

Market Enforcement under Different Legal Regimes:

A Comparison of France and Canada

Denis Cormier
ESG UQAM

Luania Gomez Gutierrez
ESG UQAM

Michel Magnan
Concordia University

Michel Magnan acknowledges the financial support of the S.A. Jarislowsky Chair in Corporate Governance and of the Institute for the Governance of Private and Public Organizations. Denis Cormier acknowledges the financial support of the Chair in Financial and Organizational Information and of Autorité des marchés financiers (AMF). The content of this article does not necessarily reflect the opinion of AMF; any errors are the responsibility of the authors.

Market Enforcement under Different Legal Regimes: A Comparison of France and Canada

Abstract

Building upon institutional theory, this study investigates whether and how market enforcement mediates the relationship between external (country-level) corporate governance mechanisms and internal (firm-level) corporate governance. Toward that end, we focus on two countries with contrasting legal, regulatory and institutional regimes, Canada and France. Market enforcement is deemed to be captured by measures of market efficiency. Our results suggest that external governance mechanisms interact with internal governance mechanisms via market enforcement, which differs greatly between both countries. Hence, the complementarity between internal and external governance mechanisms depends upon the nature and type of enforcement (i.e., emphasis on ex ante monitoring and compliance versus ex post sanctions).

Key words: Corporate governance, enforcement, legal regime.

Application de la loi et marchés financiers : Une comparaison entre les régimes juridiques de la France et du Canada

Résumé

En s'appuyant sur la théorie institutionnelle, cette étude examine si et comment l'application des règles institutionnelles dans le marché modifie la relation entre les mécanismes de gouvernance d'entreprise externes (au niveau des pays) et internes (au niveau de l'entreprise). À cette fin, nous nous concentrons sur deux pays dotés de régimes juridiques, réglementaires et institutionnels contrastés, le Canada et la France. La mise en application des règles dans le marché est mesurée par des variables captant l'efficacité des transactions sur le marché boursier. Nos résultats indiquent que les mécanismes de gouvernance externes interagissent avec les mécanismes de gouvernance internes via la teneur de l'application des règles institutionnelles dans le marché, laquelle diffère grandement entre les deux pays. Par conséquent, la complémentarité entre les mécanismes de gouvernance internes et externes dépend de la nature et du type de la mise en œuvre des règles institutionnelles (c'est-à-dire l'accent mis sur le contrôle ex ante et la conformité par rapport aux sanctions ex post).

Mots clés : Application des contraintes institutionnelles, gouvernance, régime juridique.

Introduction

The Cadbury Committee (1992) refers to corporate governance as “the system by which companies are directed and controlled”. Such a system encompasses both external mechanisms, for which the locus of action emanates from outside the boundaries of the firm, and internal mechanisms that arise from within the firm (Aguilera *et al.*, 2015). External mechanisms are essentially at country level (e.g., market for corporate control) while internal mechanisms are typically at the firm level (e.g., board of directors). For several years, since the seminal work of La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1998), the nature of the relation between external and internal corporate governance mechanisms has been the object of a spirited debate. For instance, Durnev and Kim (2005) show that internal firm-level governance mechanisms compensate (substitute) for external (country-level) corporate governance mechanisms. By contrast, Doidge, Karolyi and Stulz (2007) show that internal governance mechanisms complement external country-level corporate governance.¹

In this paper, we put forward the view that the nature and extent of the relation between external and internal corporate governance mechanisms are mediated by market enforcement, as reflected by firm-specific measures of market efficiency. Our approach is consistent with North (2010) who argues that enforcement is not only law enforcement but also the way in which formal rules and informal constraints, i.e. institutions, are applied (North, 2010). In other words, we consider that external mechanisms have an

¹ For the purpose of this paper, internal governance mechanisms refer to firm-level governance features (e.g., board independence). By contrast, external governance mechanisms refer to country-level governance features (e.g., legal origins). Hence, internal (external) or firm-(country-) level governance are used interchangeably.

impact only to the extent by which they affect the efficiency of the market for a firm's securities.

The settings we select to verify our predictions are two countries with contrasting legal and institutional regimes: France and Canada. In their seminal work, La Porta, Lopez-de-Silanes, Shleifer, Vishny and (1998) argue that some country-level legal and regulatory frameworks better protect investors and thus allow the development of more efficient capital markets. They put forward the view that common law has evolved to protect ownership rights and is thus better conducive to the development of deep and liquid capital markets since investors do not fear expropriation by the state. In contrast, code law is characterized as an instrument of the state to achieve social aims, which potentially can be in conflict with individual investors' interests. In this regard, France and Canada are at the opposite ends of La Porta et al. (1998) argument, France being a code law country while Canada is a common law country.

We consider three external corporate governance mechanisms: the legal system; the market for control; and the media. In addition, we also consider internal corporate governance mechanisms, as proxied by Bloomberg Governance Quality scores (Bloomberg ESG). Market enforcement is captured by two firm-specific measures of market efficiency: 1) abnormal returns and 2) price volatility. Market enforcement is deemed to be ex ante and to reflect institutional pressures prevalent in a common law country. By contrast, ex post enforcement, as reflected by the imposition of sanctions, reflects a country's relative weakness in institutional pressures and its reliance on code law. In this regard, we find that market enforcement is much stronger in Canada than in

France while France relies to a much greater extent on sanctions enforcement than Canada.

Overall, our results suggest that market enforcement mediates the effect of external corporate governance mechanisms on internal corporate governance mechanisms. For instance, while French regulators are much more active than Canadian regulators in imposing sanctions on publicly-traded firms and their managers, it appears that market enforcement is stronger in Canada than in France. The manner in which laws, regulations and institutions are enforced in each country is likely to explain such contrasting findings. More specifically, Canadian regulators tend to spend more resources on monitoring and compliance relative to French regulators. Such differential application implies that Canadian firms are more likely than French firms to convey higher quality disclosure, thus enhancing confidence in markets and facilitating monitoring and reducing the need to impose sanctions. In sum, each country has a different enforcement approach, the Canadian way being more conducive to market efficiency.

Our study contributes to prior work in the following manner. First, based on institutional theory, we propose a deeper analysis of enforcement and its relationship with governance mechanisms through transaction costs economics approach. From the institutional perspective, the constraints of these mechanisms come from formal and informal rules and from their enforcement (North, 2010; North, 1990). Formal rules can be observed through legal regime, as demonstrated by La Porta et al. (1998). Together, with informal constraints, they determine the effectiveness of their own enforcement. This happens because the effectiveness of enforcement is derived from human beliefs, which are the source of the institutions (North, 2010).

Second, we extend prior work on the relation between external (country-level) and internal (firm-level) corporate governance mechanisms. Studies which emphasize the country-level dimension of governance mechanisms (e.g., Durnev and Kim, 2005; Doidge et al., 2004) tend to provide mixed evidence as to the nature of its relation with firm-level governance mechanisms, i.e., substitute or complement. Studies that emphasize the firm-level dimension such as Aguilera et al. (2015), Cremers and Nair (2005), and Weir et al. (2002) show that internal and external corporate governance mechanisms are complements. However, the extent of such complementarity varies extensively. By showing that market enforcement mediates both dimensions of corporate governance, we provide a potential clue to solve the puzzle created by prior work.

Third, we also contribute to work on the relative effectiveness of corporate governance that rests on private mechanisms (i.e., internal or firm-level, such as shareholder or board oversight) vs. public mechanisms (i.e., external or country-level, such as sanctions). For instance, Liu and Magnan (2011) show that private control mechanisms with respect to self-dealing are more effective, as reflected by relative firm valuation, than public control mechanisms such as regulatory sanctions. Our results further support the view that institutions such as laws and regulations are more likely to be effective if they are applied upstream from potential governance problems, thus enhancing confidence in markets and market efficiency.

Finally, in recent years, there has been an emergence of various grids or templates to rank countries in terms of enforcement (e.g., Brown et al., 2015; Kaufmann, 2007). However, these measures are typically set at country level and do not consider firm-level

measures of perceived enforcement. Our study does innovate in assessing the consequences of this perceived enforcement via our measures of market enforcement.

The rest of the paper proceeds as follows. First, we present an overview of corporate governance as encompassing both internal and external dimensions. We then proceed to describe how governance can be viewed as a set of institutions that ultimately interact with market enforcement as a mediating factor. Second, we describe institutional forces in both France and Canada that may affect their ultimate level of market enforcement. Third, we describe our sample and methodology. Results and a conclusion come next.

Governance, Institutions and Market Enforcement

Corporate Governance: A Two-Sided Reality

Corporate governance can be envisioned as encompassing both internal and external mechanisms (Aguilera et al., 2015; Weir et al., 2002). Internal mechanisms reflect firm-specific attributes such Chair/CEO duality, the proportion of non-executive directors and executive directors' shareholdings (Weir et al., 2002). External mechanisms are typically outside of the realm of organizations and comprise a country's legal system, its market for corporate control, or the reach of its media (Aguilera et al., 2015). Over the years, the nature of the interface between external (essentially country-level) and internal (essentially firm-level) governance mechanisms has been the object of much attention (e.g., Doidge et al., 2007; Durnev and Kim, 2005). In this regard, Armstrong, Guay and Weber (2010) comment that characterizing a firm's overall corporate governance structures is difficult since it is conditional on several factors, including its economic

characteristics, its environment (both operational and informational), and its particular selection of governance mechanisms.

In fact, dependent upon the outcome being investigated, there is evidence that suggests such interface is either complementary or substitute. Through a literature review, Aguilera et al. (2015) conclude that external corporate governance mechanisms indirectly help internal corporate governance mechanisms becoming more effective. Weir et al. (2002) and Cremers and Nair (2005) empirically show the complementarity of internal and external governance institutions. Through an exploratory qualitative comparative case analysis, Misangyi and Acharya (2014) suggest that governance mechanisms work together as complements rather than as substitutes. Finally, looking at the impact of International Financial Reporting Standards (IFRS) adoption in Europe, Bonetti, Magnan and Parbonetti (2016) provide evidence on both sides of the debate. On one hand, they show that country- and firm-level governance mechanisms are complementary when a country's rule of law and its enforcement are strong, as only firms with strong governance exhibit an enhancement in the earnings quality. On the other hand, country- and firm-level governance mechanisms are substitutes when a country's rule or law and enforcement are weak, firms with strong governance then exhibiting an improvement in earnings quality.

Corporate Governance as a Set of Institutions

To better understand the nature of the interface between these two facets of corporate governance, it may be useful to draw upon institutional theory and view various governance mechanisms as actually representing a set of institutions (Aoki, 2006;

Williamson, 1996). In this respect, we heed the call put forward by Filip, Labelle and Rousseau (2015) who notice that, following La Porta et al. (1998), international financial accounting studies oppose directly the common law and civil law legal systems with little consideration for other institutional characteristics. They propose that further research on governance practices takes a more holistic approach when exploring whether internal corporate governance outcomes differ depending on the legal system and other institutional characteristics in a specific country. Specifically, they argue that institutions affect the extent to which different governance mechanisms are either complementary or substitutes.

External corporate governance mechanisms emanate from a firm's institutional context (Williamson, 1996). Institutions are social constraints that rationalize human exchanges, essentially by reducing their resulting uncertainty (North, 1990). Institutions typically exhibit three complementary dimensions: formal rules, informal constraints, and their enforcement (Aoki, 2006; North, 1990). With respect to formal rules, La Porta et al. (2008) allege that: (1) legal rules governing investor protection can be measured and coded for many countries using national commercial laws; (2) legal rules protecting investors vary systematically among legal origins, specifically, common law countries are typically more protective of outside investors than civil (code) law and particularly French civil law countries; (3) and legal investor protection is a strong predictor of financial development. Legal origin is a form of social control over economic life (La Porta et al., 2008). Common law seeks to support private market outcomes, whereas civil law seeks to support state-desired allocations (La Porta et al., 2008).

However, the same legal rules can produce different outcomes because of informal constraints, i.e., codes of conduct, norms of behaviour and conventions (North, 1990). Informal constraints are hard to measure (North, 1990; Williamson, 1996). “The complex of institutional constraints will result in various mixes of formal and informal constraints, which in turn reflect the costliness of measurement and enforcement. The higher these costs, the more will the exchanging parties invoke informal constraints to shape the exchange, although in the extreme, of course, no exchange will take place at all” (North, 1990, p. 68).

It means that formal and informal constraints form an equilibrium with the enforcement, where more enforcement is needed when formal and informal constraints mix is weaker. Moreover, because Canada invests more funds in market enforcement than France, it is expected that France invokes more informal constraints to shape markets exchanges.

Consequently, the measurement of market enforcement represents the inverse term of formal and informal institutional constraints. As formal and informal institutional constraints are reflected by the market price, market enforcement could be appreciated through the inverse term of abnormal returns and the inverse term of price volatility. These measures agree with the North (2010)’s idea of using transaction costs to observe economic and political markets efficiency and with the Williamson (1979)’s explanations of the link between governance and transaction costs.

North (2010, p. 53) puts forward that “The conception of transaction costs as the costs entailed in the measurement and enforcement of agreements can be usefully applied to analyzing the efficiency of political markets”. Transaction costs can be understood as

the costs of contracting, such as the costs of wrong adaptation of contracts (Williamson, 1996). They reflect the costs of exchanges and can then, more largely, contribute to explain the costs of a country's economic organization and the economic performance of its firms (North, 2010).

Market Enforcement and Corporate Governance

Previous work neglected the role that external corporate governance practices plays in preventing managers from engaging in misconduct activities (Aguilera et al., 2015). Filatotchev et al. (2013) illustrate how performance effects of corporate boards, ownership concentration and executive incentives may differ according to the legal system and other institutional characteristics in a specific country to inspiring and informing an emerging comparative research agenda. Filip et al. (2015) find that the French civil law environment encourages firms to publish accounting data of better quality than common law environment, whereas since La Porta et al. (1998), common law is supposed to better protect investor's rights. This could be explained by the omission of a variable: enforcement.

Governance structures differ in the way they reduce transaction costs (Williamson & Masten, 1999). For Williamson (1979), the governance structure is the institutional framework within which the integrity of a transaction is decided. Governance safeguards transactions against opportunism, but not perfectly (Williamson, 1979). Some enforcement could be needed depending on the effectiveness of the governance structures. For example, in the case of market transactions, rating services or the

experience of other buyers, provide incentives for parties to behave responsibly by formal and informal means (Williamson, 1979).

Williamson (1979)'s theoretical framework was developed for commercial transactions. For capital market transactions, ease of verification is the counterpart of transaction specific investments. The author explains that "The ease of verification is critical to the operation of capital markets. Where verification is easy, markets work well and additional governance is unnecessary. Where verification is difficult or very difficult, however, additional governance may be indicated. Occasional transactions are apt to benefit from third-party assistance, while recurring transactions are ones for which bilateral or unified governance will presumably be observed. Assessing capital-market transactions within the proposed framework is thus accomplished by substituting "ease of verification" for "degree of transaction-specific investment." Once this is done, the governance structures appropriate to capital markets are broadly similar to those within which commercial transactions are organized" (Williamson, 1979, p. 259).

If an information is easily verifiable by market participants, they will incorporate it to the market price (at least in the semi-strong market form). Therefore, easy verification could be observed through the tendency of market participants to behave in the manner expected by institutionalized rules. For Klein et al. (1978), the main alternative to vertical integration as a solution to the problem of opportunistic behaviour is economic enforceable long term contracts. These contracts take two forms: legal guarantees enforced by the government and other external institutions; or implicit contractual guarantees enforced by the market.

While formal or explicit contractual guarantees are costly to enforce, informal or implicit contractual guarantees allow to reduce litigation costs and to create flexibility without specifying all contingencies and dimensions of the transactions (Klein et al., 1978). “One way in which this market mechanism of contract enforcement may operate is by offering to the potential cheater a future premium, more precisely, a price sufficiently greater than average variable (that is, avoidable) cost to assure a quasi-rent stream that will exceed the potential gain from cheating. The present-discounted value of this future premium stream must be greater than any increase in wealth that could be obtained by the potential cheater if he, in fact, cheated and were terminated. The offer of such a long-term relationship with the potential cheater will eliminate systematic opportunistic behavior” (Klein et al., 1978, p. 304).

Enforcement is the process that makes formal and informal constraints effective (North, 1990). Therefore, we argue that market enforcement mediates the relationship between external and internal corporate governance mechanisms. The more the external corporate mechanisms are effective, the less market enforcement is needed for their internalisation by firms. The more the external corporate mechanisms are enforced, the more they help internal corporate governance mechanisms becoming more effective. That occurs because the more external corporate mechanisms are effective, the more they are enforced, and hence less efforts are needed to their internalisation by firms. Thus, the more the external corporate mechanisms are enforced, the less need for strong internal corporate governance mechanisms. This gives rise to our first hypothesis:

Hypothesis 1:

Market enforcement mediates the relationship between external and internal corporate governance mechanisms.

Institutional Environments: France and Canada

Within the framework provided by neo-institutional theory (Scott, 1995), country level institutional pressures can take three forms: 1) coercive (i.e. state laws and regulations), 2) normative (i.e., university education, professional codes of conduct and other applicable professional membership requirements) and 3) mimetic (i.e., industry associations membership and external ties). Our selection of France and Canada to test the mediating effect of market enforcement on the relation between external and internal governance mechanisms rests on the premise that these two countries offer a contrasting picture in terms of institutional environments and in terms of the pressures that ensue. We now review each source of institutional pressure within each country.

Legal Regime and Regulatory Emphasis

Prior research suggests that a country's legal origins essentially determine the laws and regulations it enacts as well as the extent of the protection it offers investors (La Porta et al., 2008; La Porta et al., 2000). In this regard, France is defined as a code law country that offers weaker investor protection than Canada, which is considered to be a common law country (e.g., Djankov et al., 2008). An illustration of that difference is the level of resources devoted to securities regulation in each country as well as its relative emphasis. In Canada, provincial securities regulators, otherwise known as Securities Commissions (e.g., Ontario Securities Commission) or, in Québec, as *Autorité des marchés financiers*, are responsible for enacting financial reporting standards, compliance monitoring and enforcement. Based upon their 2013-2014 financial statements, we can infer that the overall budget of Canada's provincial securities regulators devoted to the

pursuit of their mission is around \$300 million in 2014 (UNCTAD, 2014). By contrast, the regulatory oversight of French securities markets is more centralized. There are two national regulators, the *Autorité des marchés financiers* and *L'autorité de contrôle prudentiel et de résolution*. In 2014, their respective budgets, based upon their financial statements, were € 87 319 377 and € 184 600 000, equivalent to around \$400 million once converted into \$ Canadian, for a France/Canada spending ratio of 1.33 (according to the Bank of Canada, the average exchange rate for 2014 was about \$1.50 for each euro). However, France's Gross Domestic Product (GDP) is actually 60% larger than Canada's while its population is almost double (World Bank data at <https://data.worldbank.org/>).

The oversight of audit practice is another illustration of the contrast between France (code law) and Canada (common law). In France, the audit profession is overseen by the Haut Conseil du Commissariat aux comptes, a legal entity which powers emanate from the State and which actually includes several judges on its governing body. In Canada, the Canadian Public Accountability Board (CPAB) is a private sector entity which governing body includes the chairs of Canada's largest provincial securities regulators as well as the regulator for Canadian financial institutions (Superintendent of Financial Institutions). The governing body then appoints CPAB's board of directors which essentially comprises former practicing auditors as well as some former regulators. The CPAB evaluates audit quality by an inspection of the higher-risk clients of each audit firm, with Big 4 audit firms being the focus on attention as a result of their dominance of the market for listed firms' auditing.

Professional Context

France and Canada cannot be more different in terms of professional context. A revealing illustration is the relative reach and influence of the accounting profession in each country. In Canada, the accounting profession is unified under the acronym of Chartered Professional Accountants (CPA) and comprises more than 210,000 members (CPA Canada 2017 Annual Report). To become a CPA, one must follow a specific university education path, pass professional qualification exams and have supervised practice experience. To retain their designation, CPAs must abide by a code of professional ethics and meet professional development (or continuing education) benchmarks. In each province, a professional trustee ensures that CPAs respect the code of ethics and engage proceedings against CPAs who failed to do so. CPAs who are engaged in public practice (otherwise called “auditors”), of which there are approximately 60,000, are subject to higher educational and ethical standards. Since CPA are members of a recognized profession, they are subject to public scrutiny as their professional associations (provincial Institute or Ordre) are granted powers by the state for the protection of the public. With such a large membership, CPAs reach and influence all spheres of Canadian business, especially with respect to financial governance.

By contrast, France has two accounting professional bodies. The Ordre national des experts-comptables (literally, professional accountants) counts 20,000 members, who supervise 130,000 employees (Ordre national des experts-comptables key figures; <http://www.experts-comptables.fr/lordre-et-ses-entites/linstitution/chiffres-cles/chiffres-cles---128>). The Compagnie nationale des commissaires aux comptes (essentially, the National Association of Legal Auditors) counts less than 14,000 individual members

(plus some legal entity members). Both Expert-comptables and Commissaires aux comptes are subject to various educational, qualification and ethical requirements that ensure that they are competent to exercise their tasks and act in the public interest. For instance, commissaires aux comptes (legal auditors), swear of oath of allegiance to the Court of Appeal. However, what is striking when comparing the status of the accounting profession between both countries is its relatively limited reach and influence in France versus Canada. Hence, in Canada, most individuals acting as CFO, controllers or internal auditors or chairs of audit committees of a large proportion of listed firms are likely to be CPAs, as are large numbers of financial analysts, regulators, bankers and other company executives. All these individuals are subject and bound by the same code of professional ethics. Hence, professional pressures are likely to be far-reaching within financial markets. By contrast, in France, the relatively small number of professional accountants limits their institutional power and their ability to initiate or exert pressures beyond individuals who are active in the legal audit sector. In fact, in contrast to Canada, the illegal practice of accounting is current in France (Blum, 2015).

Another potential source of professional pressures arises from the emergence of the CFA® (Chartered Financial Analyst) designation as a signal of financial analysis/portfolio management acumen around the world. While not a recognized profession in most countries, the CFA has all its trappings such as a formal education program, qualifying exams, a code of professional ethics, continuing education requirements and expulsion in cases of misconduct. Moreover, CFAs have been shown to have a positive impact on the efficiency of financial markets (De Franco and Zhou, 2009). Hence, one can argue that the reach and influence of CFAs within a country do

represent institutional pressures that feed isomorphism. In this regard, Canada and France offer yet again contrasting perspectives. Canada represents around 10% of newly inducted CFAs worldwide while France's share is less than 2%, despite a population that is almost twice as large and a stock market capitalization that is comparable to Canada (CFA Institute). Moreover, 65% of current CFAs reside in North America (around 15% in Canada) and only 16% in Europe, which implies that Canada probably counts as many CFAs as all of European countries together.

Industry Contexts

A third source of institutional pressures emanates from industry and international ties. Both France and Canada count several industry-based lobby groups, at the industry level (e.g., Canadian Bankers Association or Fédération bancaire française) or across industries (e.g., boards of trade in Canada, Mouvement des entreprises de France, or MEDEF, in France). Union membership is much larger in Canada than in France, mostly because Canadian laws force employees to pay union dues (and employers to collect) if a union is certified within an organization (vs. France). Hence, it is difficult to judge if industry-led pressures differ significantly between Canada and France.

However, in terms of international ties, Canada is clearly less diversified than France, thus implying that the national level of isomorphism must be higher in Canada. Canadian exports totalled around \$402.4 billion, or around 20% of GDP, in 2015. 76.7% of these exports were to the United States (CIA, 2016). Imports represented \$419 billion, with 53.1% originating from the United States, 12.2% from China and 5.8% from Mexico (CIA, 2016). By contrast, France exported \$505.4 billion of goods in 2015, with its main

exports partners being Germany (15.9%), Spain (7.3%), the US (7.2%), Italy (7.1%), the UK (7.1%), and Belgium (6.8%) (CIA, 2016). For the same year, imports totalled \$525.4 billion, with import partners being Germany (19.5%), Belgium (10.7%), Italy (7.7%), the Netherlands (7.5%), Spain (6.8%), the US (5.5%), China (5.4%) and the UK (4.3%) (CIA, 2016).

In light of the above arguments, we thus propose our second hypothesis:

Hypothesis 2:

We expect less sanctions (ex post enforcement) and more market enforcement (ex ante enforcement) to arise in Canada than in France.

More market enforcement (sanctions) enhances (mitigates) its mediating role between external and internal corporate governance.

Method

Sample

The sample comprises firms for years 2012 to 2014. Canadian sample firms are members of the S&P/TSX stock market index (239 firms) while French sample firms are members of the SBF120 stock market index. The data is collected from ESG Bloomberg database. The ESG Bloomberg database relies on different sources: Annual reports, sustainability reports, press releases, direct communication with companies, including meetings, phone interviews, email exchanges and survey responses. Bloomberg ESG Disclosure Scores rate companies based on their disclosure of quantitative and policy-related ESG data. Bloomberg covers more than 11,300 companies with ESG data and more than 16,000 companies with executive compensation data in 69 countries.

Model

We conduct path analyses to test the following relationships.

$$(1) \quad \text{Internal CG} = \text{External CG} + \text{Market Enforcement}$$

To operationalize market enforcement, we have chosen two measures. First, we consider that market enforcement translates into a lower frequency of abnormal returns. Hence, our first measure of market enforcement is the inverse of abnormal returns ($1/\text{Abnormal return}$). Second, we also consider that market enforcement translates into less price volatility. Therefore, our second measure is the inverse of price volatility ($1/\text{Price volatility}$). Therefore, in both cases, the higher the level of price volatility or abnormal return, the lower the measure of market enforcement. To validate our measurement of enforcement, we compare our calculated firm-level measure with the country level measure of the Worldwide Governance Indicators (WGI).

The Worldwide Governance Indicators (WGI) is a research dataset summarizing the scores of six broad dimensions of external corporate governance mechanisms: (1) Voice and Accountability reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media; (2) Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism; (3) Government Effectiveness reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies; (4) Regulatory Quality reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development; (5) Rule of Law reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract

enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence; (6) Control of Corruption reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. Thereafter, observations of main processes that make formal and informal constraints effective at country level are summarized. Hence, WGI constitutes a valuable measure of country level enforcement. Comparing Canada and France in 2015, upper bound of 90% confidence interval for governance in percentile rank terms, Table 1 shows that there is more enforcement in Canada than in France.

[Insert Table 1]

External Corporate Governance is measured as the country's legal origin (Canada: common law; France: code law), the extent of a country's market for corporate control, and media exposure. Aguilera et al. (2015) identify six external governance mechanisms: legal system, corporate control, external auditors, governance ratings, stakeholder activism, and media. We test the effect of three of them, legal system, market for corporate control and media exposure. Legal origin is a dummy variable taking the value 1 for the French civil code legal origin and 0 for the common law legal origin. Media exposure is the pressure on the company from the media. It is observed through the number of published articles concerning the company. Data is collected from ABIinform/ProQuest. Market for corporate control represents the mergers and acquisitions pressures felt by the company. It is measured by the percentage of mergers and acquisitions in the industry in which the company operates in relation to the total mergers and acquisitions in a year. Data on mergers and acquisitions are collected from

FP Infomart for Canada and Bloomberg database for France. Internal Corporate Governance is measured by the Governance Quality (ESG Bloomberg).

The second equation concerns the determinants of market enforcement.

$$(2) \quad \text{Market enforcement} = \text{External CG}$$

To test our hypotheses, regression models are estimated and used in path analyses.

Beta coefficients are used to further test mediating effects presented in path analyses.

Results

Descriptive statistics

Descriptive results presented in Table 2 show that our two measures of market enforcement (i.e., inverse of abnormal returns in absolute value; inverse of price volatility), are lower in France than in Canada. Consistent with Hypothesis 2, this suggests that formal and informal constraints, such as codes of conduct, norms of behavior and conventions, are less restrictive in France than in Canada (Mean score of Enforcement of 11.79 and 0.040 in Canada versus 7.90 and 0.037 in France). Both country-level measures of enforcement, i.e. the absolute value of the inverse term of abnormal return and by the inverse term of price volatility, go in the same sense as the country-level measure shown in table 1. Results suggest that there is less enforcement of legal and informal constraints in France than in Canada. Weak institutional constraints could be associated with less contracts specification, which worsens the agency problem (Williamson, 1996). Together with a weaker enforcement of legal and informal constraints, this could lead to greater corruption, larger unofficial economy, and higher

unemployment. Hence, results go in the same direction as those of La Porta et al. (2008) who show that civil law is associated with greater corruption, larger unofficial economy, and higher unemployment which have adverse impacts on markets, while common law is associated with lower formalism of judicial procedures which indicates better contract enforcement.

As for other external governance mechanisms, we observe more mergers and acquisitions in France than in Canada (mean of 0.159 versus 0.087) and more media exposition (mean of 146 articles in France versus 101 articles in Canada). Hence, in France, we expect external and internal corporate governance mechanisms to compensate for the weaknesses of enforcement.

[Insert Table 2]

Path Analyses

Consistent with hypothesis 1, our results (Figures 1a and 1b) show that, except for legal origin (code law), the effect of external corporate governance mechanisms on internal corporate governance mechanisms is higher when enforcement is incorporated as a mediating variable. Thus, it means that external corporate governance mechanisms such as the extent of mergers and acquisitions (correlation = 0.361, $p < 0.01$; 0.056, $p < 0.05$), code law country (correlation = -0.054; $p < 0.01$; -0.044, $p < 0.05$) and media exposure (correlation = 0.068; $p < 0.10$; 0.092, $p < 0.01$) contribute to market enforcement (as measured by the inverse of abnormal return in absolute value and the inverse of price volatility). Results show a positive indirect effect of market enforcement on the relation

between external and internal governance, except for legal origin. For France (code law country), we observe a negative indirect effect.

[Insert Figures 1a and 1b]

Moreover, external corporate governance mechanisms enhance internal corporate governance mechanisms, as captured by the Bloomberg measure (extent of mergers and acquisitions with a correlation of 0.034, $p < 0.10$; code law country with a correlation of 0.322; $p < 0.01$ and media exposure with correlation of 0.179; $p < 0.01$). Finally, the total effect of external governance on internal governance through enforcement is observed: Extent of mergers and acquisitions (0.062); Legal origin (0.318), and Media exposure (0.184).

Our results are in line with the view that internal governance mechanisms may emerge in answer to poor external mechanisms (Aguilera et al., 2015; Cremers and Nair, 2005; Weir et al., 2002). However, the strength of their complementarity could vary (Cremers and Nair, 2005) depending on the level of enforcement.

In addition, our results presented in Figures 2a,b and 3a.b show that the relationship between internal and external corporate mechanisms, mediated by market enforcement, is stronger in France than in Canada (Total effect of mergers and acquisitions of 0.097 and 0.083 in France versus 0.025 and 0.012 in Canada; and to a lesser extent for total effect of Media exposure of 0.279 and 0.297 in France versus 0.232 and 0.238 in Canada). This is most likely an outcome of the larger direct effect of French external corporate mechanisms on internal corporate governance mechanisms, which is induced by lower market enforcement.

[Insert Figures 2a and 2b] [Insert Figures 3a and 3B]

Complementary path analyses

So far, our analyses focus on the mediating effect of market enforcement on the relation between external and internal governance. However, as these relations are likely to be multi-dimensional, it is likely that internal governance mediates the relation between external governance and market enforcement. Concerning the indirect mediating effect of internal governance on market enforcement, untabulated results (when market enforcement measure = $\text{abs } 1/\text{Abnormal return}$) are quite significant for the mediation through Legal Regime (code law) (0.025) and to a lesser extent for Media exposure (0.014). This suggests that internal governance enhances market enforcement, especially in a code law country where the negative impact of code law legal origin is more than compensated by a firm's internal governance. In France, media exposure through internal governance affects positively market enforcement (indirect effect of 0.021). In Canada, it is market for control (M&A) that affects positively market enforcement (indirect effect of 0.025).

Validation of enforcement in France

Market reaction to sanctions

In Canada, there are very few sanctions imposed to listed firms. However, in France, from 2010 to 2015, we collect data about 32 sanctions listed firms for a lack of conformity to diverse issues: financial statement misreporting, insider trading, continuous disclosure, etc. This fact corroborates our findings of more effective and strong enforcement in Canada, which manifests itself by greater emphasis on monitoring and compliance ex-ante rather than ex-post actions,

Abnormal returns are calculated as the difference between real stock price return and expected stock price (CAPM) for a 10 days window around the sanction announcement. Focusing on firms with negative abnormal returns², results presented in table 3 show that the loss of stock market value implied by the negative abnormal return significantly exceeds the impact of French sanctions on the stock price. Hence, abnormal returns are 2.5 times higher than the impact of sanctions on the stock price (-7.2% vs. -2.8%). Therefore, formal sanction costs count for around 38% ($2.8\%/7.2\%$) of the economic cost borne by firms as a result of sanctions. Table 3 provides the results for this analysis.

[Insert Table 3]

Discussion and Conclusion

Our study compares France and Canada in terms of the nature of the relations between external corporate governance mechanisms, market enforcement and internal corporate governance mechanisms. We argue that because of institutional pressures, ex ante market enforcement is likely to be stronger in Canada than in France. By contrast, France is more likely to rely on ex post enforcement in the form of sanctions. Such between country differences are likely to affect the nature of the mediating effect of market enforcement between internal and external corporate governance mechanisms. We find that the effect of external corporate governance mechanisms on internal corporate governance mechanisms is mediated by market enforcement. Moreover, consistent with expectations, we find that market enforcement is stronger in Canada than

² Eight firms, mostly banks, exhibit large positive abnormal returns surrounding the sanction date.

in France while sanctions-based enforcement is prevalent in France but almost absent in Canada. The net outcome is that the mediating effect of market enforcement is stronger in Canada than in France. Our results are consistent with La Porta studies showing that when external corporate governance mechanisms (legal origins) are stronger, there is a greater likelihood that ex ante enforcement, such as market-based, will take place.

This article explores the link between the enforcement of external governance mechanisms and the internal corporate governance. We believe that this field of research is largely neglected by empirical research. Future empirical research on external governance mechanisms could take into consideration that their effect may vary depending on the effectiveness of enforcement. Future research may also specify the degree of enforcement of each type of external governance mechanism in different institutional contexts.

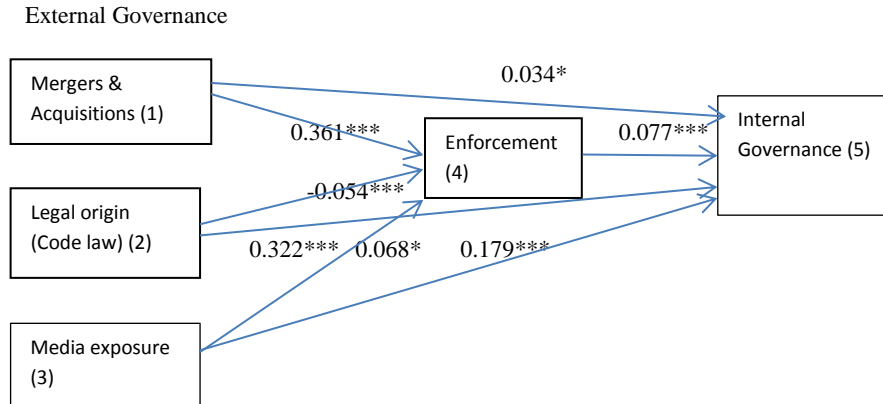
References

- Aguilera, R.V., Desender, K., Bednar, M.K., Lee, J.H. (2015). Connecting the Dots – Bringing External Corporate Governance into the Corporate Governance Puzzle. *The Academy of Management Annals*, 1-93. doi: 10.1080/19416520.2015.1024503
- Aoki, M. (2006). *Fondements d'une analyse institutionnelle comparée*. Albin Michel.\
- Armstrong, C. S., Guay, W.R. and Weber, J.P. (2010). The Role of Information and Financial Reporting in Corporate Governance and Debt Contracting. *Journal of Accounting and Economics* 50 (2–3): 179–234.
- Bank, T.W. (2017). *Worldwide Governance Indicators* : The World Bank.
<http://databank.worldbank.org/data/reports.aspx?source=worldwide-governance-indicators>
- Blum, B. (2015). *L'innovation comme levier de la performance durable dans la profession comptable libérale en France*. Paris, CNAM.
- Bonetti, P., Magnan, M. & Parbonetti, A. (2016). The Influence of Country-and Firm-level Governance on Financial Reporting Quality: Revisiting the Evidence. *Journal of Business Finance & Accounting*, 43(9-10), 1059-1094.
- Brickley, J. A., & Zimmerman, J. L. (2010). Corporate governance myths: comments on Armstrong, Guay, and Weber. *Journal of Accounting and Economics*, 50(2), 235-245.
- CIA. (2016). *The world factbook* www.cia.gov.
- Cremers, K., Nair, V.B. (2005). Governance mechanisms and equity prices. *The Journal of Finance*, 60(6), 2859-2894.
- De Franco, G., & Zhou, Y. (2009). The performance of analysts with a CFA® designation: The role of human-capital and signaling theories. *The Accounting Review*, 84(2), 383-404.
- Djankov, S., La Porta, R., Lopez-de-Silanes, F., & Shleifer, A. (2008). The law and economics of self-dealing. *Journal of financial economics*, 88(3), 430-465.
- FEUQ, F.é.u.d.Q. (2014). *Recherche sur les ordres professionnels et les bureaux d'agrément au Québec* : Montréal, Québec: Fédération étudiante universitaire du Québec.
- Filatotchev, I., Jackson, G., Nakajima, C. (2013). Corporate governance and national institutions: A review and emerging research agenda. *Asia Pacific Journal of Management*, 30(4), 965-986.
- Filip, A., Labelle, R., Rousseau, S. (2015). Legal regime and financial reporting quality. *Contemporary Accounting Research*, 32(1), 280-307.

- Jensen, M.C., Meckling, W.H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of financial economics*, 3(4), 305-360.
- Klein, B., Crawford, R.G., Alchian, A.A. (1978). Vertical integration, appropriable rents, and the competitive contracting process. *The journal of Law and Economics*, 21(2), 297-326.
- La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. 2000. "Investor Protection and Corporate Governance." *Journal of Financial Economics* 58 (1-2) (January): 3–27.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A. (2008). *The economic consequences of legal origins*. National Bureau of Economic Research.
- Misangyi, V.F., Acharya, A.G. (2014). Substitutes or complements? A configurational examination of corporate governance mechanisms. *Academy of Management Journal*, 57(6), 1681-1705.
- North, D. (2010). *Understanding the Process of Economic Change*. Princeton University Press.
- North, D.C. (1990). *Institutions, institutional change and economic performance*. Cambridge university press.
- Scott, W.R. (1995). *Institutions and organizations*. (Vol. 2). Sage Thousand Oaks, CA.
- UNCTAD. (2014). *Case study: Canada*. (Vol. 2014). UN.
- Weir, C., Laing, D., McKnight, P.J. (2002). Internal and external governance mechanisms: their impact on the performance of large UK public companies. *Journal of Business Finance & Accounting*, 29(5-6), 579-611.
- Williamson, O., Masten, S. (1999). *The economics of transaction costs*. : Edward Elgar Publishing.
- Williamson, O.E. (1979). Transaction-cost economics: the governance of contractual relations. *The journal of Law and Economics*, 22(2), 233-261.
- Williamson, O.E. (1996). *The mechanisms of governance*. Oxford University Press.

Figure 1a

Path Analyses on the Mediating Effect of Enforcement (abs 1/Abnormal return) on the Relation between External Governance and Internal Governance (beta coefficients)



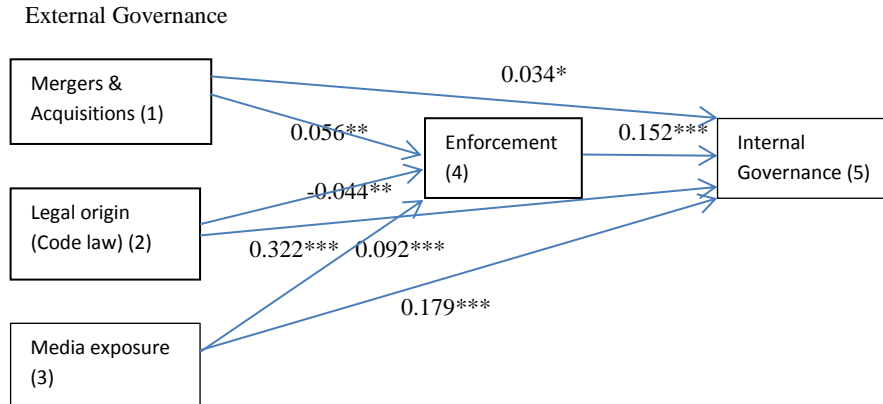
Total effect of external governance on internal governance through enforcement

Total effect Indirect effect

- (1) (5) = 0.034 + 0.361*0.077 = 0.062 through enforcement: 0.361*.077= 0.029
- (2) (5) = 0.322 + -0.054*0.077 = 0.318 through enforcement: -0.054*0.077= -0.004
- (3) (5) = 0.179 + 0.068*0.077 = 0.184 through enforcement : 0.068*0.077= 0.005

Figure 1b

Path Analyses on the Mediating Effect of Enforcement (1/Price volatility) on the Relation between External Governance and Internal Governance (beta coefficients)



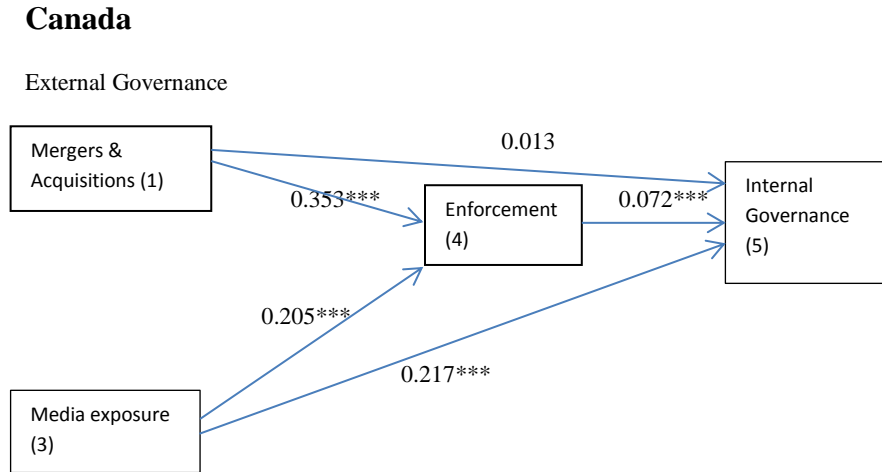
Total effect of external governance on internal governance through enforcement

Total effect Indirect effect

- (1) (5) = 0.034 + 0.056*0.152 = 0.035 through enforcement: 0.056*0.152= 0.009
- (2) (5) = 0.322 + -0.044*0.152 = 0.315 through enforcement: -0.044*0.152= -0.007
- (3) (5) = 0.179 + 0.092*0.152 = 0.193 through enforcement : 0.092*0.152= 0.014

Figure 2a

Path Analyses on the Mediating Effect of Enforcement (abs 1/Abnormal return) on the Relation between External Governance and Internal Governance – Canada (beta coefficients)

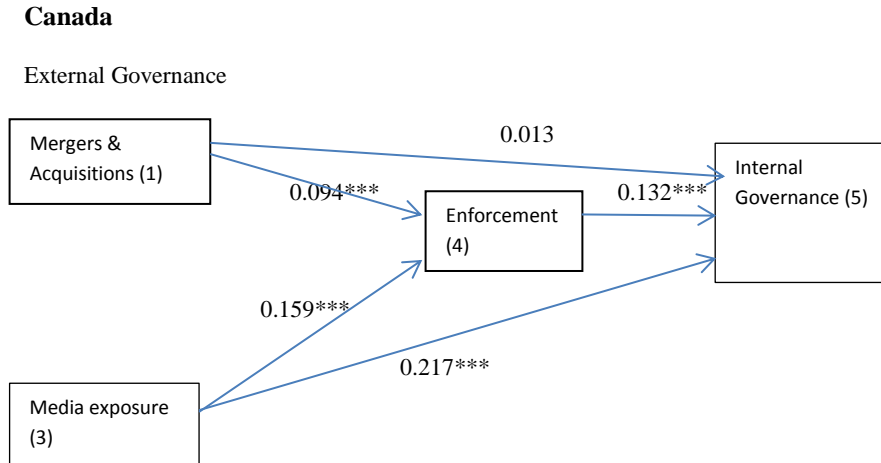


Total effect of external governance on internal governance through enforcement

	<i>Total effect</i>	<i>Indirect effect</i>
(1) (5) = $0.353 \times 0.072 = 0.025$		through enforcement: $0.353 \times 0.072 = 0.025$
(3)(5) = $0.217 + 0.205 \times 0.072 = 0.232$		through enforcement: $0.205 \times 0.072 = 0.015$

Figure 2b

Path Analyses on the Mediating Effect of Enforcement (1/Price volatility) on the Relation between External Governance and Internal Governance – Canada (beta coefficients)



Total effect of external governance on internal governance through enforcement

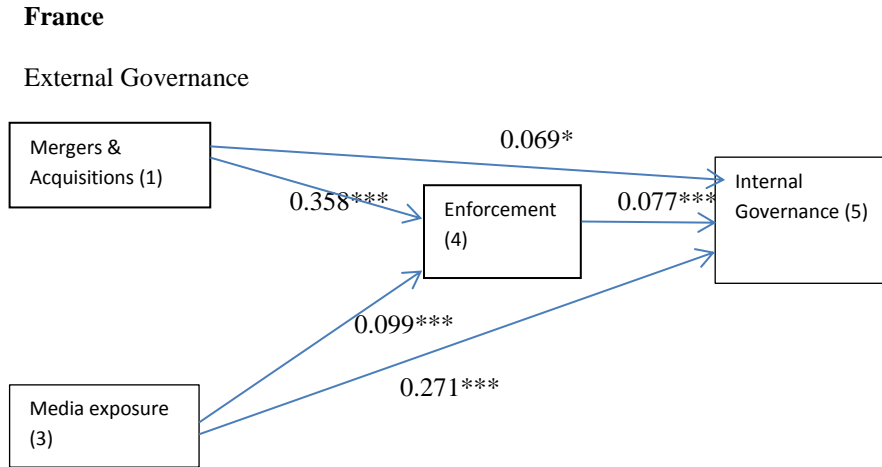
Total effect *Indirect effect*

(1)(5) = 0.094*0.132 = 0.012 through enforcement: 0.094*0.132= 0.012

(3)(5) = 0.217 + 0.159*0.132 = 0.238 through enforcement: 0.159*0.132= 0.081

Figure 3a

Path Analyses on the Mediating Effect of Enforcement (abs 1/Abnormal return) on the Relation between External Governance and Internal Governance – France (beta coefficients)



Total effect of external governance on internal governance through enforcement

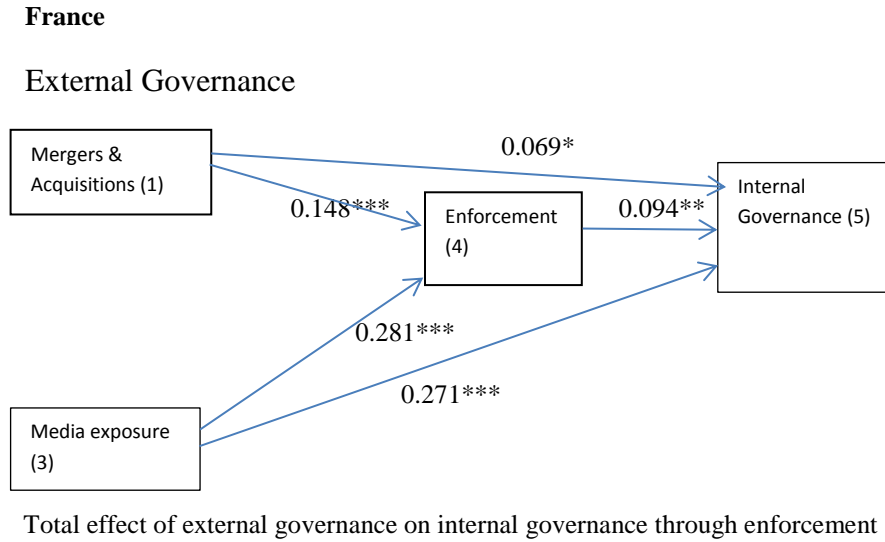
Total effect Indirect effect

(1)(5) = 0.069 + 0.358*0.077 = 0.097 through enforcement: 0.358*0.077= 0.028

(3)(5) = 0.217 + 0.099*0.077 = 0.279 through enforcement: 0.099*0.077= 0.008

Figure 3b

Path Analyses on the Mediating Effect of Enforcement (1/Price volatility) on the Relation between External Governance and Internal Governance – France (beta coefficients)



Total effect Indirect effect

(1)(5) = 0.069 + 0.148*0.094 = 0.083 through enforcement: 0.148*0.094= 0.014

(3)(5) = 0.271 + 0.281*0.094 = 0.297 through enforcement: 0.281*0.094= 0.026

Table 1
Enforcement at country-level

	Canada	France
Voice and Accountability	99,51	95,1
Political Stability and Absence of Violence/Terrorism	99,53	64,93
Government Effectiveness	99,52	96,17
Regulatory Quality	99,04	91,87
Rule of Law	100	90,43
Control of Corruption	96,17	90,43
Mean Score	98,96	88,16

Source: Worldwide Governance Indicators (WGI)

Table 2
Descriptive statistics

	Canada	France	Difference
	Mean	Mean	p-value
Internal governance (ESG Bloomberg)	53.75	58.37	0.000
Enforcement (Abs 1/Abnormal return)	11.796	7.903	0.023
Enforcement (1/Price volatility)	0.040	0.037	0.017
External governance			
-Legal origin (Code law)	0	1	0.000
-Market for corporate control (mergers and acquisitions - in % by industry)	0.087	0.159	0.000
-Media Exposure (mean # articles in the press)	100.91	146.24	0.011

Table 3
Stock market return around French AMF sanctions (-/+ 10 days around the announcement of the sanction) versus overall market return

	All firms		Firms with negative return	
	Mean	Median	Mean	Median
Firms with sanctions				
Sanctions/Share/Price	-0.026	-0.003	-0.028	-0.002
Return	-0.017	-0.014	-0.090	-0.049
Abnormal Return	-0.007	-0.012	-0.072	-0.042
P value Sanctions/Share/Price vs. Abnormal Return	0.20	Chi2 0.38	0.029	Chi2 0.36
	N=26		N=18	
Firms with no sanctions				
Return SBF250	-0.002	0.005	-0.014	-0.018