparent. As Romano states,

\[\text{T}he\ more\ efficacious\ corporate\ and\ securities\ law\ regimes\ are\ the\ product\ of\ competitive\ legal\ systems,\ which\ permit\ legal\ innovations\ to\ percolate\ from\ the\ bottom\ up\ by\ trial\ and\ error,\ rather\ than\ being\ imposed\ from\ the\ top\ down\ by\ regulators\ or\ corporate\ governance\ entrepreneurs,\ who\ are\ far\ removed\ from\ the\ day-to-day\ operations\ of\ firms.\footnote{Romano, \textit{supra} note 50, at 1529 (citing ROBERTA ROMANO, \textit{THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION} (2002)).}

A one-size-fits-all approach seems both costly and unnecessary.

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

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

IV. CHOOSING A GOVERNANCE STRUCTURE

We have seen that firms have incentives to adopt corporate governance practices voluntarily.56 As a result, it may be unnecessary to implement mandatory legal regimes compelling them to adopt such practices. But compliance in an enabling regime may be difficult to achieve with certainty. Although market forces can occasion greater compliance, there is no guarantee of an increase in compliance. The tradeoff is lower costs in a purely enabling structure, but also lower compliance, while a mandatory structure is characterized by higher costs and perhaps higher compliance overall. Because of potential difficulties regarding compliance in a purely enabling regime, I favor a partially enabling or hybrid structure where, like the regimes in Canada, the United Kingdom, and Australia, the adoption of governance practices is optional but disclosure regarding governance practices is mandatory. This structure is likely to yield a high level of compliance at a lower direct cost than a wholly enabling or wholly mandatory regime.

Mandatory disclosure is necessary because it heightens compliance with an otherwise voluntary regime by attaching consequences to firms' decisions not to disclose negative information.57 If a firm knows that the market is watching its governance practices, it will have a greater incentive to comply with the voluntary guidelines that investors deem desirable.58 A

56See supra Part II.
57See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669, 680 (1984) (citations omitted) ("In a world with an anti-fraud rule but no mandatory disclosure system, firms could remain silent with impunity. If they disclosed, they could do so in any way they wished, provided they did not lie. . . . A mandatory disclosure system substantially limits firms' ability to remain silent.").
58Each year, one of Canada's leading national newspapers, the Globe and Mail, conducts a review of corporate governance practices for companies listed in the benchmark S&P/TSX index, based on a ranking of its own devising, in the "Board Games" series. Janet McFarland, Governance Changes More than Skin Deep, GLOBE & MAIL, Sept. 24, 2003, at B2. The 2004 Board Games series suggests that firms' voluntary adoption of corporate governance practices is, in part, a response to the previous Board Games rankings. See Elizabeth Church & Janet McFarland, Board Games: Canada's Definite Corporate Governance Rankin, GLOBE & MAIL,
disclosure requirement reduces information asymmetries by giving investors a minimum amount of information on which to base their investment decisions.\textsuperscript{59} It also controls other variables, such as the time, place, and manner of the disclosure,\textsuperscript{60} thereby ensuring that information will be conveyed to investors in a standardized manner.\textsuperscript{61} Mandatory disclosure also can reduce conflicts between directors, managers, and other agents\textsuperscript{62} since they likely all have an interest in avoiding negative disclosure that may hurt the firm as a whole. Finally, mandatory disclosure provides some resolution to the credibility problem whereby managers make only self-serving voluntary disclosures.\textsuperscript{63}

While we can accept the positive effects of mandatory disclosure generally,\textsuperscript{64} we must also question whether ever-increasing disclosure

\begin{footnotesize}

59 But cf. Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 638 (1984) (explaining that "[u]nless the information to be disclosed under the 1934 Act was either very costly or wholly unavailable before the [1934 Act," the information would be incorporated into the security price any way via the efficient market hypothesis).

60 Easterbrook & Fischel, supra note 57, at 680.

61 In Canada, for example, investors can turn to the "Statement of Corporate Governance Practices" in the annual report or proxy circular for information concerning the number of independent directors and the composition of the various committees. TSX COMPANY MANUAL, supra note 5, § 473.


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

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

Furthermore, once disclosure is required, firms will come under greater public/market scrutiny if they do not comply with existing corporate governance guidelines. They will have to provide a compelling, rational explanation for their decision not to comply. Mandatory disclosure is more effective than voluntary disclosure here because it ensures that all firms provide information that investors can use in their investment decisions and also because it provides a baseline against which all firms can readily be

---

evaluated. The disclosure enables investors to react to governance choices on the basis of full information.

Moreover, there may be a number of reasons for nondisclosure or ambiguous disclosure of governance choices such as bad news or a mere desire not to be transparent about governance structures. It is difficult for investors to make informed decisions if there is no disclosure requirement, since firms may choose not to disclose information relating to governance in which investors are interested. By contrast, if there is a rule requiring explanation of the governance choices (i.e., mandatory disclosure), investors need not draw conclusions from ambiguity or nondisclosure; they know specifically why a firm has made the particular governance choice. Thus, mandatory disclosure prevents investors from having to draw inferences about governance choices, and the reasons for such choices, when firms choose to be silent.

Admittedly, one could argue that compelling disclosure where it is not forthcoming must entail penalties, and a so-called partially enabling system is in effect mandatory by virtue of the disclosure requirement—any disclosure requirement necessitates regulatory enforcement action (or at least the threat of enforcement action) of some sort. However, the costs to the state (or regulator) of ensuring that disclosure is adequate are surely less than the costs of monitoring whether a firm has complied with the substantive corporate governance practices themselves. The regulator still has a role in ensuring that disclosure is accurate and complete, but the costs of this process will likely be less than those of examining firms' governance regimes as a whole. Thus, a partially enabling structure lessens but does not eradicate the need for monitoring and enforcement activities by regulators.66

The market mechanism is not sufficient, in and of itself, to encourage compliance with a voluntary code of corporate governance practices. Unless disclosure is mandatory, firms will have a bias to disclose only positive information—the credibility problem discussed above. In addition, mandatory disclosure ensures transparency, creating a level playing field among investors in terms of the information they have about the firm's governance practices. Thus, low compliance combined with the credibility problem constitutes a major drawback of an enabling system, while direct

---

66It is true that firms may not comply with disclosure requirements. But this is not an issue specific to partially enabling regimes. Rather, it is one that plagues the enforcement of securities violations generally: How does the state ensure that those who do not comply with the law are penalized for the market abuse they occasion? In my view, the issue relates to the severity of the penalties for noncompliance. If firms are not complying because it is more cost-effective for them to absorb the penalty for noncompliance, then clearly the penalty itself is not harsh enough. The deterrence mechanism is not there.
costs are a significant disadvantage of a mandatory regime. The partially enabling structure lessens the need for penalties for noncompliance (a main feature of the mandatory system) because the disclosure itself is mandatory, compelling firms to comply with the voluntary guidelines or suffer investor repulsion.

The argument could be made that the only reason that some jurisdictions, such as Canada, can function effectively under a partially enabling regime is that another jurisdiction has adopted a wholly mandatory approach: the United States with Sarbanes-Oxley. However, it is not clear whether an entirely mandatory regime must be established in the United States in order for a more lax regime in Canada to exist. The Canadian and U.K. partially enabling governance regimes, for example, were in place long before Sarbanes-Oxley.\(^67\) Onerous legislation in the United States, however, no doubt influences the behavior of extraterritorial firms for reasons relating to competition for capital.\(^68\) Arguably, the United States sets the default standard against which firms believe they will be judged by analysts, shareholders, potential acquirors, etc. Firms thus may adopt governance practices voluntarily in order to compete with rivals that are subject to these practices under mandatory legislation.

These issues, and the present theoretical argument in favor of partially enabling governance regimes, establish the groundwork for future empirical research. Such research should examine compliance rates in enabling and partially enabling regimes and the propensity of firms to adopt governance practices voluntarily. It is possible that firms not subject to Sarbanes-Oxley will voluntarily comply with this legislation. In another paper, Purda, Milne, and I document a general increase in the voluntary adoption of governance practices following the implementation of a

---

\(^67\)The TSX regime has been in place since the 1995 adoption of the Dey Report. See TSX COMPANY MANUAL, supra note 5, § 472. As for the U.K. regime, the 1998 COMBINED CODE, supra note 8, created by the Hampel Committee was actually an update of the Code of Best Practice drafted by the Cadbury Committee in 1992. See Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice (Cadbury Code) 16-19 (Dec. 1, 1992). Although the NYSE did have some corporate governance listing requirements prior to the enactment of SOX, those requirements were relatively minor, relating primarily to audit committees. See NYSE LISTED COMPANY MANUAL § 303 (New York Stock Exchange, Dec. 20, 1999), available at http://www.nyse.com (follow About the NYSE; then follow Listed Companies; then follow Listed Company Manual) (last visited Oct. 29, 2005).

\(^68\)For example, in "Voluntary Adoption of Corporate Governance Mechanisms: The Role of Domestic and International Governance Standards," Anand, Milne, and Purda find that Canadian companies express their awareness of SOX in annual disclosure documents and that non-cross-listed firms in particular have adopted reforms to comply with SOX in the absence of a legal requirement to do so. Anita I. Anand et al., Voluntary Adoption of Corporate Governance Mechanisms: The Role of Domestic and International Governance Standards 1, 9 (Feb. 28, 2006) (unpublished manuscript, on file with The Delaware Journal of Corporate Law).
partially enabling regime in Canada. Our empirical results show that between the years 1999-2003, Canadian firms voluntarily implemented Canadian best practice standards as well as SOX-like governance mechanisms.\textsuperscript{69} These results bear out the postulation that firms act voluntarily with regards to corporate governance and that entirely mandatory governance legislation may not be necessary, at least where certain incentives exist.\textsuperscript{70} Furthermore, they raise the question of whether mandatory legislation is necessary since firms clearly do act voluntarily in the corporate governance area.

V. CONCLUSION

There is no shortage of critics of Sarbanes Oxley and, among the academic community, many of these critics have sanctioned an enabling governance regime.\textsuperscript{71} This article does not jump on this bandwagon but, rather, makes a reasoned case for a variation of this alternative. Legislators and regulators do not uniformly recognize that firms have incentives for voluntary behavior in corporate governance. It is possible to take advantage of these incentives by creating a governance regime that is less costly for firms, yet still protects investors. In particular, a partially enabling structure has the effect of minimizing costs but at the same time encouraging compliance. Mandatory disclosure seems like a good policy choice in an otherwise enabling governance regime. It solves the credibility problem and also compels the disclosure of positive and negative news.

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