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ENFORCEMENT SESSION 3:

*Voluntary Standards and Public Scrutiny*

Mr. Alex Berg  
World Bank

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Superintendencia de Valores y Seguros (SVS)

Inter-American Development Bank (IADB)

Thank you.

I am going to briefly discuss voluntary standards, and some ideas on how we might think about them in the corporate governance reform process.

I think the way to think approach this discussion is to think of law regulation, on the one hand, and voluntary standards as two sides of the same coin, or perhaps as we say the “carrot” and the “stick”. Laws and regulations are the stick that provide negative incentives for companies to behave. Voluntary standards can be thought of as the carrot, the positive incentive for companies to do the right thing. Laws and regulation set a basic minimum standard, while voluntary standards allow companies to exceed the basic minimum, and to succeed, in the international competition for capital.

To put it even more simplistically, in the same vein as when I tried to explain corporate governance to my six year old daughter, laws and regulations tend to be work on the bad guys, and voluntary standards can allow the good guys to shine.

The second general benefit of standards is that their creation (in the form of a Code) tends to result in a process that is very important, maybe at least as important as the Code itself. That is to say:

- a working group is created
- there is a lot of discussion of the issues
- When it works, real private sector support is created
- Resulting code test markets important ideas that can be inserted into law.

Mexico has been just one example of this process in action.

Given the success of voluntary standards in many environments, in my mind there is no real question about whether voluntary standards can be helpful. The questions remain in what form they should be introduced, and the process by which they should be created.

In terms of forms: standard examples are novo Mercado type special listing tiers, and Codes of Best Practice. Special tiers focus on differentiating good performers. Codes tend to be more universal, but are also often tied to listing rules. In the Bank’s policy recommendations, we have tended to support both types.

The truth is that market conditions have been so bad that we really don’t know how well special tiers work in general, and that will take some time to play out. In small market special tiers may never be workable, because companies wishing to differentiate will list in larger financial centres.

The development of Codes remains important. It is useful to contrast the example of Mexico, which had an early Code and whose code has played an important role in test marketing new legislative ideas, with places where codes have been poorly developed.

I will use two examples from outside the region. In a central European country, a Code was developed by the stock exchange and by outside experts, with no real input from issuers or the private sector generally. The code that was developed was very, very general, and the comply or explain provisions require only a very general statement of compliance. The result is that the Code is ignored and has played little role in changing behaviour or in framing legislation.

In a middle eastern country, there is no code. As a result, interest in CG is very unfocused. No test marketing of ideas. No working group that can move forward.

We can talk about issues that fit better as law or as voluntary standards. Clearly, some issues benefit from the rules based approach – the basic minimum standards required in company law, for example. Others require more flexibility – board structures and processes.

When you have a scandal or fraud, or series of scandals, and there is a perception that the problem is widespread, then voluntary standards will not answer. With a general background of scandal (for example, the US in 2002) then voluntary standards are somewhat discredited as a solution.