

**Legal Regime, Investor Protection, Governance and
Enforcement:
A Comparison of France and Canada**

Denis Cormier
ESG UQAM

Luania Gomez Gutierrez
ESG UQAM

Michel Magnan
Concordia University

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Abstract

This study investigates whether and how enforcement mediates the relationship between external corporate governance mechanisms and internal corporate governance. We measure enforcement at firm-level and determine its effect on corporate governance. Our results suggest that the enforcement of external governance mechanisms is an important and often overlooked element in understanding the internal corporate governance configurations. The complementarity of internal governance to external governance mechanisms depends on the strength and the direction of the enforcement.

Key words: Corporate governance, enforcement, legal regime.

**Régime juridique, protection des investisseurs, gouvernance et application
de la loi: une comparaison de la France et du Canada**

Résumé

Cette étude examine si et comment l'application de la loi sert à la médiation entre les mécanismes externes de gouvernance et la gouvernance interne. Nous mesurons l'application de la loi au niveau de la firme et déterminons leur effet sur la gouvernance interne. Nos résultats suggèrent que l'application des mécanismes de gouvernance externe est un élément important et souvent négligé dans la compréhension des configurations internes de gouvernance d'entreprise. La complémentarité de la gouvernance interne aux mécanismes de gouvernance externe dépend de la force et de la direction de l'application de la loi.

Mots clés : Application de la loi, gouvernance, régime juridique.

Introduction

Over the past two decades, since the seminal work of La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1998), there has been a growing interest in analyzing how a country's legal and regulatory regime maps into the corporate governance, disclosure and earnings quality practices of its firms. The argument put forward by La Porta et al. (1998) rests on the premise that some country-level legal and regulatory frameworks (e.g., common law versus code law) better protect investors and thus allow the development of more efficient capital markets. Since La Porta et al. (1998), studies concerning enforcement mechanisms generally assumed that a more strong legal system is automatically an evidence of higher enforcement.

However, legal regime is not the only external corporate governance mechanism. Aguilera et al. (2015) identifies six external corporate governance mechanisms: the legal system; the market for control; external auditors; stakeholder activists; rating organizations; and the media. External corporate governance mechanisms are those for which the locus of action emanates from outside the boundaries of the firm (Aguilera et al., 2015). Based on institutional theory, we propose a deeper analysis of enforcement and its relationship with governance mechanisms. From the institutional perspective, the constraints of these mechanisms come from formal and informal rules and from their

enforcement (North, 1990). Formal rules can be observed through legal regime, as demonstrated by La Porta et al. (1998) and the effect of all formal and informal rules by the market's reaction.

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, there is no firm-level measure of perceived enforcement and no study about the consequences of this perceived enforcement.

To investigate this issue, we calculate a firm level enforcement measure and determine its effect on corporate governance. Previous studies like Aguilera et al. (2015), Cremers and Nair (2005), and Weir et al. (2002) show that internal and external corporate governance mechanisms are complements and that this complementarity could variate. In the current paper, we provide some evidence on how enforcement explains this variability. Specifically, this study determines whether and how enforcement mediates the relationship between external corporate governance mechanisms and internal corporate governance. Previous studies like Aguilera et al. (2015), Cremers and Nair (2005) and Weir et al. (2002) show that internal and external corporate governance mechanisms are complements and that this complementarity could variate. In this paper, we show how enforcement explains this variability.

We find that the effect of external corporate governance mechanisms on internal corporate governance mechanisms is mediated by the level of

enforcement. Descriptive statistics show that enforcement is stronger in Canada than in France. It appears that French regulators are much more active than Canadian regulators in imposing sanctions on publicly-traded firms and their managers. Possible causes for such a contrast are then discussed, one of them being that Canadian regulators spend more resources on monitoring and compliance relative to French regulators, thus reducing the need for enforcement actions.

An alternative explanation is that, as enforcement comprises formal and informal institutional pressures, the effect of these pressures could be opposed. Thus, the enforcement of formal pressures helps to improve the effectiveness of internal governance, while the enforcement of informal pressures encompasses social demands. The social demands opposed to formal rules could exceed formal rules, like more transparency, or to transgressing formal rules, like a redistribution of firm benefits in ways less favorable to shareholders.

It appears that French regulators are much more active than Canadian regulators in imposing sanctions on publicly-traded firms and their managers. Possible causes for such a contrast are then discussed, one of them being that Canadian regulators probably spend more resources on monitoring and compliance relative to French regulators, thus reducing the need for enforcement actions. An alternative explanation, which has

been put forward by some, is that code law translates into more rigorous enforcement.

Our results suggest that the enforcement of external governance mechanisms is an important and often overlooked element in understanding the internal corporate governance configurations. The complementarity of internal governance mechanisms to external governance mechanisms depends on the strength and the direction of the enforcement.

Background and the hypothesis

As governance is a set of institutions (Aoki, 2006; Williamson, 1996), we draw on institutional theory. Institutions operate at institutional environment level such as external corporate governance mechanisms and at firm level such as internal corporate governance mechanisms. The second one is constrained by the first one and, contrary to external corporate governance mechanisms, it operate at the level of individual transactions (Williamson, 1996).

Filip et al. (2015) noticed 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 call for more research to better

understand this issue. They propose that internal corporate governance outcomes may differ depending on the legal system and other institutional characteristics in a specific country. Specifically, authors maintain that institutions affect the extent of complementarity/substitution among different firm-level governance practices producing patterned variations in firm-level governance mechanisms. They call for more holistic research of governance practices from an institutional perspective because the comparative understanding of institutions has so far remained poor.

Effect of enforcement in corporate governance mechanisms

Corporate governance mechanisms can be split into internal and external corporate governance mechanisms (Aguilera et al., 2015; Weir et al., 2002). Internal mechanisms concern the duality and the proportion of non-executive directors, debt financing and executive director shareholdings (Weir et al., 2002). Aguilera et al. (2015) identifies six external governance mechanisms: legal system, corporate control, external auditors, governance ratings, stakeholder activism, and media.

Previous work neglected the role that external corporate governance practices play in preventing managers from engaging in misconduct activities (Aguilera et al., 2015). Through a literature review, Aguilera et al. (2015) conclude that external corporate governance mechanisms indirectly help internal corporate governance mechanisms become 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. But, not much is known about how and why internal and external corporate governance mechanisms work together as a governance bundle.

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 supposing to better protect investor's rights. This could be explained by the omission of a variable: enforcement.

Enforcement is the process that makes formal and informal constraints effective (North, 1990). Therefore, we argue that enforcement mediates the relationship between external and internal corporate governance mechanisms. The more the external corporate mechanisms are effective, the less enforcement is needed for their internalisation by firms. The more the external corporate mechanisms are enforced, the more they

help internal corporate governance mechanisms become 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 hypothesis:



Hypothesis: Enforcement mediates the relationship between external and internal corporate governance mechanisms.

Institutional environments

Country level institutions are coercive, i.e. state laws and regulations; normative, namely universities education, professional codes of conduct and other applicable professional membership requirements; and mimetic, mostly industry associations membership and external ties (Scott, 1995). State laws and regulations are determined by legal origin (La Porta et al., 2008). We choose France and Canada to represent each legal origin, civil law and common law respectively. In both countries accounting practices are based on IFRS.

Recently, accounting universities education has undergone changes in both countries. In Canada the teaching of accounting in universities is adapted to the demands of accounting professional association (FEUQ, 2014). After the reunification of the three accounting orders into one, the academic institutions modified the courses offered to better meet the expectations of the new Canadian accounting order (FEUQ, 2014). While in France over the last few years, the texts framing the liberal accounting profession have been revised in depth (Blum, 2015). As in Canada, in France after obtaining the university degree, accountants must do a stage to become a member of an accounting order. In contrast with Canada, in France, illegal practice of accounting is current (Blum, 2015).

In France, the professional code of conduct plays a main role in accountant's behaviour. It asks for technical knowledge, integrity and impartiality. Accountants consider that their primary responsibility is to act in the public interest (Blum, 2015). Direct quality controls are applied by law to auditors, accountants and accounting firms just since 2012. In Canada, accountants are supervised by a professional inspection service, which oversees all members who are active in public accounting. Firms' disclosures and financial reporting standards are actively monitored and enforced by the Enforcement branch and the Office of the Chief Accountant. The Canadian Public Accountability Board evaluates audit quality by an inspection of the higher-risk clients of each firm. In case of violation events, audit firms are disciplined by a

requirement to take up education, a restriction, or the termination of the status of audit firm.

Canadian industries are transportation equipment, chemicals, processed and unprocessed minerals, food products, wood and paper products, fish products, petroleum, natural gas. 70.7% of gross domestic product come from service sector, 27.7% from industry and 1.6% from agriculture (CIA, 2016). Industry associations are highly organized and constitute the main pressure groups in the country (CIA, 2016). France industries are machinery, chemicals, automobiles, metallurgy, aircraft, electronics; textiles, food processing; tourism. 78.8% of gross domestic product comes from service sector, 19.4% from industry and 1.7% from agriculture (CIA, 2016). Industries are not as organised as in Canada. Principal pressure groups in France are labor associations (CIA, 2016).

Canada international ties are less diversified than France. This means that national level of isomorphism must be higher in Canada. Canadian exports count for \$402.4 billion, 76.7% are from United States. Principal exported commodities are motor vehicles and parts, industrial machinery, aircraft, telecommunications equipment, chemicals, plastics, fertilizers, wood pulp, timber, crude petroleum, natural gas, electricity, aluminum (CIA, 2016). Imports counts for \$419 billion. 53.1% of importations come from United States, 12.2% from China and 5.8% from Mexico. Principal imported commodities are machinery and equipment,

motor vehicles and parts, crude oil, chemicals, electricity, durable consumer goods (CIA, 2016).

In France economy, exports count for \$505.4 billion. Main exports partners are Germany 15.9%, Spain 7.3%, USA 7.2%, Italy 7.1%, UK 7.1%, and Belgium 6.8%. Principal exported commodities are machinery and transportation equipment, aircraft, plastics, chemicals, pharmaceutical products, iron and steel, and beverages (CIA, 2016).

Imports counts for \$525.4 billion. Main import partners are Germany 19.5%, Belgium 10.7%, Italy 7.7%, Netherlands 7.5%, Spain 6.8%, US 5.5%, China 5.4%, UK 4.3%. Principal imported commodities are machinery and equipment, vehicles, crude oil, aircraft, plastics, chemicals (CIA, 2016).

The level of resources devoted to securities regulation differs between the two countries. 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, the budgets of the four largest provincial regulators were \$97 000 000 for the Ontario Securities Commission; \$90 000 000 for the Autorité des marchés financiers; \$48 500 000 for the British Columbia Securities Commission; and \$35 500 000 for the Alberta Securities Commission.

Overall, regulators for Canadian securities markets spent about \$300 million in 2014 to pursue their mission (UNCTAD, 2014).

French securities regulators are 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.

Overall, French regulators for securities markets spent about \$400 million in 2014 to pursue their mission (according to the Bank of Canada, the average exchange rate for 2014 was \$CAD 467 millions).

Based on the World Bank data, in 2014 the Gross domestic product, GDP, of France was 1.59 times the Canadian one (\$ 2 839 162.44/\$ 1 783 775.59 million). Thus, in relative terms Canada allows 1.19 times more resources devoted to securities regulation than France.

Furthermore, in 2014, the Canadian market capitalization corresponded to 117.5% of their GDP while the French one corresponds to 73.5%.

Overall, we can conclude that Canada invest more funds in market enforcement than France in proportion of GDP and market capitalization.

Jensen and Meckling (1976) show the need of governance mechanisms to minimize agency costs. One of them is control. Control is exerted by internal or external governance mechanisms (Aguilera et al., 2015).

External corporate governance mechanisms refer to institutional context of the firm. Institutions are social constraints to rationalise human

exchanges for reducing their resulting uncertainty (North, 1990).

Institutions have three complementary dimensions: formal rules, informal constraints, and their enforcement (Aoki, 2006; North, 1990).

By clarifying their 1998 paper, 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 more protective of outside investors than civil law and particularly French civil law countries; (3) and legal investor protection is a strong predictor of financial development. Legal origin is a style of social control of economic life (La Porta et al., 2008). There are two principal legal origins, common law and civil law. Common law seeks to support private market outcomes, whereas civil law seeks to support state-desired allocations (La Porta et al., 2008).

Same legal rules produce different outcomes because of informal constraints, that are codes of conduct, norms of behavior 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 mixes are weaker.

Consequently, the measurement of enforcement represents the inverse term of formal and informal institutional constrains. As formal and informal institutional constrains are reflected by the market price, enforcement could be appreciated through the inverse term of abnormal returns. This measure agrees with the North (1990)’s idea of using transaction costs to observe informal constraints. Transaction costs can be understood as the costs of contracting, such as the costs of wrong adaptation of contracts (Williamson, 1996). 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.

They summarise the observations of main process that make formal and informal constraints effective at country level. 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.

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)

Method*Sample*

Data computed for years 2012 to 2014 based on S&P/TSX stock market index (239 firms) for Canada and SBF120 stock market index for France. The data is collected from ESG Bloomberg database and computed by based 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. The aim is to assess the firm's management and performance on each issue, i.e. assigning score.

Model

We conduct path analyses to test the following relationships.

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

Internal CG is measured by Governance Quality (ESG Bloomberg).

Enforcement is calculated on a yearly basis as the absolute value of 1/abnormal returns based on Capital Asset Pricing Model.

Aguilera et al. (2015) identifies 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. 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 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.

(2) External CG = Market for corporate control + legal origin + media exposure

(3) Enforcement = Market for corporate control + legal origin + media exposure

To test our hypothesis, regression models are estimated and used in a path analysis. Beta coefficients are used to further test mediating effects presented in path analyses.

Results

Descriptive statistics

Descriptive results presented in Table 2 show that abnormal returns are higher in France than in Canada. This means 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 22.88 in Canada versus 7.90 in France). Results suggest that there is less enforcement of legal and informal constraints in France than in Canada. Weaker informal constraints could be associated with less contracts specification. Together with a weaker enforcement of legal

and informal constraints, it could cause greater corruption, larger unofficial economy, and higher unemployment.

Previous literature shows 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 (La Porta et al., 2008).

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 exposition to press Medias (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.

Table 2

Descriptive statistics

	Canada	France	
	Mean	Mean	P Value
Internal governance (ESG Bloomberg)	53.75	58.37	0.000
Enforcement (Abs 1/Abnormal return)	22.883	7.903	0.079
External governance			
-Legal origin (Code law)	0	1	0.000
-Mergers and acquisitions (% by industry)	0.087	0.159	0.000
-Media Exposure (mean # articles in the press)	100.91	146.24	0.011

Path Analyses

Our results show that the effect of external corporate governance mechanisms on internal corporate governance mechanisms is weaker when enforcement is incorporated as a mediating variable. As hypothesized, this shows the mediating effect of enforcement on these relationships. First, it means that external corporate governance mechanisms: extent of mergers and acquisitions (correlation = 0.361, $p < 0.01$); Code law country (correlation = -0.054; $p < 0.01$) and, Media exposure (correlation = 0.068; $p < 0.10$) contribute to enforcement.

Moreover, external corporate governance mechanisms enhance internal corporate governance mechanisms: extent of mergers and acquisitions (correlation = 0.034, $p < 0.10$); Code law country (correlation = 0.322; $p < 0.01$) and, Media exposure (correlation = 0.179; $p < 0.01$). Finally, the total effect of external governance on internal governance through enforcement is observed: Extent of mergers and acquisitions (0.021); Legal origin (0.324), and Media exposure (0.177).

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).

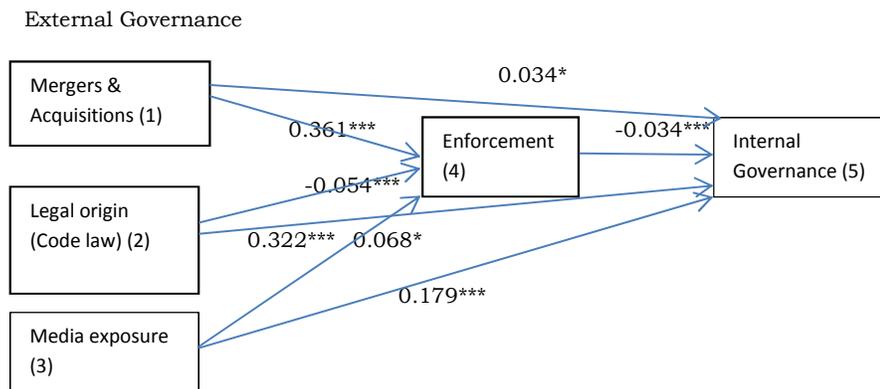
However, the strength of their complementarity could variate (Cremers et Nair, 2005). The analysis results show that it is the level of enforcement that varies. When external corporate governance mechanisms are

stronger, they exert more enforcement. In the presence of more enforcement, internal corporate governance mechanisms can deploy fewer resources to achieve a satisfactory level of effectiveness as suggested by the negative association between enforcement and internal governance (-0.034; $p < 0.01$).

In addition, our results presented in Figures 2 and 3 show that the relationship between internal and external corporate mechanisms, mediated by the enforcement, is stronger in France than in Canada (Total effect of mergers and acquisitions of 0.1123 in France versus -0.0289 in Canada; and total effect of Media exposure of 0.2829 in France versus 0.2002 in Canada).

Figure 1

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

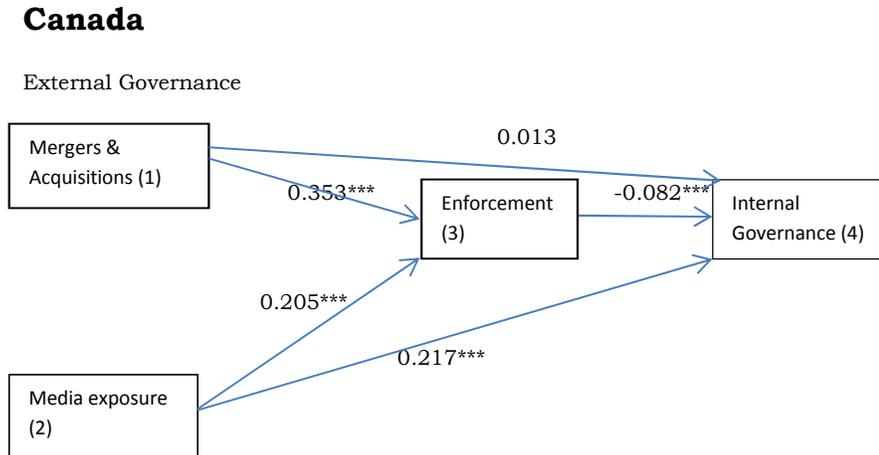


Total effect of external governance on internal governance through enforcement

- (1) and (5) = $0.034 + 0.361 \cdot -0.034 = 0.0212$
- (2) and (5) = $0.322 + -0.054 \cdot -0.034 = 0.3238$
- (3) and (5) = $0.179 + 0.068 \cdot -0.034 = 0.1766$

Figure 2

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



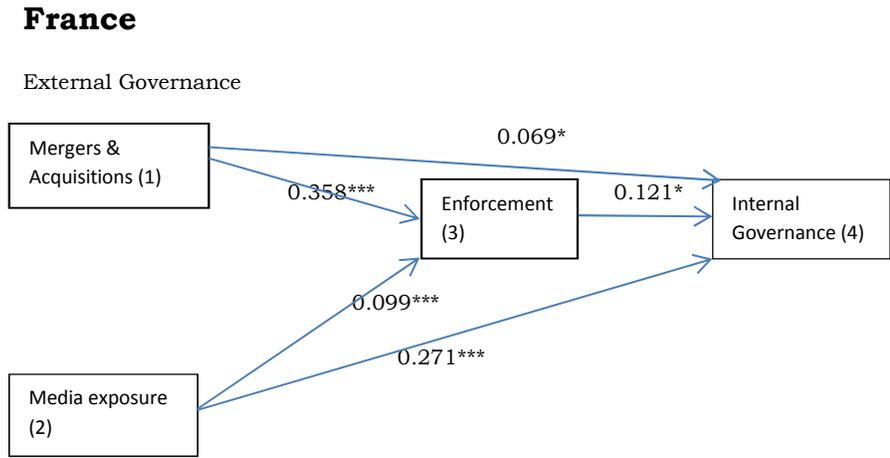
Total effect of external governance on internal governance through enforcement

(1) and (4) = $0.353 \times -0.082 = -0.0289$

(2) and (4) = $0.217 + 0.205 \times -0.082 = 0.2002$

Figure 3

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



Total effect of external governance on internal governance through enforcement

(1) and (4) = $0.069 + 0.358 \times 0.121 = 0.1123$

(2) and (4) = $0.271 + 0.099 \times 0.121 = 0.2829$

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 collected data about 32 sanctions listed firms for a lack of conformity to diverse issues: Financial statement misreporting, insider trading, continuous disclosure, etc. 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 returns¹, results presented in table 3 show that 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 constraints count for 38% ($2.8\%/7.2\%$) of total constraints. This could mean that abnormal returns capture a large part of institutional constraints, formal and informal, and that the impact of sanctions on securities' prices captures the effect of formal constraints.

¹ Eight firms, mostly banks, exhibit large positive abnormal returns surrounding the sanction date.

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 Return	-0.026	-0.003	-0.028	-0.002
Abnormal Return	-0.017	-0.014	-0.090	-0.049
	-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

Discussion

This paper provides some evidence that confirms Cremers et Nair (2005) observation, that internal and external governance mechanisms are complements in being associated with long-term abnormal returns. Our results explain why that occurs. We find that the external corporate governance mechanisms effect on internal corporate governance mechanisms are mediated by the institutional enforcement. We validate that firm level enforcement can be measured as the inverse of abnormal returns. Thus, abnormal returns would be a good proxy for transaction costs. As institutions complements each other to an equilibrium (Aoki, 2006), the interaction of formal institutions, informal institutions and enforcement sets a unity. In agreement with North (1990), when formal

and informal constraints of an institutional matrix are weaker, more enforcement is needed for improving effectiveness. In agreement with North (1990), we find that when external corporate governance mechanisms enforcement are stronger, less internal corporate governance quality is needed for attaining effectiveness.

The total enforcement has a negative sign only when there is more enforcement of the formal constraints than the informal ones. That seems to be the case in Canada. When there is more enforcement of informal constraints, as in France, total enforcement is positive. In this case, it seems that society institutional pressures are the cause of misconduct and contracts transgression and that enforcement of formal constraints is not strong enough to counteract it.

Figures 2 and 3 show how the relationship between internal and external corporate mechanisms is mediated by the enforcement for France and Canada separately. The enforcement sense may vary depending on the type of institution enforced. When enforced institutions are more informal than formal, as it is the case in France, enforcement is associated with more internal governance even though the association is statistically weak. Hence, internal governance responds positively according to needs not fulfilled by external governance. When enforced institutions are more formal than informal, as it is the case in Canada,

enforcement leads to less internal governance. Hence internal governance could deploy fewer efforts to effectively accomplish their tasks.

In sum, the quality of internal corporate governance is higher in France because their external corporate governance mechanisms enforce more informal constraints than formal ones. This could mean that Canadian enforcement is more effective to help firm's corporate governance to achieve their goals, especially their control objectives.

Conclusion

Our results build on La Porta et al. (1998) who show that common law countries tend to protect investors considerably better than do French civil law countries and that law enforcement is stronger in common law countries than in French civil law countries. We argue that it means that informal institutional constraints are less efficient in common law countries. Hence, market reaction to misconduct is less severe. Our enforcement measure is convergent with the World Bank measures (The World Bank, 2017).

Consistent with La Porta et al. (1998), results show that French code law origin is negatively related with the enforcement level, while Media exposure and Mergers and acquisitions pressures increase the level of enforcement perceived by companies. Broadly, when these external corporate governance mechanisms are more enforced, the quality of the

internal corporate governance is lower, because less internal contribution is needed to complete a high quality governance bundle. These results corroborate Misangyi et Acharya (2014) suggestion that governance mechanisms work together as complements rather than as substitutes.

In practice, our results will allow to calculate firm level enforcement, an important contribution to future research. It could help regulators to determine the level of formal enforcement required to constrain misconduct and to enhance firm's corporate governance. The effectiveness of internal governance mechanism depends on country level institutions and their enforcement. Specifically, stronger market for corporate control, legal origin and media exposure mechanisms contribute to enhance internal corporate governance quality through a more severe enforcement. Nevertheless, enforcement is a complex construct that comprises the contradictory effects of the institutions that it reinforces. Then, future research could better investigate these contradictions and their consequences.

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