The Future of Corporate Governance

CORPORATE GOVERNANCE FORUM

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THE STOCKHOLM SYMPOSIUM 2004

EDITORS:

MATS ISAKSSON ROLF SKOG

The Future of Corporate Governance
Editors: Mats Isaksson, Rolf Skog
ISBN 91-85333-01-8

Production: eddy.se ab, Visby 2004
Print: Elanders Gotab AB, Stockholm 2004

Preface

Ten years ago, the Swedish Corporate Governance Forum organized a seminar here in Stockholm at which we proudly presented as speakers some of Europe's and the United States' foremost thinkers on various Aspects of Corporate Governance. We then published the seminar's proceedings under that very title. Now, in celebration of the ten years of intense activity which our Forum has experienced, we have again assembled in Stockholm for a jubilee seminar with virtually the same distinguished speakers, and with a few added maestros, to review the corporate governance timeline during the past decade and to volunteer prognosis on the future. These are the proceedings of the seminar held on December 11, 2003.

A common theme of each speaker's retrospective thoughts is the exponential evolution of the topic and the exhilarating experience it has been to be a contributing participant in the ongoing debate. While the topic of corporate governance, indeed 10 years older, has broadened and matured, all seem to agree that it now seems more vibrant and relevant than ever.

Over this time period corporate governance has grown from an American academic quandary about the great distance between the management of US public corporations and their dispersed owners, to become a common "household" expression glibly used by politicians, company directors, journalists, CPA's, etc. to cover a plethora of activities in and around corporations and other associations – big and small, public, cooperative and private. Corporate governance now relates to the functioning of security markets, all facets of boardroom work, responsibilities of institutional owners and of the accounting profession, as well as the modernization of company law around the globe. Corporate governance has become semantically wedded to issues of ethics and morals in the business world. And "transparency", a word with a new meaning in the vocabulary of corporate governance, has become the salvation for most of the ills associated with imperfectly functioning markets and managers.

On behalf of the Corporate Governance Forum, I want to thank the participants for the excitement they brought to this jubilee seminar – particularly our outstanding speakers – and I invite the readers of these proceedings to ponder the explosive history of this young discipline and to join our authorities in trying to foresee the governance events of the coming decade.

November 2004

Karl-Adam Bonnier

Chairman
Corporate Governance Forum

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List of Contributors

Baums, Theodor, Professor of Johan Wolfgang Goethe Universitaet Frankfurt/Main; Chairman of the German Government Commission on Corporate Governance

Davies, Paul, Cassel Professor of Commercial Law, London School of Economics and Political Science; Member of the Steering Group of the British Company Law Review 1998-2001

Davis, Stephen, Dr, President, Davis Global Advisors

Ferrarini, Guido, Professor of Law, University of Genoa, Vice-Chairman European Corporate Governance Insitute (ECGI), Brussels

Gilson, Ronald, Marc & Eva Stern Professor of Law and Business, Columbia Law School; and Charles J. Meyers Professor of Law and Business, Stanford Law School

Isaksson, Mats, Head of Corporate Affairs at the OECD in Paris. He is co-founder and Director of the Swedish Corporate Governance Forum and Senior Visiting Fellow at the Centre for Commercial Law at the Stockholm University.

Lowenstein, Louis, Professor emeritus of Finance & Law, Columbia University

Skog, Rolf, Director of the Swedish Corporate Governance Forum; Company Law Expert to the Swedsih Ministry of Justice; and Honorary Professor, Department of Law, Aarhus Scool of Business

A Perfect Storm: Changing a Culture

*Louis Lowenstein**

All of us, but particularly those who attended the inaugural seminar in 1993, are delighted to be here. Thanks to Karl-Adam, we have this special opportunity to renew friendships and exchange insights on what transpired in the interim.

Ten years ago Rolf and Mats asked that I discuss the American experience from my vantage point as the "old man" of the corporate governance debate. Now in large measure my pleasure at being here is . . . well, the pleasure at being here. The notion of coming together only at ten-year intervals, however, seems a bit risky.

I don't know how others of you feel reading, in the cruel light of hindsight, what you had written in years past, but as Rolf and Mats will remember I approached this exercise with great trepidation. I found that I had identified two large dilemmas and then, with virtually no modifiers, went on to make five, Good Lord! five, predictions. Being now so much older, and no doubt wiser, I shall try to restrain myself.

I would not have referred back, of course, except that what I noted then turned out to be modestly prescient. Comparing the different cultures and values of institutional investors in the U.S. and our conceptual cousins in the U.K., I commented that the

> "remarkably American emphasis on momentary stock prices, though it goes by the misnomer of *shareholder value*." (emphasis added) Webster's defines an investor as 'individual or organization who commits capital to become a partner of a business enterprise.' . . . Instead what we see are professionals who rely on pseudo-scientific techniques of group rotation, chasing Malaysian stocks or whatever else has recently been showing the best returns, whether or not the financial reporting has any integrity. . . . The subtleties

* Rifkind Professor Emeritus of Finance & Law, Columbia University. As will be only partly evident from the citations, I am indebted to my son Roger Lowenstein for both the reporting and insights herein. (The dialogue continues.)

> and nuances of a particular business utterly escape them." (page 22)

Underlying this ephemeral notion of shareholder value, I said, were two dilemmas: First off, the utter scarcity of so-called relational or value investors capable of bringing thoughtful, well-informed oversight to their portfolio companies. A function of our highly liquid markets, the problem had long since been identified by Keynes and others. Secondly, there seemed to be no plausible way to induce investors to focus more on business prospects than on market movements.

Both problems, of course, played a critical role in the financial boom and crash of the '90s. But the reference to chasing Malaysian and other Southeast Asian stocks was inspired. In 1996 alone, the so-called Asian Tigers attracted $93 billion of foreign capital even as their economies were slowing and were soon to collapse. "The simple fact is," as James Wolfensohn, president of the World Bank said, "that very sophisticated banks loaned to Indonesian [and other] companies without any real knowledge of their financial condition."[1]

So apart from my self-congratulations, what has changed since 1993? For one thing, we no longer need to waste time on efficient market theory which had for so long blinded scholars to the behavioral realities of the marketplace. As someone said, economists really should get out more often, and lo and behold Richard Thaler, Robert Schiller, and others have done just that. Thanks to them and the dramatic events of the late 1990s, a vast collection of academic market modeling can be tossed into the dustbin.[2]

More importantly, what happened is that the phrase "shareholder value" became the mantra, the justification for a period of unrestrained greed and corruption that tarnished essentially every aspect of American financial markets and corporate governance. Corporate managements were the driving force, but they enlisted – some might say, bribed – accountants, analysts, lawyers, bankers and others to aid and abet schemes which, whatever the facial characteristics, were fraudulent to their core. Every transaction, every CEO? Of course not, but the contagion was so systemic as to amount to a cultural collapse. Rules were suddenly meant to be broken. . . or so bent as to nullify their in-

1 Roger Lowenstein, "When Genius Failed: The Rise and Fall of Long-Term Capital Management," 112 (Random House 2000).

2 Louis Lowenstein, "Searching for Rational Investors In a Perfect Storm", Working Paper, Columbia Law School, June 21, 2004.

tent. Perhaps it was also part of a larger breakdown in the social compact. This high-voltage greed and fraud went far beyond anything, of course, I had imagined.

Government has responded at many levels and with remarkable vigor. But have we succeeded in putting the genie back in the bottle, or will we, as the public's attention turns elsewhere, return to business as usual, dodging a new set of rules much as we had the earlier ones? Thus the "key issue" in the U.S. is whether we can restore a measure of credibility to corporate governance. There is a lot of tugging and pulling; in short the jury is still out.

2. A perfect storm

In October 1991, there occurred off the coast of Massachusetts, a "perfect storm," a tempest created by a rare combination of events, primarily an Arctic cold front colliding with a hurricane, that would create waves 30 meters (!) high and of course wreak havoc and death among the fishermen caught in its path.[3] In the late '90s, there was another perfect storm, a rare coincidence of events in our financial markets, which made it possible for corporate managements to scale new heights in compensation, and plum moral depths, without parallel – and, like that nor'easter, at huge cost to the innocents caught in its grip.

Executive compensation in the U.S. has always been, relative to employee wages, much higher than in Europe or Japan. In 1990, however, Michael Jensen, who had long focused on the curative properties of stock markets and prices, wrote an article with Kevin Murphy, arguing that the quantity of dollars did not matter, and that managers should receive large, very large, stock option grants, to ensure that they identify with the interests of their shareholders.[4] With that simple move, we would eliminate the separation of ownership and control that, ever since Berle and Means, had been seen to stalk our system of popular capitalism; henceforth managers would strive to enhance value *per share*, not just the size of the domain they ruled.

In fact the model was faulty; unlike shareholders, executives would take no risk – none. They would not exercise their options until such time as the options were "in the money," i.e., the stock had risen above

[3] Sebastian Junger, "The Perfect Storm," 130 (Harper Paperback 1998).

[4] Michael C. Jensen and Kevin J. Murphy, "CEO Incentive–It's Not How Much You Pay, But How," Harvard Bus. Rev., May-June, 1990.

the exercise price; and taking advantage of a 1991 relaxation of SEC rules, they were free to sell immediately after they had bought. All the while, additional options would be issued, so that if perchance the stock dropped, new options at the lower prices would reward management merely for bringing the stock price back to the starting point.

Options had long been the vogue in Silicon Valley, where emerging companies used them to conserve cash and to attract talent; but in older companies the grants remained modest – a good perquisite but not much more. It was not until compensation consultants, spurred by the Jensen Murphy article and the market's increasing vigor, seized on the concept that the scale of option grants took off.[5] In large American companies there is almost total reliance on these consultants. They come to board and compensation committee meetings armed with PowerPoint charts that highlight the "dismal" fact that the CEO's pay is only in the 28th percentile of his (carefully selected) peer group, coupled with recommendations for cash and stock options, plus a host of pension and other benefits, that will put him in the upper quartile, where, to be sure, he belongs.[6] (The game of serial leapfrog will be obvious to the reader.)

It worked. "'Pay for performance' became the universal corollary to shareholder value."[7] As the bull market unfolded, stock in one form or another took precedence in the executive pay package. The notion of excessive pay simply evaporated. With the bulls running on Wall Street, it mattered not that workers' pay was stagnating[8] or that all in all, chief executives were now taking down over 400 times average employee salaries.[9] The connection to performance, often tenuous,

> "was sundered in the numerous cases in which failed CEOs were shown the door with tens of millions of dollars to ease their paths.

[5] Roger Lowenstein, "Origins of the Crash: The Great Bubble and Its Undoing," 19 (forthcoming, Penguin, January 2004). ("Origins")

[6] The compensation committees of NYSE-listed companies have now been given the authority to hire and fire any consultants. Deborah Solomon, "SEC Rules Limit Who Qualifies as 'Independent,'" WSJ Nov. 5, 2003, A2, col. 4.

[7] Origins, at 21.

[8] Congressional Budget Office data for the year 2000 show the greatest economic disparity between rich and poor since the CBO began collecting such data, in 1979. Lynnley Browning, "U.S. Income Gap Widening, Study Shows," NY Times Sept. 25, 2003, C2.

[9] "Inequality: Would you like your class war shaken or stirred, sir?" The Economist, Sept. 6, 2003, 28.

> Frank Newman of Bankers Trust ($100 million), Jill Barad of Mattel ($50 million), and Douglas Ivester of Coca-Cola (($25 million), were examples. It is hard to think of any other society in which failure pays so well."[10]

In 1993, a perverse wind in the "perfect storm" developed in the usually obscure workings of the Financial Accounting Standards Board (FASB). The Board decided to consider whether the value of stock options should be treated as compensation expense, and therefore as a charge against corporate income. In principle, it seems clear. For example, if a company issued options to pay for inventory or a building, their value would be booked as part of the cost of those assets. The same treatment would seem to apply to stock options issued as compensation to employees or executives. No matter, there ensued a political firestorm, in which the angry protests of lobbyists and politicians forced the SEC and the FASB to back down. Henceforth, options would be treated as, well, nothing at all; even as managers' thirst for options increased, it was decided that for accounting purposes options had no value, and hence would not be deducted from earnings. Actually, companies had the best of two worlds; they did treat options as a valuable tax deduction at the time of their exercise, so that the net effect was to increase reported earnings, not reduce them.

As the stock market soared, it was clear that corporate chieftains wanted ever more stock options for themselves. Million-share awards became commonplace: Eisner of Disney received an 8 million share option in 1996, Silverman of Cendant 14 million, Ebbers of WorldCom megagrants five years running.[11] The boards of directors behaved like lapdogs; there was precious little independent oversight. As Felix Rohatyn commented earlier this year, "I have begun to question the actual definition of an independent director. I don't believe there is any such thing."[12] Unlike the U.K., American companies rarely have an independent board chair, so that the CEO writes his own agenda. When Cendant's stock fell from 40 to 7, following the failure of a major acquisition engineered by the CEO, he received a new megagrant at the now depressed price.[13]

[10] Origins, 52; the disease of rewarding failure is a problem in the U.K. as well. "Fat cats feeding," The Economist, Oct. 11, 2003, at 64.

[11] Origins, at 48.

[12] "Felix Rohatyn: Taking the measure of today's boards," Directors & Boards, Spring 2003, 16, 21.

[13] Origins, at 50.

With tens, sometimes hundreds, of millions of dollars to be made from a rising stock price, the temptation to meet the market's expectations, to increase earnings in predictable fashion, becomes exquisite. By hook or crook. In reality, businesses do not grow, or earnings increase, in monotonic fashion. There are product cycles, unpredictable lapses, delays in product development, and whoa, the impact of competition; but by now CEOs knew the game was elsewhere. Gillette, like many others, kept promising Wall Street to expect earnings and sales increases of as much as 20% a year, clearly stretch figures for a mature business, and then would push product out the door at discount prices to meet its goals.[14] Gillette, in effect, was managing the razor business for Wall Street, not for its customers. Worse yet, mesmerized by the market and their own growing wealth,[15] CEOs began to pressure their chief financial officers to find, and their auditors to bless, the "earnings" needed to pump up their stock price so that they could unload their shares. "Pump and dump" was the key.

- The most respected, indeed the most highly valued, company of the era was General Electric. Over the twenty years of his stewardship, Jack Welch delivered the steadily increasing earnings, quarter by quarter, that investors craved. Some years ago, I wrote a column explaining how several "adjustments" – all quite visible to an analyst, but ignored by most – enabled GE to report higher, not lower, earnings for the prior year.[16] More recently, an accountant, using the Standard & Poor's excellent definition of core earnings, concluded that over a six-year period the earnings had been anywhere from 1% to 20% lower. And of course, the increases were not smooth, but lumpy.[17]

By 1998, the picture had become ugly enough that Chairman Arthur Levitt of the Securities and Exchange Commission gave a seminal

[14] Claudia H. Deutsch, "For Mighty Gillette, These Are the Faces of War," NY Times, Oct. 12, 2003, Sec. 3, p. 1, 11.

[15] The ten highest-compensated executives in the U.S. had an average annual compensation in 1981 of $3.45 million, in 1988 of $19.8 million, in 2000 of $154 million. Kevin Phillips, "How Wealth Defines Power," The American Prospect A8, A9 (Summer 2003). The year 2000 figures are, no doubt, inflated by the stock market bubble, but . . . .

[16] Invited to explain the "adjustments" to my finance class, the GE CFO instead discussed the company's new light bulbs.

[17] "Like Courting a Princess," Barron's Dec. 28, 1992, 18; Origins, at 59-60.

speech excoriating the growing practice of, as he politely put it, "managing earnings." The most frequent distortions were in revenue recognition, which often meant keeping the books open for several weeks after a fiscal year close, or shipping unwanted merchandise to customers who had been assured they would not be billed. The SEC, recognizing that the problem was deep-rooted, prompted the creation of two panels, one focused on boards of directors and the other on accountants, looking in short to the two groups with statutory oversight duties and, conceptually at least, a degree of independence. (This author was on the so-called Panel on Audit Effectiveness, which for 20 months explored, with the benefit of a full-time staff. the growing failure of auditors to meet their responsibilities. The 200+ page report, issued in 2000, is a testimonial to the quiet virtues of laboring in the dark.)

Being the "old man" of these discussions, I can recall that in the 1960s, the then head of the New York Stock Exchange, speaking of a market bubble, lamented that he had seen it happen before, was seeing it happen again, and there didn't seem to be anything he could do about it. There is a contagion, an excitement, at the prospect that each of us, all of us, if only we play the game, can get rich . . . very rich. With the pulse beating fast, no one cares that we are hour by hour simply repricing, passing along, the same shares. In the long run, share prices are merely the reflection of the underlying verity, but now, in the 1990s, with eyes focused on the stock quotes flashing across the TV screens in every bar and restaurant, the "long run" was not in anyone's lexicon. No one was prepared to heed Levitt. We, and the "we" included the institutional investors, of course, simply wanted to know which stocks were rising, so as to seize the opportunity. Earnings, revenues, balance sheets, after a time none of it mattered. Dot.coms with no earnings, indeed scarcely any revenues, and often only dimly perceptible prospects would leap to billion-dollar values, on the novel theory that they would be the first to dominate some as yet non-existent market.

Applauding this mockery of intelligent investing were scholars who urged the public to buy the market, all of it, no matter what the price.[18]

[18] Jeremy J. Siegel, "Stocks for the Long Run," (1998 edition).

3. Accounting is the key

Disappoint Wall Street by a penny a share and the stock could sink 10-20 percent. Be careful, manage the earnings, that was the key to a healthy stock price. It's a truism that the earnings figure reflects a host of judgments that companies and their auditors make – about the value of inventories, reserves for bad debts and other contingencies, the number of new model 767 aircraft the company is likely to sell over the ensuing years, assumptions underlying the pension plan, and on and on. We say it's an art, not a science, because judgments – not just counting the boxes and such, but a host of valuations and estimates of future probabilities – are intrinsic to the process but largely *invisible to everyone but management and the auditor.* Computer risk models may highlight areas of likely concern, but only the time-consuming, tedious substantive checks on outstanding receivables and the like will provide the necessary assurance.

Like all the rest of us, CEOs hate to get undressed in public; while on average they earn a grade of only B, or is it B-, each of them likes to believe that, given all the challenges he has overcome, he deserves an A report. It's simple human nature. That puts the auditor under ferocious pressure, which is why federal law has for 70 years required they be independent. Lawyers, too? No, only auditors.

I love markets; they do so many things so well. What happens, for example, to a failing company? In a strong market system, it is allowed to fail, thus keeping the losses to a minimum. Think of countries, and you know them well, where, long after any reasonable hope has vanished, governments continue to prop up banks and others, and in the end the mounting losses burden the entire economy.

In short, a well functioning market system provides a healthy dose of discipline. And they do other things well, too. Let me merely list them, as I suspect they are familiar:

a. Low-cost, long-term capital for industry. Potentially lots of it, which is why companies seek to list their shares in London and New York.
b. Liquidity for investors. The combination of permanent, equity capital for industry, together with liquidity for investors, is a unique strength of a market system.
c. The efficient allocation of capital. Even though we have seen huge sums foolishly invested in U.S. and European telecommunications companies, after a year or two the market turned away and the process stopped. Compare that with Japan, where politicians have steered

capital to the real estate, retail and other poorly performing industries, and the lesson is clear.

d. Stock prices are an excellent measure of management performance *over time*. The old adage is, give me the power to see myself as others see me. Financial markets hold up to corporate managers a mirror, telling them, in stark terms, what the world thinks of their stewardship. Long speeches by prime ministers rarely catch the same attention.

Which leaves us, however, with two intractable facts: (1) While markets require a high degree of transparency, they do not by themselves create it. (2) The modern business corporation is typically a hugely complex enterprise, whose operations are often spread over many parts of the globe. Investors have no direct way to observe how well a company is doing, without that independent audit. As we say in the U.S., they cannot kick the tires. Neither can bankers, analysts, or any of us. And so we made an ultimately hollow Enron the seventh largest company in America. And Tyco, Global Crossing, WorldCom, and Lucent, and. . . and. . . . Enron's financials were opaque, dense, surely a warning to intelligent investors, such as the rare analyst at the pension fund for teachers, TIAA-CREF, who, seeking better data, was told abruptly by an Enron spokesperson "We're Enron; we don't need to have good accounting."[19] Of course, she was a buy-side analyst, not one working for an investment bank whose compensation would almost entirely depend on her ability to bring in the financing transactions that are the core of their business.

- In Project Nahanni, the name of a Canadian national park known for its wolves, Enron borrowed money from Citigroup to buy Treasury bills, then sold those bills and within days reimbursed Citigroup at an above-market interest rate. Why? The bank had assured Enron that the $500 million it received could be reported as *operating cash flow*, thus "reassuring" investors, analysts and the like.[20]
- In 1999, Enron persuaded Merrill Lynch to purchase power-generating barges moored off the coast of Nigeria for $28 million, subject to a secret side agreement to reverse the transaction, at a profit to

[19] Origins, at 167.

[20] Floyd Norris, Bankrupt Thinking: How the Banks Aided Enron's Deception, NY Times, Aug. 1, 2003, C1 (according to report of Enron trustee in bankruptcy)..

Merrill, within six months. Enron booked $12 million in bogus profits.[21] On completion of the round-trip, Merrill had indeed "earned" a $775,000 fee.

By the time of Enron's collapse, the company had piled up $38 billion in debt, but thanks to transactions such as these, only $13 billion appeared on the balance sheet.

The bankers, of course, knew full well what they were doing. Thus, one Merrill executive's note: "Reputational risk, i.e., aid/abet Enron income stmt manipulation."[22] Or a Chase banker: "Enron loves these deals, as they are able to hide funded debt. . . ."[23] Or a Citi banker, "E gets money that gives them c[ash] flow but does not show up on the books as big D Debt."[24] And of course the auditors. Through all of these palpable frauds, Enron's auditors, Arthur Andersen, never blinked. Having seen their consulting wing, Andersen Consulting – now known as Accenture – break away, they were far too eager to build a consulting business anew.

As the Panel on Audit Effectiveness saw, the decline of the accounting profession had been underway for 20 years, roughly since the firms began to see auditing, not as a public trust, but rather as providing an unparalleled (indeed, legally mandated) opportunity to gather consulting and other profitable work worldwide from the very management from whom they purported to be independent. Consulting in its various forms soared from 30% to about 75% of firms' revenues and a still higher percentage of profits. That is why the press now routinely refers to accounting as an industry, not a profession.

Audit work came to be seen as a low margin business, and a low-wage line of work. Cut the hours, use drones instead of MBAs, keep the fees low. It's not where the money is. Columbia, Harvard and like B-Schools simply do not train accountants; true they teach accounting, but only for those going to Wall Street and the like.[25] Accounting as a profession

[21] Kurt Eichenwald, "Merrill Reaches Deal With U.S. in Enron Affair," NY Times, Sept. 18, 2003, C1 (per the indictment of three Merrill executives).

[22] "Partners in Crime," Fortune, Oct. 27, 2003, 78, 94 (adapted from the book, McLean & Elkind, "The Smartest Guys in the Room").

[23] Id. at 81.

[24] Ibid.

[25] As recently as February 28, 2003, the "Columbia Daily Spectator" carried an advertisement from the state accounting society: "if you're looking for an exciting profession with opportunities. .. consider becoming a CPA. . ..average starting salary of $35,000." In NY City ?? To restore credibility to auditing, we need to pay credible salaries.

has been left to Ill. State, Case Western and other less prestigious schools. The Panel looked at audit standards (weak), discipline (nonexistent), peer reviews (a joke), and particularly independence (shattered) as accountants often "audited" the very tax schemes they had concocted.

The Panel reported that it might take a major blowup to effect real change. Be careful what you wish for! By 2002, $7 trillion in market value had been erased, some by the collapse of the bubble, some by the collapse of the frauds.[26] In the five years beginning 1999, over 1,300 companies, many of them major, restated earnings.

Every link in the chain broke. Institutional investors, security analysts, audit committees, political leaders, investment and commercial bankers, and oh yes, the lawyers who crafted all those hollow transactions devoid of any proper purpose. In short, a broad cultural failure–AOL, Adelphia, Sunbeam, Global Crossing, WorldCom, Enron, Health South, CMS, the list seems endless. As political analyst Kevin Phillips recently noted, financial corruption seems to be an inevitable consequence of the psychologies unleashed as a long bull market feeds a culture of money and greed.[27] Executive insatiability drove the process, earnings manipulation provided the sought-after cover, and sleepy boards of directors supplied the necessary nod of approval. Fiduciary duty, conflict of interest? Sorry, they dropped out of our lexicon.

Crime, it has been said by a friend (who I believe has no personal experience), is about opportunity. As we in the U.S. made banks more open, more inviting, we "invited" more bank robberies. In the parts of town where the opportunities are limited, there may only be street games of three-card monte or drugs. But in corporate America, seeing that the primary watchdogs had become household pets, managers found unparalleled opportunities. And like any sensible con artist, they seized them.

Of all the external gatekeepers, we depend most on the auditor. Which is why it is a government mandate. The nub of the problem is that accountants have two very different clients for their work: (a) management for the lucrative IT consulting services and the like, and (b) the board, the shareholders, lenders and the public generally for the audit, which is a report on the performance of *that very same management*. If

[26] John C. Bogle, "What Went Wrong in Corporate America?" speech, Bryn Mawr Presbyterian Church, Feb. 24, 2003.

[27] Phillips, supra, fn. 14, A9.

they are not independent, the process fails. Even the directors have nowhere else to turn. And with almost three-fourths of their revenue coming from elsewhere, with intense pressure to bless sham transactions, to redefine the Gregorian calendar as having 380 days, not just 365 – e.g., Sunbeam – the auditors ability to "just say no" had dried up.

While managerial greed was the driver for so much what we have seen, the contagion spread beyond even their reach. The mutual fund industry, which had seemed unscathed, has now become embroiled in several important scandals. Fund managers have bribed brokerage firms to recommend their funds to clients, no matter what the performance of those funds. Worse yet, banks allowed hedge funds, such as Canary Capital, to steal from investors in the banks' own mutual funds by permitting them to trade mutual fund shares at prices at variance with the underlying values. And still worse, specialists at the New York Stock Exchange, some of them affiliates of major Wall Street firms, injected their personal trades ahead of customers' orders, at a cost to investors estimated by the SEC at over $150 million, all in just a three-year period.[28] The Exchange knew, but seemed essentially indifferent. Meanwhile the board of directors of the Exchange, which included representatives of all but one of the five offending firms,[29] approved deferred compensation of $140 million to the chairman of the Exchange, Richard A. Grasso, a testimonial of sorts to his diligent oversight of the trading floor. In short, not every failure could be laid at the doorstep of corporate America, though palpably it was the same failed culture operating throughout.

Having boasted of my predictive powers, let me now confess, as Mats has reminded me, that as recently as 1998, I wrote that the U.S. had developed its "financial reporting and disclosure system to a degree not known anywhere else, not even in England."[30] By dint of great foresight I tucked that essay into an obscure volume intended for an audience in New Zealand, so that but for our zealous host it might have gone unnoticed. Sic transit. . . .

[28] Deborah Solomon & Susanne Craig, " Taking Stock: SEC Blasts Big Board Oversight of 'Specialist' Trading Firms," WSJ, Nov. 3, 2003, A1, col. 5.

[29] Source: www. nyse. com.

[30] "Financial Transparency and Corporate Governance: The United States as a Model?" Corporate Personality in the 20th Century (Oxford 1998, eds. Ross Grantham & Charles Rickett), 279.

4. Sarbanes-Oxley and more

Not since the first days of the Roosevelt Administration has there been such a comprehensive legislative and regulatory response.[31] At first Congress wavered, but as the huge frauds at WorldCom broke, so did the resistance, and the result was a wide-ranging bill, Sarbanes-Oxley Act of 2002 (SOXA). Some of the more salient aspects are to: impose significant new and accelerated disclosure requirements on public companies – require the CEO and CFO personally to certify their company's financial statements – increase the responsibilities of audit committees and the independence of boards – impose strict limitations on non-audit services for audit clients – establish a new Public Company Accounting Oversight Board (PCAOB), with independent funding – subject directors and officers to trading blackouts – and increase criminal penalties for violations. Also included was a requirement of up-the-ladder reporting by lawyers of securities law and fiduciary duty violations, a provision added in the wee hours before passage, and before the lobbyists knew what was afoot. The public's outrage and pocketbook losses overwhelmed the hesitancy of the White House; and while the Administration fumbled for a bit, Congress then gave the SEC the much needed additional funding.

Congress was shutting down the opportunities, both directly and more importantly for the years ahead, by reinforcing the independence of the potential watchdogs, notably directors, auditors and lawyers, and of course the potential penalties. Closing down one of the Big Five, Arthur Andersen, was itself a powerful message. Financial skullduggery is never-ending; only the tricks change. The structures put in place in the 1930s worked well for decades; the new structure seems well designed to eliminate not just the special purpose entities, the broadband swapping and the like abused by Enron and the rest, but hopefully whatever our fertile imaginations might produce next. The window for reform is always narrow; fortunately, Congress seized the moment.

[31] But see, e.g., Lawrence A. Cunningham, "The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)," 35 Conn. L. Rev. 915 (Congress failed to legislate rules for option accounting, and should have given direct responsibility for accounting and audit regulation to the SEC); Douglas M. Branson, "Enron–When All Systems Fail: Creative Destructon or Roadmap to Corporate Governance Reform?," 48 Villan. L. Rev. 989 (2003 (Sarbanes-Oxley damages federalism, stifles informed risk-taking)

Since Sarbanes-Oxley, there have been a number of criminal indictments, civil proceedings, and SEC and NYSE rules implementing the Act directly and in many instances going well beyond it. But the clear focus has been on accounting. Yes, accounting, the quintessence of boring, banal work, performed by Dickensian fellows wearing green eyeshades, had captured the attention of the Congress, the regulatory bodies, indeed the press and society generally. Only a short time before, who would have guessed that Congress would enact a law dealing explicitly with off-balance sheet transactions? Or that boards of directors would be scouring the countryside looking for audit committee candidates with the requisite level of expertise? Or that the public's attention would be riveted to the tales of how some twenty telecom and energy companies, guided by Arthur Andersen, boosted their reported revenues by some $15 billion by swapping one set of broadband leases for another?[32] As Arthur Levitt told me, he had never thought he would be spending so much of his years as SEC chairman dealing with accounting.

What also emerges is that in one fashion or another, the federal government has done what many of us had hoped for, but not envisaged in our lifetimes (or at least not in mine), adoption of nationwide rules for the governance of public corporations, and for the two professions, law and accounting, the oversight of which had been left to the far too haphazard, at best indifferent supervision of the states. Even executive greed, the core issue, came under federally sponsored regulation, by virtue of new stock exchange and NASDAQ rules giving shareholders the right to approve stock option plans, and stripping brokerage firms of their right to befriend corporate clients by voting "street-name," i.e., customers', stock in favor of such plans.[33] Ahead of the curve as usual, Michael Jensen had, as early as 2001, become an outright critic of the culture he had helped to spawn, expressed in a paper graphically entitled "Paying People to Lie."[34]

[32] Origins, at 160-1.
[33] "SEC Assents to Shareholders' Right To Rule on Equity Compensation Plans," Sec. Reg. & Law Rep., July 7, 2003, 1103.
[34] Origins, at 69.

5. Two Steps Forward and One Back?

SOXA did not in a simple flash of Congressional fervor restore ethical and moral standards. In the little more than a year since its enactment, what have we seen? In a word, swirling cross-currents.

What we are trying to do is change a systemically perverse culture. American International General (AIG), the nation's largest commercial insurer, recently conceded that "mistakes" were made writing a back-dated, bogus insurance policy, and issuing a misleading audit letter, all in order to help a client overstate its earnings by more than half. AIG, whose own disclosures have long been suspect,[35] tried to deny corporate responsibility, until confronted with subpoenas, at which point it produced a marketing paper designed to sell these very same bogus policies and counseling that some aspects of the policies should be concealed. AIG, agreed to pay a $10 million fine.[36] The problems run deep within the core of how some major companies function and how they see their goals.

Rules and enforcement proceedings clearly help, but they are only the stepping stones. Some recent polls suggest that both in the financial community and in the country as a whole, the expectation is that we will, in time, revert to "business as usual," meaning corruption. Indeed, evidence of executive excess continues to unfold. According to one survey, total take-home pay for CEOs at one hundred of the largest companies grew by an average of 14% in the year 2002, despite the slumping economy and job losses.[37] Among the CEOs reaping big increases, even while their companies suffered, was William Harrison of J.P. Morgan Chase, whose pay rose by 80% to $17 million. Think how well he would have fared if the bank had not played a key role in the Enron debacle.

A number of criminal proceedings are underway, but thus far many of them have focused on the seemingly easy cases of destruction of records, i.e., obstruction of justice. As of this writing, in October 2003, Dennis Kozlowski of Tyco, Richard Scrushy of HealthSouth, and John Rigas of Adelphia, are among the few high-profile CEOs to be indicted.

[35] "Shine a light," The Economist, Mar. 2, 2002, at 67 (analysts foolish enough to issue a critical comment get a blistering phone call)

[36] Randall Thomas & Theo Francis, "AIG Is Charged by SEC With Fraud," WSJ, Sept. 12, 2003, A3.

[37] John Cassidy, "Comment: Business As Usual," The New Yorker Aug. 4, 2003, 21, 22 (citing a Fortune survey).

Despite their companies' bald and hugely costly deceptions – and the seemingly strong evidence of their involvement – neither Bernard Ebbers of WorldCom, Kenneth Lay and Jeffrey Skilling of Enron, Richard Scrushy of HealthSouth, nor Gary Winnick of Global Crossing, have as yet been charged under federal law.[38] It is, however, a matter of public record that at least some are "under investigation."[39] Were some of them too far removed from the scene to know what was happening? Doubtful, even in the case of Lay, admittedly not a hands-on manager. When a well informed executive in the finance department warned him that Enron's accounting was a house of cards, Lay referred the letter to the very same law firm that had crafted fictional transactions. The firm, Vinson & Elkins, "reassured" by the Arthur Andersen partner in charge of Enron, promptly issued a report that no further investigation was warranted.[40] Winnick of Global Crossing, ignoring an even more graphic signal of imminent danger, continued to sell stock while his company issued misleading reports.[41]

With each revelation of still another corrupt practice, we would like to think that the worst is over. In some cases, the disclosures are new, but at least the events took place in years past. But too often we see ongoing evidence of the very same crony capitalism SOXA sought to curb. Three examples stand out.

- Freddie Mac is the government chartered company created to provide low-cost home mortgages. Although publicly traded, it enjoys enormous competitive advantages under the tax and securities laws, as well as an implicit government guarantee of its debt. It is seen as a public service corporation, and yet it distorted its earnings by over $7.6 billion pretax.[42] There has for years been a large sign outside its Virginia headquarters, "Steady Freddie," openly acknowledging what management saw as its mission, to deliver the steady earnings that investors crave. Its (now former) CEO took down a $5 million salary – hardly what its quasi-governmental role would have suggested, but then it didn't see itself as such.

[38] "Angling for the Really Big Fish," Bus. Week Sept. 15, 2003, 42 (Ebbers was charged with a felony by the Oklahoma Attorney General.)

[39] Comment of SEC Commr. Harvey Goldschmid, "PCAOB's Niemeier Raises Possibility That Not All Big Four Firms Will Survive," SRLR, Oct. 6, 2003, 1669, 1670.

[40] Origins, at 182-3.

[41] Id. at 160-2.

[42] Jonathan D. Glater, "Freddie Mac Understated Its Earnings By $5 Billion," NY Times, Nov. 22, 2003, C1, col. 6.

- Bank of America, eager to expand its private banking business, successfully courted Edward Stern, the head of the hedge fund Canary Capital, by allowing his fund to use late-breaking news to trade shares of mutual funds managed by the bank after the close of business, illegally backdating the transaction slips when needed. The other fund investors could buy/sell only at the next day's closing price. What's striking is that so many people within the bank had to know that Canary was literally stealing from other fund investors, and yet a supervisor could happily hail the relationship with Stern as "a tremendous example of leveraging the franchise."[43] They knew, but they didn't care.
- While no law was broken, what struck the country as perhaps the most jarring failure took place at the New York Stock Exchange, where in the summer of 2003, the board announced its new policy of transparency by disclosing that the chairman, Richard A. Grasso, was about to cash in $140 million of deferred compensation and retirement benefits. The board seemed genuinely puzzled that the SEC chairman, William Donaldson – himself a former chairman of the exchange – was angry. The exchange is in large measure a de facto monopoly; a so-called self-regulatory organization (SRO), it is responsible to the SEC and the public at large for setting standards for the trading practices as well as the corporate governance of the listed companies.

As mentioned earlier, Grasso's pay was thus fixed by the very traders and bankers he was charged with regulating. Cronyism at its worst – or for Grasso, opportunity at its best – the sum included a $5 million bonus for his acknowledged success in reopening trading in the wake of 9/11; his colleagues, while aware of the sacrifices of those who fought the flames and perished there, expressed their appreciation in the only currency they knew. After some delay, the exchange disclosed that Grasso was entitled to a still further $48 million, which he graciously waived, having decided apparently that if his colleagues could overlook such a modest sum, so would he.[44] The principals were unable to sense how

[43] "Patrick McGeehan and Riva D. Atlas, "How Bank of America Stumbled," NY Times, Sept. 28, 2003, Sec. 3, p.1, 2.

[44] Kate Kelly & Susanne Craig, "Grasso Forgoes Extra $48 Million, Raising New Questions for NYSE," WSJ Sept. 10, 2003, A1.

out of touch they were with the society at large.[45] No, Grasso would of course not resign, but of course he did. The head of the compensation committee, the former New York State Comptroller, H. Carl McCall, seemed perplexed by the outcry; he thought he could "now be the reformer on the board that I wanted to be."[46] No such luck, Carl; eight days later, he, too, resigned.[47]

As Mats and Rolf know, my favorite dictum is "you manage what you measure," meaning that once we had disclosure of Grasso's pay, the game was up. It was only while it was kept from public view that it could soar out of sight. And just to underscore the point, the same was true of GE, WorldCom and the rest. Financial transparency is the key.

While it is the high profile criminal cases that catch the reader's eye, largely off the screen the SEC working directly, and pushing the SROs indirectly, has been using a host of regulatory changes and 600 enforcement proceedings in the last fiscal year[48] to change that culture, or as Chairman Donaldson put it, their DNA.[49] To be sure, attitudes and expectations do not change overnight. Witness the fact that no sooner had Morgan Stanley agreed to pay $125 million to settle an enforcement action arising out of charges that the firm had paid other firms to provide favorable, ostensibly independent "research" reports for the firm's stock offerings, than the firm's CEO issued a business-as-usual statement that Morgan Stanley had done nothing to concern the retail investor.[50] Similarly, when the FASB issued its Interpretation No. 46, an interim effort to deal with the special-purpose entities so abused by Enron, and still widely used elsewhere, it was met with the vociferous protest that to recognize the "new" assets and liabilities might well cause companies to be in default under their loan covenants. By virtue of the

[45] Landon Thomas, Jr., "S.E.C. Chairman Wants Details of Compensation Paid to Grasso," NY Times, Sept. 3, 2003, C1, 8 (directors unanimous in saying that no one deserves to be blamed for the contract).

[46] Landon Thomas, Jr., "This Defender's Role is an Unusual One," NY Times, Sept. 12, 2003, C1.

[47] Lest the reader regard Grasso's pay as aberrational, note that the two Executive Vice-Presidents each received about $13 million in pay over the latest five years, and is due more than $22 million in retirement benefits. "NYSE's 23 Top Executives Owed $128 million in Deferred Payments," SRLR, Oct. 20, 2003, 1736.

[48] "GAO Report Documents 29 Auditor Referrals To SEC of Alleged Violations in Seven Years, SRLR Oct. 13, 2003, 1713, 1714.

[49] "Donaldson Warns Morgan Stanley Chief Over Remarks on Settlement," SRLR May 5, 2003, 733.

[50] Ibid.

long-practiced abuses, companies had forgotten that this was, indeed, how loan agreements should work. (As I write, the confusion over FIN 46 has caused the FASB to postpone its effective date, until the calendar year-end reports, so the deed is not yet done.)[51]

According to a poll, two-thirds of professional money managers remain deeply skeptical whether the recent governance changes are likely to prevent future accounting scandals.[52] The skepticism is plausible, given the sordid history and the reality that the reforms are recent, many of them not yet effective, and at best will only take hold over a period of years. Looked at less charitably, how would those mutual fund managers have time to know? They were turning over their portfolios at the breathtaking annual rate of 110% in 2002.[53] Nor would the funds' investors, who were redeeming their shares at a 45% annual rate.[54] Indeed, turnover in NYSE-listed stocks averaged 125% last year, the highest in almost a century.[55] So much for patient study and informed shareholding.

In short, not one money manager in ten is likely to have noticed the major implications in the announcement by William J. McDonough (formerly head of the Federal Reserve Bank of New York), now head of the new PCAOB, that henceforth the Board will set audit standards, not the industry which, despite it sorry history, had so energetically sought to keep control.[56] True, the process of staffing the Board has been moving slowly.[57] True, too, there are troublesome signs that, given the history of low fees for the basic audit, the Big Four firms still see a need to game the rules, by promoting exotic tax schemes, for example, thus raising the specter of firms continuing to audit their own work. Here, too, the PCAOB, whose budget is a hefty $68 million for 2003,

[51] The Analyst's Accounting Observer, Oct. 23, 2003.

[52] Gretchen Morgenson, "Wall St. Reform Falls Short, Survey Says," NY Times Aug. 31, 2003, Sec. 3, p.6, col. 4.

[53] Bogle, "The Mutual Fund Industry in 2003: Back to the Future," Speech, Boston, MA, Jan. 14, 2003, at 6.

[54] Id. at 9.

[55] Source: NYSE Fact Book, www.nyse.com (includes the 18% of trades away from the NYSE floor).

[56] McDonough, Testimony Concerning the Public Company Accounting Oversight Bd., Senate Comm. On Banking, Sept. 23, 2003, at www.pcaobus.org/transcripts/McDonough.

[57] Stephen Labaton, "U.S. Auditing Oversight Board Begins Policing Role by Settling on Procedure," NY Times, Oct. 8, 2003, C1.

and subject to SEC approval $103 million for 2004,[58] responded with a not very subtle warning. Telling the Senate Finance Committee in September, 2003, that he found the Big Four's selling faulty tax shelters and hiding them from government auditors "immensely and morally repugnant, " McDonough added, "If they do not save themselves, we will save them and it will not be pleasant.[59]

By contrast, the FASB seems almost becalmed. Thanks to incessant lobbying from Silicon Valley, a new standard for stock option accounting is not likely to be issued for a year, if then. An even more leisurely pace afflicts the creation of a new rule for revenue recognition, the issue highlighted by Chairman Levitt in 1998, and still the most common abuse. And, of course, the object of intense lobbying. The somewhat better news is that we may soon have enhanced disclosure requirements for pension fund liabilities and some other projects being worked on in collaboration with the International Accounting Standards Board. And the still better news is the election of the highly regarded Robert Denham as chairman of the Financial Accounting Foundation, the group directly responsible for oversight, funding and appointments for the FASB. While chairman of the SEC, Arthur Levitt, Jr., had waged a battle to recapture control of the Foundation from corporate America, and Denham's election augurs well for what Levitt was trying to do.

The task is daunting. While all the gatekeepers failed, the ultimate failure was in thee and me. We were delighted with how "steadily" and predictably Freddie and GE delivered the earnings increases we sought, no matter that, at least in the case of GE, the footnotes belied the tale. How likely are we then to persuade Americans that, instead of staring at CNBC's market quotes and trivial news, they should be reading annual reports and footnotes? Or analysts to stop catering to investors' worst impulses and to focus, not on the next quarter's earnings, but on long-term prospects? Or executives to stop catering to these myopic impulses. In short, the underlying issues raised ten years ago are still with us.

[58] "Accounting Board Votes to Lift Budget 51% to $103 Million," WSJ Nov. 26, 2003, C10, col. 3.

[59] David Cay Johnston, "Wide Range of Tax Shelters Draws Senate Inquiry," NY Times Oct. 22, 2003, at C1, C2; Jonathan D. Glater, Worry Over a New Conflict for Accounting Firms, NY Times, Sept. 23, 2003, C1.

It is well beyond the scope of this essay to describe all the remedial steps taken thus far,[60] but one very recent initiative illustrates how energetically the Commission has seized the initiative, as well as the political forces muddying the waters. In October, the SEC proposed rules to provide investors with direct access to company proxy statements so as to to permit them, under carefully circumscribed conditions, to vote for shareholder-designated nominees to boards of directors. Remember, under the so-called "internal affairs" doctrine, it has for over a hundred years been left almost entirely to the jealously guarded domain of the states – effectively Delaware – to determine how boards are elected, candidates are nominated, and the like. And the proxy statement has of course been under the exclusive control of management, subject to the typically benign oversight of the board. Ninety-nine percent of board elections are uncontested. The implications, the potential pressure on managements to consider a genuine "shareholder value," are breathtaking; the 100 largest managers of pension and mutual funds now control 56% of all U.S. stocks.[61] Predictably, the Business Roundtable, an association of CEOs, immediately attacked, and while all five SEC commissioners voted to release the proposal, two promptly expressed reservations.[62]

So what are the key issues that Rolf and Mats would have us look for in the ensuing years? We need to remake a corrupt culture that contaminated every sector of corporate and financial America. Some might argue that major failures such as these are endemic to a capitalist, market economy, or perhaps simply a reflection of the American utilitarian obsession with success. While I disagree, I do not underestimate the difficulty. There is an Aristotelian concept of the unity of the virtues, which describes the virtues – justice, courage, temperance, generosity, and kindness – as being of a piece in any given individual.[63] Without all, there would be none.

Much the same is true here. Jack Bogle, the founder of the Vanguard mutual fund group, may have had it right when he said our society "is measuring the *wrong* bottom line: form over substance, prestige over

[60] There is an excellent summary in Donaldson's testimony on Sept. 9, 2003, before the Senate Banking Committee–www.sec.gov/news/testimony/090903tswhd.htm.

[61] Bogle, "What We Must Do..." supra, at 8.

[62] Deborah Solomon, "SEC May Boost Holders' Power to Nominate, Elect Directors," WSJ, Oct. 9, 2003, C12, col. 5. The authority of the SEC to promulgate this rule is sure to be litigated.

[63] See, e.g., Terry Penner, The Unity of Virtue, 82 The Philosophical Rev. (1973) 35.

virtue, money over achievement, charisma over character, the ephemeral over the enduring."[64] Does he overstate the problem? I don't think so. What else should we think as we read a Citibank executive, Steve Bailie's, email saying that Bacchus, a year-2000 Enron partnership would enable Enron to write "up the asset in question from a basis of about $100 MM to as high as $250 MM, thereby *creating earnings*."[65] (Ital added) Or that more than 30% (sic) of the mutual fund companies surveyed by the SEC had given favored customers the nonpublic information they would need to place "advantageous" trades – translation: steal from investors.[66] Or that, or that. . . .

Among the gatekeepers, first and foremost are the corporate boards on the inside and the auditors on the outside. Sarbanes-Oxley and the SEC have zeroed in on both. The DNA of the others, analysts, and bankers are important, but they will not matter without good boards and audits. Indeed, the inverse of the Aristotelian model surely applies: corruption breeds cynicism which in turn breeds corrupt practices throughout. It's also clear, of course, that to achieve a renewed sense of fiduciary responsibility in boards and accountants, we need vigorous enforcement. Specifically, we need to send some of those high-profile figures to jail, and we need some really large-dollar civil judgments in the host of pending civil suits.[67] SOXA is remarkably good; but rules alone will never do.

The likelihood of success would be greater if the problems were not so inherently intractable. We can legislate independence requirements for directors, but independence *in fact* is beyond our reach. As those of us who have been on boards know so well, there is a collegiality factor that subtly but almost surely blunts one's judgment until the problems become truly inescapable. My mother's dictum of a stitch in time saves nine is right-on; but too often even the one director who can weave the catalytic "stitch" seems hard to find. Then, too, auditing is, as we have said, inherently judgmental. The saving grace is that investors and

[64] Bogle, "What Went Wrong .. .", supra, page 1.

[65] "Partners in Crime," supra, @ 90.

[66] Stephen Labaton, "Extensive Flaws at Mutual Funds Cited at Hearing," NY Times, Nov. 4, 2003, A1, col. 6.

[67] During the 1990s, partly by new legislation, partly by a Supreme Court decision, auditors in particular became far less vulnerable to suit. See *Cent. Bk of Denver;* Pvt. Sec. Litig. Reform Act; Uniform Stds. Act. See Bevis Longstreth, speech, 9/28/03, @6.

boards need only a "fair presentation," as the formula goes, not precision, which would in any event be illusory.

As between the two, my view is that if boards are forced to confront the unpleasant realities revealed by a good audit, they are then likely to wake up. I would be tempted to say that of the two factors, accounting is the key. (We all like to think that which is our special purview is also what matters most.) But it's a discussion that goes nowhere; we need both. The prospect is for sharply enhanced audits – the Big Four will eventually realize that auditing is how they will have to earn their keep; audit fees will increase, and shareholders, and audit committees, should be pleased, nay thrilled, at that. Sarbanes-Oxley and related rules have imposed an array of new requirements designed to improve audits, to wit: (a) that audit committees have significant expertise, (b) that they be more independent than ever, [c] that the auditors will be hired by and report to the audit committee not management, and (d) that the audit committee report directly to shareholders in the proxy material. All these and more suggest that we will see a new level of board vigor and oversight. And auditing is a fine place to start.

I will be happy to review just how well all this turns out, when we meet again in 2013. In the meantime, on to the Festival of Santa Lucia.

Re-inventing Enterprise: The First and Next Decade of the Global Corporate Governance Revolution*

Stephen Davis

Thank you for including me in this historic event. Most of all, congratulations to the Corporate Governance Forum for having the foresight ten years ago to grasp the importance of an issue that now stands at the heart of international debates over economic progress. I well recall first meeting Rolf in Washington during one of his early fact finding trips in the 1980s, and then Mats in Paris as the OECD first began probing corporate governance. They were among the lonely voices of corporate governance in those ancient days. Both have made incalculable contributions to this fertile field. But perhaps the greatest tribute to their work is that so many others from many walks of life now join them in shaping the future of corporate governance.

Unlike most conferences focused on the practicalities of the here and now, this occasion invites us to step back and ask fundamental questions. For instance, what have we learned in the last decade about corporate governance and its impact on society? I am going to offer a brief answer at the start of my remarks, with a promise to return to it later. The answer, I believe, boils down to a wise comment once made by Harvard University president Larry Summers. "In the history of the world, no one has ever washed a rented car." More on that later.

The First Decade – and Before

For now, I would like to ask you to join me in gazing with some wonder at how far we have come since this Forum first gathered – and even before that. It is tempting, of course, to say that we in this room helped

* Prepared for the 10th Year Jubilee conference of the Swedish Corporate Governance Forum, Stockholm, December 11, 2003.

spawn the first corporate governance revolution in history. But we need to be humble. Some of you may remember the television series *Star Trek*. At the start of every episode, a voice would bid viewers to join the voyage of the Starship Enterprise, whose mission was "to go where no man has gone before." But did you ever notice that whenever those brave souls got to some planet, it would be crowded with people? Our corporate governance field is something like that. We did indeed kindle a reformation ten years ago that holds the promise of improving whole economies. But we were not first, and it is sometimes helpful to put our work into context so that we better appreciate challenges we still face.

Wrestling over boardroom power, and even corporate social responsibility, accompanied the earliest moments of market enterprise some 400 years ago. That struggle is nested in the very DNA of modern commerce. A quick trip back in time to the financial market's 'big bang,' when the first publicly traded stock company appeared on the landscape, illustrates the origins of the problem.

Slide your finger down an atlas of the Western Hemisphere to the tip of South America where Argentina's Tierra del Fuego juts toward Antarctica. There, in violent seas at the very edge of the world, is an unlikely shrine to the earliest roots of today's corporate governance movement: a passage named for the first shareholder activist in history.

The Strait of Le Maire marks the wild ambitions of a Flemish merchant and investor. Swashbuckling isn't a word normally applied to air-conditioned fund managers of the 21st century. But four hundred years ago Isaac Le Maire fit that bill. His nemesis was the Dutch East India Company – *Vereenigde Oost-Indische Compagnie*, or VOC – the first enterprise ever to be listed on a stock exchange. Its managers were ruthless. In fact, they paved the opening steps of a path that led straight to Enron. Complacent insiders enjoyed opulent perks while systematically demolishing shareowner value. Directors kept financial accounts secret. Investors had no say in selecting managers or voting on policies. The board refused to pay dividends – or it would disburse them in the form of bags of surplus nutmeg rather than cash.[1] Nutmeg aside, the VOC's corporate governance practices are eerily familiar to shareholders at today's poorly governed firms.

[1] Paul Frentrop, *A History of Corporate Governance* (Brussels: Déminor, 2003) and Larry Neal, "Venture Shares of the Dutch East India Company" (http://icf.som.yale.edu/pdf/hist_conference/Larry_Neal.pdf) March 2003.

Management had almost unchecked power to abuse investors. Enter Isaac Le Maire, the VOC's largest minority investor. Fed up with anemic returns, he submitted history's first recorded dissident shareholder petition on January 24 1609. The Amsterdam trader slammed management as "absurd and impertinent" and branded its chronic squandering of investor capital "a kind of tyranny." In the rhetoric of umbrage alone Le Maire kicked off a rich tradition. "Pigs at the trough" is how author Arianna Huffington would brand similar boardroom behavior four hundred years later. *Nieten in nadelstreifen* ("nitwits in pinstripes") is how German maverick professor Ekkehard Wenger would put it.

VOC executives were unmoved, however. They brushed Le Maire's complaints aside. So the determined financier recruited a coalition of investors and speculators to drive VOC shares down through massive selling, hoping to force management capitulation. Thus was born the concept of capital market pressure.

In the event, the government hastened to save the skins of the VOC's directors with special concessions to the company and curbs on investor power. For its part, the Company bided its time before striking back at Le Maire. The assault did force the board to make token concessions to shareowners. But, equally, it convinced managers to erect formidable statutory walls against future investor attack.

In other words, here we hit bedrock in the archeological roots of the struggle for corporate accountability.

But even more of today's corporate governance controversies were born in the bosom of the Dutch East India Company. What ethical standards should a company follow, if any? That was the challenge posed by a group of anti-war investors as bankers readied the VOC for the world's first initial public offering in 1602.

This was an urgent matter. The Company's strategy in Asia hinged largely on the generous application of warfare, blockade, piracy, assassination, imprisonment, plunder, terror, slavery, bribery and other standard business tactics of the day. But when the VOC turned to ordinary citizens for capital in the form of traded stock, Dutch religious pacifists suddenly gained a tool to voice objection. Some refused to buy shares until the Company foreswore the use of violence. Others disinvested, even being so bold as to sign a notarized public petition broadcasting their protest.[2]

[2] Frentrop (2003).

Dissenters swayed the Company not an iota. But they pioneered what we now call socially responsible investment and screening. And they forced the VOC to confront – and rebuff – pressure to re-fashion business tactics to meet certain social values. Here again, Dutch East India directors were unwittingly setting a model of rejection followed by a long line of public companies stretching to the present day.

Which brings us back to investor Isaac Le Maire and the mountainous passages of Tierra del Fuego. Defeated but even more obsessed with thrashing the VOC, Le Maire challenged the Company's stranglehold on shipping to lucrative spice markets in Indonesia. In 1615 he financed – and charged his son Jacob to command – a bold expedition dubbed "Goldseekers" that discovered an uncharted channel to the Pacific 200 miles south of the VOC's monopoly-controlled Straits of Magellan. Le Maire's caravel pushed triumphantly through to Jakarta, its captain heady with visions of a new commercial empire. The Dutch East India Company, however, would have none of it. Three days after Le Maire's ship sailed into port, officials threw the crew into prison and confiscated the vessel. The Company flatly denied Le Maire's claim of a new route to Asia, and packed Jacob off to the Netherlands. He died during the interminable voyage home. The VOC had its revenge.

For the next two years a furious Isaac waged legal war on the Company – and, against the odds, won. He recovered his vessel and earned the right to match the family name with the strait Jacob discovered at the bottom of the world.

More importantly, the shareowner activism he unwittingly founded in the 17th century would, like the push for socially responsible investment, slowly move from forlorn margins of enterprise to the heart of 21st century market capitalism.

Fast forward, if you will, to 1970, when Campaign General Motors signaled the start of a grassroots investor initiative to persuade US corporations to be more socially responsible. Petitioners were the first to activate proxy voting machinery successfully to confront management on social issues. Investor dissent at GM and other firms stemmed from a confluence of rising political activism and the mounting impact of large corporations on society. Shareowners soon began submitting dissident resolutions to annual meetings – as many as 40 in 1973 – addressing issues such as worker rights, the environment and investment in apartheid South Africa.[3] That tide continues to rise. Next year in the

[3] Stephen Davis, *Shareholder Rights Abroad: A Handbook for the Global Investor* (IRRC 1989) and Lauren Talner, *The Origins of Shareholder Activism* (IRRC 1983).

US we expect yet another increase over the 1,077 resolutions introduced by rebel investors in 2003.[4]

By the mid-1980s, the market was rife with largely destructive hostile takeovers, and corporate raiders ruled. At the same time, institutional investors were discovering a startling truth: shareowner activism was working. Companies were pulling out of South Africa to avoid the nastiness of boycotts and investor insurgency. So funds started asking themselves a simple question: Why not apply similar pressure on boards to achieve objectives mainstream investors really cared about – namely growing value?

Civil service funds such as the New York State pension system led the way to routine activism. But it was the US federal government that declared it mandatory. In the landmark 1988 'Avon letter," the Reagan administration's Department of Labor (with Bob Monks behind the scenes) made proxy voting at US companies a requirement for many pension funds. In 1984, the Clinton administration expanded the rule to embrace all share votes, whether in the US or outside.

Still, scandal and controversy have been the most potent drivers of shareowner activism and corporate governance reform. Let's call the roll: Robert Maxwell in Britain. Enron in the US. The financial meltdown in Southeast Asia. Metallgesellschaft and Vodafone's takeover of Mannesmann in Germany. The Tangentopoli in Italy. HIH in Australia. Eramet in France. Ahold in the Netherlands. In Sweden, furor over the proposed Volvo-Renault merger exactly 10 years ago. And now, perhaps, Skandia.

Scandal, in fact, is just about where we here enter this history. The Swedish Corporate Governance Forum began life in the wake of the UK Cadbury Code which, in turn, came about because of the Maxwell debacle. In a fact-finding trip I undertook in Europe in 1988, the term "corporate governance" was largely unknown – even in Britain. But Maxwell's was largely a corporate governance crisis – and the great and good moved swiftly to set would become a global pace of reform.

Louis Lowenstein has wonderfully analyzed the US scandals in his paper; there is no need for repetition here. But I would like to pause for a moment among friends to pay tribute to the lush narratives provided to us over the past decade by the lengthening column of rogue companies and executives. This is not just for amusement. Illustrations of ex-

[4] Investor Responsibility Research Center. Of the 1,077 proposals IRRC tracked, 794 were classified as narrow 'governance' resolutions, and the rest as 'social.'

cess, particularly in the realm of pay and perks, have proven spectacularly potent as catalysts of change at the national level.

Everyone probably has a favorite tale. Nell Minow often cites ex-CEO Robert Annunziata, whose employment contract saw Global Crossing shareholders footing the bill for monthly, first-class air travel across the United States for his mother. My personal favorite, though, took place at failed Australian insurer HIH, in an episode I have come to call "the company that mistook its CEO's briefcase for a knight." Listen in to this August 2002 extract from Royal Commission hearings into the collapse. Counsel Wayne Martin is questioning former CEO Raymond Williams on how HIH handled his travel expenses:

> *Martin*: "Could you tell us please if, on your frequent first-class trips to London, you booked the seat next to you for your briefcase?"
> *Williams*: "I don't recall specifically. But that may have been the case, on some occasions."
> *Martin*: "That your briefcase was also traveling first class?"
> *Williams*: "That may have been the case."
> *Martin*: "Did you express the view to Qantas that this briefcase should be eligible for frequent flier points?"
> *Williams*: "I can't recall that."
> *Martin*: "And were you subsequently informed that said briefcase would not be eligible for such points on the grounds that it was not, in fact, a person?"
> *Williams*: "That may have been the airline's position on that issue."
> *Martin*: "Was that briefcase, from that point on, booked under the name of Casey Williams?"
> *Williams*: "Yes, Casey Reginald Williams, AM." [*Note: AM stands for Member of the Order of Australia, an honor just shy of knighthood.*]

Unfortunately, instances of flagrant misuse of shareowner capital have cropped up in many markets. Is it any wonder that, two years ago, if you tried to type the word "Enron" into Microsoft Word, the computer spellcheck would ask whether you really meant to type "Nero"? Our canny PCs may have been trying to tell us some underlying truths. In fact, Enron, Tyco, HIH, Hollinger and many other examples of skyrocketing pay untethered to performance remind me of an astute observation by economist John Kenneth Galbraith: "The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."

That leaves us with a challenge: Are we faced with bad apples or bad architecture? I suspect most of us believe that a strong architecture of good corporate governance can lower the risk of bad apples causing too much damage. Not only do we believe that, we have been hard work building that strong architecture around the world.

How far have we come? Looking back from this vantage point, Stockholm in December 2003, we can now see that what has happened since this Forum first met is an enormous, worldwide construction project. Every day now comes more sounds of the jack hammering underway across the world to build an infrastructure of improved corporate governance. Consider just a few barometers of this revolution:

- **Benchmarks:** In 1993 just two countries could boast codes of best practice – Ireland (the Irish Association of Investment Managers) and Britain (Cadbury). Today more than 105 codes or code equivalents exist in more than 50 jurisdictions. Moreover, about a dozen multinational codes guide corporate behavior, including the authoritative one crafted by the Organisation for Economic Co-operation and Development (OECD), thanks in no small part to Mats. Endorsement has come from the very highest levels of leadership, too. The G-7 commissioned the OECD code, called for ongoing monitoring by it, the World Bank, IOSCO and the Financial Stability Forum. Corporate governance is now a routine item on agendas of most leadership summits, whether it be the G-8, the Asia Pacific Economic Cooperation forum, Africa's NEPAD or the Commonwealth.
- **Conferences.** Back in 1997, when my firm started counting, conferences on the then-esoteric topic of corporate governance numbered 89 in 10 countries. The total for 2003 this month reached 533 in more than 46 jurisdictions.
- **The academy.** This is easy. There was no academy of corporate governance when this Forum began. Today, though, fresh scholarly centers on corporate governance are sprouting almost monthly at universities around the world, producing a welcome flood of research. It is only a matter of time before they found a professional association to give the field further definition. Already groups such as the European Corporate Governance Institute and the Global Corporate Governance Forum Research Network are trying to coordinate projects and serve as a clearinghouse of scholarly work.

- **Governance and performance.** A decade ago there was virtually no data demonstrating a link between governance and performance, even though many of us in this room believed such a relationship existed. Findings that did circulate spoke solely to the United States situation. Today there is a cacophony of research from many markets, with a majority showing a correlation between governance and either performance or risk. The latest study is by Yale University economist Paul MacAvoy in a book he co-wrote with Ira Millstein, published last month.[5]
- **Investor engagement.** Few investing institutions bothered to vote shares in any market until the US Labor Department, in its landmark February 1988 "Avon letter," made voting mandatory for funds responsible for corporate pension savings. Even then, US funds reported casting just 24% of their non-US ballots in 1991, mainly because agents were systematically failing to deliver proxy documents on time, or charging high fees to vote.[6] In 1994, the Department of Labor expanded its order to include votes at holdings outside the US. But in Europe voting remained at low levels, particularly outside the home market – even when funds held considerable stakes abroad. For instance, none of the big European institutions surveyed in 1996 voted more than 10% of shares held beyond their national market.[7] Today, voting is routine, online and nearly universal at US funds. More governments – including Brazil, Britain, France and Australia – have all-but-required voting. The OECD principles spotlight voting as a fiduciary obligation. And while voting across frontiers remains complicated, the European Commission's new Action Plan – based on the Winter Committee recommendations – contemplates early measures to eliminate hurdles. Moreover, engagement has expanded rapidly beyond simple voting. The International Corporate Governance Network has agreed guidelines to help ordinary institutions plan and disclose engagement practices. And there is an entirely new category of investments that seeks through activism to extract hidden value from underperforming, misgoverned companies. Hermes is the largest

5 *The Recurrent Crisis in Corporate Governance* (Palgrave Macmillan).

6 Rachel Ongé Lerman, Stephen Davis and Corinna Arnold, *Global Voting: Shareholder Decisions 1991-1992* (IRRC 1993).

7 Stephen Davis and Karel Lannoo, "Shareholder Voting in Europe," *Center for European Policy Studies Review* (Summer 1997).

practitioner in Europe; Relational Investors in North America. The newest entrant, as of just a month ago, is the Watchdog Fund, based in New York.

- **Cross-border cooperation.** A handful of domestic bodies advocating corporate governance – such as Britain's National Association of Pension Funds and the Association of British Insurers – have been around for a while. In the US, the Council of Institutional Investors only opened its doors in 1985; other key groups, such as the Australian Council of Superannuation Investors, Canadian Coalition for Good Governance, Germany's Corporate Governance Commission, France's Institut Français des Administrateurs and, of course, this Corporate Governance Forum, are younger. But the last decade has been marked by the energetic founding of international or regional groups to speed cross-fertilization of ideas and practices. Mats's OECD/World Bank Roundtables have often acted as midwife. Among important groups formed only in the last eight years are the Global Corporate Governance Forum, the International Corporate Governance Network, International Forum for Activist Shareowners, Commonwealth Association for Corporate Governance, EurosharehoIders, the ICFTU's Committee for International Cooperation on Workers' Capital, IDEA Net, the Asian Corporate Governance Association, the Latin American Corporate Governance Association, an eastern European directors network, and the Pan African Corporate Governance Forum. And in Bangkok, even as we speak here today, pension funds are gathered to form their own continental network for information sharing. None of these group existed when the Forum first met. Today they constitute a strengthening international web of sustainable pressure for corporate governance reform.
- **Board and transparency change.** Too much in board practice remains static. On the other hand, progress in discrete areas has been remarkable. It is almost hard to believe now that when Sir Adrian Cadbury released his committee's 1992 recommendations many UK companies had combined chairman/CEOs, and few independent directors. By 1994 fully 82% of FTSE 100 firms had split the jobs.[8] Today 90% of FTSE 100 companies divide the roles and some 42%

[8] *Compliance with the Code of Best Practice*, [Cadbury] Committee on the Financial Aspects of Corporate Governance (24 May 1995).

of board members are independent.[9] In two other categories progress has also been dramatic in major markets: accounting standards and executive remuneration. Today we are just over a year away from universal application of International Financial Reporting Standards in Europe. Other jurisdictions, such as Brazil, are moving swiftly to implement them, too. And ten years ago, if you had dared suggest that details of executive pay should be revealed, you would have been dismissed as eccentric in many markets. But in 1995 Britain's Greenbury Report set a disclosure standard similar to the US one. Australia came next. In January 2001 Ireland became the first country in the eurozone to require pay details for executives. South Africa and France followed a year ago, with Germany close behind, and now the European Commission's Action Plan – again, tracking Jaap Winter's committee recommendations – sets full disclosure of top pay as a near-term EU statutory objective. Transparency in pay has allowed investors to begin monitoring whether remuneration aligns management interests with those of shareowners.

Taken together, this inventory of change represents a monumental advance over the state of the global market economy circa 1993. The reforms mark a journey we have all undertaken. And now as we celebrate achievement it is right to return to the question I posed at the beginning of this talk: What have we learned in the course of our voyage?

Let's be frank. The kind of boardroom excess I spoke about earlier can be stupefying; but it is far more than that. The consequences of corporate misbehavior have been catastrophic for millions of savers. Further, because scandals stalled recovery by damaging investor confidence in markets, they helped suppress and delay economic recovery in the United States, the world's largest capital market. As much progress as we have made, we have not yet contained these failures.

We must be clear-eyed about the source of these meltdowns. Greed is a natural human trait, whether in boardrooms or most anywhere else. Further, if greed is properly channeled it can serve as a powerful and benign engine of growth in the marketplace. The issue before us is whether the architecture of a corporation is shaped in such a way as to allow greed destructive free reign, or whether managers' drive to succeed is closely aligned with the interests of owners and stakeholders.

[9] *Leading Corporate Governance Indicators* (Davis Global Advisors, 2002).

The truth is that chronic investor submissiveness has abetted the spread of troubles at corporations. That is what I have learned. Indeed, perhaps when we look back at the last ten years we should be far more startled by the large number of listed companies around the world that played by the rules – even while too many of their owners were immobilized by a brew of conflicts and complacency.

Here, then, is where Larry Summers's observation captures the great lesson of the decade: "In the history of the world, no one has ever washed a rented car." Far too much of peoples' savings is managed as if it is rented instead of owned. Indeed, the dark mystery behind corporate misbehavior is why so many owners of capital – employees, retirees and savers in their millions – are seemingly indifferent and unaware while agents drive off with their hard-won savings, run them down, or crash them into stocks like Enron. Things go deeply amiss when owner passivity is so chronic. Companies underperform and misbehave. Pensioners lose cash they need for retirement. Nations fail to create the jobs and wealth they should.

In fact, three sobering truths define the profile of modern business. One is how much corporate performance hinges on the vigilance of investor's money. Two is how profoundly asleep so much of that capital actually is. And three is how manifold are the barriers blocking citizen-investors from discovering how mishandled many of their assets may be.

When we solve this riddle, clearing the way for savers to shepherd their own investments as diligently as many look after their own cars, we can expect the trillions of dollars that power business to produce higher corporate performance and returns, market integrity and even social responsibility. We will have private enterprise and globalization capable of earning public confidence.

Now I would invite you to cross the frontier from the past decade to the next, moving from the concrete to the conceptual. What we and many others have wrought since the founding of this Forum is the promise of a re-invention of enterprise through new benchmarks of corporate accountability and transparency. There is still a long way to go, particularly in adapting governance principles to the realities of family or state controlled enterprises. But the next ten years, I believe, will confront us with a further challenge: re-making the investment community so that it awakens to responsible ownership by dint of being itself more accountable and transparent. The prize is nothing short of a more sustainable, more inclusive prosperity.

The Next Decade – and Beyond

The tectonic shifts we have seen are not widely recognized for what I believe they represent: the beginning of a new stage of capitalism that I call "the civil economy[10]." Construction of the institutions of a civil economy will occupy us for the next decade at least. Let me explain what I mean.

We speak of "civil society" to describe the array of institutions needed to maintain political democracy. Now, crises in the free enterprise system compel us to frame a parallel notion: the civil economy. Its promise is to save globalization from itself, building foundations for a sustainable, inclusive prosperity.

Why do we need a new paradigm? Widespread public discontent over globalization is a symptom of a perilous fault line between the new realities of world capital markets and the increasingly outmoded ways in which traditional elites – both governmental and corporate – make economic decisions. The stability of global commerce may depend on a solution that bridges the gap of mistrust. Market players will have to create what amounts to a new international constitution of economic activity capable of drawing the confidence of publics around the world. Such a civil economy compact, a modern-day equivalent of the Magna Carta, would need to define a fresh balance between society and business.

New understandings are called for because the fundamentals of commerce have changed dramatically and swiftly. Through most of the 20th century, in nearly all countries, the state controlled key marketplace assets – from airlines to banks to utilities. Now, in the wake of the end of the Cold War, and the sweeping privatization and de-regulation that resulted, a host of rookie economic powers have muscled their way onto the field.

First are giant private sector corporations, the principal inheritors of economic power. Second are their owners, institutional investors such as pension and mutual funds, who sink the savings of tens of millions of individuals into equity. In big economies such as the US and Britain they now own some 60 to 75 percent of all equity. A third new power – civil society organizations such as environmental lobbies, business

[10] Parts of the following sections come from the forthcoming book *The Civil Economy*, by Stephen Davis and Jon Lukomnik. Versions of the "Civil Economy" appear in *Renewal* (UK) (Autumn 2003); *Progressive Politics* (UK) (July 2003); *Convergence* (South Africa) (Vol. 4 No. 2); and *Company Director* (Australia) (May 2003).

and professional associations and trade unions – is expanding influence, helped strongly by instant Internet communication. All three constituencies are awakening to a striking fact: suddenly, they have displaced politicians and civil servants as the principal drivers of worldwide economic activity.

The architecture of private enterprise is conspicuously out of synch with facts on the ground. Corporate executives and controlling owners accustomed to wielding unfettered power are confronting challenges from minority investors local and foreign. Most corporate boards are at sea trying to figure out how to meet fresh pressure to monitor and improve their records on the environment, workplace issues and human rights. Making matters far worse, the governance of many institutional investor funds is equally troubled. People all too often have no influence over how their hard-earned retirement savings are managed. And when such funds themselves are unaccountable, they too readily let torpor or commercial conflicts stop them from doing what they should: protecting their clients' investments by serving as watchdogs against corporate malfeasance. Finally, and damagingly, the very genome of commerce – long-standing accounting principles widely deployed to value companies – fails to include the worth of employee skills and other "intangibles" which have emerged as the pivotal assets of knowledge-economy companies.

This yawning divide between post-World War II tradition and today's reality is eroding the public mandate for economic arrangements that constitute a corporation's implicit 'license to operate.' As more individuals quite rightly ask "Who are these people now running our lives?" – and as they get relative silence in response, we risk a mainstream backlash in many countries far more perilous to growth than stones hurled at McDonalds restaurants.

The bottom line: we are in urgent need of a fresh central organizing principle that takes account of the new shape of economic growth, throws sunlight onto practices now hidden, and enfranchises new constituencies.

Thus, the civil economy. It is not so much an invention as an original term allowing us to connect the myriad dots of individual developments bubbling up in international enterprise. Interpreting these changes as part of a single phenomenon gives us insights into what is happening, where it is heading and how to help it along.

The global market ideal implicit in a civil economy is one in which institutional owners accountable to their millions of savers push corporations toward sustainable prosperity through socially responsible management. Put as a simple equation, if accountability plus social responsibility equals shareowner value, we achieve the civil economy. But how does a civil economy come about? In a civil society, political parties, an independent judiciary, a free press, impartial law and civic bodies are the core sustainers of democracy. Parallel institutions of a civil economy can be understood as engaged shareowners, independent monitors, credible standards and civil society organizations participating in the marketplace. Change occurs when these agents are mobilized, thus altering the infrastructure and rules, the unwritten constitution, of commerce.

Let me put it in a different way. In a Darwinian sense, submissive owners, marginal or conflicted monitors, absent civic groups and blinkered accounting standards cannot help but give rise to companies that celebrate shortsighted stock price jumps instead of sustainable growth. Creatures of a flawed economic terrain, many firms by their actions understandably provoke public resentment of globalization.

By contrast, a new species of corporation naturally evolves when owners are energized, monitors are girded with safeguards against conflict, civil society organizations become a constructive market force, and performance yardsticks help managers and investors gauge real drivers of value. This kind of civil economy terrain spawns corporations skilled at cultivating commercial dynamism in a context of accountability and responsibility. For early indications of how this works, just look at the extent to which intense consumer and investor pressure on some of the world's big multinationals – Royal Dutch/Shell, BP, Nike and Reebok – has convinced them to become vocal, if still perhaps imperfect, apostles of socially responsible management.

Evidence coming in from diverse markets already illustrates the evolution of a virtuous circle. Companies with active, long-term shareowners are ones that introduce more responsive governance and are more likely to produce higher returns, drawing in turn more long-term – and loyal – investors. Such corporations gain access to capital at a lower cost, giving them advantages over rivals. Latest studies showing this effect come from S&P, the Hong Kong-based brokerage CLSA and McKinsey & Co. Accountability in all parties, in short, is surfacing as one of the most effective keys to unlocking sustainable value. We might even call it, in effect, the "invisible hand" of the civil economy.

Engaged Shareowners. In civil society, we talk of voters. In a civil economy, we address owners. Today, as you know well, institutional investors managing the savings of tens of millions of people quietly own vast swathes of the market all over the world. But too many funds shirk their fiduciary obligation to savers and offer unquestioning obedience to corporate authority, even when a company's management is patently flawed. The root cause: most funds fail to meet the bedrock governance standards they increasingly demand of companies. Savers can only rarely discover how their funds behave as owners. Nor do savers normally have a voice in how the funds operate. As a result, many pension plans, mutual funds and unit trusts are inevitably hobbled by conflicts and do little to challenge wayward companies in which they own stock. A mutual fund, for instance, is unlikely to vote shares against a company's management if it wants business from the CEO. That aversion to oversight frees corporations, enabled by somnolent boards, to engage not only in high-volume larceny, as we have seen at Enron, HIH, Tyco, Adelphia, Worldcom and others, but in a more corrosive everyday mismanagement of companies' impact on shareowner capital, employees and the environment.

Through voluntary codes, law or regulation, institutional investors must become transparent and accountable. They must disclose regularly what guidelines they use in investing, including whether or not they consider social criteria and how they vote their shares. Outreach to members through the Internet and electronic communications should make this routine. Savers should have a role in selecting trustees of such funds. And trustees should have access to robust, independent training programs. At the same time, market regulators should be vigorous in ensuring that funds operate solely in the interests of their clients, rather than for other conflicting business interests.

Some of these reforms have only recently been introduced by statute in the UK, US, Australia, France and Germany. Where implemented, they are spurring funds to play a more active role as owners. That, in turn, has compelled more companies to clean up their management and improve their social responsibility performance.

An especially effective grassroots engine of shareowner engagement is the scrappy band of investor groups representing small individual savers. They include Aktiespararna in Sweden, PSPD in Korea, DSW in Germany, the Investor Protection Association in Russia and the Australian Shareholders Association. National public policies should be shaped to encourage such civil economy institutions, since they often are freer from conflicts to act as watchdogs. Malaysia has even gone so far as to create a state-sponsored Minority Shareholder Watchdog Group to capture for the nation the civil economy benefits of activism.

What are those benefits? As discussed earlier, academic and industry studies now overwhelmingly show that funds enhance the value of their investments if they are activist players in the marketplace. Benefits also flow to corporates. Companies that respond to watchful shareowners by improving governance can lower their cost of capital. Research further demonstrates that activism – and accompanying improvements in corporate governance – significantly boosts a country's economy. The reverse is likewise true. Countries with poor corporate governance lose out on wealth and jobs. ANZ Bank once calculated that in 1998 alone poor corporate governance cost New Zealand the equivalent of 7% of GDP in shareowner value. In short, a civil economy of engaged shareowners pays.

Independent Monitors. In civil society, we expect the surveillance of a free press and the brawn of an independent judiciary to guard against tyranny. In a civil economy, we need a wide range of monitors that help make corporate behavior transparent so that firms end up advancing the interests of the economy as a whole. Such monitors include, of course, media willing and able to scrutinize boards. Only recently have even prominent newspapers awakened to the impact on society of malignant corporate governance. Until 2001, the *New York Times* did not even use the term except in quotes or with an explanation. They also include fair and vigilant regulators. But, in addition, we need a dynamic, worldwide industry of accountability screeners.

A great many bodies specializing in corporate governance already exist. Among them are the Association of British Insurers, Déminor, European Corporate Governance Service, Manifest and the National Association of Pension Funds in Europe; the Corporate Library, Institutional Shareholder Services and the Investor Responsibility Research Center in the US; Corporate Governance International in Australia; LCV in Brazil. Specialized Internet services have joined them. Witness Hong Kong's webb-site.com, the US's eRaider.com and Australia's Crikey.com. Other firms probe companies on their social, environmental or international security performance. Look at SIRI and Vigeo in Europe; KLD and Conflict Securities in the US; Sustainable Investment Research Institute in Australia; or Corporate Footprint in South Africa.

Some of these monitors have unresolved, and sometimes undisclosed, commercial conflicts of interest of their own. Their "constitutional" obligation in the new market – a message they are hearing more frequently from clients – is to address such tensions openly. But the biggest challenge facing accountability screeners is that many of them are barely commercial. Moreover, a huge number of countries feature no such domestic services at all. That, in turn, reflects the enduring ambivalence many funds – the monitors' potential clients – have had until now about acting as true owners. Fund managers do not want to pay for monitors unless they have to. But more are finding they do have to, thanks to pressure from pension plan trustee boards or investor groups. Britain's Institutional Shareholders' Committee, for instance, declared in a landmark October 2002 statement that funds must either hire outside corporate governance monitors or do the work in-house if they expect to meet fundamental fiduciary standards. The International Corporate Governance Network guidelines on shareholder responsibility, adopted last July in Amsterdam, echo that view. In other countries, regulators may act to require monitoring.

A civil economy hinges on the integrity of other intermediaries as well. We have seen the implosion of reputations among broker analysts in the US owing to conflicts of interest with related investment banks. Auditors have been badly tarnished by consulting conflicts. Actions by regulators and the professions must ensure that advice to shareowners is as independent as advertised.

Finally, new civil economy tools are beginning to appear in response to market demand. For instance, commercial services are offering investors quantitative ratings designed to measure a company's governance risk. S&P produces issuer-commissioned ratings. Other firms are developing scorecards for national indices in Australia, Brazil, Greece, France, India, Korea, Poland, Russia, and the US. Déminor rates European blue chips. And GovernanceMetrics International[11] is pioneering worldwide risk ratings using more than 600 data points per company. For the first time, portfolio managers now have on their screens the ability to define "investment grade governance" when making buy and sell decisions. And companies are able to benchmark their own accountability practices against peers at home or anywhere in the world.

Credible Standards. Civil society depends on a web of law derived with the consent, and attuned to the social environment, of the electorate. In the world of owners, the invisible hand of accounting standards serves alongside law as a rough equivalent. Such rules pilot executives and accountants toward how and what to manage and measure. But do these

[11] The author is a founder of and partner in GovernanceMetrics.

buoys – long the handiwork of a priesthood of specialists – reflect the views and needs of modern investors? Shareowners must make judgments on a firm's value and market price based in large part on analysis of financial information released by companies. But current conventions set in cement the great, ill-concealed secret of traditional accounting: rules greatly underrate the financial impact of a company's relationship to employees and society at large.

The gap can result in acute distortion. Former New York City deputy comptroller Jon Lukomnik often cites a vivid illustration. "If Bill Gates were to leave Microsoft and go to Sun Microsystems, you can be sure the stock of Microsoft would go down and Sun's up. Yet Gates is listed nowhere as an asset on Microsoft's books. If anything, he is a liability because of accrued compensation and other rules. So the accounting we use is just plain inadequate to a services and intellectual-capital based economy." Investors resort to educated guesses as an alternative.

No one knows this more than accountants themselves. Their firms are first among the many mainstream bodies scrambling to develop common measures of assets so hard to define that experts officially label them "intangibles." If they elude classification, though, such attributes nonetheless are among the most powerful drivers of modern business success. They include a corporation's management of intellectual property such as brands and innovation, employee skills – often dubbed 'human capital,' its reputation, and its capacity to control environmental risk. Civil society organizations would call most of these social, or stakeholder, relationships. Entrenched accounting standards, by contrast, were developed in the manufacturing-centered era to compute the tangible assets – bricks and mortar – of a firm. As long as measurements fall so short, risks are opaque. Managers and investors alike find themselves unable accurately to price in the bottom line implications of a corporation's social performance.

Here again, though, new powers on the ground are re-shaping market architecture. Solutions are emerging from groups never before involved in accounting standards. The Global Reporting Initiative, SA 8000, AccountAbility's AA1000, the SIGMA Project and other models are ahead in recruiting companies to experiment with fresh asset-measuring techniques aligned with new capital interests. Consumer advocates in the US (the Association for Integrity in Accounting) and the Netherlands (SOBI) want a say in how standards evolve. Various corporations around the world are testing in-house methodologies, too. At the end of the day, universal adoption of such formats will hinge on whether civil economy institutions exercise sufficient clout on stock exchanges, standard setters and corporates. It may also depend on the willingness of governments and regulators to intervene in support of more accurate benchmarks of business achievement.[12]

If they succeed, though, proponents will have built a common financial infrastructure that effectively links social responsibility to shareowner value. When companies begin releasing accounts based on and audited against such standards, the financial impact of a firm's social performance will become transparent. Stock prices will begin to reflect more than they can now the ability of a company productively to manage critical stakeholder relationships.

Civil Society Organizations as Market Forces. The success of a civil society rests on the proliferation and clout of non-governmental organizations working within the law for change. So does a civil economy – except that civil society groups must adapt their strategies to suit channels afforded by capital. Many still shun the market, hewing to the conventional Cold War habit of seeking solutions only at the political level. Some champion violent protest or use muscle for corrupt purposes, placing themselves decisively beyond the bounds of a civil economy. But others who understand the latent power of capital peacefully marshaled are paving fresh paths.

Trade unions in certain countries are among them. Through its Office of Investment and Center for Working Capital, the US AFL-CIO federation has honed tactics that convert labor-run pension funds into powerful instruments of shareowner activism. They press fund managers and, through them, corporations, to improve governance as well as employee relations. Australian, Dutch, German and UK union federations are taking a similar course, collaborating with each other through the ICFTU Committee for International Cooperation on Workers' Capital.

Anti-poverty groups, too, have recently recognized advantages of mobilizing capital. In 2001 the London-based War on Want and Traidcraft Exchange issued a handbook guiding pension fund trustees and fund managers on means to push companies for responsible practices. In 2002, environmental advocates joined them en masse in embracing a shareowner agenda. Boston-based CERES launched its "sustainable governance" initiative in an effort to achieve results through shareowner activism. It also published a report making a financial argument for cor-

[12] For instance, see the UK Department of Trade and Industry's Kingsmill report, www.accountingforpeople.gov.uk.

porate attention to climate change. Along the same lines, the Rose Foundation for Communities and the Environment issued *The Environmental Fiduciary: The Case for Incorporating Environmental Factors into Investment Management Policies*. Britain's Chartered Institute of Management Accountants published its similar *Environmental Accounting.* The International Finance Corp. (an arm of the World Bank) and the Ethos Institute released *Developing Value: The Business Case for Sustainability in Emerging Markets*. In only the last few weeks funds have responded by uniting with advocates behind two bodies – the Investor Network on Climate Risk, in North America, and the Institutional Investors Group on Climate Change, in Europe.

Groups such as these can themselves best enhance their legitimacy as players in the civil economy – can earn their own 'license to operate' – by meeting fundamental governance standards they demand of corporations. That, too, is a requirement of the implied constitution of the new capital market. Policies and leaders of non-governmental organizations should be fully accountable to their members, their actions and conflicts of interest transparent, and their means peaceful.

Pressed by their own members and clients, big funds too are acting on the environment. Some steps would have been unthinkable just a couple of years ago. For instance, the UK's National Association of Pension Funds now routinely issues social profiles of all major UK listed companies. And mainstream coalitions in the US and UK each recently formed climate change taskforces calling on corporations to report more completely on harmful emissions.

To reach such ends, funds are finding new ways to collaborate with each other within and across borders. Such efforts are giving rise to a growing population of civil economy groups, some of which I mentioned earlier.

Taken together, these fast-moving developments can be seen as knitting together a nascent market-based network of civil economy organizations bound to help shape the new face of enterprise.

Government's role. Is there a role for public policy in speeding progress? There is – at both national and international levels. Governments are necessary partners in creating conditions for accountable commerce. They are the ultimate guarantors of rules applying to all parties. However, the most effective results come from intervention with a light touch, allowing market forces to do the heavy lifting. Indeed, most of what is needed from government is surgical adjustment of regulation and law.

The beauty of that equation – small public expenditure yielding big results – is that it could be a winning platform for any political leader under pressure to spur both growth and social justice when there is little money in the public till.

At home, governments best capable of stimulating reform are those arising themselves from successful civil societies. They are inherently more stable. And policies grounded in democracy and exposed to public scrutiny inevitably yield wider acceptance and fairer implementation. But once a government embraces the need for action, the agenda for change is long.

Lawmakers can aid the rise of a civil economy by promoting the development of domestic investing institutions: pension funds and shareholder associations. Further, governments can compel such funds to meet fundamental standards of accountability so that savers' financial clout is exercised rather than disregarded, and aligned solely with the interests of savers. Individuals with money in pension funds should have rights to elect trustees, and gain regular updates on how asset managers vote and act on behalf of savers on corporate issues. Such measures wake up markets by empowering institutional owners and making them responsive to the interests of citizen pensioners.

Domestic policymakers must also ensure that those investors have the tools they need to act as real owners. To a large degree, this means a set of simple rules on disclosure. Every listed company should have to place all financial statements and regulatory filings on the web in a timely fashion. For large corporations with nonresident shareowners, such information should routinely be provided both in the home market language and in English, the dominant tongue of capital. Boards should have to explain how management handles risks related to the workplace and the environment. And they should reveal in detail the ways in which executive remuneration is linked to performance.

Policymakers can spur a race to the top through tested measures such as best-practice company law, tough regulation and impartial prosecution, and codes covering board and disclosure standards. They can permit forms of class action lawsuits, another brake on malignant management. But they can also use less direct means, such as innovative tax incentives, or rules channeling civil service pension fund investments to best-governed firms. Some stock exchanges are already rewarding enterprises boasting star governance with premium rankings or discounts on listing fees. Britain even has a minister in the Department of Trade and Industry charged specifically with the job of finding public sector means to promote corporate social responsibility.

All these actions can be understood as building an architecture and constitution of engaged owners and responsible corporations. But progress can be painfully sluggish where powerful interests resist the prospect of challenge. Nations with robust corporate governance traditions can help. If they have overseas development aid programs, they should reinvent them to nurture indigenous civil economy institutions in struggling markets. The US Center for International Private Enterprise is a worthy model.

At the international level, glimmers of a new paradigm in economic decision-making are rare. But they are the future. Governments continue to call the shots on trade rules, world debt and central banking. Still, doors are opening to the new grassroots players of modern enterprise. At the United Nations, Secretary General Kofi Annan negotiated with business executives and investors to produce his groundbreaking Global Compact, a set of corporate responsibility principles. The United Nations Environment Programme gave critical assistance to the Global Reporting Initiative, which issues disclosure guidelines on social responsibility. With Mats's wise guidance, the OECD is reaching out to civil society organizations, businesses, investors and trade unions to update corporate governance principles. The OECD and the World Bank also cooperate in unprecedented fashion with the autonomous Global Corporate Governance Forum, which boasts potent ties to the private sector. The OECD and the Bank now have mandates to aid market-based institutions in emerging and transition countries – in effect, a civil economy agenda.

These developments signify only the start of a worldwide transformation of postwar economic life reflecting the profound democratization of capital power. After all, "the proper governance of companies will become as crucial to the world economy as the proper governing of countries," observes World Bank president James Wolfensohn. But corporate excesses now so emblematic of globalization stir urgent dangers of public backlash. If unchannelled, such reaction could derail change rather than speed it. That is why public and private sector policymakers such as those of us gathered here must consider whether the prudent path to a new worldwide 'constitution of the marketplace' lies today in speeding the rise of a civil economy. Our challenge in the next decade, I submit, is to build institutions that promote the fusion of accountability and commerce. If we succeed, we can ensure that globalization truly fulfills its promise of spreading sustainable prosperity.

European Corporate Governance Harmonisation Plans: A Critical Assessment*

*Guido Ferrarini***
Professor of Law, University of Genoa

I. Introduction

In this paper, I examine current trends and perspectives of company law harmonisation in Europe, focussing on two recent Communications by the EU Commission. In section I, I analyse the Communication "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward", which was adopted by the Commission on the 21st May 2003. This Communication builds upon the High Level Group of Company Law Experts' Report "A modern regulatory framework for company law in Europe" published on 4 November 2002 ("Winter Report"), the conclusions of which are largely reflected by the Commission's proposals. In section II, I consider the Communication "Reinforcing the statutory audit in the EU", which was adopted by the Commission on the same date as the Communication on company law and corporate governance, and complements the same by suggesting an extensive revision of the 8th Company Law Directive.

The former Communication includes a Company Law Action Plan envisaging both legislative and non-legislative actions and defining the same in terms of short, medium and long-term objectives. The latter touches upon issues already included in the Financial Services Action Plan adopted by the Commission in 1999 in an attempt to build a regulatory framework for a single financial market. Both Communications also respond to concerns created by the Enron affair and similar US financial scandals, recently matched in Europe by scandals such as those concerning Ahold, Adecco and Parmalat. The EU responses to Enron

* Section II of this paper reflects comments made by the author at a hearing at the European Parliament on December 1, 2003.

** Vice-Chairman, European Corporate Governance Institute (ECGI), Brussels.

also address other issues, such as financial reporting, for which the decision was taken to make International Accounting Standards (IAS) binding for all listed companies; transparency in the international financial system, with particular emphasis on financial engineering techniques and hedge funds; and financial analysts' research and the role of rating agencies. Research by financial analysts is now covered by Article 6 (5) of the Market Abuse Directive, while investment recommendations are also covered by the new Investment Services Directive.

The general question that I try to answer in this paper is whether the creation of a single securities market and the need to meet Enron type concerns in Europe justify the harmonising measures contemplated by the Commission's two Action Plans and related documents with respect to corporate governance and statutory audit. To the extent that this paper includes any criticism of current harmonisation proposals, this should not be understood as a rejection of regulatory reforms in the critical areas involved by Parmalat and other recent scandals. On the contrary, similar reforms can be introduced by national legislators tailoring the same to each country's needs.

II. The Company Law Action Plan

In this section, I analyse the EU Action Plan as illustrated in the Communication on Modernising Company Law, with particular reference to those aspects of the Plan which directly affect corporate governance. I focus, therefore, on corporate governance codes (sec. 1); on the proposed annual corporate governance statement (sec. 2); on the proposed regime of information from institutional investors (sec. 3); on mechanisms to protect shareholders' rights (sec. 4); on the composition, remuneration and responsibilities of the board of directors (sec. 5); on groups and pyramids (sec. 6).

In my analysis, I assume that the Commission's arguments concerning corporate restructuring and mobility, which reflect the comments made by the High Level Group of Company Law Experts (Winter Group), are correct and consistent with the European Court of Justice's recent judgements in this area ("Centros", "Ueberseering" and "Inspire Art"). I further assume that the new perspectives on corporate mobility should influence the reshaping of EU company law by enhancing the role of regulatory competition with respect to that of regulatory harmonisation. I note, in addition, that corporate mobility will be enhanced by harmonisation measures such as the recently proposed Tenth Directive on cross-border mergers of companies with share capital (COM(2003)703) and the planned Fourteenth Directive on cross-border transfer of seat. Moreover, I share the Commission's view that the Second Directive on capital maintenance should be simplified on the basis of the SLIM recommendations as supplemented in the Winter Report (SLIM-Plus).

I concentrate on public limited companies. However, and by way of introduction, I express doubts on the feasibility of a European Private Company Statute as suggested, subject to further study, by the Commission's Communication. On the one hand, the *Societas Europaea* experience shows that harmonisation in this area cannot be complete and that recourse to national rules makes the European Company much less interesting to business undertakings. On the other, the increasing mobility of companies determined by the ECJ judgements and the proposed Tenth and Fourteenth Directives will create opportunities for regulatory arbitrage thus making the EPC Statute redundant.

1. Corporate Governance Codes

The Commission launched in 2001 a review of the main corporate governance codes relevant to the EU. The comparative study conducted by the US law firm of Weil, Gotshal & Manges concluded that the EU should not devote time and effort to the development of a European corporate governance code. A similar conclusion was reached by the Winter Group . The Commission's Communication shares this view arguing that the existing corporate governance codes show a remarkable degree of convergence, whilst the main differences between Member States are found in differing company law and securities regulation (p. 11). The Commission suggests, therefore, that "the adoption of such a code would not contribute significantly to the improvement of corporate governance in the EU, as the code would have either to allow for many different options or confine itself to abstract principles" (*ibidem*). Moreover, the OECD already adopted corporate governance principles in 1999 and will adopt a modernised version of the same in 2004. The Commission's Communication concludes that "a common approach should be adopted at EU level with respect to a few essential rules and adequate co-ordination of corporate governance codes should be ensured" (p. 12). In the following paragraphs, I will analyse the proposed rules and recommendations. As to co-ordination, the Commission regards it as important to encourage convergence of national codes through regular meetings of the European Corporate Governance Forum (p. 17). This Forum should comprise representatives from Member States, regulators, issuers and investors, other market participants and academics, and be chaired by the Commission (*ibidem*).

On the whole, the idea of enhancing co-ordination and convergence amongst national codes of corporate governance is acceptable. However, the proposed mechanism risks removing corporate governance codes from the area of private autonomy to that of regulation. In particular, the participation of governments and regulators in the European Corporate Governance Forum will influence the discussion on corporate governance codes and distort the incentives which have successfully led to the formation of these codes at the national level. Considering that the codes were generally drafted by committees comprising representatives of private companies, investors, stock exchanges and business associations, rather than governments and regulators, it would be advisable to replicate similar structures at the EU Level. Therefore, the work of the European Corporate Governance Forum when dealing with co-ordination of national codes should be organised along the lines already experimented at the Member States level in the production of similar documents.

2. Annual Corporate Governance Statement

The Commission also suggests requiring listed companies to include in their annual report and accounts a statement covering the key elements of their corporate governance structures and practices (p. 12). This statement should include "a reference to a code on corporate governance, designated for use at national level, with which the company complies or in relation to which it explains deviations" (p. 13). The Commission suggests the inclusion of a similar "comply or explain" rule in a Directive to be adopted with reference to the annual corporate governance statement in general. The proposed statement should also include other items, such as the operation of the shareholder meeting; the composition and operation of the board and its committees; the major shareholdings and related parties transactions (p. 12).

On the whole, this suggestion is acceptable and extends to the EU level a solution which has already been successfully experimented in some Member States. In particular, the reasons for legal harmonisation are found in the governance function of corporate disclosure and in transaction cost reductions ensuing from uniform disclosure of corporate governance practices in the EU. However, the proposed "comply or explain" rule also includes elements of rigidity as the Commission suggests that "each Member State should progress towards designating a code of corporate governance, designated for use at national level, as the code with which listed companies subject to their jurisdiction are to comply or in relation to which they are to explain deviations". The indication of only one code of corporate governance at national level appears too restrictive. Even if generally there is only one code to which listed companies may adhere in each Member State, the situation could evolve in the future. The existence of one code per country is often a reflection of the monopoly still enjoyed by national stock exchanges with respect to domestic companies. However, the market for listings could become more competitive despite the trend to exchange consolidation. Therefore, room should be left for more than one corporate governance code at national level, so that new entrants in the exchange market could offer improvements on existing practices. It would be sufficient, for this purpose, to require that listed companies refer to the national code indicated by their regulated market's operator. Similarly, companies of country A choosing to list their securities in country B should be free to adopt either a code existing in country A or one indicated by the exchange where the listing occurs.

3. Information from institutional investors

The role of institutional investors in listed companies is so important that it is sometimes suggested that they should be required to exercise their voting rights at the shareholders' meetings. The Commission's Communications rightly excludes such a drastic proposal and recommends a disclosure-based solution (p. 13). Institutional investors should disclose both their policy with respect to the exercise of voting rights and how these rights have been used in a particular case. The relevant requirements should be adopted through a directive amending other existing directives applicable to the various types of institutional investors (such as insurance companies, mutual funds, etc.).

4. Shareholders' rights

Three types of actions are suggested by the Communication to strengthen shareholders' rights (p. 13 f.).

4.1 Access to information

The use of electronic facilities to access the relevant information in advance of general meetings is already foreseen by the Transparency Directive and could be expanded to enhance shareholders' rights.

4.2 Cross-border voting

The exercise of shareholders' rights in listed companies across the EU, including the rights to vote in absentia and to participate in general meetings via electronic means, encounters a number of legal difficulties for the solution of which the Commission recommends the adoption of a Directive in the short term.

4.3 Shareholder democracy?

The Commission suggests "a strong medium to long term case for aiming to establish a real shareholder democracy in the EU" and seems to identify shareholder democracy with the one share – one vote principle often supported by corporate governance advocates (p. 14). However, this principle has been intensely debated from a theoretical perspective and its desirability in terms of economic efficiency rejected by renowned scholars. In truth, the Commission acknowledges the need for a prior study of "the principle of proportionality between capital and control advocated by the High Level Group" (*ibidem*). However, it is not difficult to anticipate that such a study will not find undisputed theoretical or empirical support. Moreover, the one share – one vote principle still receives intense opposition from those countries, such as the Nordic ones, whose corporate governance is largely based on dual class share structures.

5. Board of directors

The role, composition and functioning of boards of directors and equivalent bodies in two-tier systems are governed either by national laws or by corporate governance codes. To the extent that these codes will be subject to co-ordination efforts at EU level, the relevant practices will be further harmonised within the limits allowed by the distinction between unitary and dual governance structures. However, the Commission believes that harmonisation should be further enhanced with respect to some key areas.

5.1 Board composition

To start, a Recommendation should define "minimum standards applicable to the creation, composition and role of the nomination, remuneration and audit committees" (p. 15). Two criticisms can be made in this respect. Firstly, the organisation of the board by way of committees is typically reserved to corporate governance codes. The adoption of a Recommendation might have a negative impact to the extent that recommendations are political acts, albeit of a non-binding character. In addition, audit committees are already subject in some Member States to mandatory rules. This may highlight a trend, possibly inspired by the US Sarbanes-Oxley Act, with respect to which the proposed Recommendation would not appear as particularly meaningful. Secondly, the minimum standards proposed do not necessarily reflect European best practices and appear to be rather weak if confronted with US and UK standards. For instance, a majority of independent non-executive or supervisory directors is required for audit and remuneration committees, whilst US and UK requirements ask for all the members of these committees to be independent. Furthermore, the Commission would recommend nomination committees to be composed mainly of executive directors "since executive directors can usefully bring their deep knowledge of the challenges facing the company and of the skills and experience of the human resources grown up within the company" (p.15). However, there are even more reasons for requiring these committees to be made up by a majority (at least) of independent directors, the main reason being that the committee at issue should assure the selection of truly independent directors for the board. If a majority of executives sit on the committee, it is less likely that these independent candidates will be proposed for appointment as non-executives; in addition, executive members of the committee will be in a conflict of interest when the appointment of a new CEO is at issue.

5.2 Directors' remuneration

The Commission's suggestions as to directors' remuneration reflect those of the Winter Report and deserve approval. They touch upon four key items: disclosure of remuneration policy in the annual accounts; approval by the shareholder meeting of share and share option schemes in which directors participate; recognition in the annual accounts of the costs of such schemes for the company.[1]

5.3 Directors' responsibilities

Under this heading, four suggestions are advanced by the Commission (p. 16).

5.3.1 Collective responsibility

The first one is to confirm through a Directive "the collective responsibility of all board members for financial and key non financial statements (including the annual corporate governance statement) …". Two comments are useful in this respect. On the one hand, collective responsibility is already the basic approach in Europe: "As such, it is firmly entrenched in Germany with its two-tier-structure, and is equally recognised in England within a one-tier-system. Adopting this principle, is particularly advantageous from an agency perspective: … collective responsibility adds a dimension of horizontal monitoring to board decision making and avoids undue influence or biased decisions by single board members".[2] On the other hand, collective responsibility should not mean that all directors are equally liable. Executive directors, for instance, are more exposed, to the extent that they assume greater responsibilities in the area of financial reporting either directly or by way of review of the work done by others. This is acknowledged by the US Sarbanes-Oxley Act requiring CEOs and CFOs to certify in each annual or quarterly report that, based on their knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact, and fairly presents in all material respects the issuer's financial conditions and results of operations (sec. 302(a)).

[1] For arguments supporting similar suggestions, see G. Ferrarini and N. Moloney, 'Executive Remuneration and Corporate Governance: Convergence, Divergence and Reform Perspectives', in G. Ferrarini, K.J. Hopt, J. Winter and E. Wymeersch (Eds.), *Reforming Company and Takeover Law in Europe*, Oxford University Press, 2004, p. 267.

[2] See H. Fleischer, 'The Responsibility of the Management and its Enforcement', in G. Ferrarini, K.J. Hopt, J. Winter and E. Wymeersch (Eds.), *op. cit.*, p. 407.

5.3.2 Special investigation right

As recommended by the Winter Group, a special investigation right should be introduced in EU company law “whereby shareholders holding a certain percentage of the share capital should have the right to ask a court or administrative authority to authorise a special investigation into the affairs of the company” (Communication, p. 16). The Winter Report noted that “a number of Member States have recognised the need for a special investigation procedure. The core provisions are rather similar, but the details vary considerably” (p. 58). Consequently, the Report suggested the adoption of a “European framework provision” which should be “short and precise”, whereas “the details should be left to the Member States in order to enable them to make the rule compatible with the procedural and administrative practice in their jurisdictions” (*ibidem*). This recommendation is quite reasonable and appears to strike a fair balance between harmonisation and national company law provisions.

5.3.3 Wrongful trading rule

The Commission proposes the enactment through a Directive of a rule “whereby directors would be held personally accountable for the consequences of the company’s failure, if it is foreseeable that the company cannot continue to pay its debts and they don’t decide either to rescue the company and ensure payment or to put it into liquidation” (p. 16). Similar rules are already in existence across Member States: “However, a closer look reveals considerable divergences in salient points which may have a great impact on the efficacy of a wrongful trading regime”.[3] These divergences concern, in particular, the time when wrongful trading rules come into play and the protection of creditors who contracted with the company after the critical date.[4] It is clear that harmonisation should tackle similar issues; however, uniform rules will not be easily found given the existing divergences amongst legal systems in Europe.

[3] H. Fleischer, *op. cit.*, p. 393.

[4] *Ibidem*.

5.3.4 Directors' disqualification

The Commission suggests imposing directors' disqualification across the EU "as a sanction for misleading financial and non-financial statements and other forms of misconduct by directors" (p. 16). This should be done by way of a Directive to be adopted in the medium term, as further analysis is needed. Also the Winter Group highlighted the need for further review of the issue based on a comparative analysis of Member States' laws and on a specific inquiry into the proper scope of European harmonisation in this area. As suggested by a German scholar more recently, the review should differentiate between two possible areas of application: securities regulation and the problem of misleading market information, on one side; company law and the abuse of limited liability, on the other.[5]

5.3.5 Assessment

On the whole, it is clear that legal harmonisation as to directors' responsibilities will be problematic, given that national laws are divergent in this area and that liability rules and their enforcement also depend on the working of other legal institutions (such as those concerning civil procedure and the administration of sanctions). The introduction of European framework principles should leave room to Member States' rules reflecting national traditions and institutions. In any case, the impact of EU rules will be quite limited and considerable divergences will persist, unless an effort is made to better analyse the reasons for differences and the economic grounds for harmonised solutions. This could be the task of academia with the support of the private interested parties, such as practicing attorneys, notaries, accountants and business organisations. Only a wide and serious research effort could, in fact, highlight the grounds for approximation of laws in complex areas such as those selected by the Commission for legislative action. However, the very idea of adopting Directives in this area should also be questioned, considering the rigidity of similar instruments and the fact that only framework principles would be harmonised. Possibly, Recommendations would be better equipped to obtain approximation of laws in the relevant fields, whilst keeping national differences. Also the works of the proposed European Corporate Governance Forum could be instru-

[5] H. Fleischer, *op. cit.*, p. 414.

mental to agree upon common solutions which would then be adapted to domestic corporate governance settings.

6. Groups and Pyramids

The Commission suggests the adoption of provisions in three areas (p. 18 ff.).

6.1 Financial and non-financial information

Listed companies are subject to improvements as to information concerning their groups on at least three counts: application of IAS to consolidated accounts; ownership disclosure under the Takeovers Directive; annual corporate governance statement. As the scope of these measures is limited to listed companies, the Commission suggests adopting additional measures with respect to groups where the parent company is not listed. This could in fact enhance the protection of both shareholders and creditors of a group in cases where the disclosure rules of capital market law are not applicable.

6.2 Group policy

Whilst the plans for a Ninth Directive on group relations are set aside, a framework rule on co-ordinated group policy is suggested. This is a minimal solution that avoids the problems of a fully-fledged group law by focussing on a less controversial issue of management's responsibility. The proposed rule would allow the directors and managers of a company belonging to a group to implement a co-ordinated group policy, provided that the interests of creditors are protected and that there is a fair balance of burdens and advantages over time for the company's shareholders. Similar rules can be found already in national company laws (e.g. the recent Italian company law reform includes a provision reflecting the Commission's proposal).

6.3 Pyramids

Pyramidal groups are particularly problematic when involving more that one listed company (e.g. company A is listed and its sole asset is a controlling block of company B which is also listed). These groups exacerbate separation of ownership from control by allowing someone to control two or more listed companies with a relatively small investment. The Winter Group recommended that national authorities should be required not to admit to listing companies belonging to abusive pyramids. This is already the rule in some Member States. However, it is often difficult to decide whether a pyramid is abusive or not; in addition, a group including two or more listed companies may become a pyramid in the course of time due to unexpected contingencies (e.g. dismissal of an unprofitable business). It is therefore acceptable that the Commission "considers it necessary to give further examination to the risk inherent in abusive pyramids" taking account of "the need to avoid undue restrictions of companies' freedom to choose their appropriate organisation" (p. 20).

7. Conclusions

I summarise, by way of conclusion, the main criticisms raised in this section with respect to the European company law Action Plan.

(i) The co-ordination of national corporate governance codes through the European Forum proposed by the Commission risks removing these codes from the area of private autonomy to that of regulation, and subjecting the same to political influence. As to the proposed "comply or explain rule", the indication of only one code of corporate governance at national level appears too restrictive.

(ii) The Commission's suggestion to enhance shareholders' democracy through adoption of the one share-one vote principle is not supported by economic analysis and will continue to meet opposition from some Member States (as shown by the discussion on the proposed Takeover Directive).

(iii) The standards proposed as to board of directors' composition and organisation do not necessarily reflect European best practices, whilst their inclusion in a Recommendation would unduly politicise the relevant discussion.

(iv) Legal harmonisation of directors' responsibilities is problematic, given that national rules are divergent and their enforcement depends on the efficiency of other legal institutions. Therefore, the very idea of adopting Directives in this area should be questioned, also considering the rigidity of these instruments and the fact that only framework principles could be adopted.

III. The Plans as to Statutory Audit

In this section, I analyse the Communication "Reinforcing the statutory audit in the EU" (2003), which follows another Commission Communication on statutory audit (1998) and two Recommendations, one on external quality assurance (2000), the other on auditor independence (2002). As a result of further studies taking into account the implications of Enron and similar financial scandals, the Commission proposes a modernisation of the 8th Company Law Directive (which was adopted in 1984 and deals mainly with the approval of persons allowed to perform statutory audits) to provide a comprehensive legal basis for all statutory audits conducted in the EU (p. 5). The Communication touches upon issues such as the proposed new approach to statutory audit (see para. 8 below) and the main problems shown by recent European and international experience, including appointment of auditors and communication with the same, auditor independence and auditor liability (see para. 9).

8. New Regulatory Framework

The new European approach to audit is principles-based – the same as that applied to financial reporting (p.5). The proposed new 8th Directive shall state framework principles as to the appropriate audit infrastructure, audit independence, appointment of auditors, etc. Further clarification will be provided by best practice recommendations (as already done, e.g., for audit independence) and by implementing measures adopted through comitology. The Lamfalussy approach is explicitly referred to by the Commission that suggests revising the "monitored self-regulation" approach laid down in its 1998 Communication: "...in the present situation, a shift in the balance between representatives of the public interest and those of the audit profession must take place in order to sufficiently ensure the independence of EU policy making" (p.6). This statement is clearly influenced by recent US developments, such as the establishment of the Public Company Accounting Oversight Board.

8.1 Three-tier Structure

In particular, an Audit Regulatory Committee of Member States representatives will be established in the modernised 8th Directive to assist the Commission in the adoption of implementing measures, whilst an

Audit Advisory Committee of regulators and audit professionals shall take care of the preparatory work. The regulatory structure will consist, therefore, of three levels: the co-decision procedure leading to the adoption of directives (first-tier); the comitology procedure required to implement the directives through detailed regulation (second-tier); the preparatory work done by professionals and regulators through the Advisory Committee (third-tier). This structure is similar to that found for financial reporting which consists, at second-tier level, of the Accounting Regulatory Committee charged with the endorsement of international accounting standards and, at third-tier level, of the European Financial Reporting Advisory Group. EFRAG participates in the standard setting process conducted by the International Accounting Standards Board (IASB) and assists the Commission in the implementation of IAS/IFRS.

The main difference from the Lamfalussy structure is found at third-tier level, given that CESR (the advisory body for securities markets) consists entirely of securities regulators, whereas the proposed Audit Advisory Committee will include members from the audit profession. In addition, the proposed structure for audit regulation will comprise a co-ordination mechanism to link up national systems of public oversight into a European network (pp. 8-9). Similar co-ordination activities are undertaken by CESR with respect to securities markets' surveillance. In the field of audit, however, public oversight is subject to different national regimes and is exercised either by securities regulators or by sector specific regulators. The Commission, therefore, proposes to introduce minimum requirements for audit oversight in the 8th Directive and to set up a specific co-ordination mechanism amongst audit oversight institutions.

Moreover, similarities with the Lamfalussy structure exist at second-tier level, where the proposed Auditing Regulatory Committee, like the European Securities Committee (ESC), helps in the adoption of implementing measures. Therefore, the regulatory framework suggested for audit may suffer from the same limits already seen with respect to securities markets. On the one hand, directives often include detailed provisions instead of framework principles to avoid negative reactions from the European Parliament (concerned over the loss of its prerogatives under the co-decision procedure). On the other, political conflicts over technical issues often lead to compromise solutions different from those obtainable under a system granting quasi-legislative powers to an independent regulator. Also for auditing, therefore, the question may arise in the future whether the proposed regulatory structure should be modified so as to foresee an independent regulator at second-tier level, whilst limiting the first-tier actions to real "framework directives".

8.2 Common Auditing Standards

Further similarities exist between the proposed regulation of statutory audit and that already in force for financial reporting. The Commission suggests the use of common auditing standards "to support a uniformly high level of audit quality throughout the EU" (p. 6). In particular, the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) should be used for all EU statutory audits from 2005 onwards. The position is similar for financial reporting where the IAS Regulation provides for application to all EU listed companies of the International Accounting Standards issued by IASB and endorsed by the Commission through comitology. In both cases, the production of standards (second-tier rules) is delegated to private bodies (such as IASB and IAASB) subject to these standards' compliance with EU requirements stated in directives and regulations (first-tier rules). A similar structure is justified by the technical nature of the relevant standards and the need for the same to be issued by professional experts operating in independent organisations created to further the public interest. In addition, the standards should reflect best market practices and be fixed through public consultation with all interested parties.

However, the adoption of IAAS in Europe still requires several steps to be made. Not only should these standards be further developed, but also the European requirements for their endorsement need clarification (p. 7). In addition, the standard-setting's organisation should be reviewed, in the light of the fact that IAASB is one of the standing technical committees of IFAC, the International Federation of Accountants. As suggested by the Commission: "A standard-setting body independent of IFAC, operating primarily from a public interest perspective, under a governance structure with a majority of (non-practitioners) international stakeholders would be more credible from a public interest perspective and could be more easily recognised by the EU" (*ibidem*). The IASC/IASB structure, which was extensively reviewed at the end of the 90s, is a possible model to replicate for the creation of an international auditing standard-setter subject to suitable requirements of independence and professionalism.

9. Main Regulatory Issues

9.1 Audit Committees

The Commission suggests that, from a corporate governance perspective, one of the main regulatory objectives should be that auditors "maintain an appropriate degree of independence from executive directors" (p. 9). In the Commission's opinion, "audit committees can play an important role in the governance of a company by assisting the auditors to stay at arm's length from management" (*ibidem*). In a similar vein, the second Winter Report argued that the audit committee should be concerned with the external auditor's performance (p. 70). In particular, the audit committee should: select the external auditor for appointment by the shareholder meeting (as is the rule in most Member States) or the full board; monitor the external's auditor independence and the non-audit services provided by the auditor firm; meet regularly with the external auditor; ensure the auditor's access to information; receive the auditor's management letter with comments on the financial statements.

All this corresponds to best practice in Europe, whilst similar provisions are found in U.S. legislation. Under sec. 301(2) Sarbanes-Oxley Act, audit committees are responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by the issuer. In addition, under sec. 204 of the same Act, outside auditors must report to the audit committee: all critical accounting policies and practices to be used; all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management; and other material written communications between the auditor and management. On the whole, the audit committee's powers with respect to auditors are regulated by the Sarbanes-Oxley Act similarly to international and European practice. A major difference is that in the U.S. outside auditors are appointed directly by the audit committee, whilst in most European States they are appointed by the shareholders meeting. Nonetheless, also in Europe audit committees participate in the selection of auditors (as recommended by the Winter Report) and this is beneficial to the extent that in concentrated ownership companies the shareholder meeting is dominated by controlling shareholders who also appoint the managers. The audit committee, therefore, mitigates the conflicts of interest affecting auditors' appointment, particularly if the committee's members are in the majority independent from executive directors and controlling shareholders.

The Commission recommends to include in the 8th Directive principles on the appointment, dismissal and remuneration of statutory auditors, and on the communication of the statutory auditors with the audited entity's governance body (pp. 9-10). These principles would contribute to the independence of auditors making the relevant requirements uniform at EU level with ensuing benefits in terms of uniformity of the financial reporting quality. However, the proposed provisions would also impact on the company's governance structure, particularly if they dwelt on the appointment, composition and functioning of audit committees. The Communication in question refers back to that on company law and corporate governance which was examined in the previous section. Consequently, the 8th Directive should not deal with the details of board organisation and functioning; rather, it should fix framework principles that any governance body (be it a board of directors, supervisory board, audit committee or board of auditors) could implement. However, limiting the impact of the proposed principles will be a difficult, if not impossible task, as shown by Sarbanes-Oxley Act which was often accused of interfering with the companies' internal governance structures, despite its ample *renvoi* to the listing rules to be adopted by stock exchanges under SEC supervision (and yet within the Act's framework principles).

9.2 Auditor Independence

The Communication at issue proposes that the basic principles stated by the Commission's Recommendation on auditor independence (2002) be incorporated in the modernised 8th Directive. The key objective of the EU approach is set as follows: "the statutory auditor should not carry out a statutory audit if there are any financial, business, employment or other relationships between him and his client (including the provision of non audit services) that a reasonable and informed third party would conclude compromising the statutory auditor's independence" (p. 11). Non-audit services are permitted provided that general and specific safeguards are complied with (see the Commission's Recommendation of 2002). It is recommended, in any case, that "the individuals employed by either the audit firm or its network member firm neither take any decision nor take part in any decision-making on behalf of the audit client or one of its affiliates, or its management while providing an audit service".

Strengthening auditor independence is also one of the Sarbanes-Oxley Act's main goals (a circumstance which may have influenced the Commission's suggestion to incorporate the principles on auditor independence in a European Directive). To this end, the Act mandates approval by the audit committee of all audit and non-audit services provided by the issuer. Moreover, sec. 201 prohibits accounting firms from providing a variety of non-audit services contemporaneously with the auditing of any public company. Auditors may provide non-audit services not specifically prohibited by the Act; however, these services must be approved in advance by the audit committee and such approval must be disclosed to investors. The Act's rigidity can partly be explained as a reaction to public outrage determined by the behaviour of Arthur Andersen in the audit of Enron's accounts. However, the prohibitions foreseen by Sarbanes-Oxley Act are also justified, to a large extent, by the conflicts of interest inherent in the provision of non-audit services to an issuer by its auditors.

Despite rejecting an outright prohibition for non-audit services, the Commission Recommendation reaches conclusions not too distant from the Sarbanes-Oxley Act's provisions. This is done through an analysis of individual services, clearly selected having regard to the recent American scandals, for which the Commission's conclusions, notwithstanding the recommended principles-based approach, are often in line with the Act's prohibitions. It is easy to understand, therefore, why the Communication in question also suggests studying the impact of a more restrictive approach to the provision of additional services (p. 11). On the one hand, a similar approach would narrow the distance between the EU and US treatment of auditor independence; on the other, the same approach would be largely consistent with the Recommendation's conclusions concerning individual services.

9.3 Auditor Liability

The issue of auditor liability is central to any regulatory framework of statutory audit. Auditing quality should not be assured by public oversight only. An effective system of private enforcement should also be in place covering audit failures that public regulators were unable to prevent. The perspective of being sued for damages will exert pressure on auditors and improve their services' quality. However, the solutions adopted in the Member States with respect to auditor liability are diversified, as shown by a comparative study published by the Commission in January 2001 that highlighted significant differences, for instance, as to: the legal nature of the liability action brought by the audited company against the statutory auditor; the standing of third parties to bring liability actions against the statutory auditor; the statutes of limitation; and the possibilities of limiting liability. This raises two questions for European law: the first one is whether harmonisation is needed; the second is whether harmonisation is possible at all, given the divergent preferences expressed by national legal systems. The two questions are intertwined: answering them requires a clarification of both the comparative law aspects and the economic grounds for the liability rules and criteria adopted at national level. The core issue is whether national responses to the auditor liability problem are adequate from the viewpoint of the single financial market; only if these responses appeared to be insufficient, would a case for harmonisation arise. Therefore, the whole problem cannot be dismissed too quickly, as the Commission does by stating that harmonisation of professional liability is very difficult and that it "does not believe that harmonisation or capping of auditor liability is necessary" (p. 14). Nonetheless, the Commission leaves the door open to further developments by recommending an "analysis of the economic impact of auditor liability regimes" (p. 15).

IV. Conclusions

In this paper, I have tried to answer the question whether the Commission's plans for the harmonisation of company law and audit regulation are necessarily justified as a result of the creation of a single capital market and the need to meet Enron type concerns (exemplified in Europe by scandals such as that involving Parmalat company and its auditors). As to company law, the conclusions reached in section II can be summarised by saying that the Commission seems to be too active in suggesting harmonisation. Whilst a "comply or explain" rule could be conveniently adopted at European level with respect to national codes of corporate governance, the other harmonising measures concerning the "one share – one vote" principle and directors' responsibilities appear to be premature. As to audit regulation, harmonisation proposed by the Commission has more merit also in light of the fact that audit is linked to financial reporting, the latter already subject to European harmonisation and international convergence. However, the proposed regulatory architecture for audit, modelled as it is on the Lamfalussy structure, may need to be modified in the future to minimise political influence. In addition, auditor independence criteria may need revision if convergence with US regulation is sought. Furthermore, auditor liability rules require further study to explore perspectives of harmonisation, given the importance of private enforcement in assuring auditing quality. On the whole, approximation of company law and corporate governance practices would require deeper comparative law analysis and a better understanding of the economic foundations of national company laws. This is clearly the task of academia and of practitioners involved in the corporate governance arena. Their research and discussion are needed before further regulatory action is taken at EU level.

Shareholder activism and institutional shareholders in the United Kingdom

*Paul Davies**

I. Introduction

When I spoke in Stockholm a decade ago on the topic of corporate governance in the United Kingdom I reported some research then recently carried out by myself and a (then) research student, Geof Stapledon, on the composition of the shareholding body in listed British companies.[1] Our theme was that it was by that time wrong to view the shareholder structure of such the companies as falling squarely within the analysis established by Berle and Means in the 1930s for large US companies.[2] In the typical Berle and Means company no single shareholder has a shareholding of sufficient size that, either alone or – and this is important – in combination with a manageable number of other shareholders, it is rational for that shareholder to devote effort to changing the business policies of a company in which it is invested. Instead, such a shareholder will sell the shares on the market or to a take-over bidder and invest the proceeds in a company in whose management the investor has greater confidence. Such an investor is, in the famous phrase, 'rationally apathetic' about the exercise of governance rights within any particular portfolio company, though, of course, not apathetic about taking steps to maintain the value of the investment portfolio overall. Such an investor might well be an active trader, but it was not rational for the investor to be an active shareholder. The investor's collective action problems as a shareholder were simply too costly for it to overcome, in comparison with either the likely benefits of exercising

* Cassel Professor of Commercial Law at the London School of Economics and Political Science.

1 M Isaksson and R Skog (eds), *Aspects of Corporate Governance* (Juristförlaget, 1994) at pp 55ff.

2 A A Berle and G C Means, *The Modern Corporation and Private Property* (Rev'd ed, New York, 1967).

governance rights or by reference to the competing cost/benefit analysis arising from the alternative strategy of selling the shares and re-investing elsewhere.

There has been some debate since then about the extent to which the Berle and Means analysis applied in the UK.[3] The suggestion has been made that family control persisted longer in the UK than in the US. I do not want to enter into that debate, because it is clear that family control is not today and has not been for some decades a significant feature of the shareholding structure of listed British companies. The argument by Stapledon and myself a decade ago was that the Berle and Means analysis was inapplicable to the UK because of the rise of institutional shareholding, especially the rise in the proportion of the market held by pension funds and insurance companies. We accepted that this had not produced the blockholder pattern of shareholding so common in continental European countries, but we did argue that the rise of institutional shareholding had made the exercise of governance rights by small groups of institutional shareholders in portfolio companies a feasible strategy.[4] We attempted a preliminary analysis of how the cost/benefit analysis of the exercise of governance rights on the one hand and trading on the other worked out in this brave new world of dominance of the markets by institutional shareholders. Our overall conclusion was that institutional activism was on the rise but there existed a number of significant hurdles to the effective co-ordination by such shareholders of the their governance rights.

How much has changed in the past decade? On the factual level, not a great deal. The apparently relentless onward march of the institutions has come to a halt or substantially slowed down, so that the statistical picture has largely stabilised. Insurance companies have held about 20% of the market since 1990, whilst domestic pension funds' holdings

[3] B Cheffins, 'Law, Economics and the UK's System of Corporate Governance: Lessons from History (2001) 1 *Journal of Corporate Law Studies* 71.

[4] See now also M Becht and C Mayer, 'Introduction' in F Barca and M Becht (eds), *The Control of Corporate Europe* (Oxford, 2001). In particular, they point out: 'The size of the largest block [of shares] is therefore appreciably smaller in the UK than on the Continent but the size of blocks does not decline very rapidly thereafter. Indeed, the third largest block and beyond is larger in the UK than any other country in this study. Even beyond the tenth largest blockholding, the mean voting block in the UK is greater than 3%, whereas it is below disclosure levels in virtually all Continental European companies in this study.' (at p 19). This is consistent with the idea of control being exercisable by a coalition of institutional shareholders.

have declined by nearly one half over the decade to represent in 2002 about 15% of the market. However, over the same period the rise in the proportion of the market held by investors outside the EU has more than doubled to 32.1% in 2002.[5] Although the statistics, unhelpfully, do not break down the non-EU investor category any further, one can conservatively assume that about half this category is institutional, thus bringing the total institutional share of the market to 60%, which is the figure Stapledon and I arrived at a decade ago. There are a number of reasons for the decline in the proportion of the market held by pension funds. The increasingly mature status of many funds has led to a re-balancing of the asset classes out of equities and into bonds. The combined impact of the long bear market and new accounting standards[6] has led many employers to close existing defined benefit schemes to new members and substitute defined contribution schemes with usually lower levels of contribution.

Overall, however, it would appear that the governance potential of the institutional shareholders today is at least as great as it was a decade ago. What about the policy implications of this set of facts? How has the policy prescription moved on over that decade? Ten years ago, we were in the middle of a quite active trans-national debate on 'relational investing'. In the US, in particular, there was criticism of the domestic law for putting obstacles in the way of institutional investors combining to take action against ineffective management. In this context, the British system was subject to an acute analysis by Professors Black and Coffee[7] on the grounds that it seemed to offer an interesting contrast with the US, because there were not the same legal barriers in British securities laws as were then thought to exist in US law to co-operation among institutional shareholders. One cannot say that British law was, or is, free of all barriers to co-operation among institutional shareholders. Insider dealing rules in the UK will often mean that institutional shareholders which engage in intense dialogue with the management of portfolio companies will have to accept that during the period of engagement, and even for a while afterwards, they lose their freedom to

[5] National Statistics, *Share Ownership 2002* (London, 2003), Table A.

[6] Financial Reporting Standard 17, which requires 'marking to market' of the investments held in pension funds. FRS 17 is issued by the British Accounting Standards Board, but it seems likely that the International Accounting Standards will take the same approach.

[7] Black and Coffee, 'Hail Britannia? Institutional Investor Behaviour under Limited Regulation' (1994) 82 *Michigan Law Review* 1999.

trade the securities of that company. Further, the British take-over Panel has recently had to look at its mandatory bid rule to ensure that institutional shareholders combining simply to effect a change of the board of a portfolio company did not come under a collective obligation to launch a take-over bid.[8]

Nevertheless, for Professors Black and Coffee the interesting thing about the UK was that levels of institutional activism appeared to be sub-optimal, even in a legal system which was substantially more receptive to combination by institutional shareholders for the purpose of exercising their governance rights. This suggested that explanations for sub-optimal levels of institutional shareholder activism might lie in structural, rather than legal, obstacles to institutional shareholder combination for the purposes of the exercise of governance rights. This was in line with the analysis of myself and Stapledon, who argued that the competitive nature of the fund-management industry and the conflicts of interest to found within it made the formation of effective coalitions among institutional shareholders more difficult than a simple reading of the statistics might suggest.[9]

The relational investor debate has now rather departed from the prominent position it once occupied in US circles. In the UK, by contrast, although relational investing never became a major policy issue, its close cousin, shareholder activism, has come centre stage in Governmental policy. In fact, my argument is that institutional shareholder activism is now seen by Government in the UK as the driving force behind good governance in the private sector. As a prelude to that, however, it is necessary sketch briefly the major developments in corporate governance in the UK over the past decade.

II. Corporate governance post Cadbury

A decade ago was the year after the Report of the Cadbury Committee,[10] the first committee in the UK on corporate governance. Since

[8] The complex results of this reform are now stated in a lengthy note 2 to Rule 9.1 of the City Code on Take-overs and Mergers, defining whether a shareholder resolution is 'board control-seeking' or not.

[9] See further G P Stapledon, *Institutional Shareholders and Corporate Governance* (Oxford, 1996) ch 10.

[10] Report of the Committee on the Financial Aspects of Corporate Governance (London, 1992).

then there have been four (or really five)[11] further committees report on corporate governance, the most recent being the report of Mr Higgs.[12] The appointment of Mr Higgs was triggered by events in the US which in the UK are referred to under the general heading of 'Enron'. In itself this was a tribute to the way in which national corporate governance systems are converging. After all, Enron, Worldcom etc held assets in the UK but these passed into new hands with very little friction or little political fall-out. Certainly, in terms of job losses the restructuring efforts of continuing US companies, such as Ford and GM, have had a much bigger impact in the UK than anything associated with Enron. What Enron did create in the UK was a reasonable fear similar things could happen in the UK and that, in consequence, the UK should carry out a health check on its corporate governance system. It is difficult to think of any foreign event which previously has triggered such a significant set of domestic reform proposals. The DTI, which in one way or another, was behind most of the initiatives soon created a post-Enron section on its web-site and that site continues to record the government's actions in this field.

Despite the number of reports which have followed Cadbury, that initial report is the crucial one, because it produced the ideas which later committees have extended and reinforced, but within which they have been content to work. There were two crucial aspects to Cadbury. The first was that the focus of the reform effort should be concentrated on the structure and composition of the board. This gave rise to two policy prescriptions: (a) that the number and role of the independent non-executive directors (NEDs) on the board should be enhanced; and (b) that there should not be a concentration of power at the top of the company, in particular that the CEO and the chairman of the board should not normally be the same person.

[11] The three before Higgs/Smith were: Directors' Remuneration: Report of a Study Group (Greenbury Committee) (London, 1995); Final Report of the Committee on Corporate Governance (Hampel Committee) (London, 1998); Institute of Chartered Accountants, Internal Control (Turnbull Committee) (London, 1999).

[12] Review of the Role and Effectiveness of Non-Executive Directors (Higgs Committee) (London, 2003). This is available on: http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf. The Higgs Report was accompanied by an important but more specific report on audit committees: Audit Committees: Combined Code Guidance (Smith Report) (London, 2003). Somewhat unfairly to Sir Robert Smith, the two reports, whose recommendations constitute a coherent whole, are normally referred to as 'Higgs'.

These prescriptions have been further enhanced so that, under latest reforms propounded by Mr Higgs, the independent NEDs become one half, rather than one third, of the board; and the roles of the committees which they dominate, especially the audit committee,[13] have been enlarged. Equally, the desirability of splitting the CEO and chairman role is now stated in more prescriptive language, and it particular it is said that a retiring CEO should not normally move into the chairman's slot.

Thus, focusing on the structure and composition of the board was one of two central ideas in Cadbury. The notion was that it was through independent NEDs and an independent chair of the board that an effective counterweight could be provided to the otherwise all-powerful executive management of the company.

The other central idea of Cadbury was that enforcement of the governance rules should not be via legislation but via a Code of Practice (the 'Combined Code')[14] nor, and this is the more important aspect, should the Code rules be put on a purely mandatory basis. Instead, the obligation on a listed company should be to comply with the Code or to explain why it has not done so. The Combined Code contains a set of default rules in other words, though, as we shall see in a minute, a set of strong default rules. However, it is important to note that the obligation to comply or explain is not a matter of choice. Any British company listed on the main market of the London Stock Exchange must, annually, report on whether it has fully complied with the Code and explain areas of non-compliance.[15] This obligation is placed on listed companies by the Listing Rules, made by a statutory body, the Financial Services Authority, acting as the UK Listing Authority. There are legal sanctions for non-compliance, including the imposition of financial penalties on the directors of the company which breaches its obligation.[16]

The flexibility in the system derives from the fact that the Listing Rules permit companies to explain areas of non-compliance. Non-compliance with the Combined Code is not a breach of the Listing Rules, provided areas of non-compliance are explained. A company must in its annual report make an audited statement as to how far it has complied

[13] The role of the audit committee was the particular concern of the Smith Report: see previous note.

[14] 'Combined' because it brings together the recommendations of the various committees listed in notes 12 and 13.

[15] Listing Rules, para. 12.43A.

[16] Financial Services and Markets Act 2000, s 91.

with the Code. And it must explain areas of non-compliance. It would be perfectly in accordance with the Listing Rules for a company to report that it had not complied at all with the Code, provided it explained why not. No sanction from the FSA nor any public authority would follow if a company proceeded in this way.

Does this mean the reporting requirement is meaningless? There may be reputational losses arising from non-compliance. But one might think this a weak sanction. The real point about sanctions in relation to the Code is that it leaves any adverse action vis-à-vis the management of a non-complying company to the shareholders of that company. It is at this point that the board structure precepts of Cadbury link up with the changes in the structure of the shareholding body, mentioned above. In other words, the risk that a company runs in choosing to explain non-compliance, rather than to comply, is that it may trigger adverse action on the part of the shareholders. That possibility, which is not a fanciful one, helps to explain a paradox in the reactions of the management of British companies to the recent Higgs report.

III. Shareholder activism and corporate governance

The paradox of British management's reaction to Higgs consists in that, on the one hand, what Higgs recommended was simply more of what is already there in the Combined Code, whose structure, as said, was laid down by Cadbury. On the other hand, there was fierce resistance to the proposals from management. Thus, even though Higgs proposed no changes in the comply and explain system via the Listing Rules nor, in relation to the substantive content of the Code, was it proposed to introduce new elements but simply to strengthen the existing elements, nevertheless opposition from management circles was especially strong, and not just on the grounds that this was the straw which breaks the camel's back. The main ground for management's opposition, in my view, was the parallel changes which Government had been promoting, independently of Enron, in the role of institutional shareholders as holders of governance rights within companies. Since non-observance of the Code carries sanctions for companies only to the extent that shareholders respond adversely to explanations of non-compliance, a more active shareholder body has the potential to impart to what seem relatively straightforward developments in the Code a qualitatively different character.

However, is the feared level of shareholder activism a realistic prospect in the United Kingdom? As has already been mentioned, despite the potential for greater shareholder activism in portfolio companies which institutional shareholding has created, there is general agreement that the levels of such activism have been, and still are, sub-optimal. By sub-optimal in this context is meant that less intervention in the affairs of portfolio companies occurs than would be the case if the institutions, individually or collectively, were single-mindedly committed to the maximisation of the value of their portfolios. Both Black and Coffee and my former collaborator Geof Stapledon in his book, *Institutional Shareholders and Corporate Governance*, found levels of intervention to be sub-optimal, despite increasing absolute levels of intervention.[17] Partly, such sub-optimal behaviour is due to competition among the fund managers acting on behalf of institutional shareholders and the consequent temptation for any one manager to free ride on the efforts of others when it comes to forming a coalition to exercise corporate governance rights. The recent Company Law Review identified conflicts of interest as an important additional contributor to sub-optimality, again especially at the fund-management level.[18] Financial conglomerates which provide investment management services to institutions are reluctant to be active shareholders in portfolio companies if this would jeopardise their corporate finance links with the management of those companies.

The Government's interest in changing that situation was revealed most clearly with the appointment of Paul Myners to carry out a review of institutional investment, whose report was received in 2001,[19] ie before Higgs was appointed. This report accused institutional shareholders of failing to discharge their obligations to those on whose behalf they held the shares by failing to exercise their voting power at meetings of the company and more generally by failing to exercise their governance rights so as to influence the management of portfolio companies. The Government proposed legislation, partly derived from US model

[17] See notes 8 and 10 above.

[18] Company Law Review, *Completing the Structure*, November 2000, paras. 5.2-5.12; Company Law Review, *Final Report*, Vol 1, paras. 6.19-6.40, July 2001. The author was a member of the Steering Group for this Review.

[19] P Myners, *Institutional Investment in the UK: A Review* (March 2001) pp 1 – 26 and pp 147 – 151. This is available on: http://www.hm-treasury.gov.uk/mediastore/otherfiles/31.pdf.

of the ERISA,[20] to require greater activism. For the time being, however, the institutional shareholders seem to have staved off that threat by adopting a voluntary code which commits them to monitoring the performance of portfolio companies, including compliance with the Combined Code; intervening where necessary, up to and including seeking to change the board; and reporting the results of their activities to their clients.[21] However, that the pressure is still on the institutions is shown by a recent, well-publicised speech by the relevant Treasury minister, in which she said that she was unconvinced about the commitment of the institutional shareholders to activism.[22] This speech was followed up by another, this time from the Secretary of State at the DTI in which she threatened the institutions with legislation requiring them to disclose publicly their voting records.[23]

Thus, one may say that at the moment relationships between the Government and institutional shareholders are marked by mutual suspicion. The Government thinks the institutions are insufficiently active because conflicts of interest still operate. The institutions think the Government is pressing activism because it thinks activism is in the public interest, not necessarily in the interests of those on whose behalf the institutions invest. The institutions' Code of Practice is careful, for example, to retain the freedom for institutions to sell their shares if they think that is the course more in the interests of their beneficiaries than the exercise of corporate governance rights; and to cap the resources they spend on the exercise of governance rights by reference to the likely benefits to their beneficiaries.

However that relationship ultimately resolves itself, the prospect of more active institutional scrutiny of areas where companies are not in compliance with the Combined Code was enough to generate on the part of management of large British companies a spirited opposition to Higgs' proposals, when they were first announced. In particular, management feared that institutions would not take seriously companies' explanations of their reasons for not complying with areas of the new Code, so that the Code would become based *de facto* on compliance, rather than comply or explain.

[20] Employee Retirement Income Security Act 1974 (29 USC 1001 ff).

[21] Institutional Shareholders' Committee, The Responsibilities of Institutional Investors and Agents – Statement of Principles, 2002.

[22] *Financial Times fm*, October 13, 2003.

[23] *Financial Times*, November 3, 2003

However, just as with the institutions and shareholder activism, so also with management and the Combined Code, the government holds the whip hand: the threat of legislation. Once the Government made it clear it supported the Higgs proposals, management had little choice but to accept them, for fear of the Government deciding to take the Combined Code system out of the Listing Rules and placing it in the Companies Act, with possibly stronger sanctions attached. In the adjacent area of directors' remuneration the Government had just acted in this way. One of the post-Cadbury committees had looked at the issue of directors' remuneration in detail – this was the Greenbury Committee[24] – and its results had been partially embodied in the Combined Code and the Listing Rules. But the Government did not regard them as having been effective. So, in 2002 the Government moved the obligations into the Companies Act and strengthened them at the same time.[25]

The effect was to add to the annual reports boards of quoted companies must make to their shareholders a report on the board's remuneration policy for executive directors (especially in the area of performance-related pay) plus an audited account of amounts actually paid to directors, individually, in the relevant reporting period. That report is subject to a mandatory but advisory vote of the shareholders. This new requirement certainly livened up annual general meetings at the beginning of the current reporting season, with one famous company, GSK, having its report rejected by the shareholders and several others suffering significant votes against. Consultation with institutional shareholders in advance of setting remuneration policies is as a result a more widespread activity than it once was.

Thus, in the end the Financial Reporting Council, the body responsible for the Combined Code, accepted the Higgs proposals with essentially cosmetic changes, and they came into effect in the second half of 2003.[26]

[24] Above n 12.

[25] This was effected by the Directors' Remuneration Report Regulations 2002 (SI 2002 No 1986), which added the new provisions to the Companies Act.

[26] The current version of the Combined Code is available on: http://www.frc.org.uk/about/combined.cfm.

IV. Conclusion

My argument has been that Cadbury and Higgs may be the names which are on people's lips in the corporate governance debate, but the sanction behind the whole process is that provided by the institutional shareholders, where Myners is the name to conjure with. More broadly, one can say that the modernising of corporate governance in the UK turns on a very old-fashioned principle of company law, namely the primacy of the shareholders in the structure of the company. The CLR adopted the same approach by proposing a re-formulation of the duties of directors so as to put the shareholders firmly centre-stage. The duty of the directors is to be 'to promote the success of the company for the benefit of its members'.[27] Although that duty is stated inclusively, ie it recognises that it is in the interests of shareholders to promote effective relations with other stakeholders in the company, it is essentially a shareholder-centred, not a stakeholder-centred, approach to company law. One imagines that this proposal would have attracted a great deal more criticism than it has, were it not for the fact that those shareholdings represent by-and-large the retirement savings of the economically active sections of the population, rather than pools of individual wealth.

[27] Final Report, above n 19, vol. II at p 46.

Taking Shareholder Protection Seriously? The Case of Germany

Theodor Baums
Professor of Law, Johann Wolfgang Goethe – Universität Frankfurt

I. Introduction

Since the article "Corporate Governance in Germany – System and Recent Developments" prepared for the first meeting of the Swedish Corporate Governance Forum in Stockholm 10 years ago[1] the German corporate governance system – both the factual system and the regulatory framework – has changed quite dramatically. The following remarks will be confined to pointing out the driving forces behind these changes in the first part. The main part of the article will then deal with the present reform process and some deficiencies still remaining in the German corporate governance system.

II. The Driving Forces

What are the driving forces behind the changes in our traditional corporate governance system and the regulatory reforms? The following reasons can be identified.

First, a *scientific and political debate* developed in the nineties about the pros and cons of the traditional German way of corporate finance and governance with its unique features like firm-housebank-relationships, the depositary voting system, and capital and personal interlocks between the big financial and industrial groups in the famous "Deutschland AG".[2] This debate gained political momentum when corporate

[1] In: Isaksson, Mats/Skog, Rolf (eds.), Aspects of Corporate Governance, Stockholm 1994, 31- 54.

[2] Cf. Edwards, Jeremy S.S./Fischer, Klaus (eds.), Banks, Finance and Investment in Germany, 1994; Baums, Theodor, The German Banking System and its Impact on Corporate Finance and Governance, in: Aoki, Masahiko/Patrick, Hugh (eds.), The Japanese Main Bank System, 1994, 409- 449; Baums, Theodor/v. Randow, Philipp,

Germany encountered several major *corporate scandals*, which led to spectacular corporate collapses and damage to investors. Government reacted to these developments by enacting several laws and appointing a reform commission.

This domestic debate has of course to be seen within the broader trend towards *globalisation* of the markets and of the financial markets in particular. In this context globalisation acts in two ways. Large German businesses increasingly take up equity not only in Germany but also abroad, for example in the U.S. or in Japan, where they are then confronted with the requirements of foreign capital markets law. Large companies listed in New York for example have to conform to the requirements of the Sarbanes Oxley Act. Vice-versa, globalisation means that the percentage of foreign institutional and private investors in the equity of German businesses is continuously rising. These globally orientated investors make their expectations known to the managers of the portfolio-businesses which they are investing in. This leads to an altogether different "investor relation"–orientation than previously.

The *revolution in information and communication technology* supports and enables the changes described in the structure of investors. Technologically speaking, it is nowadays no problem for an institutional investor domiciled in California to take part in a general meeting in Munich via Internet, nor for a member of the board from Japan to take part in a meeting of the supervisory-board taking place in Frankfurt. However, regulations have to be adapted to such developments wherever necessary.

A further keyword in this context is *restructuring of our pension system.* The demographical development necessitates a restructuring of the traditional pensions system and, more than ever, private investments have to be directed towards the capital market. The protection of the private investor therefore becomes an important political aim. And the greater supply of capital leads to a change in the financing behaviour of busi-

2 continue Shareholder Voting and Corporate Governance: The German Experience and a New Approach, in: Aoki, Masahiko/Kim, Hyung-Ki (eds.), Corporate Governance in Transitional Economies (EDI World Bank Studies) 1995, 435 – 458; Wenger, Ekkehard/Kaserer, Christoph, German Banks and Corporate Governance: A Critical View, in: Hopt, Klaus J./Kanda, Hideki/Roe, Mark J./Wymeersch, Eddy/Prigge, Stefan (eds.), Comparative Corporate Governance, 1998, 499 – 536; Becht, Marco/Böhmer, Ekkehard, Ownership and Voting Power in Germany, in: Barca, Fabrizio/Becht, Marco (eds.), The Control of Corporate Europe, 2001, 128 – 153.

nesses and to a change in the role of the old finance intermediaries, the banks. In Germany the number of companies listed on the stock-exchange has tripled since 1990, whereas the traditionally important role of the banks in the context of corporate finance and corporate governance has diminished downright dramatically. The scheme of the old "Deutschland AG" which had been presented at the first meeting of the Corporate Governance Forum 10 years ago showed an impressive web of personal and capital interlocks between German firms with the financial conglomerates in the middle.[3] This web has almost completely vanished since.

A last point should be made. Until recently, the debate among our colleagues in the U.S. about *competition amongst different regulatory systems in corporate law*[4] had been followed by European scholars more for intellectual than practical reasons.[5] Up to now, the development of national corporate governance systems has taken place largely independently, immediately influenced at most by certain harmonization requirements from Brussels. The registered office theory which is prevalent in continental Europe has rather effectively prevented any competition for the best corporate governance system so far. However, following the decisions of the European Court of Justice in Centros, Überseering and Inspire Art, things will be different in the future. In the long run, these decisions will force the German corporate governance system to far-reaching adaptation measures, in particular also in relation to our co-determination rules.

[3] In: Isaksson/Skog, op. cit. (fn.1), at p. 52.

[4] Romano, Roberta, The Genius of American Corporate Law, 1993; Bebchuk, Lucian A./Chen, Alma/Ferrell, Allen, Does the Evidence Favor State Competition in Corporate Law, 90 Cal.L.R. 2000, 1775 – 1821; Bebchuk, Lucian A./Hamdani,Assaf, Vigorous Race or Leisure Walk: Reconsidering the Competition over Corporate Charters, 112 Yale L.J. 2002, 553 – 615; Bar-Gill,Oren/Barzuza, Michal/Bebchuk, Lucian A., The Market for Corporate Control, Discussion Paper No. 377 (07/2002), Harvard Law School; Roe, Mark J., Delaware's Competition, 117 Harvard L.R. 2003, 588 – 646.

[5] A thorough overview and assessment can be found in Eva Maria Kieninger's book "Wettbewerb der Privatrechtsordnungen im Europaeischen Binnenmarkt", Tuebingen 2002.

III. Functions and Elements of the Corporate Governance System

Having identified the main driving forces which necessitate and occasion the changes to our corporate governance system, let me now shed some light on a snap-shot of those elements of our corporate governance system which exhibit these changes.[6]

The interests of investors can, generally speaking, be influenced in two ways by the behaviour of management: Firstly, by managers giving priority to their personal interests rather than the interests of the investors where there is a conflict of interests ("conflict of interests situations"), and, secondly, by bad business performance, in as much as this can be attributed to management.

It is the responsibility of the corporate governance system to deal with these two problem areas. In order to do so, it makes particular use of the following 4 elements or system-components :

- first, *legal rules* that to a limited extent define and protect certain shareholder rights;
- second, the powers and duties of the *board of directors*, in the German case: the supervisory board;
- third, the *threat of displacing the incumbent management* after the purchase of control by an acquirer or bidder;
- fourth, efforts to align management and stockholder interests by designing appropriate *incentive compensation plans*.

In the following review of these 4 elements the question for each of these will be whether and how are effective they are in fulfilling the two responsibilities of the corporate governance system mentioned above, namely to avoid or solve conflicts of interests in favour of the investor and to promote good management performance; where reforms are pending and where reforms are still necessary.

IV. Legal Rules

Let me start with a look at the legal rules.

6 The following stems partly from a comparative study on the US and German corporate governance systems; Baums, Theodor/Scott, Kenneth E., Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany, Working Paper, ILF Frankfurt and *ECGI*, 2002.

As indicated above, the central concerns of outside stockholders have to do with self-enrichment by those in control and with poor performance by the firm. To what extent do legal rules address those concerns, and could they do it more effectively? And are there efficient mechanisms to enforce the legal rules, whatever their content?

1. Conflicts of interest

The core conflict of interest situation is the self-dealing transaction.

Traditionally, German stock corporations (*Aktiengesellschaften*) have had shareholding structures that differ from those of their Anglo-Saxon counterparts. Most German corporations are controlled by a family, a controlling majority shareholder, or at least a number of large shareholders.[7] For this reason, German corporate law has focused less on the regulation of conflicts between shareholders and managers and more on those between controlling and minority shareholders. A specialized area of German corporation law (*Konzernrecht*) addresses, *inter alia*, the conflicts of interest that may arise in connection with transactions between a corporation and its controlling shareholders.[8]

Rules and principles regulating conflicts of interest between managers and the corporation, in particular with regard to self-dealing, are less developed in German than in, for instance, U.S. law.[9] Of course, transactions between a member of the management board and the corporation may not be approved by the interested manager or even by the entire management board, but only by the supervisory board, to which law assigns this specific duty (§ 112 Stock Corporation Act).

However, this procedural rule addressing transactions between directors and the corporation technically applies only to members of the management board. It does not extend to other related party transactions, such as those involving relatives of the directors or firms in which directors have a substantial holding. Only since last year there is a German Corporate Governance Code[10] which states that *material* related

[7] Cf. Becht/Boehmer, op.cit.(fn.2).

[8] See §§ 311 *et seq.* Stock Corporation Act (*Aktiengesetz*).

[9] Comparative study (U.S., UK, German law): Thoma, Katrin, Eigengeschaefte des Vorstands mit der Aktiengesellschaft. Frankfurt/Main 2002.

[10] English translation at http://www.corporate-governance-code.de/eng/kodex/4.html. The GCGC is not a set of mandates, but a set of desirable practices; if a corporation does not observe them, it must explain its non-adherence.

party transactions should be approved by the supervisory board.[11] There is, however no direct sanction for a violation of the Code. And personal liability of board members for a violation of their duty of loyalty is difficult to assert in court as will be explained later.

2. Management performance

Let us return to the distinction between private benefits of control and unsatisfactory performance that underlies our analysis. What is the role of legal rules as to unsatisfactory performance? Legal liability rules are basically irrelevant to addressing the concerns of minority shareholders in German companies over poor, or even miserable, managerial performance.

At first sight, the general principle of German corporate law that the director of a stock corporation must act with the diligence of a prudent businessman (§ 93 Stock Corporation Act) appears to be quite rigorous, especially considering that this is a principle of mandatory law. Culpable action, i.e., negligent or willful action, that breaches this duty of prudent business management, triggers liability to the corporation. Actions based on a breach of the duty of care are, however, significantly restricted in two ways.[12] First, German courts have admitted a "business judgment" defense that allows a director to argue that the action alleged to breach the duty of care was undertaken on the basis of business judgment.[13] Second, as will be explained in more detail later, current German law makes it difficult for a corporation to bring a liability action against one of its directors. In practice, the most important sanction for business errors and commercial failures is that of not being re-elected to office or, in serious cases, being prematurely removed from office. A German manager in practice would almost never be faced with liability for a breach of the duty of care (except in a case where the breach also involved a violation of law, such as a social security or tax law).

And that is probably as it should be, in the shareholders' own interest. Judicial control of business decisions and assessment management's performance seems not to be a good idea. That makes it all the more

[11] Para. 4.3.4 GCGC.

[12] For a detailed analysis in English, see Baums, Theodor, "Personal Liabilities of Directors in German Law", 7 Int'l Company and Commercial L. Rev. 1996, 318 ff.

[13] See the decision of the German Federal Civil Court (Bundesgerichtshof) in ARAG/Garmenbeck, 135 BGHZ 244 (April 21, 1997).

important that there be other effective mechanisms to deal with the problem which will be discussed below.

3. Disclosure obligations

Another type of legal duty imposed on management is mandatory disclosure requirements, in the interest of investor protection.

At present, German law does not provide a suitable action against management and supervisory board members to hold them directly liable to shareholders and the investing public for false or misleading information that they release to the market and for the omission of material information. This gap is a result of the traditionally unimportant role that the organized capital markets have played for corporate finance and private investment in Germany. In theory, liability could result from the release of false or misleading information (or material omissions) provided to investors in securities prospectuses, interim reports, financial statements, shareholder newsletters or current reports, and information released in annual shareholders' meetings or analyst meetings. However, only the liability that attaches to securities prospectuses meets international standards.[14] Under current German law, a director incurs liability for other releases of false information only if it is demonstrated that he willfully sought to deceive. The prosecution of such actions is further aggravated because German law does not provide a class action or representative action mechanism in such cases. In 2001, the German government established a Reform Commission, which made recommendations for correcting the defects of the existing framework.[15] The government included these recommendations in a plan for legislative action that was released in February of last year.[16] The following are the key points of the plan:

[14] §§ 44 seq. Stock Exchange Act (Boersengesetz); § 13 Securities Prospectus Act (Verkaufsprospektegesetz).

[15] See T. Baums (ed.) Bericht der Regierungskommission Corporate Governance 112 et seq. (2001) and an English translation of the Commission's recommendations in T. Baums, "Company Law Reform in Germany", Joh.Wolfgang Goethe – Universität Frankfurt, Working Paper nr. 100, sub VII. (2002), available at www.uni-frankfurt.de/fb01/baums/.

[16] Bundesministerium der Justiz/Bundesministerium der Finanzen, „Bundesregierung staerkt Anlegerschutz und Unternehmensintegritaet", Press Release Nr. 10/03(Feb. 25, 2003), *available at http://www.bmj.bund.de.*

- First, in the future, not only the issuer, but also the competent members of management and supervisory bodies, will be personally liable for materially false or misleading information that the issuer releases to the secondary market.
- Second. Consideration will be given to whether such liability should be extended to all written and oral information regarding the capital market.
- Third. The liability of management and supervisory board members will be capped for acts of gross negligence. The level of the cap is still being debated; there will be however no cap in cases of willful actions.
- Fourth. A number of procedural improvements are to be undertaken to allow larger numbers of plaintiffs to prosecute actions together, but this will not be a true *class action* as used in the U.S.[17]
- Fifth. In addition to the above, measures are planned to effect significant improvements in the auditing of corporate financial statements-increased auditor independence, improved and more independent supervision of the auditing profession, and an enforcement system for auditing financial statements for compliance with the law and accounting standards. There are two draft bills pending in the Federal Parliament right now providing for reforms in this area (Bilanzrechtsmodernisierungsgesetz; Bilanzkontrollgesetz).

4. Enforcement of legal liability rules

If legal rules are not effectively enforced, their existence and scope does not much matter, except for whatever moral influence they may have.

In this respect, we have to distinguish between liability to the corporation and liability to the shareholders.

In actions seeking to enforce liability initiated by the corporation against a member of the management board, the corporation is in principle represented by its supervisory board (§ 112 Stock Corporation Act). The problem with this rule is that when the supervisory board alleges that a management board member has breached its duty, such allegation may also imply that the supervisory board itself has failed to fulfill its oversight duties. For this reason, supervisory boards undertake

[17] This part of the plan has been tabled as a draft meanwhile; cf. Bundesministerium der Justiz, Entwurf eines Kapitalanleger-Musterverfahrensgesetzes (KapMuG), *available at http://www.bmj.bund.de* .

this type of liability action only rarely ("one crow doesn't gouge out the other crow's eye"[18]).

The German legislature has observed this problem of cautious supervisory boards, and attempted to address it: Shareholders with collective holdings constituting either 5.0 % of the share capital or a market value of € 500,000 may petition a court to appoint a special representative if evidence demonstrates a compelling suspicion of illegal activities or serious violations of the law or the articles of association (§ 147 Stock Corporation Act). Thus, German stock corporation law, in contrast to partnership law, does not recognize a derivative suit by a single shareholder.

This legal framework seems flawed and has been sharply criticized by German legal scholars. In particular, the thresholds for the action are too high and the manner in which costs are allocated is prohibitive. Differently than, for instance, in U.S. law, German lawyers may not work on a contingency fee basis, and in contrast to the so-called "American Rule", an unsuccessful shareholder must bear not only her own costs and those of her lawyer, but also the costs of the opposing party.[19] Beyond this, a court-appointed special representative is under no obligation to follow instructions received from the shareholders. Also in this area, the German government's Reform Commission recommended making changes to bring German law up to international standards.[20] The government has followed these recommendations and meanwhile tabled a draft bill[21] which seeks to strengthen the right of shareholders to prosecute the company's claims against directors by, *inter alia*:

- First, lowering the threshold for actions to the significantly smaller shareholding of 1% of the share capital or a quotation or market value of € 100.000.
- Second, there will be a demand requirement. The board may decline to bring a suit only where prevailing interests of the company

[18] "Eine Kraehe hackt der anderen kein Auge aus".

[19] This is not to say that the "American Rule" is a good idea. For critical assessments cf. Hughes/Snyder, "Litigation and Settlement under the English and American Rules: Theory and Evidence", The Journal of Law and Economics, Vol 38, 1995, 225 ff.; Adams, Michael, Ökonomische Theorie des Rechts, Frankfurt 2002, 311 ff., 321 ff.

[20] Cf. Bericht der Regierungskommission, op. cit. (fn. 15), at pp. 107 – 114.

[21] Bundesministerium der Justiz, Entwurf eines Gesetzes zur Unternehmensintegritaet und Modernisierung des Anfechtungsrechts (UMAG), of Jan. 2004, *available at http://www.bmj.bund.de* .

not to sue can be shown to the court, but these reasons will be subject to judicial review.
- Third, in order to avoid "strike suits", the trial court will hold a preliminary hearing to assess the merits of the case. If the court admits the case to a full trial, the company will bear the costs of the proceeding even if plaintiff loses on the final judgment. If the preliminary hearing goes against the plaintiff, the latter may still proceed at his own risk.

These measures will, however, still not eliminate the basic problems dampening any plaintiff's motivation to undertake such actions. The plaintiff will bear the (low) costs and risks of initiating the action; there is no remuneration for a successful suit; and in the case of success, free riding shareholders will benefit equally from the judgment.

V. The Supervisory Board

One specific feature of some continental corporate governance systems is the separation between the management board (Vorstand) and the oversight body, the supervisory board (Aufsichtsrat). This roughly corresponds to a distinction between inside and outside directors. However, pursuant to German law, these two sets of directors have significantly different duties and work in different management bodies.[22] This separation was, at least initially, thought as another mechanism for constraining the behaviour of management in the public corporation.

Returning to our distinction that underlies our analysis, the supervisory board has to monitor to prevent self-dealing and similar unjustified private benefits of control, and the supervisory board has to monitor the success of management's performance and create the conditions for such success, in particular through the appointment of capable managers, the removal of incompetent management board members (if sufficient legal grounds exist) and through vigilant, continuing supervision through expression of its views. However, this second task in particular presents both theoretical and practical problems.

First of all, the oversight duties of the supervisory board provided for by law flow from the duty of loyalty that each supervisory board member owes to the corporation. The purpose of these duties, however, is by

[22] Cf. Hopt, Klaus J., The German Two-Tier Board: Experience, Theories, Reforms, in: Hopt et al. (op. cit., fn. 2, supra), 227 – 258.

no means exclusively to protect the interests of the shareholders. The majority position is that the supervisory board must primarily protect the interests of the firm (*Unternehmensinteresse*).[23] This position is emphasized and strengthened by the representation of employees on the supervisory board. In firms with more than 500 employees, one-third of the seats on the supervisory board are reserved for employee representatives, and in firms with more than 2,000 employees, one-half of the seats are so reserved. To break ties, the shareholder-selected chairman has a second vote. Subcommittees of the board reflect the same split.

This ambiguity and absence of a single focus for the exercise of duties is exacerbated by another problem that, in practice, hinders the efficient oversight of management in the German system. In connection with the mandatory co-determination rules, German law also sets obligatory sizes for supervisory boards; for larger corporations, a 20 member supervisory board is required. If one includes the members of the management board, the company is saddled with a cumbersome body of about 30 members or more, and this in itself points at an inefficiency of the German system in comparison to the smaller boards that are common in international practice. As a consequence, the supervisory board meets less frequently than would a smaller body; and much depends on the work of the chairperson of the supervisory board and individual committees rather than on the activities of the board as a whole. Legal policy makers have made repeated recommendations to reduce the size of the supervisory board; however, these attempts have in the past been unsuccessful, primarily because of opposition from labor unions. Labor unions have a concrete interest in large supervisory boards because they can appoint three officers to such boards, and because the representatives of the labor unions and of the employees direct most of their compensation for work on the board back to the unions. As a result, the role of plenary supervisory board meetings has been reduced to a few sessions to hear reports from the management board, adopt formal resolutions and air issues that particularly affect employee interests. Strategic questions and criticism of the management board are often addressed in separate informal meetings between shareholders' representatives on the supervisory board and the management board. In emergency situations, however, the supervisory board is forced to become active. Also, if a corporation has a major shareholder that is represented on the su-

[23] Cf. German Federal Civil Court, 64 BGHZ 325, 329 (June 5, 1975).

pervisory board, a picture of the board could develop that would be quite different from that found in a widely held company.

What conclusion should be drawn? German companies should be permitted to choose between using a two-tier (supervisory and management board) and a one-tier (board of directors) management structure, which is the model set forth in the EC Regulation for a European Corporation (*Societas Europaea*). The market would then be able to decide on the respective strengths and weaknesses of the two management structures. Regardless of this, German supervisory boards are too large to effectively carry out their duties, and should thus be reduced in size. Furthermore, although it is unlikely that employee co-determination will be changed in the medium-term, it appears to be a mistake that only employees residing in Germany are represented in co-determination. The entire co-determination system should be examined and adjusted where necessary. In the long-term, international investors will not accept nationally appointed supervisory boards because they will (correctly) fear that decisions are made not to further business efficiency, but rather to serve parochial interests and in particular local labor interests.[24] While there may be efficiency arguments in favour of a supervisory board made up by outsiders and insiders (employees as supervisory board members may have better information about problems within the group than directors who come from outside) the role of the trade union representatives on the supervisory boards is questionable. Overall, both the management and the supervisory boards of German corporations must adapt their operations to international business practices. This means improved information flows to the outside directors on the supervisory board, closer collaboration of both organs, supervisory board members with greater independence and international stature, and better pay for them (in particular, the practice of employee representatives diverting their salaries into the treasuries of the labor unions is questionable) – which should be accompanied by stricter enforcement of duty of loyalty obligations once the statutory regulation of director liability is improved.

[24] On the German codetermination system and possible changes cf. the articles in: Baums, Theodor/Ulmer, Peter (eds.), Unternehmensmitbestimmung der Arbeitnehmer im Recht der EU-Mitgliedstaaten/Employee's Codetermination in the Member States of the EU, Heidlberg 2004 (comparative reports and discussion), and the proposals of the "Berlin Corporate Governance Network" (with articles of v. Werder, Schwark, Saecker, Schwalbach, Windbichler and Kirchner) in: Die Aktiengesellschaft , issue 4, 2004, at pp. 166 ff.

VI. Purchase of Control by an Acquiring Form

The market for corporate control is potentially the most powerful mechanism for achieving effective corporate governance, in terms of both firm performance and managerial control rents. By the same token, it is potentially the most threatening to underperforming or self-enriching corporate management.

Hostile takeovers executed through public tender offers – and the threat they pose to executives of possible removal from office if the corporation's share price drops because of unsuccessful management – do not significantly affect corporate governance in Germany, but they do occur. Vodafone's hostile takeover of Mannesmann rocked corporate Germany, and there have been several smaller hostile takeovers since that time. However, hostile takeovers through public bids are only one among a number of ways of achieving control. Since German companies often have a dominant shareholder or a number of significant minority shareholders, a hostile change of control (that is, a change of control that management opposes) can take place through the privately negotiated placement of a large block of shares.[25] Until recently, such transactions were also less capital intensive because German law – unlike that, for example, in England – contained no requirement that all shareholders be offered the right to sell their shares at an appraised price in case of a change of control.

Until recently there was also general agreement that the management board and the supervisory board had no right to influence the makeup of the shareholding ownership. This meant that in the case of a tender offer or a change in control through other means, the management was not authorized to use any defensive tactics. However, when the European Community attempted to adopt a directive that would have prevented the managements of all EU companies from using defensive tactics, Germany led a coalition to defeat the directive. This was stated to be because a number of other EU member states had defensive tactics that were not available in Germany and would have slipped under the directive's prohibitions. For example, Electricité de France could have taken over a German electric utility against the will of German management, but was itself immune to takeover because the French government held preferred shares with special voting rights ("golden shares"). While Germany was working to defeat this European directive, it

[25] Cf. Franks, Julian/ Mayer, Colin, "Ownership and Control of German Corporations", 14 Review of Financial Studies, 2001, 943-977.

adopted its own takeover legislation that rejected the so-called "duty of neutrality". The management board of a German corporation may now pursuant to the Securities Acquisitions and Takeovers Act be authorized by the shareholders' meeting for a period of 18 months to undertake defensive measures such as the sale of an essential asset which would require the consent of the shareholders' meeting or the issuance of new shares to a third party. The management board and supervisory board acting together may also use (albeit very limited) defensive tactics, such as the sale or purchase of assets or the use of authorized capital, if they are compatible with prudent and diligent management. U.S.-style poison pills, which would dilute the value of the acquirer's stock, are, however, illegal, as is any measure that would damage the company.[26]

The European Union has recently found a compromise which will permit Germany to retain its defensive mechanisms, particularly those involving concerted actions of the management board and the co-determined supervisory board. This regulation most certainly puts the decision as to the success or failure of a hostile bid into the wrong hands. However, according to the EU regulation proposal, companies may in future declare that they will not make use of such defensive tactics. The capital market will then assess companies open to a takeover differently from those averse to a takeover.

VII. Incentive Compensation

Another approach to align management's interests with those of shareholders is by using rewards (performance-based compensation) rather than sanctions (liability), contract rather than legal rules. Returning again to the distinction that underlies our analysis, incentive compensation has little impact on conflict of interest transactions; it is instead addressed to enhancing motivation and overcoming the agent's inclination to shirk. In particular, agency theory postulates agents (officers) who are risk averse and principals (diversified shareholders) who are risk neutral, and seeks to reward the agents for taking more risk in the interest of the owners of the firm. The theory leads to compensation packages that include a fixed-salary component and a variable incentive component. Leaving aside the firm-specific questions of what the total

[26] See the detailed analysis in Gordon, Jeffrey, "An American Perspective on the New German Anti-takeover Law", Working paper, Columbia Law School, June 2002).

amount of compensation should be and how that is actually determined, problems arise with how the performance of top management is measured and the choice of incentive plans.

Performance measures generally fall into two types: accounting-based and stock-price-based. Neither is free from serious defects. Accounting numbers are subject to substantial manipulation by top management, within accounting rules as well as in violation of them, as recent cases have exemplified. Stock prices reflect general trends in the economy, up or down, for which management is not responsible and deserves neither credit nor blame.

In terms of the type of plan, again there are two broad categories: payment in cash and payment in stock or stock options. They differ in tax treatment and in accounting treatment, and the rules can become intricate and beyond my level of detail here. But there is a problem that cuts across all types, and that is the time period required for the executive to reap full benefit. If there is immediate full ownership (so that the bonus cash can be spent, or when the option is exercised the stock can be immediately sold), and the amounts are large, the agent may be induced to move from risk averse beyond risk neutral into becoming risk insensitive, or in the extreme to becoming a manipulator of the financial reports, if the short-term payoff is great enough. This seems to be part of the explanation for recent cases like Enron, WorldCom and Tyco in the U.S. and several cases on the Neuer Markt in Germany.

Incentive compensation is clearly useful; it does address one agency problem. It is also readily abused to obtain rents, in the presence of a pliable board. And it does not really align management and shareholder interests, since management does not share in the shareholders' downside risk under most plans.

VIII. Concluding Remarks

The article has tried to point out three things:

- first, how dramatically the German corporate governance system has changed since the first meeting of the Swedish Corporate Governance Forum in Stockholm 10 years ago;
- second, the driving forces which occasioned these changes and which will provide for further changes in the future;
- third, the article tries, on the basis of an analytical framework, to identify those areas in which the German corporate governance system still seems to be deficient and which will be seen reformed, some very soon, some only in the distant future.

Complicating the Controlling Shareholder Taxonomy

*Ronald J. Gilson**

It is an honor to have been asked to provide an essay in celebration of the Swedish Corporate Governance Forum's Jubilee, just as it was to have participated in the initiating conference.[1] Ten years ago, the issue of the moment – and probably of the decade – was hostile takeovers. And on that subject and at that time, European views differed quite dramatically. Two quotes capture the tension of the period. In the face of the mainstreaming of hostile takeovers in the United States and United Kingdom's business culture and jurisprudence, Continental Europe had a radically different conception. The Chairman of the Deutsche Bank described hostile takeovers as one of the "blunders of American Capitalism."[2] In turn, Francois Mitterand, the President of the French Republic, characterized hostile takeovers as "gangsterism and the law of the strongest."[3]

Ten years later, the tone of the debate, if not necessarily the politics of reciprocity, seems to have moderated a great deal. Marco Becht, an active participant in the European academic debate and a sophisticated

* Marc and Eva Stern Professor of Law and Business, Columbia Law School, and Charles J. Meyers Professor of Law and Business, Stanford Law School. This paper was initially presented as a lecture on the occasion of the Swedish Corporate Governance Forum's 10 Year Jubilee Seminar on The Future of Corporate Governance, and retains some of the informality of that format. I am grateful to the Swedish Corporate Governance Forum for inviting me to participate in this wonderful event, and for their gracious hospitality during my visit to Stockholm for the conference. I am also grateful to conference participants and to Jeffrey Gordon for very helpful comments.

1 The papers from the original conference were published in Aspects of Corporate Governance (Mats Isaksson & Rolf Skog eds., 1994).

2 Ernst-Ludwig Von Thadden, On the Efficiency of the Market for Corporate Control, 43 Kyklos 635, 635 (1990)(citing Frankfurter Allegemeine Zeitung, Dec. 23, 1988).

3 Id. (citing Le Monde, Feb. 14, 1989).

observer of the politics of European corporate governance, recently described the now civilized role for hostile takeovers in Europe: "An European market for corporate control is seen as an integral part of a single market and a major driver of European competitiveness, innovation and growth."[4] To be sure, the European Parliament recently approved the aptly numbered Thirteenth Directive in substantially diluted form some fours years past its own Jubilee.[5] The European Parliament's unexpected rejection of a more aggressive proposal in 2001 by a tie vote, despite an agreed text following conciliation, reopened the revision process. The result is a Directive that, for practical purposes, gives individual states the right to opt out of both the Directive's prohibition of post-bid defensive tactics and the Directive's break through rule that would limit the operation of structural defenses like dual class common stock with different voting rights when a bidder secures more than 75 percent of the target's voting equity. Where a state elects the opt-outs, the Directive nonetheless gives individual companies the option to follow the more restrictive rules. But even if a company elects the more restrictive rules, they can be suspended if a particular bidder is not subject to equivalent defensive restrictions.[6] Thus, the Directive has hardly cleared the way for hostile takeovers as the 2002 Commission proposed

[4] Marco Becht, Reciprocity in Takeovers, ECGI Working Paper No. 14/2003 (Oct. 2003), available at http://ssrn.com/abstract=463003.

[5] The Thirteenth Directive was formally proposed in 1989, Com(88)(823 final – SYN0186), with the first draft dating back to the early 1970s. Report on Takeovers and Other Bids, COM Doc. XI/56/74. RolF Skog, The Takeover Directive – an Endless Saga, European Business Law Review (April, 2002), traces the directive's history through its rejection by the European Parliament in 2001. The version approved by both the European Union Council of Ministers and the Legal Committee of the European Parliament on November 27, 2003, and by the European Parliament on December 17, 2003, was first proposed by the European Commission on October 2, 2002. The opt-out and reciprocity provisions were added in compromises made to the Commission proposal.

[6] The new proposal is ambiguous as to whether the reciprocity exception applicable to companies that chose the Directive's more restrictive formulation would be triggered by bids from countries outside the European Union that did not impose reciprocal barriers. This includes especially the United States where a combination of the poison pill and a staggered board may amount to a structural defense. See Lucian Ayre Bebchuk, John U. C. Coates IV & Guhan Subramanian, the Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy, 54 Stan. L.Rev. 887 (2002). The United States has formally objected to this application. Daniel Dombey, US Fears Rise Over Takeover Code in EU, Financial Times, Nov.24, 2003, p.1.

draft would have done, but at least the debate now is framed in terms of subsidiarity and reciprocity, rather than by epithets such as gangsterism.

We are all, by now, far too skeptical to conclude that a domestication of hostile takeovers in Europe will lead to a Fukyama-like[7] end of corporate governance history. Our charge today is to look ahead to the next ten years. What issues will command our attention going forward? What should drive our agenda for the next decade?

As my title suggests, I believe, with the confidence that comes from having a great deal of company, that we are going to stop spending so much time on understanding the role of hostile takeovers, which remain largely a phenomenon of the United States and United Kingdom capital markets because only in those two jurisdictions is control of most public companies in the public float. Rather, I not so boldly predict that scholarship and policy debate will complete a shift whose beginnings are already visible in both venues. Attention will increasingly center on understanding the kind of control structure that dominates public corporations everywhere in the world other than the U.S. and the U.K and which the Thirteenth Directive, as adopted, will not itself dissipate: a shareholder or group of shareholders with effective voting control, often but not invariably without corresponding equity holdings.

In this essay, I venture some early thoughts concerning how this inquiry might usefully be framed. As I will develop in more detail later in this essay, the simple dichotomy between "controlling shareholder" systems and "widely-held shareholder" systems that has largely dominated academic debate thus far seems to me much too coarse to allow a deeper understanding of the diversity of ownership structures in different national capital markets and their policy implications. My goal here is to complicate things by taking a first step in developing a more nuanced taxonomy of controlling shareholder structures.

Part I sets out some necessary background. Part II provides a framework to structure the analysis. Part III then begins to complicate the controlling shareholder taxonomy by distinguishing between two very different kinds of controlling shareholders: efficient and inefficient controlling shareholders. Part IV then continues the effort at complication by distinguishing between two very different kinds of private benefits of control: pecuniary and non-pecuniary private benefits. Part V

[7] See Frances Fukyama, The End of History?, 16 The National Interest 3 (1989).

concludes with a brief consideration of some policy implications that arise from a more complicated taxonomy of controlling shareholders.

I. Background: Facts and Generations of Scholarship

At the risk of belaboring a point that has become commonplace, it is helpful to start by recalling the way the ownership structure of publicly traded corporations actually looks. Over the last 10 years, important empirical work has revealed that, excluding the U.S. and U.K., the world wide corporate governance landscape has a single monolithic feature: control of publicly traded corporations is typically lodged in a single individual, family or group.[8] Marco Becht, for example, reports that 82.5 percent of German listed companies, 65.8 percent of Italian listed companies, and 64.2 percent of Swedish listed companies, have a blocking minority of at least 25 percent. Moving the control level up to a majority lowers the percentage of listed companies with a control block to 64.2 percent in Germany, 56.1 percent in Italy, and 26.3 percent in Sweden,[9] but the importance of controlling shareholders remains dramatic. For East Asian countries, Classens, Djankov and Lang found that a single shareholder controls more than two-thirds of listed firms.[10]

It is also commonplace in Europe for control by a dominant shareholder to result from structural devices that leverage voting rights above the level of equity investment. For example, 66 percent of listed Swedish companies, 51.7 percent of listed Swiss companies, 41.3 percent of listed Italian companies, and 17.6 percent of listed German companies issue dual classes of common stock, with one class having dramatically higher voting rights.[11] Control is also frequently enhanced through the

[8] See, e.g., ECG book, Mara Faccio & Larry H.P. Lang, The Ultimate Ownership of Western European Corporations, working paper (2002), available at http://papers.ssrn.com/abstract=286053 (forthcoming, J.Fin. Econ.); Stijin Classens, Simeon Djankov & Larry H.P. Lang, The Separation of Ownership and Control in East Asian Corporations, 58 J.Fin. Econ. 81 (2000); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J.Fin. 471 (1999).

[9] Becht, supra note 4, at 19.

[10] Classens, Djankov & Lang, supra note 8.

[11] Becht, surpa note 4,. at Table 6. Dual class shares are rarely used in Portugal, Spain, Belgium and France. Id. In Sweden, for example, Rolf Skog reports that controlling shareholders with dual class shares have 41 percent of the votes but only 21 percent of the equity. Rolf Skog, The European Union's Proposed Takeover Directive, the

use of pyramids and multiple control chains.[12] The pattern is repeated in East Asia.[13]

The initial reaction to the empirical reality that systems in which control of listed companies is in the public float are the exception rather than the rule reflected a teleological view of the evolution of capital markets. A U.S./U.K. style widely-held distribution of stock ownership and control was seen as the end point of corporate governance evolution; progress consisted of accelerating what selection would make inevitable. While there were some early skeptics – Masahiko Aoki with respect to "J-Form" governance in Japan[14] and Julian Franks and Colin Mayer with respect to "inside systems" in Europe[15] were among the most tenacious – global policy seemed to be influenced by this belief. A preference for dispersed shareholdings was plainly evident in the IMF and the World Bank's response to the 1997-1998 East Asian financial crisis; financial assistance was conditioned not just on macroeconomic criteria, but also on corporate governance reform.[16] The same prefer-

11 continue "Breakthrough" Rule and the Swedish System of Dual Class Common Stock 14 (working paper, 2003).

[12] Becht, supra n.4, at Table 7. For example, of the firms in Germany with a control bock of 20 percent, 22.89 percent use a pyramid structure and 7.22 percent use a multiple control chain to leverage their equity.

[13] "East Asian firms also show a sharp divergence between cash-flow rights and control rights – that is, the largest shareholder is often able to control a firm's operations with a relatively small direct stake in its cash flow rights." Stijn Classens, Simeon Djankov, Joseph P.H. Fan & Larry H.P. Lang, Disentangling the Incentive and Entrenchment Effects of Large Shareholdings, 57 J.Fin. 2741, 2742 (2002).

[14] See, e.g., Masahiko Aoki, Toward an Economic Model of the Japanese Firm, 28 J.Econ. Lit. 1 (1990).

[15] See, e.g., Julian Frank & Colin Mayer, Capital Markets and Corporate Control: A Study of France, Germany and the UK, 10 Econ. Pol'y 189 (1990)

[16] See, e.g., Timothy Lane, et. al., IMF-Supported Programs in Indonesia, Korea, and Thailand 72-73 (Int'l Monetary Fund Occasional Paper No. 178, 1999); Asia Pacific Talks Vow Tough Action on Economic Crisis, N,Y.Times, Nov. 26, 1997, p. A1. Ronald Dore captured something of the tone of this perspective in relation to Japan:

> What … all these slogans [concerning Japanese capital market reform] add up to is a general belief that (1) the principles according to which the typical neoclassical economics textbooks say the economy works are a priori correct principles, (2) those principles are best exemplified in the American economy; (3) the rightness of those principles is further confirmed by American success, and (4) Japan's present plight is not just a cyclical phenomenon and a debt-deflation hangover from the bubble; it is the natural and wholly just retribution on Japan for not following these principles.

ence also seems at the core of the focus on breakthrough rules in connection with debate over the Commission's 2002 proposal for the Thirteenth Directive.

In turn, this quite skeptical view of controlling shareholder regimes was provided academic support by a growing "law and finance" literature that has sought to reveal the empirical links between measures of the quality of legal regimes and the nature of national capital markets and corporate governance systems.[17] For present purposes, a particular claim is central – that a controlling shareholder structure is associated with "bad law." Where minority shareholders are not protected from controlling shareholders extracting large private benefits of control, the argument runs, entrepreneurs will not part with control through public offerings because they then would run the risk of their own subsequent exploitation by someone who assembles control through the market and whose extraction of private benefits would be unchecked by the legal system. Under this analysis, controlling shareholder systems will be characterized by weak equity markets – too much liquidity tied up in control blocks – and by large differences in the value of controlling and minority blocks as a result of private benefit extraction.

This brings us to a more recent, emergent generation of scholarship that, at present, stresses two themes. The first, largely positive, argues that the parsimony of the law and finance taxonomy – whether or not a national system is characterized by controlling shareholders – camouflages a much more complicated reality. In fact, countries with both good and bad law are characterized by controlling shareholder systems. For example, both Mexico with bad law, and Sweden with good law, have controlling shareholder systems. Moreover, countries with a controlling shareholder system appear to experience dramatically different

16 continue Ronald Dore, Japan's Reform Debate: Patriotic Concern or Class Interest? Or Both?. 25 J. Japanese Stud. 65, 66 (1999).

[17] See, e.g., Rafael LaPorta, Florencio Lopez-de-Silanes & Andrei Shleifer, Corporate Ownership Around the World, 54 J.Fin. 471 (1999); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Legal Determinants of Outside Finance, 52 J. Fin. 1131 (1997); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Law and Finance, 106 J.Pol. Econ. 113 (1998); Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, Investor Protection and Corporate Ownership, 58 J. Fin. Econ 3 (2000). Charles P. Himmelberg, R. Glenn Hubbard & Insessa Love, Investor Protection, Ownership, and Investment: Some Cross-Country Evidence (working paper, Sept. 2000), reaches a similar result using different econometric techniques.

levels of private benefit extractions, at least as they have been measured so far.[18] To stay with the same example, Mexican controlling shareholders are said to expropriate approximately half the value of the company; in contrast, expropriation by Swedish controlling shareholders is limited to approximately one percent of company value.

To further complicate the controlling shareholder landscape, controlling shareholders are different – for example, families as opposed to widely-held corporations – and hold control through different devices; as we have seen some controlling shareholders' control is matched by their equity investment, while others' control is leveraged through structural devices like dual class stock and pyramids. At least in some countries, early empirical studies suggest that the level of private benefit extractions differs among different types of controlling shareholders. Benefit extraction is lower when the controlling shareholder's stock is widely-held, as opposed to family owned, and when the divergence between control and equity is smaller.[19]

Recognition of the variety of types of controlling shareholders and their potential for having different impacts on minority shareholders gives rise to a second, and as yet more tentative theme, in the new generation of controlling shareholder scholarship. What, after all, is wrong with controlling shareholder systems? If they do not *necessarily* lead to large private benefits of control at the expense of minority shareholders, then the nature of the problem must be stated more precisely. And if controlling shareholders therefore need not fear subsequent dilutive private benefit extraction if they part with control, why do we still observe this shareholding pattern? This position surfaces clearly in Sweden's energetic defense of its dual class voting structure within the European debate over the Thirteenth Directive.[20]

So where does this recitation of familiar facts and emerging scholarly themes leave us? When the world seems more complicated than what our theory can explain, we probably do not yet really understand the world. Put differently, perhaps the mistake is in thinking that the critical factor in understanding corporate governance systems as different as those of the Far East, Latin America, Europe and Scandinavia, is their shared controlling shareholder systems broadly defined. And if this is right, then we need a richer taxonomy of controlling shareholder sys-

[18] See text at notes 22-29 infra.

[19] Classens, et. al., supra note 13 (East Asia).

[20] See Skog, supra note 5.

tems than we are currently using. In this essay, I propose to take a first step in responding to that deficiency by looking more closely at two central features of a more complex taxonomy: what is a controlling shareholder, and the concept of a private benefit of control.

II. A Framework for Analysis

The first step in complicating the taxonomy of controlling shareholders is to understand what I will call the controlling shareholder tradeoff.[21] The role of controlling shareholders lies at the intersection of the two elements of the agency problem that is at the core of public corporation governance. The first element is the familiar agency problem that arises from the separation of ownership and control. This is the domain of governance devices like hostile takeovers and independent directors that have been the focus of so much attention over the last 20 years. While important techniques, these efforts to bridge the separation have real limitations. It is hard to get the incentives of independent directors right: paying them enough to secure their full attention may be inconsistent with their independence. Takeovers, in turn, are rather blunt instruments: they are responsive to only some kinds of governance problems, and the large premiums necessary for success makes them appropriate only for very large problems.

From this perspective, a controlling shareholder may better police the management of public corporations than the standard panoply of market-oriented techniques employed when shareholdings are widely-held. This is the point that motivates the efficiency defense of controlling shareholder systems. Because of a large equity stake, a controlling shareholder is more likely to have the incentive to effectively monitor managers or to manage the company itself. Rather than being the result of bad law, a controlling shareholder system is in this view an alternative to the frictions associated with ameliorating the separation of management and control that inevitably arises from widely-held shareholdings.

The second element of the public corporation agency problem is the conflict between a controlling shareholder and non-controlling shareholders over the potential for the controlling shareholder to extract private benefits of control – benefits to the controlling shareholder not provided to the minority shareholders. Thus, controlling shareholder

[21] The following discussion draws on Ronald J. Gilson & Jeffrey Gordon, Controlling Controlling Shareholders, 152 U.Penn. L.Rev. 785 (2003)

monitoring as a means to ameliorate managerial agency problems also comes with frictions. Conditional on maintaining control, the less equity the controlling shareholder has, the greater the incentive to use control to extract private benefits. A controlling shareholder may increase productivity by effectively monitoring managers, but may take more than its share of the gain.

There is, however, a point of tangency between these two elements. Because there are liquidity and non-diversification costs to the controlling shareholder from holding a concentrated position as well as the direct costs of monitoring, some private benefits of control likely are necessary to induce a party to play that role. Thus, from the public shareholders viewpoint, the two elements of the corporate agency problem present a tradeoff. Public shareholders will prefer a controlling shareholder as long as the benefits from reduction in managerial agency costs exceed the private benefits that the controlling shareholder will extract.

Framing the controlling shareholder structure as an alternative to techniques such as independent directors and takeovers as a monitoring device, whose attraction depends on a trade off between increased monitoring and increased private benefit extraction, provides a framework to better understand the complexity of controlling shareholder systems and the role of law. Different law may result in particular controlling shareholder systems having very different costs and benefits.

III. Complicating the Controlling Shareholder Taxonomy: Different Kinds of Controlling Shareholders

The central implication of the controlling shareholder tradeoff framework is that the fact that a country has a controlling shareholder governance system is too general an observation to tell us very much. A first cut at a more complicated taxonomy recognizes that a national pattern of concentrated control of publicly traded corporations can be consistent with two very different equilibria. First, the ownership pattern may reflect a structure of *inefficient* controlling shareholders, where the cost of private benefit extraction exceeds the benefits of more focused monitoring of management – minority shareholders are worse off from the monitoring effort. Alternatively, the ownership pattern may reflect a structure of *efficient* controlling shareholders, where the benefits of more focused monitoring exceeds the cost of private benefit extraction and the value of minority shares increases as a result. From this perspective, an inefficient controlling shareholder regime is a drag on the financial system; while an efficient controlling shareholder regime can be a preferred alternative to market based monitoring.

This first step toward a more complex typology seems to have a good deal of explanatory value. Without the ambition of being exhaustive, I survey in the remainder of this Part the implications that follow from distinguishing between inefficient and efficient controlling shareholder systems.

A. Inefficient and Efficient Controlling Shareholder Systems and the Quality of Law

First, a more complex taxonomy provides a context to understand the more nuanced empirical studies of controlling shareholder systems and, in particular, the role of legal rules in supporting a particular ownership pattern. Recall that the initial claim made by the law and finance literature was that controlling shareholder systems were associated with bad law: entrepreneurs retained control to protect themselves against private benefit extraction by someone who might subsequently assemble control if the existing controller gave it up. Having retained control, the entrepreneur then exploits it by extracting private benefits of control. This framework has clear empirical implications. In inefficient controlling shareholder systems (1) the value of controlling shares should be dramatically larger than minority shares; and (2) the extent of private benefits will decrease in the amount of the controlling shareholders' equity holdings and increase in the difference between percentage of control and percentage of equity. In contrast, efficient controlling shareholder systems will be characterized by good law; that is, law that limits private benefit extraction to an amount necessary to compensate a controlling shareholder for the costs of focused monitoring and which is less than the benefit from focused monitoring.[22] Thus, in efficient

[22] See Gilson & Gordon, supra note 21. While it is beyond my task here, it should be noted that this framework allows identification of the characteristics that distinguish between good law and bad law and highlights the differences in observing them. In order to limit private benefits of control, good law must specify substantive standards; require sufficient disclosure that those with the power to enforce the standards know of violations; and provide an effective enforcement process. This can be attempted through detailed legislation, as with European laws governing corporate groups, or by judicially developed principles of fiduciary duty. I recognize that I am sliding over how to actually assess whether a country actually has good law and why

controlling shareholder systems (3) the value of controlling shares will exceed that of minority shares by a much smaller amount than in inefficient controlling shareholder systems.

The new generation of scholarship supports all three implications of the controlling shareholder tradeoff framework. The level of private benefit extraction should be reflected in the difference in value between controlling and minority shares; only the value of controlling shares includes the net present value of expected private benefits of control. Whether measured by the difference between the market price of high voting and low voting shares,[23] or by the size of the premium paid for a controlling block,[24] the level of private benefit extraction in bad law regimes is large. Measured by differential market price, control represents approximately 36 percent of firm value in Mexico, 29 percent in Italy, and only 1 percent in Sweden.[25] Mexico and Italy are typically characterized as bad law states and Sweden as a good law state. Measured by the size of block premium to the value of firm equity, control represents 34 percent of firm value in Mexico, 37 percent in Italy, and 7 percent in Sweden.[26] Both studies report that differences in the quality of law account for a large portion of the difference between countries.

A recent study of Southeast Asian countries, also said to be characterized by bad law, provides empirical support for the relationship between the size of equity holdings by controlling shareholders and the extent of private benefit extraction, and for that between the size of the difference between equity ownership and control on the one hand and private benefit extraction on the other. In systems that are dominated by controlling shareholders, firm value increases in the equity share of the largest shareholder, and decreases with the size of the difference between control rights and equity holdings.[27]

22 continue good law developed in some countries and not others. These are interesting and important questions, but ones that must be left to completion of the project of which this essay is a part.

[23] See Tattiana Nenova, The Value of Corporate Voting Rights and Control: A Cross-Country Analysis, 68 J.Fin. Econ. 325 (2003).

[24] Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison, working paper (Dec. 2002)(forthcoming, Journal of Finance).

[25] Nenova, supra note 23, at Table 3, p. 334.

[26] Dyck & Zingales, supra note 24 at Table II.

[27] Claessens, Djankov, Fan & Lang, supra note 14.

Finally, the link between the level of private benefits extraction and the quality of law appears from the results of another empirical strategy. A recent study of large publicly traded companies in South Korea, a jurisdiction characterized by a controlling shareholder system, tracked the impact of a legal reform that mandated a majority of independent directors; i.e., the reform added a component of good law. Controlling for measures of productivity and all other governance characteristics, Black, Jang and Kim find that large firms with 50 percent outside directors, required by a recent change in South Korean law, experienced a 40 percent increase in stock price.[28] Of particular significance, the increase in stock price did not result from increased firm productivity; companies did not become more productive because of a majority of independent directors. Rather, the presence of a majority of outside directors caused the market to value more highly the company's existing cash flow. The authors interpret their results as showing the importance of outside directors – i.e. good law – in controlling private benefit extraction by controlling shareholders: "The most likely reason why outside directors add value is that they may control self-dealing by controlling shareholders."[29]

In short, then, the controlling shareholder tradeoff framework implies a different relationship between the quality of law and controlling shareholder regimes. Good law supports efficient controlling shareholder systems; bad law supports inefficient controlling shareholder systems.

[28] See Bernard S. Black, Hasung Jang & Woochan Kim, Does Corporate Governance Predict Firms' Market Value? Evidence from Korea (July 2003), Stanford Law & Economics Working Paper No. 237, avalible at http://ssrn.com/abstracts=311275.

[29] Id. at 48. Making the same point a little differently, the authors state: "We do not find strong evidence that better governed firms are more profitable or pay higher dividends. We do find that investors value the same earnings or the same dividends more highly for better governed firms." Id. at 6. A similar result emerges in a recent study of market valuation of research and development investments in Europe. Hall and Oriani report that research and development investments by publicly traded Italian firms are not as highly valued by the market as similar investments by German and French firms. The authors attribute the difference to the potential for Italian controlling shareholders to appropriate the returns on the research and development investments. The authors report that they "found a positive relationship between R&D and market value only after controlling for the eventual control by the major shareholder." Bronwyn H. Hall & Raffaele Oriani, Does the Market Value R&D Investment by European Firms: Evidence from a Panel of Manufacturing Firms in France, Germany, and Italy 24 (working paper, 2004).

B. Functional Convergence and Diversity of Shareholding Concentration.

In an efficient controlling shareholder system, concentration of control operates as a cost effective response to the managerial agency cost problem. It is observed when the benefits of more focused monitoring exceed the limited extraction of private benefits of control allowed in a country with good law. This represents a form of functional convergence – within limits, different corporate governance systems may solve the same monitoring problem through different institutions.[30]

As well, we can expect diversity – different firm level ownership patterns – within the same efficient controlling shareholder system. The advantages of a controlling shareholder in a system with good law that minimizes the potential for private benefit extraction depends on the value gain that results from more focused monitoring of management performance than possible with market-based techniques like independent directors and the market for corporate control.[31] And the size of this value gain, in turn, should be sensitive to differences in industry, companies, and controlling shareholders. For example, focused monitoring by a controlling shareholder may have no comparative advantage over market-based monitoring when competition in the product market is sufficiently intense. So, in high technology industries characterized by intense product market competition and rapid technological change, we may observe companies with widely distributed shareholdings even in an efficient controlling shareholder system. These alternative monitoring techniques make even limited private benefit extraction unnecessary.[32] Similar diversity may result from differences

[30] See Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 49 Am. J.Comp. L. 329, 332-33 (2001); Ronald J. Gilson, Corporate Governance and Economic Efficiency, 74 Wash. U.L.Q. 327, 332-33 (1996). For example, the extraction of private benefits of control by a controlling shareholder can be constrained by rules against self-dealing, or by a mandatory bid rule that forces the controlling shareholder to increase its equity ownership. Gilson, Globalizing Corporate Governance, at 336-37.

[31] The focus on the benefits of monitoring performance rather than merely private benefit extraction distinguishes this discussion from that of Mike Burkhart, Fausto Panunzi &Andrei Shleifer, Family Firms, NBER Working Paper 8776 (Feb. 2002), which treats monitoring as extending principally to the consumption of private benefits by a non-owner manager.

[32] For discussion of product market competition as a monitoring mechanism, see Mark Roe, Rents and Their Corporate Law Consequences, 53 Stan. L.Rev. 1463 (2001); Dyck & Zingales, supra note 24.

between particular controlling shareholders with respect to their taste for or skill at focused monitoring, which may tip the balance between a controlling shareholder system and a widely-held shareholder system, so that some diversity of shareholder distribution may exist in an efficient controlling shareholder system even within the same industry. Thus, the controlling shareholder tradeoff framework predicts diversity of ownership structures within an efficient controlling shareholder system. We should see companies with both controlling shareholders and widely-held shares.[33]

In contrast, the controlling shareholder tradeoff framework predicts much less diversity of ownership structures within an inefficient controlling shareholder system. In the absence of constraints on private benefit extraction by a subsequent acquirer of control, an existing controlling shareholder cannot part with control. And since here the concern is not monitoring performance, but monitoring self-dealing or tunneling, alternative techniques are far less likely to be available. To be sure, this analysis does not rule out the presence of any widely-held companies in an inefficient controlling shareholder regime. For example, companies that begin as widely–held, perhaps through privatization, may survive. Nonetheless, we would expect there to be less diversity of shareholder distribution in an inefficient controlling shareholder system than in an efficient controlling shareholder system.

The available data appear to support this prediction. Table 1 shows the percentage of widely-held and family controlled public corporations in Sweden, an efficient controlling shareholder system, and in Italy, an inefficient controlling shareholder system. While Sweden has rough parity between publicly traded

Table 1

	Controlling Shareholder (family)	*Widely-held*
Sweden	46.94 %	39.18 %
Italy	59.61 %	12.98 %

Source: Mara Faccio & Larry H.P. Lang, The Ultimate Ownership of Western European Corporations Table 3 (working paper, 2003)

[33] Part IV takes up in greater detail the importance of differences in tastes among controlling shareholders in an efficient controlling shareholder system.

companies with controlling shareholder and those with widely-held shareholder structures, Italy has close to 5 times more companies with controlling shareholders than companies whose shares are widely-held.

C. Path Dependency in Patterns of Shareholder Distribution

In the preceding section, the controlling shareholder tradeoff framework suggested that efficient controlling shareholder systems and widely-held shareholder systems may be functional substitutes. Conditional on the presence of good law, in some industries and in some circumstances a controlling shareholder structure may be superior. In others, a widely-held shareholder structure may be superior. Finally, the two patterns of shareholdings may be functional substitutes. In the absence of extremely competitive markets and rapid technological or market change, the domain in which the two patterns are substitutes may be substantial.

In the setting where the two patterns are substitutes, the ultimate outcome may be path dependent; that is, the pattern that develops will turn on a set of initial conditions driven by factors other than efficiency, and with the passage of time will prove costly to change even if a different pattern becomes more efficient at a later date.[34] So, for example, recent studies of the origins of the shareholding patterns in the U.K and Sweden, both good law countries, stress non-efficiency circumstances as explanations for each country's start down a path toward widely-held or controlling shareholder systems.[35] Once on that path, and contin-

[34] The application of a path dependency analysis to explain differences in industrial organization dates to Michael J. Piore & Charles F. Sabel, The Second Industrial Divide (1984), in which the point was to explain on non-efficiency grounds the U.S. pattern of mass production and the European pattern of smaller team oriented organization. For applications in the corporate governance context, see Lucian Ayre Bebchuk & Mark J. Roe, The Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L.Rev. 127 (1999).

[35] See Peter Högfeldt, The History and Politics of Corporate Ownership in Sweden, ECGI Finance Working Paper No. 30/2003 (Sept. 2003), available at http://ssrn.com/abstract=449460 (pattern the result of coalition between labor and family owners to socialize capital without public ownership); Julian Franks, Colin Mayer & Stefano Rossi, The Origination and Evolution of Ownership and Control, ECGI Working Paper No. 9/2003 (Jan. 2003), available at http://ssrn.com/abstract=354381 (pattern the result of implicit contracts enforced by informal relations of trust and confidence that encouraged participation of largely local outside investors).

gent on good law, there is little cause to change. Both systems are efficient, and will persist unless significant environmental change substantially alters the balance. For a controlling shareholder system, the frictions which hold the pattern in place range from the lock-in effect of capital gains taxes on the sale of a controlling position,[36] to the fact that while good law keeps the size of pecuniary private benefits of control low, it may do little about non-pecuniary private benefits, a distinction that will be addressed in the next Part. As a result, persistence in shareholder distribution in efficient controlling shareholder systems will depend in part on the persistence of controlling shareholder tastes. Anticipating the outcome of the next Part's analysis, an efficient controlling shareholder system may be less stable than an inefficient controlling shareholder system.

IV. Complicating the Controlling Shareholder Taxonomy: Pecuniary versus Non-Pecuniary Private Benefits of Control

In Part III, I extended the standard good law/bad law account of controlling shareholder systems by complicating the taxonomy of controlling shareholder systems to distinguish between efficient and inefficient controlling shareholder systems. The next step is to further complicate the taxonomy by looking more carefully at the concept of private benefits of control, a central but to this point unexplored element of the analysis.

Consistent with the vast majority of the existing literature, I have not as yet defined what I mean by private benefits of control. That now needs to change. For present purposes I want to make a quite simple distinction between two kinds of private benefits of control. The first is *pecuniary* private benefits of control; that is, the non-proportional flow of real resources from the company to the controlling shareholder. A familiar example is tunneling accomplished by inter-company dealings

[36] Capital gains taxes may reinforce the path dependency of controlling shareholder systems by imposing a substantial charge on a controlling shareholder selling its long held position even if, in a world without taxes, changes in the economy would cause controlling shareholders to sell. Eliminating this barrier to restructuring the ownership distribution of German corporations led Germany to eliminate the captal gains tax on the sale of long held cross-holdings. See Gilson, Globalizing Corporate Governance, supra note 30, at 341-42.

whose terms favor the company in which the controlling shareholder has the larger equity stake.[37] The second is *non-pecuniary* private benefits of control; that is, forms of psychic benefits of control that, without more, are non-dilutive of the value of the company's stock to a diversified investor. A good analogy may be to the difference between common values and private values in the economics of auctions.

The existing literature, both analytical and empirical, focuses almost exclusively on pecuniary benefits of control although typically without acknowledging the distinction.[38] This can be seen most clearly in the empirical literature. Whether measured by differences in value between high and low voting classes of common stock, or by the premium paid for a control block relative to the entire firm, these amounts reflect the capitalized value of real resources diverted to the controlling shareholder at the expense of minority shareholders. As we have seen, a number of studies show clearly that the market values the same cash flows differently when produced by a company with an inefficient controlling shareholder as opposed to an efficient controlling shareholder.[39] The difference is pecuniary private benefits of control.

Focusing on pecuniary private benefits of control, however, raises a real quandary. The empirical evidence shows very low pecuniary private benefits of control in efficient controlling shareholder systems. But holding a controlling position imposes real costs in liquidity and lack of diversification on the controlling shareholder. Why then do we observe efficient controlling shareholders if they can extract only limited amounts of pecuniary private benefits of control? Unlike in an inefficient controlling shareholder system, these controlling shareholders are free to sell their positions without fear of subsequent exploitation by someone who subsequently assembles a new control position. This is the realm of non-pecuniary private benefits of control. Almost tautologically, non-pecuniary benefits of control must play a prominent role

[37] See Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Tunneling, 90 Am. Econ. Rev. (papers and proceedings) 22 (2000).

[38] Dyck & Zingales, supra note 24 at 32, are notable in that they recognize the difference between the two categories. Their principle point, however, is only to show the importance of pecuniary private benefits of control – "that not all private benefits are psychic" – rather than to examine the implications of psychic benefits.

[39] See TAN 27-29 supra. Black, Jang & Kim, supra note 28, provide the best example. The same cash flows increase in market value as a result of an improvement in law that reduces the potential for pecuniary private benefits for controlling shareholders.

in efficient controlling shareholder systems where good law keeps pecuniary private benefits low.

While a more thorough understanding of non-pecuniary private benefits of control is part of a larger project, a hypothetical question can serve to motivate the analysis. Suppose a family that controls a firm has a net worth of €4 billion. What does the family's utility function look like? What does the family maximize? For example, suppose a potential acquirer will pay a €300 million dollar premium for the family's controlling interest because the acquirer can increase the company's productivity or capture synergies. The family confronts a tradeoff: control of a major industrial company versus a 7.5 percent increase in family wealth. Is the role of leading industrialists in a country, with the social and political access associated with that role, worth more than additional wealth at a point where decreasing marginal returns to wealth must surely have set in?

To generalize the intuition, the existence of private benefits of control means that for the controlling shareholder the separation theorem does not apply; that is, the controlling shareholder's utility is affected by company decisions in ways other than through the decision's impact on the company's stock price. As a result, maximizing the controlling shareholder's utility may mean something other than maximizing the value of the corporation. As with complicating the concept of controlling shareholder in Part III, complicating the concept of private benefits of control has a number of interesting implications.

A. Macroeconomic Implications of Non-Pecuniary Private Benefits of Control

The empirical evidence supports the proposition that minority shareholders are not uniquely disadvantaged in an efficient controlling shareholder system. Good law keeps diversion of pecuniary private benefits of control low and, in a reasonably efficient stock market, the costs of these payments for focused monitoring, as well as the risk that the talent of future generations of family managers will regress to the mean, will be priced fairly albeit imprecisely. Unlike in inefficient controlling shareholder systems, minority shareholders in an efficient controlling shareholder system are playing in an honest game.

The inquiry, however, does not end with the position of minority shareholders. The existence of a significant role for non-pecuniary private benefits of control has macroeconomic significance, which impacts the country as a whole. We take up three such circumstances.

Consider first the failure of separation just discussed. Some controlling shareholders' preferences may simply reflect misjudgment or over confidence. To the extent that the controlling shareholder wishes to continue to directly manage the company, there may be a powerful inclination to over invest in the company's existing businesses – those with which the family manager is more comfortable. Alternatively, the controlling shareholder may prefer to enter new businesses about which she knows little; the recent transformation of the businesses in which companies associated with the Bronfman family engage may be an example. To the extent these actions are motivated by non-pecuniary benefits of control, the fact that they are value reducing may matter a great deal to the country as a whole even if minority shareholders accurately predicted both the controlling family's preferences and ability.

A second implication of the failure of separation concerns the focus of the controlling shareholder's attention. If the controlling shareholder's wealth is spread among a number of companies, then her decision rule may be to maximize the value of the controlling shareholder's portfolio, rather than the value of each company.

A final implication may be the most significant. As suggested in Part III, efficient controlling shareholders systems have greater diversity in patterns of shareholder distribution. Part of this diversity is positive – driven by the fit between particular companies and particular industries on the one hand and controlling shareholder or widely-held shareholder distributions on the other. But part of this diversity may be negative – reflecting the absence of market pressures on controlling shareholders to respond to changes in the external economic environment and of market mechanisms to impose those changes from the outside when the controlling shareholder fails to respond.

The insulation of the controlling shareholder from market pressure is not necessarily always bad. As I have argued previously, "institutions matter when they fit with existing industrial technology."[40] The stability that a controlling shareholder can provide may be quite effective when, as with the happy match between Japanese corporate governance and Japanese industrial organization over a large part of the post-War period, it supports worker investment in firm and team specific human capital and the industry experiences largely linear change. The con-

[40] Gilson, Corporate Governance and Economic Efficiency, supra note 30, at 341.

verse, however, is also true: "institutions matter when they do not fit with the industrial technology demanded in a state of the world different from that which gave rise to the governance institutions in the first place."[41] When companies and industries must adapt quickly to large and abrupt changes in the economic environment, the stability associated with an efficient controlling shareholder system becomes a barrier to necessary adaptation; in this circumstance, a widely-held shareholder system, with control open to the market, likely will be more efficient.[42] If it is difficult to design a system that is both adaptive like a widely-held shareholder system and stability providing like an efficient controlling shareholder system, the choice between them will depend on one's predictions of the future: will the environment be one that favors adaptation or stability?

B. Ameliorating Influence I – The Potential Instability of Efficient Controlling Shareholder Systems

Some factors work to ameliorate an efficient controlling shareholder system's insulation from market pressures for change. The fact that non-pecuniary private benefits of control are significant in efficient controlling shareholder systems also has a positive side. Precisely because non-pecuniary private benefits are idiosyncratic to the particular controlling shareholder, and because the identities of controlling shareholders change with generations, it is plausible to expect changes in the value of the non-pecuniary private benefits of control over time (whether from lifecycle changes, increased wealth within a single generation, or intergenerational changes in taste or abilities). At some point, the wealth gain from adaptation reflected in a large acquisition premium, or an increase in market value from giving up control and hiring pro-

[41] Id.

[42] See Ronald J. Gilson, The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment, 61 Ford. L. Rev. 161 (1992); Gilson, Corporate Governance and Economics Efficiency, supra note 30. This concern with the barriers to adaptation in efficient controlling shareholder systems recently has received broader attention. See Hans Tson Söderström (ed.), Erik Berglöf, Bengt Holmström, & Eva M. Meyersson Milgrom, Corporate Governance and Structural Change, SNS Economic Policy Group Report 2003; Raghuram Rajan & Luigi Zingales, Banks and Markets: The Changing Character of European Finance, NBER Working Paper 9595 (March 2003).

fessional managers, outweighs the non-pecuniary private benefits of control experienced by that controlling shareholder.

As a result, efficient controlling shareholder systems will tend to deteriorate in the sense that control moves into the public float. For example, the recent SNS Economic Policy Group report notes with respect to Sweden, an efficient controlling shareholder system, that "[o]nly a few of the 'fifteen families' who used to dominate Swedish industry remain major owners in a position of control… ."[43] To the extent that the deterioration is in part driven by a control premium that increases with the value that would result from change, the timing of the deterioration may at least be influenced in the direction of efficiency: the greater the efficiency gain from adaptation, the faster the shift of control to the market. This assessment is consistent with another recent characteristic of the Swedish system. Despite the dominant role of controlling shareholders, Sweden has experienced a high level of friendly takeovers. Rolf Skog reports that of the 245 Swedish listed companies that were taken over between 1990 and 2002, 157 or 64 percent of the targets had dual class stock with different voting rights, roughly the same percentage as companies with dual class stock are among all listed companies.[44] This suggests that the circumstance when the size of the offered premium exceeds the controlling shareholder's non-pecuniary benefits of control may track the circumstances that give rise to takeovers more generally.

C. Ameliorating Influence II – Public Pressure on Efficient Controlling Shareholders

There is reason to think that external pressure may operate as some constraint on controlling shareholders. The role of public opinion has been raised primarily in connection with reducing pecuniary private benefits of control in bad law countries, essentially as a substitute for an effective legal system.[45] Public opinion driven policing of non-pecuniary private

[43] Söderström, et. al., supra note 42, at 13. Högfeldt, supra note 35 at 11, describes the extent to which the Wallenberg group in Sweden has recently withdrawn control from a significant number of companies.

[44] Skog, supra note 12.

[45] See, e.g., Dyck & Zingales, supra note 44, who use the importance of newspapers (circulation per 100,000 inhabitants) as a measure of the force of public opinion in a jurisdiction. They find that one standard deviation increase in circulation reduces the value of control measured by pecuniary private benefits by 6.4 percent.

benefits of control, however, may prove more difficult. For public opinion to operate as a constraint, two conditions are necessary (although not necessarily sufficient). First, the controlling shareholder's conduct must be observable to the public, which is why the most promising empirical study of the role of public opinion as a constraint on private benefits of control uses newspaper circulation as a measure.[46] Second, and for present purposes more difficult, there must be a shared public conception that the behavior disclosed to the public is wrong. This is plausible with respect to pecuniary private benefits of control – the concept that "thou shalt not steal" is surely widely shared and diversion of company cash flows for the benefit of a controlling shareholder may well be widely understood as stealing. However, the range of behaviors that may provide non-pecuniary private benefits of control may lack the same public consensus. Thus, the extent to which public opinion acts as a constraint on non-pecuniary private benefits of control likely is quite sensitive to the particular manifestation of the private benefit. For example, the extent to which nepotism is widely viewed as improper may differ widely among jurisdictions.

V. Implications and Conclusion

In this essay, I have argued that a good deal can be learned by complicating the usual taxonomy of controlling shareholders by looking at the problem through the framework of the controlling shareholder tradeoff – focused monitoring in return for some private benefits of control. In particular, the framework highlights the value of distinguishing between efficient and inefficient controlling shareholder systems, and between pecuniary and non-pecuniary private benefits of control. I want now to conclude by briefly considering two of the policy implications – one broad, the second narrow – that are suggested by a more complicated controlling shareholder taxonomy.

A. Eliminating Inefficient Controlling Shareholder Systems: Better Law or More Market Exposure?

One straightforward implication of a more complicated taxonomy is the need to eliminate inefficient controlling shareholder systems. This

[46] Dyck & Zinglaes, supra note

can be attempted through two general, but not mutually inconsistent, strategies. First, an inefficient system can be attacked directly by improving the legal system to constrain pecuniary private benefits of control to levels that, net of these costs, leave minority shareholders better off as a result of focused monitoring. Second, an inefficient system can be attacked indirectly by changing legal rules to increase the exposure of control to the market.

Improving the legal system generally involves eliminating deficiencies in three areas – the statement of the standards that make significant pecuniary private benefits of control unlawful; the disclosure process that allows pecuniary private benefits of control to be observed by those who have the power to enforce the legal standard; and the available public and private enforcement mechanisms. This process can be slow, and certainly requires a political moment when the public perception of the need for reforms outweighs the influence of entrenched inefficient controlling shareholders, but there is some evidence that it can be effective. Recent reform in Italy may be a case in point.

Recall that empirical studies show that in Italy private benefits of control amount to as much as 30 to 37 percent of total firm. In 1998, Italy adopted legislation that improved the enforcement component of "good law" by marking it significantly easier for minority shareholders to pursue litigation against management appointed by a controlling shareholder. Dyck and Zingales report a dramatic drop in the level of pecuniary private benefits of control after the reform, although the results can only be suggestive given the very small sample.[47] In 2003, new legislation in Italy extended reform to both the standard specification and disclosure elements of "good law" by substantially reforming the legislation governing groups of companies dominated by a controlling shareholder.[48] In addition to extending the circumstances in which voting control imposes responsibility on the controlling shareholder for the actions of the controlled company management, the legislation imposes extended disclosure obligations concerning transactions with the controlling shareholder and, with respect to decisions actually influ-

[47] Dyck & Zingale, supra note 24. Unfortunately, the Dyck & Zingales sample containes only 6 observations of a controlling shareholder block sale before the 1998 reform and two after the reform.

[48] Legislative Decree n. 6 of January 17, 2003. See Umberto Tombari, The New Italian Company Law: An Emerging European Model?, working paper (May 2003).

enced by the controlling shareholder, a requirement to disclose the reasons for taking the decision in question.

Despite the seemingly important efforts in Italy, broad based legal reform may move quite slowly in some countries. For example, legislation may state standards of conduct more aggressively, may require more effective disclosure, and may expand formal enforcement rights, but reform still may founder on the reality of the enforcement process. If a country lacks a sophisticated and effective court system, it may be a time consuming process to create one, even if political barriers can be overcome.

In these cases, the second strategy – legal reform that exposes controlling positions to the market – may be more effective. Here the most obvious example is the mandatory breakthrough rule proposed by the Winter Report and reflected in the 2002 Commission draft of the Thirteenth Directive. Under the proposal, if a bidder secures 75 percent of the equity, then the extra votes of a high voting class would be ignored for such things as election of directors. The effect of the rule would be to sharply limit the extent to which a controlling shareholder can lever its equity into control; a minimum of 25 percent of the equity value plus one share would be necessary to command a majority of the vote.[49]

For our purposes, the breakthrough rule had two important characteristics. First, it was to be imposed on a European level, thereby at least partially bypassing the political problem of controlling shareholder influence on a particular country's legislature.[50]

The second characteristic is rather more speculative. The Thirteenth Directive, as imagined by the Winter Report and the Commission, might have had the interesting effect of having a quite different impact on inefficient and efficient controlling shareholder systems. For inefficient systems, a breakthrough rule opens up control to widely-held bidders, who will be in a position to purchase 75 percent of the equity at a premium that shares with minority shareholders the gain from eliminating pecuniary private benefits of control, much like a 1990s style takeover motivated by eliminating the misuse of free cash flow.[51] In

[49] Jaap W. Winter et al., Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids in the European Union (Jan. 10, 2002), *available at* http://ssrn.com/ abstract=315322

[50] To be sure, individual states can and do drag their feet on adopting legislation implementing a directive.

[51] See Ronald J. Gilson & Bernard Black, The Law and Finance of Corporate Acquisitions c. 11 (2nd ed. 1995).

contrast, the breakthrough rule's threat to control in efficient controlling shareholder systems is substantially more muted. Because of the low level of pecuniary private benefits of control in an efficient controlling shareholder system, there would be no easy source of premiums for would-be bidders. To be sure, controlling shareholders would in some cases have to increase their equity ownership to 25 percent to protect control, thereby increasing the costs of focused monitoring and in particular circumstances resulting in a shift in the outcome of the controlling shareholders tradeoff, but European Union-wide, the balance would seem to be positive.

B. Understanding the Dynamics of Efficient Controlling Shareholder Systems

The most serious concern with efficient controlling shareholder systems is that controlled firms adapt less quickly to changes in the economic environment. Because of the non-pecuniary nature of private benefits of control, controlled firms in efficient controlling shareholder systems may respond less quickly to changes in the economic environments than widely-held firms. Put differently, the market for corporate control can force a firm to internalize change. At the same time, we also saw that the fact of non-pecuniary private benefits of control may make efficient controlling shareholder systems less stable. From the perspective of the controlling shareholder, the relative value of non-pecuniary private benefits of control – the balance between non-pecuniary private benefits and the gains from a more adaptive control structure – can shift with the identity and generation of the controlling shareholder.

At this point, however, we can do little more than identify the tension, rather than either model or test empirically the relationship. And this is an appropriate point with which to conclude. To better understand the macroeconomic impact of efficient controlling shareholder systems, we need to better understand the micro level dynamics of this ownership structure. To answer the question at which the Jublilee Conference was directed, this inquiry would be a useful focus for research in the next decade.

Corporate Governance and Public Policy

Mats Isaksson[1]

Introduction

During the last decade, corporate governance has in no uncertain terms established itself on the public policy agenda. Numerous national and international initiatives have seen the light of day and more and more governments have created special departments, units or agencies that are dedicated to work on corporate governance. For those of us that have gathered here today to celebrate the 10th anniversary of the Swedish Corporate Governance Forum, this is in many respects an encouraging trend. At the same time however, it is a development that calls for an earnest discussion about the rational and ultimate objective of public policy in the field of corporate governance. And here, I believe, the picture is less rosy.

Like in so many other areas, policy initiatives in the field of corporate governance are often reactive rather than pro-active. Scandals occur, opinions are formed and reforms are pursued based on an uneven mix of emotions, perceptions and rational reasoning. Far too seldom do we see a more genuine economic or legal analysis that can assist decision makers in understanding the nature and consequences of different policy options. And only in rare cases are policy makers ready to focus on those longer term changes in saving patterns and business organization that will provoke further challenges for corporate governance in the coming years.

It is also important to remember that the shaping of public policy always is subject to the influence of special interests. A clear formulation of the rationale for public policy is therefore an important step in estab-

[1] Mats Isaksson is Head of Corporate Affairs at the OECD in Paris. He is co-founder and Director of the Swedish Corporate Governance Forum and Senior Visiting Fellow at the Centre for Commercial Law at the Stockholm University. The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its Member countries.

lishing the agenda and aligning expectation of what public policy can, and should, contribute in the interest of society as a whole. To establish these boundaries is particularly important in the field of corporate governance, which is still in its infancy as a coherent policy area and where there is still widespread confusion about both aims and means.

In this short address I suggest that public policy should be based on the link between corporate governance, investment and economic growth. I will also provide some examples of current economic trends that will influence the future corporate governance agenda and of some specific issues that will demand our attention in the coming decade.

The Key to Investment and Growth

The rationale for public policy in the field of corporate governance is based on the positive correlation between investment and economic growth. As a matter of fact, this is one of the most salient relationships that we know about in economic life. By continuously investing in the quality and quantity of fixed capital and human skills, our economies have for more than a century experienced an unprecedented increase in real income per capita; a development that has made it possible to improve the quality of life dramatically for *all* citizens.

At the very heart of the investment process is the business corporation, which constantly is searching for the most effective ways to combine all the different inputs that are needed to produce those goods and services that markets demand. Of special interest for understanding the role of corporate governance are market efforts to match viable business projects with the *financial* resources that are required to actually turn an idea into a profitable enterprise. To be sure, capital is only one among several important inputs that are needed to build a competitive company. Access to a well functioning infrastructure, to skilled labour and managerial talent is also vital. But, while access to capital may not be a sufficient condition, it is for all practical purposes a necessary one. This is particularly true for equity financing which allows companies to increase their exposure to risks that are associated with long term and forward looking undertakings, such as corporate re-structuring, research and development.

But it is not only the absolute *amount* of capital that will determine economic growth. History is littered with horrifying examples of monumental investment projects that in centrally planned economies have led to the impoverishment of people rather than to increased welfare.

At least as important as the absolute amount of investment is the *effectiveness* with which the capital is allocated among alternative investment opportunities and, not least, how well the use of this capital is actually *monitored* once it is invested in an individual company. If household savings and corporate earnings for some reason are not allocated to their best possible use, society will undoubtedly forego business opportunities that would have generated additional economic welfare; entrepreneurs will not find appropriate funding for profitable projects; existing companies will not be able to expand their operations; innovations will never be commercialised, etc. Moreover, necessary re-structuring of individual companies and entire industries will be impaired, and productive assets will be locked into under-performing activities.

The three steps in the investment process described above: *the mobilization of capital; the allocation of capital among alternative ends; and the monitoring of the final use of the invested capital*, are among the key functions of the financial system. In market economies, they are carried out by a multitude of investors and the overall outcome will to a large extent depend on their individual skills. But the final outcome will also be highly dependent on the quality of those laws, regulations and business practices that influence the incentives of investors and the way in which corporations are directed and controlled; that is to say, the corporate governance framework. *By specifying the distribution of rights and responsibilities among the different participants to the corporation, the quality of the corporate governance framework influences the outcome at all stages of the investment process.* A few examples may help to illuminate this point:

At the first stage of the investment process, secure methods of ownership registration and the opportunity to obtain legal redress for violation of shareholder rights are just two examples of corporate governance provisions that will facilitate the mobilisation of capital. If households cannot be assured that the assets they invest in are properly recognised and protected, their savings will remain idle, hidden away in mattresses or instantly consumed, instead of being employed in productive uses. At the second stage of the investment process, reliable and transparent accounts of corporate operations and their financial situation are of course essential to make informed decisions about the allocation of financial resources among alternative uses. At the third stage, the procedures for corporate decision-making, the distribution of authority among company organs, the design of incentive schemes and workable lines of accountability are all obvious corporate governance issues that have to be in place in order to ensure that companies actually use their resources effectively.

Looking at these relationships it is easy to conclude that the importance of good corporate governance goes far beyond the interests of shareholders in an individual company. It is a public policy concern. A weak corporate governance framework will severely impede all stages of the investment process and hence the economy's overall prospects to maintain a strong private sector basis for economic growth. Poor corporate governance will damage the capacity to mobilise savings, it will hinder efficient allocation of financial resources, and it will prevent proper management of corporate assets.

Closely Linked to Important Economic Trends

Because of its critical role in economic life corporate governance has for a long time, and certainly before the term itself came into swing, been an important item on the agenda of policy makers and practitioners. The central elements of corporate governance, for example the distribution of rights and responsibilities among different participants to the corporation, have over the last century been elaborated in a sequence of successive reforms, and today they form an integral part of such regulatory domains as company law, securities legislation and insolvency procedures.

This said, it is still evident that the last decade has brought about an unprecedented public awareness of corporate governance. Today, discussions are no longer limited to business circles, lawyers, financial experts and regulators. The topic has become an everyday headline. There are numerous journals, newsletters, web-sites, consultants and university courses that now specialise in corporate governance – and a wide range of different interests take part in the debate.

One important explanation for this growing interest is of course all the high-profile cases of governance failure and misconduct. This was certainly what inspired the work of the British Cadbury Committee in the early 1990s, and similar initiatives in other countries, including Canada, Australia, the Netherlands and France. In later years, Enron, Arthur Andersen and Parmalat are only a few examples of scandals that have helped to usher corporate governance to the front pages and prime time TV shows.

But important as they are, these events do not fully, and by themselves, explain why corporate governance has come to attract so much attention. The interest in corporate governance didn't disappear once the Cadbury Committee submitted its report and it will prevail long after Enron has left the media limelight.

The reason for this, is that *the issues that corporate governance deals with are intimately linked to some of the most pervasive developments in modern economies*. While these developments haven't necessarily changed the fundamental corporate governance questions themselves, they have in many cases placed corporate governance in a new context and certainly amplified its importance for our economies and societies as a whole.

Among the most important developments in this respect are a growing reliance on the private sector; increased international interdependence, and; changing competitive circumstances for investors as well as corporations.

Growing Importance of the Private Sector

The business corporation has become an increasingly important vehicle for wealth creation world-wide. More than two decades of capital market liberalisation, improved competition policy and privatisation programs in OECD countries have played an important role for developing and strengthening the private sector basis for economic growth. We increasingly trust corporations to create jobs, to generate tax income and to furnish the markets with goods and services. Importantly, and at an unprecedented scale, we also make use of private sector institutions as intermediaries to manage our savings, assess investment opportunities and secure our retirement income. A mix of demographic reality and political rhetoric has in many countries led to pension reforms that in one way or another requires private sector intermediation, be it in the form of individual or collective pension schemes. Since many of these schemes are heavily invested in equity, their success is to a large extent depending on the performance of the corporate sector.

In addition to developments in the OECD countries, the fall of communism in the Soviet Union and Eastern Europe has put a large number of countries on an irreversible path to market economy. The last decade of privatisation in these countries has only been a first step in a much longer and more profound process to establish a solid private sector basis for economic growth. The same scenario is also valid in other parts of the world, including a range of developing countries where increased attention is now given to establish sound conditions for true private sector development.

In order to meet public expectations and fulfil their increasingly important role in our economies, it is imperative that companies and investors are governed in a way that keep them focused on their objectives, competitive in their operations and accountable for their actions. If not, countries will not only be deprived of substantive economic values, but will also experience a growing public distrust in market institutions. For these reasons, it is imperative that market oriented reforms now and in the future are accompanied by an unambiguous commitment to sound business practices. Good corporate governance is not only a safeguard against waste of corporate assets; it is also a guarantee for the financial transparency, corporate accountability and investor responsibility that is necessary in order to preserve long term public legitimacy of market institutions.

Increased International Interdependence

Most investors are no longer limited to make equity investments only in domestic companies. In their constant search for investment opportunities they can now allocate their investments on a global scale. This development has also created new opportunities for companies around the world that are now able to raise money from a much larger pool of investors. Commercially viable business opportunities should no longer have to be impeded by the lack of domestic capital sources.

Ambitions to reap the full benefits of these new opportunities have triggered a need among investors and corporations alike to better understand different business cultures and corporate governance arrangements. For investors to actually allocate money abroad on a long term basis, and for companies to open up to overseas ownership, they need to appreciate, and have well founded confidence, in the rules of the game.

The ability to communicate and understand different corporate governance practices therefore becomes an increasingly important factor for companies and countries who want to attract internationally mobile capital, be it domestic or foreign. And at a more general level, it will be an important vehicle for improving the effectiveness of global capital allocation. In an international context, good corporate governance is also seen as an important aspect of the international financial architecture aiming to diminish the risk of financial turmoil. It will facilitate cross-border equity flows and at the same time provide an early warning system for corporate and financial distress.

New Competitive Circumstances

Many of today's fast growing and highly successful enterprises differ quite radically from the traditional image of a smokestack blue-chip corporation. Not only do they differ in terms of market conditions, the character of their products, etc; they may also have a very different asset base. They are often more human capital intensive and highly dependent on intangible assets such as brand names, patents, strategic agreements and organisational know-how. They may also operate under more flexible contracts with employees, business partners and other resource providers.

While these enterprises are highly successful, future oriented and attractive to many investors, their internal structures and the character of their operations often provoke their own genuine challenges in terms of corporate governance. Investors are faced with new evaluation problems and the corporations themselves often struggle very hard trying to communicate the potential value of the company without disclosing any commercially sensitive information or making investors subject to insider status restrictions. Other governance issues that frequently announce themselves in these enterprises are how to recruit, keep and motivate highly qualified staff, such as scientists and top management, and not least, how shareholders should monitor and evaluate managers that have unique entrepreneurial talents and almost exclusive insights about the company's future opportunities.

Since the success of these companies is of critical importance to the renewal of a country's industrial base, the related corporate governance challenges are far from trivial. And it is not surprising that we have already started to see the market's responses to some of them. This is perhaps most obvious in the most advanced versions of venture capital financing and in the private equity industry where new governance techniques are constantly being engineered. These experiences have in turn triggered an interest to improve and customise corporate governance arrangements also in larger and more mainstream public companies. *In fact, the ability to match evolving corporate characteristics with the most appropriate corporate governance arrangements will for many modern enterprises be an important part of their competitive edge.* If policy makers can not deliver a regulatory framework that enable such adaptability at company level, they may very well impede the emergence of new industries and business opportunities that are not well served by more traditional corporate governance arrangements. Just as we need innovation in terms of products, management and financing, we also need innovation in terms of corporate governance practices.

Some More Specific Challenges

In this address I have tried to briefly describe the wider economic, and sometimes social, ramifications of corporate governance. I have also provided examples of how corporate governance is closely linked to some of the most important developments in modern economies. Considering the growing importance of corporate governance I have also argued that we need to develop a better understanding of the boundaries and rationale for public policy. Uncertainty and blurring of objectives will not only hurt investors, entrepreneurs and corporations, it will be to the detriment of our entire economies. And if we look into the future, the challenges are abundant. In concluding I will only mention three examples of more specific issues that I believe will occupy scholars, policy makers and markets in the coming decade.

The Regulatory Architecture

First is the issue of regulatory approach and how different elements of hard law, self-regulation, voluntary undertakings and established business practices should fit together. We need to develop a better understanding of why and in what cases we should prefer one approach over another. Without such an understanding it is likely that parallel and even competing initiatives will confuse rather than clarify expectations. In particular, we need to make sure that various corporate governance codes and guidelines do not leave markets with uncertainty about their status, implementation and enforcement. The new OECD Principles of Corporate Governance therefore state very clearly that when codes and principles are used as a national standard or as an explicit substitute for legal and regulatory provisions, their status in terms of coverage, implementation, compliance and sanctions must be clearly specified. In the longer term policy-makers need to articulate better how various codes fit into the overall legal and regulatory architecture. It will also be important to address why and to what extent there is a need for international harmonization across borders. Present initiatives within the European Union will hopefully be informative in this respect.

The Role of the Board

A second key issue is the future role and character of the board of directors. In times when shareholders have been absent and when the loyalty of executive directors, at best have been seen with suspicion, there has been a tendency to vest more and more responsibilities with the board of directors. In addition, many countries now have quite elaborated rules about the qualifications of directors and the composition of boards in public companies. Most notable is of course the requirement for independent directors, which has created an industry in itself, trying to figure out the proper definition. There are also suggestions to regulate issues such as accreditation of directors, minority representation on the board, gender balance, etc. An equally important development has been the increased use of special purpose board committees, such as remuneration, audit and nomination committees. In some cases the remit of these bodies is fairly straightforward but in other instances, their function and their relationship with the board as a whole remains unclear.

In sum, we do not only see an increase in board responsibilities, we are also experiencing profound changes in terms of board composition and organisation. This is an exciting development, which will probably lead to a gradual re-definition of the board. In this process of defining the responsibilities and working methods of the board, it is essential that policy-makers maintain a functional approach. The role of the board must never be viewed in isolation. The board must be regarded in relation to other company organs. Only if we understand the specific incentives of board members will we be able to understand how they, individually and as a group, can contribute to the structure of corporate checks and balances. As for judgements concerning the proper composition of board or the desired qualifications of individual board members, this is probably best left to the shareholders' meeting that should be in charge of electing the board.

Investor Incentives

Last but not least we need to look at the longer term consequences of an increase in institutional, or intermediary, ownership. This development is partly driven by political decisions and its consequences deserve political attention. Some of the issues that follow from institutional ownership, notably an increased dispersion of ownership, have already been addressed at some length. But there are other, and perhaps more profound effects that have received less attention. We are facing a dilemma beyond the traditional principal-agent problem. The reason is that we have a diminishing number of owners in public companies that fit the traditional model of individual shareholders. Importantly, institutional investors have different incentives when they exercise their ownership rights than individual direct owners. Not because they are lazy, obstructive or uninformed but because they operate with a different set of opportunities and constraints. They will most likely have a different portfolio strategy than large individual investors; their profits may be only vaguely related to stock performance; they are probably subject to different layers of regulation than an individual investor; and from time to time also subject to political influences.

It is therefore reasonable to ask how the existence of intermediary owners should affect those laws and regulations that aim at influencing and taking advantage of shareholders' incentives. We know that regulations are most effective when they promote and build on the self-correcting incentive structures of market participants. This is also the assumption on which much of corporate governance laws and regulations rest. But if the ownership structure changes so that laws and regulations no longer appeal to the incentives among the new shareholders, or if the new shareholders are constrained in their efforts to serve as informed and active investors, then our efforts to improve corporate governance will be in vain and we will lose one of the most important underpinnings of the market economy, namely, the active and informed owner. It will not matter one iota how many rights shareholders are provided with, they will never make full or informed use of them if they don't have the proper incentives.

One of the reasons why we have overlooked this problem is the existence of some very vocal and active institutional investors. These have indeed played a very positive role and made many observers believe that institutions will step forward and serve the traditional ownership function. Unfortunately however, these investors are, and will probably remain, the exceptions. Moreover, many of the more vocal institutional investors are public pension funds, which of course make them vulnerable to political influences that may further skew their incentives as shareholders.

These are only three short examples that from different perspectives and at different levels will present concrete challenges for policy-makers in the coming decade. To find an accurate response to them is neither easy nor given in advance. What we do know is that the ability to respond successfully depends on our ability to understand the boundaries and the rationale for public policy in the field of corporate governance.

A Remarkable Decade: The Awakening of Swedish Institutional Investors

Rolf Skog

Dear Colleagues,

I would like to conclude this inspiring day you have all once again contributed to by shifting the focus from international corporate governance to Sweden, and remind you what an eventful ten-year period we can also look back on from a Swedish corporate governance perspective, especially with regard to institutional investors' involvement in corporate governance issues.

1. Swedish listed companies

In Sweden there is only one form of limited liability company, the *aktiebolag*. In total, there are approximately 300,000 *aktiebolag*, most of them very small. As in most countries, Sweden's corporate governance discussion primarily revolves around publicly listed companies. At the start of 2003, 276 Swedish *aktiebolag* were listed on the Stockholm Stock Exchange. The combined market capitalization of these companies at the time was around SEK 1.6 trillion (EUR 170 billion).[1]

The basic rules on corporate governance in these companies are contained in the Swedish Companies Act.[2] Swedish company law has its historical roots in Continental European law, particularly German. This also applies to the current companies act, which was drafted in the

[1] Figures do not include other, significantly smaller marketplaces for equities. The total value of the shares listed on these marketplaces is negligible in relation to the market value of the Stockholm Stock Exchange.

The total stock market value represented almost 70 percent of GDP (SEK 2.3 trillion).

[2] Aktiebolagslagen (1975:1385) (Companies Act, "CA").

mid-1970's, although it doesn't quite match the German attention to detail and formalism.

A little more than a decade ago, Sweden began a comprehensive review of its Companies Act. In a series of reports to the government, the Company Law Committee proposed extensive amendments, concluding its work just prior to the new millennium on a consolidated proposal for a new Swedish Companies Act.[3] The new Act will become effective on January 1, 2006.

Listed companies must also abide by important corporate governance regulations in the listing rules of the Stockholm Stock Exchange, as well as self-regulation through the Swedish Industry and Commerce Stock Exchange Committee and the Swedish Securities Council.[4] In short, the Companies Act and other laws lay down the basic corporate governance rules for all types of limited liability companies, while the stock exchange and the self-regulating bodies set higher standards for listed companies.

Despite interest in corporate governance issues and strong influences on the corporate governance debate, particularly from the UK, Sweden does not yet have a national or all-inclusive corporate governance code. On behalf of the government, an expert group consisting of representatives from businesses, the market and shareholders is now drafting such a code, however. The code will probably take effect January 1, 2005.

2. Shareholder structure: What has happened?

Corporate governance is fundamentally a question of the opportunities afforded shareholders to govern and control the allocation of resources by individual companies and the business sector as a whole. In considering developments in corporate governance, it is natural therefore to

[3] Ny aktiebolagslag (SOU 2001:1).

[4] The Swedish Industry and Commerce Stock Exchange Committee is a self-regulatory body set up by, among others, the Confederation of Swedish Industry in 1966 to promote best practices among Swedish listed companies by issuing recommendations (now rules). The Swedish Securities Council was set up by the same organizations twenty years later, in 1986, to promote best practices among Swedish listed companies by giving statements on individual cases. For more information, see www.naringslivetsborskommittee.se and www.aktiemarknadsnamnden.se.

start with the shareholder structures of companies and changes in those structures.

Continued institutionalization

From an historical perspective, private owners have dominated the ownership of listed Swedish companies. In the early 1950's, nearly 75 percent of the market capitalization of the Stockholm Stock Exchange was directly held by individual investors. The remaining 25 percent or so was owned in part by family-controlled foundations, holding companies and investment companies, and in part by listed companies themselves, which had significant holdings in other companies. Institutional portfolio investors were practically nonexistent at the time.

Two decades later, in the mid-1970's, direct holdings by individual investors had declined to around 50 percent of the market's capitalization, and by the mid-1980's it had dropped to 25 percent. When we met in Stockholm in 1993 it was around 20 percent, and it has since shrunk even more. Today less than 15 percent of the total market capitalization of the Stockholm Stock Exchange is attributable to direct shareholdings by individuals. Institutional investors account for more than 85 percent. There are few countries – if any – in the world where institutional ownership of listed companies is more predominant than Sweden.[5]

The reasons behind the institutionalization of shareholder structures are well known. Due to, among other things, changes in savings, pen-

[5] As regards the distribution of the stock market's capitalization by shareholder categories, see, e.g., Henrekson, M. & U. Jakobsson, The Swedish Model of Corporate Ownership and Control in Transition, SSE/EFI Working Paper Series in Economics and Finance, No. 521, 2003. See also by the same author, in Swedish, *Ägarpolitik och ägarstruktur i efterkrigstidens Sverige* [Ownership policies and ownership structures in post-war Sweden], in Jonung (eds.), *Vem skall äga Sverige? 2002* [Who will own Sweden? 2002]. See also, e.g., *Ägande och inflytande i svenskt näringsliv* [Ownership and influence in Swedish business] (SOU 1988:38), *Ägande i det privata näringslivet* [Ownership in private business] (SIND 1980:5), and *Ägande och inflytande i det privata näringslivet* [Ownership and influence in private business] (SOU 1968:7). As regards the ownership structures of listed Swedish companies, especially during the 1950's and 60's, refer also to, among others, Lindgren, H., *Aktivt ägande. Investor under växlande konjunkturer* [Active ownership: Investor under changing economic conditions], 1994, p. 100 ff.; Glete, J., *Nätverk i näringslivet* [Business networks], 1994; and, by the same author, *Ägande och industriell omvandling* [Ownership and industrial transformation], 1987.

sion and tax legislation, capital accumulation has been collectivized and increasingly channeled to institutional investors. These institutions, in turn, have invested more of their assets in the stock market.[6] Over a number of years, pension funds, insurance companies, mutual funds and other institutional portfolio investors have been net buyers of shares, while individuals have been net sellers. Moreover, institutions have been overrepresented in new share issues, whereas individuals have been equally underrepresented.[7]

It is no exaggeration to say that individual investors in equities will have soon essentially played out their role as providers of risk capital for most listed Swedish companies. This is despite that fact that more Swedes than ever directly own shares.[8] Their shareholdings are so small as to be negligible as a source of risk capital.

Internationalization

The institutionalization of share ownership has been a lengthy process, and is in no way unique for the ten-year period we are focusing on here today. That is the case, however, with another change in the shareholder structure of listed companies: internationalization.

To protect Sweden's natural resources and Swedish businesses from excessive foreign ownership, special legislation was introduced in the early 1900's whereby practically every purchase of real property and large shareholdings in Swedish limited liability companies by foreigners required the approval of the Swedish state.

This control legislation effectively held foreign ownership of limited liability companies in check for almost a century. A slight change was noted during the 1980's, when U.S. pension funds were among those to see the potential in undervalued shares in Swedish-based, internationally recognized public companies. The share of the market capitalization of the Stockholm Stock Exchange owned by foreign investors rose slightly, but as recently as the late 1980's only around five percent

[6] See, e.g., Henrekson & Jakobson (2003).

[7] See, e.g., *Ägande och inflytande i svenskt näringsliv* [Ownership and influence in Swedish business] (SOU 1988:38), p. 98 f.

[8] In 1945, an estimated 165,000 Swedes owned shares. By the mid-1960's, the number had risen to just over 500,000. Today more than 3 million Swedes directly own shares (*Aktieägandet i Sverige* [Share ownership in Sweden], Aktiefrämjandet, January 11, 2002.

of total capitalization of the Stockholm Stock Exchange was in the hands of such investors.

The more significant change came about the same year we last met. On January 1, 1993, Sweden joined the European Economic Area, and two years later the EC (EU). One result was that it was forced to adapt its legislation to the non-discrimination principle of the EC treaty and once and for all eliminate restrictions on capital flows and investments by investors from other member states. Sweden decided to take the opportunity to abolish all restrictions on acquisitions of shares in Swedish companies, not only vis-à-vis other countries in the EEA and EC but also the rest of the world.[9]

The results were almost immediate. Direct foreign investments in the form of, among other things, corporate takeovers and portfolio investments in Swedish listed companies rose dramatically. Ten years after the abolishment of the control legislation, 37 of the 100 largest Swedish companies are foreign-owned,[10] and foreign ownership of Swedish listed shares now ranges between 30 and 40 percent[11] – a dramatic change indeed.

Not surprisingly, the main reason for the increased foreign ownership of Swedish listed shares is that foreign institutional investors with global portfolios have adjusted their holdings to include Swedish equities. Similarly, Swedish institutions, due to more liberal investment regulations, have reduced the portion of Swedish shares in their portfolios during the same period.[12]

[9] See, e.g., *Bundna aktier* [Restricted shares] (SOU 1992:13) p. 77, and Skog, R., Foreign Acquistions of Shares in Swedish Companies, International Company and Commercial Law Review, April 1992.

[10] Figures refer to 2001; see the report *Med utländska flaggor i topp och konjunkturen i botten – Hur går det för Sverige?* [With foreign flags flying high and the economy sinking low, how is Sweden doing?], ISA 2003 s. 64. Major foreign takeovers of Swedish companies have frequently been debated and criticized by high-ranking representatives of Swedish business, including Carl Bennet, chairman of Boliden, in *Dagens Industri*, Nov. 27, 2001; Sören Gyll, chairman of Svenskt Näringsliv [Federation of Swedish Industries], in *Dagens Industri*, Nov. 29, 2001; and Marcus Storch, former president of AGA, in *Dagens Nyheter*, August 25, 2002. The debate has also encompassed mergers between major Swedish and foreign companies (e.g. Astra and Zeneca), following which their Swedish head offices have been moved abroad.

[11] See, e.g., Statistics Sweden: Ägandet av aktier i bolag noterade på svensk marknadsplats, åren 1983-2003 [Ownership of shares in companies listed on Swedish marketplaces, 1983-2003].

[12] See, e.g., Henrekson & Jakobson (2003) p. 26.

Controlling and non-controlling owners

Since the focus of the corporate governance debate is on the control and oversight of individual companies, it is not enough to describe shareholder structures in terms of the percentage of the total market capitalization attributable to various categories of shareholders. We also have to look at the shareholder structure – the existence of controlling and non-controlling shareholders – of individual companies.

Fifty years ago, the ownership structure of most listed Swedish companies was typically dominated by a single family with control of the company, along with a couple of thousand individual investors with smaller holdings.[13] The dispersed ownership structure that at that point had long since characterized major American corporations and become noticeable among British companies had not found its way to Sweden, where few companies lacked controlling shareholders.

Furthermore, institutional ownership was limited. Many controlling shareholders channeled all or part of their holdings via family-controlled foundations, holding companies or closed-end investment companies, but institutional portfolio investors were practically nonexistent. Institutions were the tools of families and individual owners, not independent players.[14]

Today the picture is a little bit more complex, although most, though not all, listed Swedish companies still have a shareholder or closely connected group of shareholders whose holdings are so large they can be called controlling shareholders. If we study the listed companies with a market capitalization of at least SEK 1 billion (105 companies), to eliminate the impact of the large number of very small and often family-controlled companies that have listed on the stock exchange in recent years, we have little difficulty in identifying a controlling shareholder in nearly 80 percent of the companies.[15] This is a very high percentage

[13] See, e.g., SOU 1968:7, p. 30. In 1963, listed Swedish companies had an average of 5,600 shareholders, SOU 1968:7, p. 18. As regards the concentration of the ownership structures of listed companies in the 1940's, see, e.g., Lindgren, G., Shareholders and Shareholder Participation in the Larger Companies' Meetings in Sweden, *Weltwirtschaftliches Archiv*, Vol. 71, No. 2, 1953, p. 281 ff.

[14] Glete (1987) p. 93 f.

[15] Listed companies vary greatly in size. The market capitalization of the largest companies is more than 10,000 times that of the smallest companies. By limiting our analysis to the largest companies, we reduce the impact of the many small, often family-controlled companies that have gone public in recent years. The aggregate market capitalization of the 105 companies that have a market cap of at least SEK 1 bil-

from an international perspective. What are the reasons for this continued high concentration? A closer analysis shows that part of the explanation lies in shares with differentiated voting rights.

The presumption in the Swedish Companies Act is that each share confers the same right in the company. In its articles of association, however, a company can prescribe that it shall have or can issue shares of different classes with different rights in the company.[16] This means that a Swedish company can, for example, issue shares of different classes that are distinguished by their voting power. However, the maximum voting ratio between high vote and low vote shares may not exceed 1 to 10.[17] [18] The listing requirements of the stock exchange do

15 continue lion represents around 99 percent of the total market value of the Stockholm Stock Exchange.

[16] Chap. 3 Sec. 1 CA.

[17] Chap. 3 Sec. 1 CA. The Companies Act originally did not contain any provisions limiting the size difference in voting rights. The limitation was introduced in the 1944 version of the act, which entered into force on January 1, 1948. Companies that had already issued shares with differences greater than 1 to 10 were permitted to retain these shares and continue to issue shares with such a large differentiation in voting rights. Sweden has never permitted companies to issue non-voting shares.

[18] Shareholders' right to influence a company's business is exercised at the general meeting (Chap. 9 Sec. 1 CA). Every shareholder has the right to participate in the meeting and have an issue brought up, regardless of the size of his or her holding (Chap. 9 Secs. 1, 2 & 11 CA).

The rules in the Companies Act on decision making at the general meeting are based on the majority principle. The basic rule is that a proposal passes if it wins more than half of the votes cast (Chap. 9 Sec. 28 CA). In board elections, a closely related but not quite identical rule applies, i.e. that the winner is the person who has garnered the most votes (Chap. 9 Sec. 29 CA). Hence, a shareholder with enough shares – high or low vote – to hold a majority at the general meeting can decide himself on the board's composition. The act has no rules on minority representation for shareholders on the board. In listed companies, however, the board must have at least two directors who are independent of any shareholder who holds more than ten percent of the shares or votes in the company (Stockholm Exchange Listing Requirements, September 1, 2003).

A decision to amend a company's articles generally is valid only if supported by both two thirds of the votes cast and shares represented at the general meeting (Chap. 9 Sec. 30 CA). In addition, the decision-making rule is designed in such a way that the more sweeping an amendment to the articles of association typically is for individual shareholders, the higher the majority requirement (Chap. 9 Secs. 30-33 CA). If the amendment, for example, changes the legal relationship between various shares, the decision will carry only if supported by all shareholders present or represented at the general meeting, who together must represent at least nine tenths not include any restrictions on dual class stock.[19]

The system of dual class common stock is widely used among listed companies. Among the group of 105 of the largest listed companies, half (53) have two classes of common shares with different voting rights.[20] Almost without exception, the voting ratio is 1 to 10. The other half of the companies has only one class of shares.

If we study the prevalence of controlling shareholders in each group, we find the following.

Among the group of companies with *dual class stock*, all but one[21] have a major shareholder or group of shareholders that unquestionably can be characterized as the controlling owner. In more than half of these companies, the controlling shareholder falls into the category of individuals, i.e. the largest shareholder is an individual or family.[22] Among the other companies in this group, the controlling shareholder is typically an investment company or foundation, although in several of these companies control ultimately rests with a family.

In all companies in this group, the controlling shareholders' position is based on holdings of high vote stock. In many cases, however, the

18 continue of all shares in the company. In this instance, any differences in the voting power of the shares are irrelevant.

The requirement of a majority of two thirds of the votes cast and two thirds of the shares represented at the general meeting also applies to decisions on new share issues that deviate from current shareholders' preemptive rights or involve reductions in share capital, share repurchases or mergers.

Last but not least, Swedish company law expressly states that neither the general meeting, board of directors nor managing director may take a decision that could give an undue advantage to one shareholder or other party to the detriment of the company or another shareholder – "the principle of equal treatment" (Chap. 9 Sec. 37 and Chap. 8 Sec. 34 CA).

19 A company with two classes of shares can choose to list both classes or just one. In 25 percent of the companies listed on the Stockholm Stock Exchange that have dual class shares, both classes are listed, while in 75 percent only low vote shares are listed.

20 The figure refers to January 2003. In the early 1990's, around 85 percent of the listed companies had multiple classes of shares carrying different voting rights. Due to, above all, initial public offerings by companies having only one class of shares, this is less frequent today. During the period 1990-2002, a total of 268 initial public offerings were floated on the Stockholm Stock Exchange. In 122 of these companies, or 46 percent, there were dual classes of shares with different voting rights.

21 In one company, the largest owner is a mutual fund, which can hardly be characterized as a controlling shareholder.

22 In many cases, the shares in question are owned in part by individuals directly and in part by private holding companies.

controlling shareholder also own low vote stock and therefore owns a significant share of the capital in the company as well. The controlling shareholder's holding represent, on average, around 25 percent of the total number of shares (or dividend stream) and 45 percent of the total number of votes in the company.

In the group of the *companies that do not have dual class stock*, the situation is different. Less than half, 40 percent, of the companies in this group have a controlling shareholder. The remaining 60 percent are essentially management-controlled.

In this group, the controlling shareholder owns an average of 25 percent of both the total number of shares and the total number of votes in the company.

In summary, we see evidence of a bifurcation of sorts among companies. Half have shares with different voting rights and a clearly identifiable controlling shareholder, while the other half have only one class of stock and essentially lack controlling shareholders.

3. Institutional investors' corporate governance activities

Institutional investors such as pension funds, insurance companies and mutual funds are portfolio managers. By spreading their risks, they try to create a stable return for their beneficial owners. As a result, it is not strange that their actions as owners traditionally have focused more on "exit" than "voice"[23]. Their mission is to buy low and sell high. This is just as true in Sweden as in other countries.

Like their international counterparts, however, Swedish institutions in the last decade have gradually taken on more of a proactive approach to corporate governance. As far as Sweden is concerned, we can precisely pinpoint when this trend originated. It was about the same time we last met.

The merger plan that triggered institutional investors

On September 6, 1993, automakers Volvo and Renault announced their plans to merge. The cooperation that dated back a couple of years between Sweden's largest company and flagship, Volvo, and the French

[23] As regards terminology, see Hirschman, A., Exit, Voice and Loyalty, 1970 and Hedlund, G. et al., Institutioner som aktieägare [Institutions as shareholders], 1985.

giant Renault was culminating in their joining forces. It was heralded as the largest deal in the history of Swedish business, and the merger plans received enormous attention in the media.

Initially, it seemed that the deal would get done without a hitch. Most reactions were positive. Volvo's chairman and former president, PG Gyllenhammar, couldn't have looked happier in the Swedish and international press. While Volvo's shareholders would have to give their final approval at an extraordinary general meeting a couple of months later, management saw no reason to fear that they wouldn't.

Volvo is one of the few listed companies in Sweden that traditionally has not had a controlling owner. That was also the case in the early 1990's. Other than its cross-ownership with Renault, Volvo's shares were predominantly held by Swedish institutional portfolio investors. The largest shareholder was a public pension fund, the Fourth National Pension Fund, controlling 8 percent of the total number of votes in the company. The ten largest shareholders – all pension funds, mutual funds and insurance companies – together controlled more than half the votes in the company. Traditionally, these owners had not tried to exert influence over the company, and even less so tried to coordinate their actions. Nor did the other institutional investors or the more than 100,000 individuals who had invested in Volvo shares. In terms of influence, they were negligible. Volvo was controlled by its chairman, PG Gyllenhammar, the rest of the board and management.

All this would change in the fall of 1993, and it was set into motion by Aktiespararna, the Swedish Shareholders' Association, an organization made up mostly of small-time investors, but which, over the years, had figured out how to make its opinions heard in the media. Back in the late 1970's, the association – and several large institutional investors – had put a stop to another of Volvo's planned deals, that time in Norway.[24] Now it was ready to do the same thing. In early October, a month after the merger plans were announced, the association recommended that its members vote no to the merger at the upcoming general meeting. The deal wasn't beneficial for Volvo's shareholders, the association said and put great public pressure on institutional shareholders to take a stand and openly state their opinion of the merger.

Volvo and Renault understood the seriousness of the situation and decided to invite ten of Volvo's largest shareholders to an information

[24] See e.g. "Volvostyrelsen förlorade" [Volvo board lost], *Dagens Nyheter*, Jan. 27, 1979.

session. Two small planes were chartered to fly institutional representatives to Paris to hear firsthand about the benefits of the merger. What the arrangers didn't realize was that they were giving these shareholders, by seating them beside each other on the planes for a couple of hours, their first opportunity to discuss the company in which their combined holdings gave them ownership control. After returning from Paris, one institutional investor after another came out publicly against the merger and, in essence, against PG Gyllenhammar and Volvo's board.

Criticism against the merger also grew among executives within Volvo, and with time it became evident that the board and management also were split on the issue. This criticism reached a peak when it became known that the French government, through a golden share, would *de facto* have the right to veto key decisions in the new company.

In early December 1993, the situation became untenable. PG Gyllenhammar and the directors and executives who still stood by him could no longer count on winning a vote at the general meeting. At its meeting on December 2, the board decided to withdraw the merger proposal. PG Gyllenhammar immediately resigned from the board and company he had de facto led for more than two decades. Most of the other directors resigned their posts too.

For the first time, institutional investors had stood up to the board and management of a listed Swedish company. Not only that, it was Sweden's largest company. This meant more than just stopping the merger and replacing PG Gyllenhammar. Just as importantly, the investors were taking responsibility for Volvo's future. Together, they formed a nomination committee that worked intensely over a two-month period to draft a strongly supported proposal for a new board and, as a consequence, a new direction for Volvo. In the years ahead, these same investors would continue to closely watch the company's development.[25]

[25] The revolt by institutional investors against Volvo's board was led in large part by the state-owned Fourth National Pension Fund, which had been one of the company's largest shareholders for decades. In a self-critical analysis of the events, the fund's president, Thomas Halvorsen, stated in February 1994 that responsibility rests not only with Volvo's board and management but also its owners: "In the case of Volvo, a strong dose of humility is required when evaluating the course of events from an owner's perspective. We as owners share responsibility when the interplay between us and the board isn't working. As an institutional investor, we have not sufficiently exercised our ownership role. Consequently, perhaps the most important thing I have learned is that owners must constantly remain vigilant in order to

The development of corporate governance policies

The fight over Volvo's merger became an eye-opener for institutional investors and marked the start of greater institutional activism that, more than anything else, has distinguished corporate governance in Sweden in the last ten years.[26]

Institutional investors' stance in the case of Volvo was followed the very next year by other more or less coordinated actions. One of the more noteworthy concerned the insurer Skandia, another company that traditionally lacked controlling shareholders and in essence was controlled by the board and management.

Skandia's articles of association contained an extreme form of voting cap that effectively minimized every form of shareholder control of the company, and proved instrumental to Skandia's management in fending off a takeover bid by the Norwegian insurer Uni Storebrand in the early 1990's.[27] When Skandia turned to its shareholders in the spring of 1994 with a new share issue, institutional investors took the opportunity to force an amendment to the voting right rules.[28]

25 continue prevent the kind of situation represented by the Volvo-Renault merger." (Fourth National Pension Fund, Annual Report 1993, p. 4). Ten years later, in its annual report for 2003, the fund looked back on the failed merger in a retrospective article: "As a result, a handful of Swedish financial institutions with little experience of corporate governance found themselves responsible for nominating a new board to develop a new strategy for the company based on shareholders' wishes. This responsibility had to be discharged quickly and amid intense media interest." (p. 12).

[26] "Many of the experiences of those intensive weeks have served as reference points for institutions' continued work with governance issues." Fourth National Pension Fund, Annual Report 2003, p. 12.

[27] According to Skandia's articles of association, a shareholder with 1–30 shares received 1 vote at the general meeting, a shareholder with 31–60 shares 2 votes, etc. A shareholder with at least 30,000 shares received 30 votes at the meeting. No shareholder could receive more than 30 votes. In an attempt to take over Skandia, Uni Storebrand (with the assistance particularly of SEB) acquired nearly half the shares in the company but was forced to give up when Skandia's management refused to discuss the matter. Uni Storebrand sold the shares.

[28] At an extraordinary general meeting in April 1994, the articles of association were amended so that no shareholder could vote more than 10 percent of the shares represented at the meeting. (See the minutes of Skandia's general meeting of April 14, 1994 [§ 18], where the chairman at the time, Sven Söderberg, provides background on the proposal to amend the articles). The general meeting in April 2000 eliminated also this limitation, so that every shareholder now can vote the full number of shares he or she owns.

Increased activity on the part of the institutional investors was not, however, limited to pronouncements and actions in individual instances, but also included a greater overall commitment to corporate governance issues, which fits well with the international pattern.

In December 1992, the Cadbury Committee in the UK published the Cadbury Code, placing corporate governance on the public agenda in the UK and eventually throughout Europe for the foreseeable future. The Swedish Shareholders' Association quickly realized what was going on. The following spring it published its own version of the Cadbury Code, a list of demands called "Guidelines for better control for owners of publicly listed companies." It also encouraged institutional investors to draft their own codes of best corporate governance practices.[29]

Others made similar challenges. In an interview in one of Sweden's businesses journals, the head of the stock exchange at the time, Bengt Rydén, expressed his concern that few companies had active owners. He felt that this vacuum should be filled partly by institutional investors working in concert. "There is a growing sentiment among institutional investors that they should be more active as owners," he said.[30]

The Wallenberg sphere's leading spokesmen, Claes Dahlbäck, CEO of the investment company Investor, was quoted as saying that institutions had the potential to fill the ownership vacuum that had arisen in several companies due to a lack of strong owners and unclear lines of responsibility.[31]

One of the institutional owners that realized early on where the winds of change were blowing was Skandia, which in late 1995 published its own corporate governance policy. While some other institutional owners already had adopted similar policies, Skandia was the first to publicly express its opinion on key governance issues.[32]

Others soon followed Skandia's example. By the early 2000's, practically every major institutional investor had published its own corporate governance policy on general meetings, board elections, board compo-

[29] See, e.g., an article by the association's chairman, Per Lindblad, and president, Lars-Erik Forsgårdh, entitled "Dags för institutionerna att ta sitt ägaransvar!" [It's time for institutions to take ownership responsibility!] in the association's magazine, *Aktiespararen* 9/93, p. 38 f.

[30] *Veckans Affärer*, 40/1993, p. 3.

[31] *Affärsvärlden*, 8/94, p. 27 f.

[32] The largest public pension fund at the time, the Fourth National Pension Fund, had already adopted a corporate governance-policy in the mid-1980's; see, e.g., Fourth National Pension Fund, Annual Report 1995, p. 4, and 2003, p. 11.

sitions, board procedures, the role of auditors, executive compensation and so on.[33]

Coordination of efforts

In the late 1990's, institutions were still issuing their opinions individually. There was no coordination as far as the public could tell.[34] This would also change in time, however, and what more than anything else forced a coordinated effort was three issues: the nomination of board members and board composition, executive compensation programs and takeovers.

I. Nomination of board members and board composition

The Swedish Companies Act prescribes that all public companies have a board elected by the general meeting and a managing director appointed by the board.[35] The act presumes that the board is elected by the general meeting based on the recommendation of shareholders. The act does not stipulate how directors are nominated; that is left to the shareholders.

Traditionally in board elections in most listed companies, the controlling owner – in some cases together with other major owners and often with the chairman – has decided who to nominate for the board and at the general meeting asked someone to read up the candidates' names. Typically, other shareholders have not received any detailed information on why these individuals were running for board positions.

To ensure a more thorough election process and achieve greater openness, the Shareholders' Association began, through its policy statement in 1993, to push listed companies to create nomination committees to prepare directors' elections. According to the association, such

[33] Corporate governance policies were published in 1996 by Robur, SEB, Nordbanken, SPP, Trygg-Hansa and WASA (now Länsförsäkringar), in 1997 by Handelsbanken, in 2001 by Alecta (revised version of SPP's policy), in 2002 by AMF Pension and the First through Fourth and Sixth National Pension Funds, and in 2003 by the Seventh National Pension Fund.

[34] Institutions' corporate governance policies are very similar in many respects. There is no doubt that they had inspired each other, although I have found no evidence that they consulted on the details of their codes.

[35] The structure is similar to Britain's monistic model, although it also shares elements with Germany's dualistic model.

committees should represent the shareholders and hence be appointed by the shareholders' general meeting. Institutional investors gradually began to argue for the same thing, and ever since the debate on nomination of board members has been intense.[36]

Businesses were initially divided, and when the Swedish Industry and Commerce Stock Exchange Committee (NBK) tackled the question in 1994 the result was not rules on nomination committees but rather on the disclosure of information to shareholders and the stock market prior to board elections.[37]

In the eyes of the Swedish Shareholders' Association, the NBK response was too weak. The association continued to argue in favor of nomination committees and was given widespread media coverage. In a new version of a policy document published in 1999, board issues were clearly the focus. "What's new is that we feel, among other things, that the board and its work should be evaluated each year. Furthermore, we are going to push our demand for nomination committees much harder than before. Everyone benefits when the selection process is more professional and there is a wider choice of candidates to choose from," said Lars-Erik Forsgårdh in a newspaper interview when the new policy was published.[38]

In the process, the association again put pressure on institutional investors, who became more active in matters concerning board elections. Although it was common practice by the latter half of the 1990's for companies, prior to board elections, to hold discussions with major institutional investors, these meetings were not coordinated; each institution held its own meeting with the company. By the end of the decade, institutional investors began to coordinate their efforts by sending representatives to joint meetings. Eventually they also informed the public of these informal nomination committees in the annual report and, later, through information in the notice of the general meeting.

[36] It should be noted, however, that while the Swedish Shareholders' Association feels that the nomination committee should be appointed by the general meeting, most institutional investors instead believe that the general meeting should authorize the chairman of the board to, later in the year and in accordance with instructions given by the meeting, appoint a nomination committee composed of representatives of the company's largest shareholders.

[37] Rules on Information Prior to the Election of the Board of a Stock Market Company (NBK 1994).

[38] *Finanstidningen*, Nov. 2, 1999, p. 15.

Today, ten years after the Shareholders' Association started its campaign, a clear majority of listed Swedish companies have nomination committees. In some cases they are appointed by the general meeting, while in others the general meeting mandates the board to set up a nomination committee representing the largest shareholders. Institutional investors have an instrumental role in almost all these committees.

In the Swedish corporate governance code that will be presented in 2004, nomination committees will most likely be mandated.

An issue closely related to board elections concerns board composition. The Companies Act presumes that the owners elect the board according to the majority principle. This means that a shareholder or group of shareholders with effective control at the general meeting can decide on the board's composition. There are no provisions on minority shareholder representation. On the contrary, legislators have expressly rejected such provisions.[39] The main reason is that directors have an obligation to act in the interests of the company and, hence, all its shareholders. Mandating minority representation would run counter to this basic concept and possibly lead to conflicts within the board.[40]

A recurring topic in the U.S. and British corporate governance debate is how many directors should be "independent." This discussion is rooted in the fact that boards of listed companies in those countries have traditionally been recruited primarily from corporate executives. In Swedish listed companies, the situation is different. The board there normally does not include any representatives of the management other than the managing director/CEO.

Strongly influenced by the British debate and the Cadbury Code, the Shareholders' Association, in its corporate governance policy in 1993, began to advocate that the boards of listed Swedish companies should not be composed of any members of management other than the managing director, even though this was already the case in the majority of companies. Institutional investors soon followed with similar, and eventually more extensive, demands, including that a specific number

[39] Prop. [Bill] 1975:103 s. 251.

[40] The board of almost every listed Swedish company also includes employee representatives who are appointed by the company's unions but have the same rights, duties and responsibilities as other directors. In contrast to what we now see in other countries, primarily Germany, there has been little or no debate in Sweden on the advantages and disadvantages of this system from a corporate governance perspective.

of directors should be independent of the company's major shareholders as well.

The debate on board composition led the Stockholm Stock Exchange to introduce a rule in its listing requirements in the mid 1990s whereby a majority of directors elected by the general meeting of shareholders must be independent of the company.

Controlling owners with large shareholdings in individual companies create the risk of partiality in the board's decision-making. To reduce this risk, the listing requirements now also state that at least two of the directors independent of the company must also be independent of owners with more than ten percent of the shares or votes.

It seems highly likely that the Swedish corporate governance code will also reflect this development and perhaps further tighten the requirements.

II. Executive compensation programs

One of the most controversial corporate governance issues today is how to compensate executives and other key employees. To what extent should their compensation be tied to the company's performance? Which employees should be included in performance-related compensation systems? How should compensation systems be designed? And how much should various individuals receive in performance-related compensation? There are many questions but few sweeping answers. The reality of the situation is too multi-faceted. One of the essential questions that has to be answered, though, is who decides on performance-related compensation systems: is it management, the board or the shareholders?

In Sweden, this issue came to a head in the mid-1980's in connection with several highly publicized share issues and share sales to directors and executives of the company Leo. This incident received so much attention that the government was forced to step in and appoint a commission, which drafted a special law – the so-called Leo law – according to which every issue of shares floated to board members or to management or other employees of a listed company or subsidiary of a listed company must be approved by a super qualified majority of the shareholders.[41]

[41] Ds Fi 1986:21 and Prop. [Bill] 1986/87:76.

Through the Leo law, Sweden at the end of the 1980's had what was probably the world's toughest legislation on establishing incentive programs for executives and other employees. The upsurge in incentive programs among listed companies in the 1990's would prove, however, that not even that was enough to prevent excessive compensation schemes.

The first public shareholder dispute over incentive programs for executives occurred in 1994 and concerned synthetic options to some 200 top managers at Sweden's largest construction company, Skanska. Critics, led by the Shareholders' Association, focused on the fact that the company's most senior management stood to gain more than SEK 200 million in the space of just a few years provided the Skanska share performed in line with expectations.

Skanska's then chairman, Percy Barnevik, mounted a public defense. In a much-discussed article in the leading business newspaper, he argued that options, as opposed to other incentive schemes, aim to reward long-term performance and help to ensure that management and shareholders share the same goals. Barnevik also highlighted the trend in the U.S., claiming that the price of the options was of secondary importance. Instead, he said, the main issue was whether the option scheme was beneficial to the company's long-term development – and that issue had been answered in the affirmative by Skanska's board. Those outside the board remained unconvinced, however. Like Volvo, Skanska lacked a controlling shareholder at that time. Six institutional shareholders with a combined holding of less than 20 percent of the votes instead wrote to the Swedish Securities Council requesting a general inquiry into synthetic options and asking that general guidelines be published. The president of the largest pension fund, the Fourth Swedish National Pension Fund, openly criticized Skanska's board in the media and urged it to withdraw the proposal in the light of legal uncertainties and the patently low pricing of the options. Shortly afterwards the proposal was withdrawn.[42]

But there was more to come. In the seemingly endless bull market of the late 1990's, company after company offered incentives to their executives, key persons or employees in general. The programs were ex-

[42] Fourth Swedish National Pension Fund, Annual Report 2003, p. 12 f. See also, e.g., "Skanska drar tillbaka optionsprogrammet" [Skanska withdraws option program], *Finanstidningen*, May 15, 1994, and "Konstgjorda optioner dras tillbaka" [Synthetic options recalled], *Dagens Nyheter*, May 15, 1994.

tensive in scope, complex in nature and difficult to evaluate in terms of impact. In many cases, they were approved on short notice, eventually making the situation untenable for institutional investors. Skandia's decision to call an extraordinary general meeting at year-end 1999 to approve yet another option program proved to be the straw that broke the camel's back. The Shareholders' Association and institutional investors revolted once again. The general meeting was cancelled and the program reworked and cleared by the owners before later being formally approved by a new general meeting.[43]

In practice, institutional investors lacked the resources to critically evaluate all the proposed compensation systems that managements put forth. The situation finally became untenable. In the spring of 2001, eight of the largest institutions therefore joined together to publish a document expressing their opinions on various issues involving incentive programs.[44] This was a remarkable event; for the first time ever in Sweden institutional investors had openly come together to issue a common statement of opinion on a key aspect of corporate governance.

III. Takeover regulations

To the public, corporate governance is often incorrectly seen as consisting exclusively of the system whereby shareholders, by exercising their shares' voting rights, can impact the decision-making of companies. On the contrary, an indispensable component in a well-functioning corporate governance system is a market for corporate control, a market in which control of companies can be acquired by those who value it the most and, as a result, can be expected in the long run to utilize the company's resources most efficiently.

Takeovers are common in the Swedish stock market. During the period 1990 – 2002, there were a total of 245 takeovers of listed Swedish companies, or an average of 19 per year. On average, 8 percent of the total number of listed companies were acquired through a public take-

[43] Fourth Swedish National Pension Fund, Annual Report 2003, p. 13. See also Skandia's press release from March 7, 2000: "Skandia's Board submits revised proposal for stock option programme".

[44] Fourth Swedish National Pension Fund, Annual Report 2003, p. 13.

over bid each year.[45] Not surprisingly, foreign buyers accounted for an increasing share of takeovers during the period.

Sweden's takeover rules are modeled on the British takeover code, which was issued for the first time in 1968. Three years later, in 1971, the Industry and Commerce Stock Exchange Committee issued the Swedish rules on takeovers. Since then, they have been continuously revised and developed as warranted by new developments.[46]

For years, Swedish institutional investors showed very little interest in takeover rules. In the autumn of 2000, however, an incident occurred that would greatly change this.

The private equity firm IndustriKapital had issued a takeover bid for the shares in the listed company Perstorp. The bid was extended several times and eventually withdrawn by the bidder. The reason was that its bank was no longer prepared to provide the loans to secure the bid. Institutional investors reacted vehemently to what, for the Swedish market, was an unprecedented event. Several turned for support to the Securities Council, which strongly criticized the buyer, but the institutions also planned to sue for damages. After long negotiations, IndustriKapital presented a new bid largely designed to meet institutional investors' demands. [47]

4. A fundamentally changed corporate governance map?

In a statement on the last decade's developments in the area of corporate governance, the board of one of Sweden's largest institutional investors, the Fourth National Pension Fund, noted that "the way institutions

[45] See Skog, R., The European Union's Proposed Takeover Directive, the "Breakthrough" Rule and the Swedish System of Dual Class Common Stock, *Rivista delle società*, 5/2003, pp. 1141–1155.

[46] For a long time, the Swedish rules differed from the British in that they did not contain a mandatory bid rule, i.e. that a buyer who acquires enough shares to take control of a listed company must also offer to acquire the remaining shares. The consensus in Sweden was that a mandatory bid rule would greatly complicate trades involving large shareholdings and thereby constrict business sector's structural transformation. In 1999, Swedish business leaders changed their mind and rules on mandatory bids were added to the takeover rules. Anyone who acquired enough shares to gain control of at least 40 percent of the votes in a listed Swedish company would be forced to acquire the remaining shares. The limit was reduced to 30 percent in 2003.

[47] Fourth Swedish National Pension Fund, Annual Report 2003, p. 14.

handled the Volvo situation showed that the Swedish corporate governance map had fundamentally changed." That is no doubt correct, but what happened in Volvo in 1993 was just the beginning. In the years to come, corporate governance would become a matter of utmost importance to all large Swedish institutional investors, and many of them would change their focus from individual exits to at times a more coordinated voice.

Institutional investors became increasingly active in terms of *board elections and board composition*. After having more or less been forced into acting in the case of Volvo, they gradually increased their demands for a formalized, transparent nominating procedure leading up to board elections. A decade later, the results can be seen in the fact that a clear majority of listed companies have established nomination committees with strong representation from institutional investors. Institutional investors' commitment and demands also contributed during the period to a gradual tightening of the Stockholm Stock Exchange's rules on board composition, especially with regard to independent directors.

The upsurge in *management incentive schemes* forced institutional investors, in company after company, to take a position on issues involving executive compensation and eventually led them, for the first time ever, to issue a joint public statement on corporate governance issues, this time on certain issues involving incentive programs. Consequently, institutional investors would play a vital role in the drafting of the comprehensive statement on generally accepted principles for incentive schemes issued by the Securities Council in early 2002.

Last but not least, certain events in the takeover market brought institutional investors closer on issues concerning *takeover regulation* and made them a driving force in the reevaluation of the Swedish takeover regulation concluded in the fall of 2003.

Swedish institutional investors have begun to put their mark on Swedish corporate governance in practice and are participating in the ongoing development of rules for corporate governance. They are currently among the principals behind the Industry and Commerce Stock Exchange Committee and the Securities Council[48] and are represented

[48] In January 2004, ten of the largest institutional investors announced that they had formed an association to promote self-regulation in the Swedish stock market. In the future, the institutions will be represented on the Securities Council and the Industry Commerce Stock Exchange Committee by the association.

in the expert group that is drafting a Swedish corporate governance code.

Have we in Sweden now found an efficient model for exercising corporate ownership in a society where collectively owned institutional investors supply listed companies with most of their risk capital? Can institutional investors fulfill the ownership role traditionally played by large controlling owners? I am concerned they can't, and, in conclusion, I will briefly suggest why.

First, the basic role of most institutional investors is to guarantee their beneficial owners a stable, long-term return. This requires spreading risks, which limits the potential size of investments in individual companies and curtails the opportunity – or, in any event, the willingness – to be represented on the boards of these companies. Looking ahead, I believe it is time to discuss the difference between, on the one hand, institutional investors such as pension funds and life insurance companies, which provide what could be called long-term capital and, on the other, mutual funds, which provide more short-term capital. The latter can easily face unexpectedly large, rapid withdrawals and therefore have to be more cautious about tying themselves to individual companies.[49]

Secondly, institutional investors in many cases lack the necessary resources and competence for active ownership. Although some of the larger institutional investors have staff to handle corporate governance issues, they still largely lack the industrial expertise to play an active ownership role in the individual companies they invest in.

[49] This is why mutual funds have had the greatest misgivings about serving on boards and being part of nomination committees over the years. "We shouldn't sit on boards, since we do not have full control over our fund assets and cannot guarantee a long-term commitment," said Anders Lannebo, head of the country's largest mutual fund companies, Robur, in a newspaper interview in 1996 (Finanstidningen, Jan. 19, 1996). Along the same vein, Marianne Nilsson, an responsible for governance issues at Robur, was quoted in the spring of 1997 as saying, "We constantly have to reassess our holdings. If there is any reason to change our long-term scenario for a company, if we find a better return elsewhere, or if we feel that a share is overvalued, we will consider selling. We certainly can't marry ourselves to our holdings." (Dagens Industri, May 12, 1997). Times change, however, and in the fall of 1999 Handelsbanken funds, followed by Nordbanken funds (Dagens Industri, Oct. 4, 1999), signaled that they would be active owners and put pressure on listed companies. In February 2002, the Swedish Investment Fund Association adopted its "Recommendation for investment fund managers as shareholders".

"Institutional investors can formulate as many ownership policies as they like, but they will never be able to act as true owners," said Melker Schörling, president and major shareholder in Securitas and Assa Abloy, in a newspaper interview in the fall of 1999, expressing a widely held concern that the role of owners in businesses was being undermined.[50]

Institutional investors understood the problem themselves. In an article in *Dagens Industri* in the summer of 2002 on the risk that institutional investors' power was becoming too great, President Christer Elmehagen and Vice President Tor Marthin of the occupational pension provider AMF Pension debated the situation: "We do not have the competence to speak out on how to strategically manage companies in such diverse industries as engineering, forestry, telecom, media and pharmaceuticals." They went on to conclude that it could be "potentially damaging for companies and, as a result, for Sweden's economy and public welfare" if AMF Pension were represented on the boards of the companies it invests in. "The reason, plain and simple, is that we would do a lousy job."[51]

In an article written in the spring of 1996, a representative of one of Sweden's largest pension funds stated that in the future his fund may have to create a new internal organization for "active ownership." "We may have to create and recruit a group with competence similar to what [the investment company] Investor's management has so that we can provide at least some of the companies in which we are a major owner specific know-how. There are insurance companies in the U.S., for example, that are doing just that."[52] Today, nearly ten years later, not much has happened in this regard, and the question is who should exercise the active ownership role in the future.

My conclusion is that we have to think along new, bolder lines. We have to create better control instruments than we have today. We have

[50] *Finanstidningen*, Nov. 27-29, 1999. See also, e.g., the statement by Sweden's Minister of Finance at the time, Erik Åsbrink, on institutional investors' lack of competence at a public seminar in February 1999 (*Dagens Industri*, Feb. 3, 1999, with follow-ups on Feb. 4, 1999 and Feb. 5, 1999).

[51] *Dagens Industri*, July 6, 2002. Along the same lines, the recently retired president of the pension fund Alecta, Lars Otterbeck, was quoted two years later as saying, "The efforts that have been made thus far are not enough. We need more people who understand how business works, not just financial experts. Institutional investors have too little industrial know-how." *Dagens Industri*, July 13, 2004.

[52] SPP's head of corporate communications, Klas Råsäter, in Dagens Industri, March 6, 1996.

to more clearly distinguish between controlling owners and capital providers – and be prepared to pay for having someone playing the role of controlling owner.

The Corporate Governance Forum will continue to monitor what happens and encourage a critical, constructive debate on these issues. But we will also try more during the next ten years to enliven the debate and ask fundamental questions on the importance of the role of owners to the development of businesses and the economy. This, we feel, is the future of corporate governance.