Comparative Corporate Governance

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Learning objectives

By the end of this chapter you will be able to:

- grasp the concept of corporate governance
- contrast the differences between alternative models of corporate governance and more particularly the shareholder versus stakeholder model
- provide a societal explanation for the differences between these corporate governance models
- evaluate the position of the Japanese model of corporate governance vis-à-vis the shareholder and stakeholder models
- understand the European difficulties in developing one unified European model of corporate governance
- understand how corporate governance is practiced in the BRIC countries
- assess the differences between corporate governance issues in large, small and medium- sized companies
- recognize the cultural and institutional influences on the worldwide diffusion of codes of corporate governance
- reflect on the effects of globalization and contextual drivers to convergence or divergence of corporate governance systems.

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Chapter outline

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6.1 Introduction

The question of how the governance of enterprises, including the governance of markets for shares in enterprises, should be arranged is as old as the market economy and capitalism itself. Reforms have been stimulated by scandals, through the ages. More recently, corporate scandals such as Ahold in the Netherlands, Enron in the US, Parmalat in Italy or Maxwell in the UK imposed a critical discussion on the way public corporations are directed and controlled. More dramatic scandals could have been revealed from other countries, if they had had more open discussion and an investigative press.

The literature on corporate governance, which originated in the USA and the UK, was initially concerned with a fairly narrow set of issues such as how shareholders can monitor and motivate management to act in their interests (the agency problem) or how to improve 'shareholder value' through increasing share price (Vitols, 2001). Effective corporate governance was all about: (1) the ability of owners to monitor and, when required, intervene in the operations of management, and (2) the vigour of the market for corporate control, which should vest the monitoring task in those owners most capable of carrying it out.

From the mid-1990s onwards, corporate governance has become a fiercely debated topic in the comparative management and international business literature. While this literature has aimed to grasp the existence of international variations in corporate governance and explain the impact of these differences on the competitive performance of firms, less consensus exists on a single unifying definition of corporate governance. Scholars and practitioners of corporate governance give the term a large variety of definitions. For example, social scientists and economists define corporate governance as 'the institutions that influence how business corporations allocate resources and returns' (O'Sullivan, 2000) or as 'an institutional framework in which the integrity of the transaction is decided' (Williamson, 1996). For corporate managers, capital providers, and policy makers, corporate governance is considered as a system of rules and institutions that determines the control and direction of the corporation and that defines relations among the corporation's primary participants (Aguilera and Jackson, 2003). These definitions focus not only on the formal rules and institutions of governance, but also on the informal practices that evolve in the absence or weakness of formal rules. They incorporate both the internal structure of the corporation and its external context, including capital market and government policies (Haxhi and Aguilera, 2014).

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This literature distinguishes between two dichotomous models of corporate governance for which different terms are used interchangeably in the literature:

1 The shareholder, outsider or market-based model, also called the Anglo-American model, which is characterized by strong shareholder rights, single powerful CEO and protection of minority shareholders, prevails mainly in Australia, Canada, the US and the UK. Here the maximization of 'shareholder value' is the primary goal of the firm and shareholders enjoy strong formalized links with top management.

2 The stakeholder, insider or bank-based model, also called the Rhineland model, which is characterized by weaker shareholder rights, consensus leadership, and concentrated ownership, prevails in most of the European continent, Latin America and Japan. A variety of firm constituencies – including employees, suppliers and customers, and the communities companies are located in – have a say in the firm, and the interests of all of them are balanced in management decision-making (e.g. Aoki, 1999; Gregory and Simmelkjaer, 2002; Shleifer and Vishny, 1997).

The term market-based refers to the fact that, within the system, the financial needs of firms are fulfilled through the capital markets, while the outsider means that the locus of corporate control and monitoring resides in the disciplines of capital markets. The model presumes that information flows are relatively good and that the regulatory system requires ample disclosure of information, enforces strict trading rules and allows a market in corporate control (via hostile takeover) to flourish. The model is based on liquid stock markets and diversification of portfolios and has a dispersed share ownership (e.g., Coffee, 1999; La Porta et al., 1998).

The contrasting stakeholder, or insider, model is in part a misleading term because interests of the wider community are certainly not insider interests. It relies on the representation of diverse interests on the board of directors, which is expected to play a strong monitoring and disciplining role with regard to management. Management discipline via securities markets is weak in this model. There is concentrated shareholding, with cross- holdings among companies being fairly common. Another feature of the insider or stakeholder model is that securities regulators often permit asymmetric information and are not overly concerned about the rights of minority shareholders. The term bank-based refers to the fact that firms generally turn to banks rather than capital markets for finance. In the stakeholder model, the large publicly traded corporations are run by control groups or blockholders with substantial equity interests in the firm (e.g., Del Brio et al., 2006).

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Shareholder model

• Financial needs of firms fulfilled through the market • Locus of corporate control and monitoring resides in the disciplines of the market • Assumption of perfect information flows • Effective regulatory system • Model is based on liquid stock markets and diversification of portfolios

Stakeholder model

• Financial needs of firms are fulfilled through bank finance • Monitoring and control function resides in the dual-board system • Concentrated shareholding and thus illiquid markets • Regulators often allow for asymmetric information flows • Rights of minority shareholders are not always protected effectively

In addition, the comparative management literature often treats corporate governance as a facet of the broader debate about the evolution of the different models of capitalism. In this context, scholars claim that one or the other corporate governance model is economically superior and that, over time, we should observe convergence towards this model of 'best practice'. A considerable controversy has emerged among corporate governance scholars regarding an inevitable global convergence towards the shareholder value maximization model as the normative ideal type (Aguilera and Jackson, 2010). A key debate exists on three fronts. First, several scholars argue that cross-national patterns of governance are converging towards the Anglo-American, shareholder-centred model (e.g. Coffee, 1999; Hansmann and Kraakman, 2001). A second set of scholars suggest the 'hybridization' perspective, where economic institutions are capable of change and transnational practices are adapted to fit local institutional contexts (Djelic, 1998). As a result, such adaptation leads to increasing hybridization rather than to a global convergence to one ideal model. Finally, a third body of researchers, has advanced compelling arguments against convergence by demonstrating that powerful path dependencies can arise out of adaptive sunk costs, network externalities, or endowment effects (Bebchuk and Roe, 1999).

For a number of reasons, comparative corporate governance debates often take place within the contours of the cultural–institutional or societal approach used in this book. First, corporate governance issues can fruitfully be examined within the framework of this approach as it helps to explain the differences among countries, as governance structures and systems are a product of societal and institutional contexts. Divergent paths resulted in multiple governance forms and practices. The

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'institutional clusters' concept of coordinated market economies (CMEs) and liberal market economies (LMEs), which are discussed in Chapter 4, provide a framework for this.

Moreover, the corporate governance regime itself is perceived as an institution, which helps to explain the comparative institutional advantage of firms. Indeed, some firms appear to view differences in corporate governance as an untapped source of competitive advantage. As part of their efforts of value creation, they adopt structures and mechanisms from different governance systems. For example, Ford Motor Company has adopted extensive cross-ownership relationships through equity holdings, acquisitions, alliances and research consortia, practices common in the Japanese keiretsu. German firms such as DaimlerBenz, Deutsche Telecom and Hoechst have altered their financial disclosure practices to gain access to American financial markets (Rubach and Sebora, 1998).

Since institutionalists and the societal approach stresses the embeddedness of national institutions and 'complementarities' between institutions, alternative responses to internationalizing capital markets, other than convergence, appear possible (Haxhi et al., 2013). Companies may respond very differently to similar sorts of pressure, and distinct sets of 'best practice' contingent on the national context may emerge. This argument is discussed in Chapter 7.

The current chapter applies this approach by examining the interaction between corporate governance aspects in large, small and medium-sized firms and national institutions in different countries, in the context of internationalizing capital markets. The focus here is on the impact of formal institutions on the corporate governance aspect, without playing down the impact of informal institutions. Since governance institutions are embedded in the societal framework, cultural effects are reflected in the choice of formal institutions. For instance, the lower a country value on the uncertainty avoidance dimension of Hofstede (2001), the more it will be market-orientated. Capital market investments entail risks, which risk-averse nations would arguably want to avoid as much as possible.

The next section relates the discussion Anglo-American to the institutional approach through an analysis of the major corporate governance features influencing postwar company decision-making in advanced economies. At the same time, these features together make up the broad definition of corporate governance used here:

- the structure of ownership of companies

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- the relationship between management and the various stakeholders in a company
- the structure of management or top management institutions (i.e. unitary or two-tier boards), and
- the method of bringing about corporate restructuring.

The in-depth explanation of the two main models is followed by an analysis of the Japanese model of corporate governance, which is argued to be similar to the Rhineland model. The subsequent section explores the continental European models, which are variants of the two main models. The analysis shows that variations among the advanced and transition economies in these corporate governance features stem from differences in key societal institutions, such as governmental regulation, the character of the financial system, corporate law, and cultural values. Next, we offer an overview of the models of corporate governance in BRIC countries and more specifically, we discuss in the form of case studies, Russian and Chines models of corporate governance. The fourth section deals with the worldwide diffusion of codes of corporate governance, which are instruments of self-regulation, defining best practices with respect to boards, management, supervision, disclosure and auditing (Aguilera and Cuervo-Cazurra, 2004). We discuss the main drivers of diffusion of codes and their characteristics across countries. Codes show similarities related to their objectives, which improve the quality of companies' governance and increase the accountability of companies to shareholders while maximizing shareholder or stakeholder values (Aguilera and Cuervo-Cazurra, 2004; Haxhi, 2010). Further on, the discussion on the worldwide diffusion of codes is complemented with a broad view on a possible convergence or divergence of corporate governance best practices (Haxhi and Aguilera, 2012). Finally, the closing case, dealing with the Ahold scandal, should be seen in the light of the link between corporate governance and corporate social responsibility (CSR). The movement for more responsive corporate governance seeks to ensure that managers act in the best interests of their shareholders. While there are many questions with respect to whether and how companies should be responsible in society, the focal point here is whether there is a new meaning for CSR that is consistent both with the greater need for corporate responsiveness to employees and communities, and with the greater demands from investors for performance. The chapter concludes with the major strengths and weaknesses of the two main corporate governance models. At the same time, a summary is provided of the discussion on the direction of change in the two main models.

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6.2 Major capitalist models of corporate governance

While there is a range of different modes of corporate governance systems in advanced economies, as indicated, two offer clear and distinctly different characteristics: the share- holder, or outsider, model (also referred to as the 'Anglo-American') and the stakeholder, or insider, model (referred to as the Rhineland model). The first is dominant in the Anglo- American cluster, including the US, the UK, Ireland, Australia and Canada. Rhineland capitalism is attributed to Germany, Japan and continental European countries.

However, the distinction between the two systems does not express the variations that exist between the systems classified as 'insider'. Each of the continental European systems has some elements of the outsider system. For example, the Netherlands, Sweden and Switzerland, three countries considered to have insider systems, have a relatively large number of domestic listed companies and a high stock market capitalization (see below). Classifying Germany and Japan as examples of the insider system is also rather problematic. Both might have some similar mechanisms of corporate control, but their dissimilarities are even greater. The corporate governance systems of continental Europe and Japan could perhaps best be positioned somewhere on a continuum between the Anglo-American model with its strong emphasis on shareholder value, and the Rhineland model with its attention to broader societal needs.

This section illustrates how difficult it is to generalize about corporate governance systems. Recent changes in corporate governance aspects are highlighted throughout the section, which concludes with a case on BRIC countries, to illustrate the problems that countries in transition experience in setting up a reliable corporate governance system.

The Anglo-American model

Capital markets and regulation

Aguilera and Jackson (2003) stylize the Anglo-American model in terms of financing through equity, dispersed ownership, active markets for corporate control and flexible labour markets, and the stakeholder or continental model in terms of long-term debt finance, ownership by large block-holders, weak markets for corporate control and rigid labour markets. Anglo- American corporate governance places the emphasis on equity finance for business. This means that companies issue shares or

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bonds rather than relying on bank loans for fulfilling their financial needs. Capital markets tend to be large and regulated in a manner favourable to trading in equities. Large, diversified and efficiently functioning stock markets are argued to develop when supported by complementary institutions, such as the legal protection of small shareholders and maximum limits on the shareholdings of financial institutions (Roe, 1994). These are typically institutions that are characteristic of the Anglo-American model.

As in most countries, and akin to the Rhineland model of finance, small firms in the US and the UK rely on bank lending to make investments. The large firm model in Germany and Japan, on the other hand, is said to be converging towards the Anglo-American model. As will become clear later on in this section, the main differences between the two models are found in the medium-sized firm segment.

The structure of ownership

In the Anglo-American model, companies do not generally hold each other's stocks. In other words, unlike in Germany and Japan, one does not find extensive cross-shareholding.

Also, unlike the case in Germany and Japan, financial institutions rarely hold stock issued by their customer companies for longer periods, except in certain cases such as venture capital firms. For the US, the latter can be explained by the fact that US banks were pre- vented by legislation from holding large stakes in industrial companies. Ownership of shares is largely in the hands of private funds (e.g. 44.4 per cent in the UK), whose focus is on relatively short-term return on capital, rather than longer-term market share issues. The major investors in the UK and the US – investment funds, pensions funds and (to a certain extent) insurance companies – take a 'portfolio' approach to risk management by taking small stakes in a large number of companies. The types of investor more likely to take large strategic shareholdings – enterprises, the public sector and banks – account for a minority of the shareholdings. In sum, the Anglo-American system is characterized by dispersed ownership by share price orientated financial institutions (Vitols, 2001).

The relationship between stakeholders and management

Anglo-American corporate governance is characterized by arm's-length relationships between all the stakeholders and management. Neither investors nor employees, nor the local communities within which firms invest, have any close links with companies. As banks provide a relatively small share of business finance,

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the links between banks and companies are not strong either. Consequently, the US and other Anglo-American countries depend heavily on active markets for corporate control.

Institutional investors in the US and the UK continue to view the corporate governance problem as one of assuring that the corporation is managed in the best interests of share- holders. For Americans, corporate governance is about shareholders controlling managers for purposes of shareholder value (managerial fiduciary duty); for many Europeans, it is more about society controlling corporations for the purpose of social and economic long term sustainability (Haxhi and Aguilera, 2014). In addition, company law, stock market regulations and rules all originated in defence of shareholder interests. The conventional proposition of the Anglo-American model is that a company has only one responsibility, both morally and legally: to maximize the value of the shares of those who have invested in it (Friedman, 1962). Corporate board members and executives are 'fiduciaries' under the law – agents solely of the shareholders. But in fulfilling their responsibility to the investors, according to this view, boards and executives also indirectly fulfil their responsibility to the rest of society – to other 'stakeholders' such as their employees, members of their community and fellow citizens – because they help to ensure that society's productive assets are allocated to the most efficient uses.

Optimistic advocates of corporate social responsibility argue that what is good for a company's shareholders over the long term is also good for its other stakeholders over the long term. That is, if one looks far enough into the future, all interests converge: all stake- holders have an interest in a strong economy, well-paid employees, a healthy and clean environment and a peaceful society. However, fuzzy long terms are no match for hard- nosed short terms. Capital markets are notoriously impatient, and are becoming less patient all the time. Most of today's institutional investors have no particular interests in a 'long term' that extends much beyond the next quarter, if that long (Reich, 1998).

While the relationship between investor and company can be seen as a 'cultural' feature of the system of corporate governance, it originates from and is supported by regulatory policies that are shaped by interest groups (Woolcock, 1996). For example, the combined effect of bankruptcy laws and insider trading legislation contributes to explaining the absence of relationship banking[1] (see the following pages for an explanation) and of closer relations between shareholders and the management of companies in the Anglo-American model (OECD, 1998).

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Company law and the structure of top management institutions

Company law is based on a unitary board system, which is seen as most efficient because it avoids fragmentation of responsibility. Board composition, in both the US and the UK, tends to reflect a preference for outside directors or non-executive directors (NEDs). In the UK and to a lesser extent in the US, boardroom scenery was dominated by executive directors; however, the role of NEDs became paramount following the issuance of several codes of corporate governance such as the UK Combined Code (2003,see www.ecgi.org) and the Sarbanes-Oxley (SOX) Act in 2002 in the US. For example, the UK Higgs Review in 2003 strengthened the independence requirement, through measures such as the unequivocal separation of roles of the chief executive and the chairman, and a board com- posed by at least 50 per cent NEDs, excluding the chairman. In addition, the SOX Act covers a vast amount of behavioural issues that tie in with managerial and director conduct. Amongst other elements, it encompasses elements like the erecting of the Public Company Accounting Oversight Board, Auditor Independence, Corporate Responsibility, Enhanced Financial Disclosures, Analyst Conflicts of Interest, and Corporate Fraud Accountability, which addresses the penalization of knowingly obstructing judicial actions against oneself or one's firm. It is effective for all US firms that are publicly traded, and concerns foreign corporations listed at US indices as well.

Consequently, NEDs who are currently in the majority are seen as a countervailing power against the dominant influence on the board, whether of the management or of the shareholders. Hence, in states where the shareholders have a limited impact on decision- making, NEDs will be seen as a check on the overwhelming influence of the management.

This is the case in the US and the UK, where due to the wide distribution of share owner- ship, management was able to exercise a dominant influence. The appointment of NEDs is a favourite instrument for the institutional investor to use to bend the company's policies without assuming responsibility for the actual management decision.

The existence of the joint chief executive officer (CEO)–chairman of the board blurs the separation between management and oversight functions in many companies. While there are no legal rules related to this issue, in the UK separation is highly recommended and often practiced by large companies. In the US, in contrast, CEOs still often chair the board. And although CEOs can neither hire nor fire directors,

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they often choose the nominating committee for the directors, or even indirectly nominate the directors them- selves (Lightfood, 1992). The US unitary board system could, in fact, be seen as an expression of the CEO-dominated system. The typical leadership role is for the CEO who, after a period of consultation with other managers, makes major decisions unilaterally and takes sole responsibility for these decisions.

Consensus and the institution of employee representation

Another clear distinction between the Anglo-American and continental European corporate governance is on the issue of statutory employee representation. In contrast to most of continental Europe – especially Germany, which has laws requiring parity co-decision- making in supervisory boards and works councils – in the Anglo-American model there are no legal provisions for employee representatives on company boards. However, the UK's membership of the European Union has not stopped its government and business from continuing to oppose statutory requirements on employee participation. Underlying the opposition to any form of employee participation in the UK is a legacy of confrontational attitudes to industrial relations, especially during the 1970s, compared to the more consensual approach in Germany (see Chapters 5 and 7 for an extended explanation of this topic).

More fundamentally, however, there is a deep-seated difference between the free market philosophy of the Anglo-American model and different forms of 'social market economy' in continental Europe. The predominant view in UK industry and government circles is that increased social provision and efforts to seek consensus are costs that undermine competitiveness and thus general economic prosperity. For many continental Europeans social provision and consensus are seen as prerequisites of stable (long-term) economic growth. The conviction that cooperative forms of industrial relationship are not possible in the UK continues to shape employers' approaches (Woolcock, 1996).

Corporate restructuring

As indicated, the takeover mechanism is at the heart of the Anglo-American open-market model for corporate governance. Any party can bid for the control rights of a listed company by accumulating a large enough ownership stake. Takeovers are commonly viewed as playing two related roles.

. 1 First, the threat of takeover may contribute to efficient management by making

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managers concentrate on maximizing shareholder value, rather than on pursuing their own personal objectives (an example of potential principal–agent problems).

. 2 Second, in the event of managerial failure, takeovers allow poor management to be replaced with good management.

In general, takeovers are not the normal form of corporate control. The US and the UK are the exception rather than the rule in this regard. The UK accounts for the bulk of mergers and acquisitions within the European Union (EU). The use of takeovers in corporate restructuring follows, among other things, from the size and regulation of the capital markets, defensive and strategic considerations, tax motives, empire building and the pursuit of monopoly power (Shleifer and Vishny, 1997).

The legitimacy of the takeover option has militated against enterprise growth from small to medium size (Lane, 1994) and has thus contributed to the creation of a polarized industrial structure in both the UK and the US. Small family-owned companies choose to remain small because if they grow they will be forced to go to the stock market to obtain funding and will not only lose control of the company but will also face the threat of take-overs. Hence, in comparison with Germany, in the Anglo-American world there is a low incidence of medium-sized companies.

The Rhineland model

Capital markets and regulation

In general, the Rhineland form of corporate governance relies more on debt finance by banks. All banks are universal – that is, by law, they can engage in the full range of commercial and investment banking services. Moreover, banks can often adopt a longer-term focus, partly because they know that German firms may credibly offer sustained commitments to employees and other stakeholders in the firm, and can often closely monitor the status of their investments through their seats on the supervisory board or by means of direct contracts (Casper, 2000). Despite the recent expansion of capital markets, Germany remains a bank-centred financial system.[2] The majority of German firms continue to rely on banks and retained earnings to finance investments.

Small and medium-sized enterprise (SME) owners have been criticized for avoiding listing in order to prevent any dilution of their control and for their unwillingness to

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reveal profitability. Such SMEs have not made much use of share capital as a means of meeting their growing financing needs, despite reforms aimed at making it easier for them to do so (the 1986 introduction of a 'second market', or geregelter Markt, and the 1994 Law on Small Public Companies, or Gesetz über kleine Aktiengesellschaften).

Case: Grohe AG[3]

The disadvantages of being listed from the point of view of small and medium- sized family-owned firms

Friedrich Grohe AG & Co. KG, which was founded in 1911, manufactures sanitation products that range from single taps to electronic water management systems. In 1991, the favourable market situation induced the family to make the company public, both to gain access to funds for growth and to enable the family owners to cash in some of their shares on attractive terms. At the launch, Friedrich Grohe AG floated 1.3 million non-voting shares to the public, with the Grohe family holding all of the remaining 1.7 million ordinary shares. Members of the Grohe family also filled all the seats on the supervisory board. But in the late 1990s, with the stock trading at disappointing levels, the Grohe family decided to delist and go private again. The reasons given were as follows:

- to avoid ongoing listing costs
- to prevent a possible hostile takeover by a competitor
- to achieve greater flexibility from operating as a different legal corporate entity, and
- the family's unwillingness to raise equity at the low prices commanded by its stock.

As the company's major shareholder, the Grohe family considered that their firm belonged to an industry that investors considered 'boring and unattractive'. As a result, they felt that the company was in the undesirable position of being unable to attract further capital through share offerings, while they were at the same time constrained by the 'inflexible legal duties' of a listed stock corporation. But the next chapter in the history is again different. As so often happens when there is no central figure to carry on the entrepreneurship and the family cannot agree or they lose interest in the firm, Grohe was sold to a private equity investor in 1998. Such

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investors tend to be different from the 'patient capital' ownership more familiar in family capitalism. As family members 'cashed in' on their ownership by selling, the private equity investor who had acquired the firm with 'leveraged' funds, was compelled to earn sufficient return on the investment. And they did this by implementing a cost-cutting operation. This led to some conflict with the union and the works council, and it was argued to jeopardize the position of the firm as a market leader in quality. Grohe did however succeed in maintaining such a position, and it set up production facilities in China. The end of the story is that Grohe was in 2013 bought up by Lixil, a Japanese group. Back to 'Rhineland capitalism', which oddly enough includes Japan. But it was not an owner-managed firm any more.

Questions

. 1 Trace the links between insider interests, patient capital, employment relations and quality manufacturing!

. 2 Give reasons why it might not be an accident that Grohe finished up in the ownership of a Japanese group.

The SMEs argue that there remain barriers to listing. For example, banks must be involved in the first segment of trading (i.e., issuing shares). As the banks are concerned about their reputation they are thought to be careful about dealing with new entrepreneurs. In contrast to the situation in the US or the UK, therefore, it is difficult for young entrepreneurs to raise equity capital. This is seen as an impediment to the growth of young dynamic companies in fast-moving technology or services sectors (Vitols and Woolcock, 1997). Another consequence is that capital markets tend to be smaller and to have fewer public companies than in the UK and the US. Even during the stock market boom of 1999– 2000, it was clear that the activity included only a handful of companies in certain industries (Schaede, 2000). In the meantime, the stock market created for smaller joint-stock enterprises in Germany had collapsed in the wake of the bursting of the 'dotcom' bubble in 2001.

From the late 1990s, a handful of large German companies increasingly turned to the global capital markets for funding. In order to gain access to the liquid US capital markets, German firms had to adopt US accounting standards. The German accounting system adopts a long-term view and is investment- rather than trading-orientated – profit figures and asset values tend to be understated. Furthermore, it allows for building up 'hidden reserves', also due to the traditional German emphasis on exercising 'commercial caution'. Overall, the adoption of US accounting

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standards by some large German firms means that they are more in line with international practices and that the transparency of their published accounts has improved significantly (Schlie and Warner, 2000).

The transparency of accounts, or increased information disclosure, in turn, is positively related to corporate social responsibility. Providing increased disclosures is arguably responsive to the needs of several stakeholders. Firms that engage in socially responsive activities are said to provide more informative and/or extensive disclosures than do companies that are less focused on advancing social goals (Gelb and Strawser, 2001). In addition, it has been found that socially responsible firms are more likely to provide this increased disclosure through better investor relations. Investor relations, however, have only recently become important in the German model of corporate governance, as it is essentially a bank-based model. Whilst the importance of new international or American accounting standards has remained strong, the fashion to list at the New York stock exchange has however subsided.

The structure of ownership

Owner–company relations in the 'large firm' Rhineland model are most often characterized by one or more large shareholders with a strategic motivation for ownership. The types of investor likely to have strategic interests – enterprises, banks and the public sector – hold the majority of shares. Enterprises generally pursue strategic business interests. The state generally pursues a public goal. The large German banks have tended to view their shareholdings as a mechanism for protecting their loans and strengthening their business relationships with companies rather than as a direct source of income (Vitols, 2001). From the end of the 1990s onwards, large banks have reduced the size of most of their equity stakes in non-financial companies in order to reduce risk exposure and the likelihood of having to bail out a client. These changes in the 'large firm' financial model accelerated in the 1990s as a result of financial internationalization and the efforts of the German financial and industrial community to transform Frankfurt into an international financial centre. It could, in fact, be argued that the German financial model is increasingly becoming two distinct (though intertwined) models: a finance and corporate governance model for the small and medium-sized companies (the Mittelstand) and a different model for the large firms (Deeg, 1997). The German Mittelstand firms are usually family-owned, but are some- times also tied by shareholdings to larger firms.

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The ownership types having smaller shareholdings – investment funds, pension funds/ insurance companies and households – account for only 35 per cent of total shareholdings of the large German companies. The Rhineland system is, then, characterized by concentrated ownership by actors pursuing a mix of financial and strategic goals (Vitols, 2001). Hence, despite the tendency for the German 'large firm' financial model to adopt features of the Anglo-American model of finance, a least one critical distinction remains: the majority of the large German firms continue to have stable, long-term shareholding, protecting firms from the short-termism of Anglo-American capitalism.

The relationship between stakeholders and management

The relationship between the company and all the stakeholders – investors, employees and local communities – tends to be closer than is the case with Anglo-American corporate governance. Consistent with CSR views, the German stakeholder model implies that, by law, management must pursue actions that are bear regard to a broad class of stakeholders rather than those that serve only to maximize shareholder interests. This casts the corporation as a social entity where firms are not only driven by shareholder value maximization (Aguilera and Jackson, 2003). Moreover, the German model emphasizes long-term relationships built upon trust. Banks in particular have retained relatively close links with companies through their role as shareholders in their own right, through their role as proxies for smaller shareholders[4] through participation in supervisory boards and by fulfilling the role of 'lender of last resort' during crises. The latter implies that when problems arise, the normal practice is for the stakeholders to voice concern and for changes in management to take place, rather than stakeholder 'exit' and a change in ownership. This enables implicit contractual relationships to develop between management and the stake- holders, and means that take-overs or changes in ownership are not the norm for corporate restructuring. The structure of regulation and practice tends to favour such long-term commitment to companies. For many years, Germany had subjected its stock exchanges to a 'gentleman's agreement' that supposedly kept bankers and executives from trading on special information. In short, this model advocates social efficiency of the economy through trust relationships and long-term contractual associations between the firm and stakeholders as well as inter-firm cooperation and employees' participation.

From the end of the 1990s onwards, however, the relationships between some of the large German firms and the stakeholders have weakened. Against the German tradition of social responsibility, several companies have adopted a cruder form of

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capitalism by rigorously shifting production away from Germany to lower-cost countries, despite rear-guard action by their 'social partners' in the supervisory board. Moreover, in some large firms, corporate performance is increasingly being measured in terms of share price, thus adopting the Anglo-American shareholder value concept. Having opted for an emphasis on 'shareholder value' over 'stakeholder welfare', the subsequent step large firms made was the introduction of performance-related pay schemes for executives, to ensure that managerial incentives are sufficiently aligned with shareholder interests (Schlie and Warner, 2000). One can also observe an increase in the number of firms listed at the stock exchange; a trend explained by the fiercer global competition and the need to reach a certain size in order to effectively compete against other MNEs (Deeg, 1997). German banks have also begun to lose their traditional position in large firms such as the Deutsche Bank, which was transformed into an investment bank, generating a higher income through the continuous buying and selling of companies more in line with an Anglo-American model. In addition, changes in taxation have encouraged the selling of protective cross of shares, which corporate owners of cross-holdings promptly did. However, another change hap- pened after the 2007 financial crisis; since then, political parties and employers have been re-discovering the productive 'virtues' of the 'social market economy'.

Company law and the structure of top management institutions

The clearest manifestation of employee rights in large German companies is the dual company board system, with an executive (Vorstand) and a supervisory board (Aufsichtsrat). The supervisory board is mainly in charge of the selection, appointment or dismissal, and the supervision of the Vorstand. Its task is mainly that of supervising the functioning of the company. The supervisory board contains bank representatives and employee representatives. Half of the members of the supervisory board of very large joint-stock companies are chosen by shareholders and the other half are elected by workers. Since the supervisory board appoints the management board members, workers can indirectly influence management. The obligatory supervisory board system applies only to stock corporations (Aktiengesellschaft, or AG) and companies with limited liability (Gesellschaft mit beschränkter Haftung) and more than 500 employees.[5] While there are no supervisory boards in smaller firms, they often have advisory boards (Beirat) which also have representatives of one or more banks.

The management board is clearly separated from the supervisory board. The management board has a chair, generally considered to be 'first among equals'.

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Major decisions or proposals to the supervisory board are reached through consensus. The individual appointment of top managers by the supervisory board reduces the dependency of individual members on the chair/speaker (Vitols, 2001).

Consensus and the institutions of employee representation

As indicated, employees in large German companies enjoy strong 'voice' thanks to corporatist bargaining and codetermination. Every plant with at least five regular employees is entitled under the Works Constitution Act 1972 (Betriebsverfassungsgesetz) to elect a works council. This works council has the right to negotiate key issues with management, including the hiring of new employees, the introduction of new technology, use of overtime and short-working time, and, in the case of mass redundancies, the negotiation of social plans (Sozialpläne) covering redeployment, severance payments and early retirement.

As indicated, employee representatives are also included on German supervisory boards under the 1976 Codetermination Act (Mitbestimmungsgesetz), which applies to almost all companies with 2000 or more employees. This law makes the following key provisions.

- Employee representatives are to comprise half of the supervisory board representatives, and shareholder representatives the other half. Shareholders, however, elect the chairperson, who holds the casting vote in cases of 'deadlock' between shareholder and employee blocs.

- The number of supervisory board seats total 12 in the case of companies with between 2000 and 10,000 employees, 16 in the case of companies with between 10,000 and 20,000 employees, and 20 in the case of companies with more than 20,000 employees.

- In the case of companies with between 2000 and 20,000 employees, two employee representatives can be union functionaries (i.e. non-employees); in the case of companies with more than 20,000 employees, three may be union functionaries. In practice there is typically a close overlap between codetermination at board level and plant level; the head employee representative on the supervisory board is typically a leading works council member (Vitols, 2001).

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Consensus has a higher priority than in the Anglo-American system, both within society and within the company. Within the economy as a whole, consensus is supported by the social market economy; within the company it is supported by solidarity in the shape of moderate wage and skill differentials, and institutions such as works councils (Woolcock, 1996).

Corporate restructuring

The German financial system and the greater protection from hostile take-over it affords help to explain the survival of many small and medium-sized companies in Germany. The Mittelstand model is based on close, long-term relationships between the many regional cooperative and municipal banks and firms to which banks provide not only long-term finance, but also an increasing number of non-financial business services – notably business consulting to their clients. The close relationship of these banks with local industry is demonstrated by the fact that their boards are typically composed of local industrialists (Sabel et al., 1987). This not only provides a close connection between industry and banking, but also forges horizontal links between SMEs in a region. Moreover, the guaranteed financial support enables SMEs to grow into medium-sized firms more easily than is the case for their UK and US counterparts.

As indicated, the use of takeovers in corporate restructuring has been the exception rather than the rule in the Rhineland model. Hostile takeovers were prevented from occurring through legal safeguards and the high degree of concentration of corporate control (in terms of bank ownership and/or voting rights). Groups of banks have acted as 'crisis cartels' to assist in the restructuring of traditional industries or to rescue ailing giants (Lane, 1994). When companies begin to run into difficulties it is the major shareholders, usually the banks that step in to coordinate a rescue. Rather than sell up to a predatory holding company, which would probably realize the value of assets 'locked up' in the financial statements, the German approach is to seek to preserve as much as possible.

From the end of the 1990s, however, like their Anglo-American counterparts, large German companies have started to use domestic and foreign takeovers to restructure. For example, in 1997, Krupp-Hoesch, a German steel conglomerate, launched a hostile take- over bid for its local rival Thyssen, which provoked an outbreak of public opposition from politicians, union representatives, the media and employees, as well as the management of the target company. The leader of the IG Metall union, Klaus Zwickel, accused Krupp management of using 'wild west'

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methods, and Chancellor Helmut Kohl urged both parties to find a 'prudent solution' based on careful consideration of their 'social responsibility'. In April 1999, as part of a shake-up in the German telecommunications industry, Mannesman staged a domestic takeover of rival O.tel.o. and, in May 1999, launched a bid for the UK mobile phone provider Orange.

Other examples can be found in the car industry, and in the chemical and life sciences. The question arises as to whether the Rhineland model is, indeed, adopting elements of the Anglo-American system in response to increasing and new forms of competition. On the surface, it seems that this is happening. When looking at the details, one will find that most if not all of these takeovers failed or ended in a 'voluntary' merger. Hence, while the large firm model has been changing and seems slowly to be adapting to increased global competition, the embeddedness of the model explains that its deep-rooted features are preserved and remain visible through the changes.

The Japanese model of corporate governance

Capital markets and regulation

Rather like the Rhineland model, the Japanese model is characterized by corporate reliance on bank lending or on retained earnings. In contrast to the German banks, Japanese banks were not universal banks; until the Financial System Reform Act was introduced in 1993, there was a clear separation between commercial banks (specializing in deposits and loans) and securities firms (in charge of securities underwriting and dealing).

From the late 1980s onwards, large Japanese firms have shown high levels of self-finance and increased use of securities markets (at home and abroad). From that time onwards, the large city banks, which used to concentrate on providing loans to large firms, were forced to actively seek new borrowers and started to channel funds into the smaller firms. Until 1985, Japan's small and medium-sized firms had to rely on their local banks, which did not have sufficient resources. From the late 1980s onwards, the small and medium-sized firms have, thus, found borrowing restrictions easing. From the 1990s onwards, the crisis in the financial sector under the recession forced banks to become more selective in their lending habits. Smaller firms in particular have been hit hardest by these changes. Unable to go to the bond markets and restricted in their bank borrowing, these firms face hard times.

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Also rather like the German situation, in Japan the corporate governance and finance models seem to be moving towards a hybrid model, where the traditional bank model continues to be used in the small and medium-sized firms, while the large firms incorporate elements of the Anglo-American model. We cannot speak of convergence towards the Anglo-American model or divergence from it. However, due to international pressure from foreign investors, more attention is given to adapting towards a more Anglo-American system which is more outsider-shareholder focused, thus providing more transparency (Yoshikawa et al., 2007).

The structure of ownership

The majority of shares of major corporations in Japan are held by stable shareholders, which include other corporations in the same business group, major creditors and major customers/suppliers connected through interlocking directorships, cross-holding of shares and inter-firm relations. These shareholders hold shares primarily to maintain their relationships rather than for financial gain. Governance is largely external and in the hands of the banks, but employees have a relatively strong voice as part of rather informal arrangements between labour and management (Jackson and Moerke, 2005). As part of a network, Japanese managers are highly committed to their company and develop informal business relationships to achieve consensus through vertical and horizontal decision-making.

For example, in 1990, Mitsubishi Corporation owned 1.6 per cent of Mitsubishi Heavy Industries, which, in turn, owned 3.2 per cent of Mitsubishi Corporation. Although these cross- holdings are usually small on a bilateral basis, between 10 and 25 per cent of all the outstanding shares of group members are generally held within the keiretsu (corporate group) itself.

Banks and insurance companies often number among the major shareholders of their main large clients. While Japanese banks were prohibited by law from holding more than 5 per cent of the outstanding stock of any other firm, the main bank could mobilize shareholdings by the group-affiliated trust bank, insurance company, trading company and other firms for reasons of concerted voting or to protect a customer firm from hostile takeover. Banks thus also allow large firms to have a long-term strategy.

The bank crisis and the need for Japanese banks to boost their capital-to-assets ratios at the end of the 1990s forced banks to sell some of their shareholdings. The

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banks did not, however, sell shares of companies in which they held a larger amount of the companies' stocks than any other bank, being their 'main bank'. Hence, like German firms, Japanese companies can invest while not having to worry about short-term profits for reasons of stock market performance.

Similar to the German Mittelstand, Japanese SMEs are also usually family owned and, if listed on the stock market, are tied to larger companies, thus providing them with stable shareholdings. However, due to a durable crisis since 1997 and regulatory changes, stable shareholdings and reciprocal shareholdings dropped. Some of the shares were redistributed to new stable shareholders, mostly acquired by foreign and domestic arm's-length investors (Yoshikawa et al., 2007).

Another pressure on the Japanese capital market was the increase of foreign ownership, performance-oriented expectations and social and political pressures. Because of this more shareholder-orientated approach, the new foreign investors can pressure Japanese firms to restructure their operations in the case of poor performance. Thus, the structural reforms, revision of Japan's regulation and government policies promoted corporate restructuring and increased the FDI in Japan through mergers and acquisitions.

The relationship between stakeholders and management

Rather like in Germany, relationships between stakeholders and management in large, small and medium-sized Japanese companies are close. Relationships are especially close between a company and its 'main bank'. The relationship between a main bank and its customer can be viewed as a particularly intense manifestation of relationship banking. The main bank not only positions one of its employees as a board member, when requested it also seconds bank officers to customer clients as full-time employees. The main bank also plays the leading role in monitoring and substantial intervention.

The most powerful safeguard in the Japanese corporate governance system is the ability of one or more equity-owning stakeholders to intervene directly and explicitly in the affairs of another company when this is required in order to correct a problem. Such assistance can be as modest as helping a troubled company generate new sales, or as dramatic as injecting new capital, restructuring assets and replacing top management. As in Germany, such intervention is typically led by a company's main bank, usually to remedy non-performance in the face of impending financial distress. Unlike in Germany, however, intervention in Japan is by no means

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limited to banks. Although less common, major industrial stakeholders will sometimes take quick, decisive steps to supplant an important supplier's or customer's autonomy with temporary de facto administrative control when non-performance becomes imminent (Kester, 1996).

The stability of cross-shareholding patterns in Japan could be seen as an indication of the fact that as in Germany, Japanese capital markets will tend to remain relatively illiquid and will continue to be prevented from playing an active role in corporate control in the foreseeable future. Unlike in Germany, however, as a result of the morally hazardous behaviour[6] of banks during the stock market boom, the Japanese banks' monitoring abilities have been called into question. Moreover, the banks' diminished control over the supply of capital to the large firm segment and the practice of zaiteku[7] has greatly reduced both the ability of the banks to undertake corrective action and to perform their corporate control function effectively. As a consequence, and given the continuing importance of major aspects of the traditional model, one option could be the strengthening of the role of the board of directors and the introduction of a legislative requirement for outside directors to occupy a certain number of seats on the board (Koen, 2001).

Company law and the structure of top management institutions

Like the Anglo-American model, Japanese corporate law is based on the unitary board system. Though outwardly similar in some respects, Japanese boards differ from those of most Anglo-American companies in numerous ways. The Japanese Commercial Code stipulates that a shareholders' meeting elects directors and makes decisions about 'fundamental changes' to the company, such as a merger, a sale of all the firm's assets and amendments to the firm's charter. There must be at least three directors. The board elects representative directors, the Japanese counterparts of US and UK executives. There must be at least one representative director. Representative directors are managers, and they run the company.

In reality, the board of directors in a typical large Japanese company consists of about 20 to 25 directors, most of whom are at least 50 years old. However, unlike normal practice in Anglo-American economies, it is rare to find independent outside directors on Japanese boards. Japanese company law does not require outside directors. Instead, virtually all Japanese directors are inside managing directors chosen from the ranks of top management itself. Although, formally, shareholders are supposed to elect (usually unanimously) directors at annual meetings, the majority are nominated by management itself. Indeed, most members of the board are appointed as a reward, near the end of their careers, and regard the position as an honour rather than an opportunity to contribute (Williams, 2000). Major share-owning stakeholders in a Japanese company often obtain indirect representation through former executives that assume positions on the boards of companies with which their former employers do business. Typically, an executive from a share-owning corporation, bank or other financial institution who is well into his career (most often in his mid-fifties) will be 'retired' from his first job and start a 'second career' as a director of the associated company in question. In some instances, mid-career executive transfers become permanent when the transferred executive rises relatively quickly to the position of managing director (Lightfood, 1992).

Any control over the president in the past came from the banks; however, now these are much weakened by their own severe problems, any controls largely come from the president's predecessors: they are normally appointed, frequently for life, as advisers (soudan-yaku) or senior advisers (meiyo-yaku), who generally have to be consulted on all major decisions (Williams, 2000). Moreover, instead of outside directors, Japanese company law requires kansayaku, often (somewhat misleadingly) translated as 'statutory auditors'. These are elected at the shareholders' meeting and do not have to be accountants or other professionals. A statutory auditor is responsible for overseeing the activities of management. This is understood to include the legality of management's activities. The statute requires collaboration between accounting auditors and statutory auditors.

Consensus and the institutions of employee representation

Japanese company law prescribes a one-tier board system. Employee participation, or codetermination, has not been adopted; however, the enterprise-based unions provide employees with an opportunity for internal participation. Employees are important constituencies in Japan, promoted for loyalty, social compatibility and performance (Tricker, 2009); however, the labour market is almost completely closed. Employees can exercise voice through 'the extensive use of joint labour-management consultation' (Jackson and Moerke, 2005:352), which are then 'written into collective agreements as basis for firm decision making' (Aguilera and Jackson, 2003: 455). A traditional and frequent statement is that Japanese companies are run in the best interests of employees and not in the interests of shareholders. The strong emphasis on employee retention is also evident when looking at employee competence formation. Employees enjoy frequent in-house and cross-functional training, which is essentially firm specific, as employee turnover is not expected. Thus a common phenomenon is that when a Japanese company is facing financial

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distress, management will cut dividends before it starts firing employees. In fact, lifetime employment, compensation tied to seniority and company-by-company labour unions are often singled out as the distinctive characteristics of Japanese companies, and have functioned to keep employee supremacy alive (Hideki Kanda, 1998).

Corporate restructuring

Again rather like in Germany, as a consequence of stable shareholding patterns, a hostile take-over is very difficult to implement and rarely happens in Japan. Also rather like in Germany, mergers and rescue operations to aid financially troubled firms are generally set up by the main bank. In addition, past research suggests that the Japanese government has also been closely involved in the corporate governance process by initiating mergers and persuading banks to set up rescue operations. Hence, despite the fact that the government is not a shareholder, it has intervened substantially in corporate governance issues.

In short, following the 2008 financial crisis, we can denote three major changes in Japanese corporate governance. First, the governmental intervention has become more important, for example, when it comes to the initiative for corporate restructuring and providing loan guarantees for traditional Japanese firms. Second, the role of the bank is considered for redesigning the corporate finance and governance, as the bank is expected to be an important monitor for the traditional Japanese firm, which takes more explicit contracts with clients. Finally, inside ownership has developed, which means that corporate and employee holding of equity is considered as an alternative to public and bank ownership.

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6.3 Corporate governance systems in Western Europe

As indicated above, continental European models of corporate governance are situated in-between the Rhineland and Anglo-American models. Due to the implementation of EU directives and requirements of the financial markets, changes have been introduced in the corporate governance systems of EU countries. Changes have excluded the central part of internal company life and structure, mainly as a consequence of member states' reluctance to modify the internal company structure, which is often based on balances of influence and power. These matters deal with core rules in the governance debate, such as: the structure of the board, and the corporate control market, especially the regulation of take-overs and protection against them the rules on groups of companies, and the protection of minority shareholders (Wymeersch, 1998).

Hence, while change and harmonization efforts have taken place in European corporate governance, differences in policy practice and philosophy have frustrated efforts to agree on a number of measures, hampering the development of a common system of European corporate governance. Comparative statistics help here to provide a clear picture of the diversity in corporate governance and finance practices that exists in Europe.

Capital markets and regulation

All European states have their own stock exchanges. In order to measure the significance of the stock exchange phenomenon in the different economies of Europe several yardsticks are used. The traditional yardstick is the relationship between market capitalization[8] and GDP. Market capitalization is assumed to be related to GDP because a larger economy would normally produce larger firms and hence a higher capitalization.

It is apparent that five states show a higher than average intensity in the use of the securities markets. Switzerland, with 170.96 per cent of GDP, has the highest capitalization; while Italy with 23.85 per cent of GDP the lowest market capitalization. Similar disparities are shown for Switzerland, Sweden, the Netherlands and Luxembourg. All of these are states in which the securities business has experienced the strongest development. These states are also most concerned with market organization, regulation of the securities business and financing in general. This evidence partly suggests that the Netherlands, Sweden, Luxembourg and Switzerland exhibit a tendency to shift from the insider model of corporate

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control to the outsider model, in which corporate control is left to the markets.

At the opposite end of the spectrum, Austria, Italy, Portugal and Germany are the states in which capital markets play a less important role in comparison to their relative economic weight. This also means that the industry in these states is mainly supported by financing means other than securities financing, and that securities financing has not been widely practiced in two-thirds of Europe. The latter figures are the more striking as these states contain some of the larger European firms.

The number of shares available on a market also illustrates its importance. In 2012, the Rhineland countries were still less market orientated than the Anglo-American model. The US and the UK markets show the highest capitalization ratio (except Luxemburg and Switzerland). The higher ratio of Japan in comparison with Germany indicates that large Japanese firms are turning more to the securities markets for financing than are large German firms.

The structure of ownership

An analysis of the patterns of share ownership can be carried out on macro figures and yields information on the amount of capital shares held by the different classes of securities holder, such as physical persons, institutional investors, and so on. It appears that there are clear differences between nations, giving the impression of strong national effects. For example, as already indicated, dispersed ownership is common in the UK and (to a lesser extent) in the Netherlands, but rare or non-existent in the rest of Europe. Foreign ownership is predominant in the Netherlands and Finland but much less frequent in Germany and Italy. Government ownership is common in Spain and France, but not in the Netherlands and Finland. These differences in owner- ship structure can largely be explained by history and were dealt with in the analysis of Chapter 4.

Ownership structures in French corporations to some extent depart from a path-dependent evolution. French corporations used to be characterized by a large share of government ownership. This was partly a consequence of nationalization after the Second World War and by the Mitterrand government in the early 1980s. It also reflected the French tradition of government intervention. Large-scale privatization, in recent times, explains why the large share of government ownership in France has been reversed. Another interesting feature of French ownership structure is the role played by holding companies originally established by industrial companies to overcome financing constraints, which also helps to explain the frequency of cross-

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holdings and dominant minority ownership.

The high degree of government ownership in Austria dates back to nationalization of property that was technically German, a major drive of industrialization of Austria being due to the government of Germany; Austria was part of Germany 1938–45. Italy is notable for the extent of state ownership, which dates back to industrial reconstruction after the Second World War. State ownership of some large Norwegian energy companies (Norsk Hydro, Statoil) may be explained by a combination of German occupation, nationalism and inadequate domestic finance.

In Belgium, the strategy of attracting foreign direct investment from the USA in particular became a national economic strategy after the Second World War; this helps to explain the high frequency of foreign ownership. Spain has a large number of multinational companies, which in part reflects a conscious policy to attract foreign direct investment initiated by the Franco government. A high frequency of family and cooperative owner- ship in Denmark is partly attributable to the small size of the average company and a relative factor advantage in agricultural products. Sweden's share of minority ownership is partly a consequence of the German-style industrialization in which banks and large entrepreneurs played a major role. In Germany banks played an active role in the industrialization process and financial institutions continue to exercise dominant minority control over many large companies, although founding families have often continued to exercise some control (by large shareholdings) even in joint-stock companies. The Netherlands is said to have been influenced by its proximity to the UK, which may have increased the frequency of dispersed ownership (Pedersen and Thomsen, 1997).

The relationship between stakeholders and management

In general, relationships between companies and stakeholders tend to be closer in continental Europe than in the UK and the US. In continental Europe, while there is increasing attention to shareholder value, the stakeholder model, with its attention to wider social concerns, is still prevalent. In most European countries, relationships between banks and companies have not been as close as in Germany and Japan. Banks do provide finance to companies but generally do not perform the same role as in the Rhineland model. More- over, the relatively close relationships, based on trust, between banks and companies have become harder to maintain. EU legislation has limited bank holdings in all EU countries. International capital adequacy rules agreed under the auspices of the Bank for International Settlements (BIS) and largely incorporated into the EU through the EU's Capital Adequacy Directive, have

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increased the costs of bank equity holdings. Deregulation has resulted in increased competition among banks as well as between banks and other financial institutions (Pedersen and Thomsen, 1997).

Company law and the structure of top management institutions[9]

The unitary-board system

In most EU member states, listed companies are obliged by statute to organize a board of directors. Most European company laws have adopted the unitary board structure, which are the exclusive board structure in the UK, Belgium (except for banks), Denmark, Greece, Ireland, Luxembourg, Spain, Italy, Sweden and Switzerland. Board members are formally elected by a general meeting of shareholders, which also determines the number of seats on the board. In all systems, the main sources of influence on the appointment of directors come from the chairman of the board, or CEO, often supported by the full board. Only in France and Belgium do shareholders have an influence on appointments. For France and Belgium, institutional investors are also mentioned as having a significant influence on board nomination: one can probably identify these 'institutional investors' as 'holding companies', in which case the finding would be comparable to that for Germany. In each case, the larger or largest shareholder has a significant influence on the nomination of board members (Wymeersch, 1998: 1090).

In the systems where shareholders have an overwhelming influence, independent directors are seen as instrumental in balancing shareholder influence in favour of other share- holders. Independent directors can only exercise 'balancing' power, keeping in check the overwhelming influence of the dominant shareholder without being able to actively direct the firm's policy. The dominant shareholder will not easily surrender this influence – except on a de facto basis – particularly as this would reduce the value of his shares. Therefore, it has been more difficult to impose independent directors on continental European schemes than in a system with wide share ownership, such as that of the US and the UK.

Case: Parmalat – The failure of Italy's corporate and market regulation

Million of dollars worth of Parmalat bonds were sold to an estimated 100,000 unwitting mom-and-pop investors before that company's 24 December bankruptcy. 'Italians feel betrayed,' says Rosarios Trefiletti, president of Federconsumatori, a Rome-based consumers' group that's filing suits and staging noisy demonstrations.

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‘We Italian investors get no help at all from the government,’ laments Vincenzo Nieri, a retired manager of a Bristol-Myers Squibb unit in Milan. ‘Nobody has ever taken the initiative to protect investors’. Meanwhile, Berlusconi & Co. have will- fully overlooked the need for stiff penalties for accounting irregularities. . . . Berlusconi’s government, by contrast, essentially decriminalized most kinds of fraudulent accounting in 2001 by making it a mere misdemeanor instead of a felony. The law should be revised – but only some factions of Berlusconi’s coalition agree. That hardly sends the right signal to Italy Inc. Moreover, little of the government debate on financial market reform has focused on key issues like the need for more independent board members and an autonomous audit committee. Crony boards are flourishing in Italy. Parmalat had one – stacked with family and friends of boss Calisto Tanzi. Italy urgently needs to extend the law giving minority shareholders the right to choose independent board members. It now covers only privatized former state-owned companies.[10]

The dual-board system

In some jurisdictions, companies are directed by a ‘supervisory’ and a ‘managing’ board together; there are both optional and compulsory two-tier board systems. Membership of employees, here called ‘codetermination’, is usually placed at the level of the supervisory board.

Systems with an optional two-tier board system, not necessarily linked to co-determination, can be found in Finland, in France and in smaller firms in the Netherlands. Two-tier boards without obligatory worker representation are compulsory for Portuguese companies. This structure is also found in Italy, where the managing board is headed by a collegio sindacale, whose powers and influence are however considerably less than those of the traditional supervisory board. Belgium is often wrongly classified among those systems with a two-tier board. This is a consequence of banking law, which recognizes the use of two-tier boards in credit institutions. No other companies may, technically, introduce a two-tiered board. Aside from Germany’s large companies, the two-tier board with compulsory worker representation is also found in large Dutch and Austrian firms.

Finland has introduced an optional regime: companies opting for a one-tier board should provide for the designation of a board of three members to be elected by the general meeting of shareholders. However, the charter can stipulate for a minority of board members to be appointed by a different method (i.e. by the employees). Larger companies must appoint a ‘managing director’ to act within the limits of his

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assignment by the board of directors. Larger companies may provide for a two-tier system: the supervisory board must be com- posed of at least five members, elected by the general meeting or in a different way, allowing for employee representation. Although there is no compulsory system of employee representation, there is a widespread practice of organizing voluntary representation: 300 companies are reported to have voluntarily introduced this type of industrial democracy.

In France, too, a two-tier system may be introduced by charter provision in a public company limited by shares (Société Anonyme, SA). However, this is found in only about 12 per cent of French companies (Williams, 2000). The members of the management board, called directoire, are appointed by the supervisory board. The number of its members varies from one to five, or seven if the company is listed. The president is also appointed by the supervisory board. Members of the supervisory board cannot be members of the directoire. The supervisory board is appointed by the shareholders. It is composed of three to 12 members, to be increased to 24 in the case of a merger. In general, French companies are directed by the Président Directeur Général (PDG), who is both chairman of the board and CEO. The possibility of challenges to the PDG is limited by the culture of the French corporate establishment, in which a very large number are graduates of a very small number of écoles supérieures (elite schools mostly separate from the universities), and there are numerous interlocking directorships and shareholdings: it is not hard for the PDG to handpick those he or she believes will support him or her (Williams, 2000).

Since 1971, Dutch company law has prescribed the 'structure regime' to be adopted by large corporations. The regime applies to firms that meet the following three conditions during a 3-year period:

- outstanding capital (issued capital and reserves) of at least 12 million euros according to the balance sheet

- a works council

- at least 100 employees of the company and its dependent companies employed in the Netherlands

When these criteria are met, the 'large' company is legally obliged to establish a supervisory board. Each of the members of this board is appointed by the board itself (called co-optation). The general meeting of shareholders and the works council is allowed to object to candidates if they believe they are not qualified, or if

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they judge the composition of the board to be inappropriate. Moreover, the general meeting of shareholders, the works council and the managing board is allowed to recommend candidates for appointment to the supervisory board. These recommendations are binding. The supervisory board (raad van commissarissen) of the structure corporations is legally endowed with a number of compulsory powers that, under the normal regime, are allotted to the general meeting of shareholders. Thus the structure regime transfers some major competencies from the shareholders to the supervisory board. These competencies include the right to appoint and dismiss members of the managing board (raad van bestuur) and to adopt the annual accounts. Furthermore, a number of major managerial decisions are compulsory, subject to approval by the supervisory board. These include the issue of shares, investment plans and company restructuring. Companies that do not meet the aforementioned criteria for large companies are legally allowed to voluntarily opt for the structure regime by including this in their articles of association. This is only possible if they have a works council in the company. Certain types of 'large' company may request exemption from the application of the structure regime. This is granted to international concerns that have their principal headquarters in the Netherlands, function merely as management companies, and employ the majority of their employees outside the Netherlands. The Dutch subsidiaries that meet the criteria for 'large' company are then subject to a milder regime, which implies that they must have a supervisory board. However, this milder regime means that the supervisory board is not given the right to appoint and dismiss members of the managing board or to adopt the annual accounts. If a parent company, which has its principal seat in the Netherlands, is fully or partly subject to the structure regime, its subsidiary is exempt from the regime.[11]

Austria has maintained the German approach, dating back to the 1937 German law. A two-tier board is compulsory, with at least one person at management level (Vorstand) acting on his own responsibility. At the supervisory level, there should be at least three members. Members are elected by the general meeting, but one-third may be appointed – or revoked – by specific shareholders, such as the holders of a class of shares. The number varies according to the size of the capital.

Belgian law recognized the two-tier board, but only in the field of credit institutions. In Belgium, banks may (in practice, they are urged to) introduce a two-tier board. In major Belgian banks, the board of directors acts as a supervisory board; it deals with general policy issues and is in charge of overseeing the management board's actual banking. Initially, the rules governing the composition of the board served to isolate

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the bank's actual management from the influence of the controlling shareholders, with the aim of ensuring that the bank was run in its own interests, rather than the interests of its controlling or referee shareholders. In the early 1990s, shareholders took over the reins of power. The objective is no longer to reduce the influence of the dominant shareholder, nor to avoid the bank functioning in the exclusive interests of its shareholders. Instead, the rule aims to exclude undesirable shareholders.

Technically, the Italian società per azione is also characterized by the presence of two levels of 'boards'. The larger companies are managed by a board of directors – the consiglio di amministrazione – composed of inside and outside directors. This board often elects an internal managing board, the comitato esecutivo. In addition, Italian law provides for a surveillance body, the collegio sindacale, composed of members elected by the general meeting and in charge of supervising the activities of all company organs, including the general meeting. Italian legal writers do not consider this board to be comparable to the German supervisory board. Instead, they classify the Italian system as belonging to the unitary board system.

Consensus and the institutions of employee representation

In some of these jurisdictions, the presence of labour representatives or other stakeholders at board level has been introduced. Boards with employee representation are, first and foremost, a German–Austrian–Dutch phenomenon. However, in the 1970s, employee representation was introduced in several other European states, either as part of the unitary board's functioning or, more usually, in the two-tier structure. Apart from mandated code- termination, most states have voluntary systems of co-decision-making at board level, based either on employer-organized co-decision-making or on collective labour agreements. These evolutions are not very well documented and have not been investigated in detail (Wymeersch, 1998).

In addition to representation at board level, employees may be able to influence decision- making through their participation in other bodies, most frequently the 'enterprise council'. These are parallel bodies that are mandatory for all larger organizations whether they are engaged in business or not. These bodies are mostly not involved in corporate decision- making, but are restricted to employment conditions, including layoffs and plant closures. At the European level, a 'European Works Council' has become compulsory for all larger undertakings or groups of

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undertakings with at least 1000 employees within the EU, of which there are at least 150 employees in two or more member states. In the UK, however, this system continues to be opposed by employers. The fear is that the introduction of the Works Council would be a step towards employee representation at board level.

The institution of employee representation

One-tier board systems and employee representation

Employee representation is obligatory in the one-board system in Denmark, Sweden, Luxembourg and France, and, as just explained, optional in Finland. In Denmark, the Companies Act provides that half the number of the members of the boards elected by the shareholders, or by the other parties entitled to appoint directors, will be elected by employees, with a minimum of two. Companies and groups (parents and subsidiaries) located in Denmark and with at least 35 employees are subject to this regime, which is applicable to the parent companies.

In the 1977 Codetermination Act, Sweden introduced a system of compulsory co-determination with respect to all companies – of SA or cooperative type – that employ more than 25 people: two labour representatives must be appointed to the board. If there are more than 1000 employees, three members of the board must be designated. However, since representatives are reportedly reluctant to intervene in the board's decision-making, participation is essentially regarded as serving informational purposes only.

In France, there is a threefold system of voluntary codetermination within the unitary board. Codetermination had long been opposed both by employers and employees, the unions refusing to be involved with running the firm. Gradually the idea began to gain momentum, though, and in 1982 a form of compulsory representation was introduced to public-sector firms, followed in 1986 by an optional minority codetermination system in the private sector. A 1994 law rendered the system compulsory for privatized state enterprises. The system of codetermination was introduced in all firms with an enterprise council: two representatives of this council take part on the board, as observers and without votes. Their influence is actually very limited: the decisions are made by the directors in a preliminary meeting. This type of codetermination decision-making has been referred to as 'a mockery'.

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Another system of codetermination in France is based on a voluntary scheme; this can be introduced by the general meeting by way of a charter amendment. Representatives of employees of the firm – numbering between two and four, and occupying a maximum of one-third of the board seats – are elected by their peers, not by the general meeting. They take part in the meetings of the board in the same position as the other directors. In practice, however, board meetings are often split into two parts, with the representatives invited to the formal part. Hence the system is reportedly not very effective, especially as a result of the fear that the representatives might divulge information. Also, the directors fear that co-decision-making will increase the union's power. The number of companies that have opted to adopt this regime is unknown, but is probably rather small.

France has introduced a more elaborate system of codetermination for its privatized public sector, including firms that are majority owned by the French state. Apart from representatives of the state and expert members (both one-third), one-third of members of the supervisory board or of the management board are representatives of the employees. In general, employee representatives on French boards are relatively rare.

In Switzerland, although the law does not call for employee participation at board level, some companies have voluntarily introduced codetermination. Examples are Nestlé and the retail distributors Migros and Co-op.

In Ireland, the Worker Participation (State Enterprises) Act 1977 introduced board-level employee participation at a selected number of state-owned enterprises employing 43,700 employees. Members are appointed by the minister competent for the state firm in question, and are nominated either by the union or by a percentage of the employees (a mini- mum of 15 per cent). In addition, only employees of the firm may be appointed. The system has not been extended to the private sector, although proposals have been made to that purpose.

In Italian business firms, employees are not represented at the board level. The Italian union tradition is based on confrontation not on co-gestione. In Belgium there is no labour representation at board level. In some state-owned firms there may be limited representation of labour (e.g. in the national railway company, where three members are nominated by the unions and elected by the employees). Belgian (unitary) boards usually comprise internal managers, representatives of large shareholders, and independent out-siders. In Spain, there is no legally imposed system of codetermination, but it can be continued on a voluntary basis. The latter is the case in state-owned enterprises.

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Two-tier board systems and employee representation

The Dutch system of labour representation is based on the consensus between the two traditional production factors: capital and labour. Labour representation at the level of the supervisory board is indirect and based on co-optation of members of the board who, without being labour representatives, enjoy the confidence of the employees. Therefore, members of the supervisory board do not represent labour interests, but have to take care of 'the interests of the company and its related enterprises' as a whole.

Austria has introduced employee representation more or less along German patterns: at the level of the supervisory board in large companies, one-third of the members should be employee representatives. These are appointed for an indefinite time period by the works council or, in larger firms, by the central works council, and chosen from among their members. Union influence is reported to be strong.

As indicated, there is no legally imposed system of codetermination in the two-tier system in Portugal.

Corporate restructuring

As with issues concerning the structure of boards, the corporate control market (especially in terms of the regulation of takeovers and protection against them) has escaped European harmonization and is still determined nationally. Diverging features of share ownership and related regulations explain, to a large extent, the relatively wide diversity in the way the corporate control market is organized and functions. While public take-overs and comparable transactions are common in the UK, they occur less frequently in continental European countries.

Company restructuring in most continental European countries takes place by negotiated measures rather than directly as a consequence of market transactions. In all states there is an active 'private' market for corporate assets and corporate control. In terms of the number of transactions, about half those taking place worldwide involve European companies, whether on the buying or the selling side. This 'private' market for corporate assets and control runs through the communication channels of the large accounting firms and investment banks that operate across Europe. The transactions mostly, if not exclusively, relate to privately owned firms, including subsidiaries and divisions of listed companies. Both in terms of the number of transactions and turnover, the mergers and acquisitions market largely exceeds the more visible markets for public takeover bids (Wymeersch, 1998).

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6.4 Corporate governance in BRIC countries

BRIC has come into fashion as a term for Brazil, Russia, India and China. The reason for the grouping is highly pragmatic: they are all countries with very large populations (about 150 million in Russia, 200 million in Brazil and well over a billion in China and India); they were becoming increasingly important by opening up to world trade, becoming more liberal capitalist, economic growth and investing in other countries, in roughly the same period. But in most other respects they are quite dissimilar. Never mind the pragmatic grouping, these countries are more recent industrializers and they merit attention, because of their size and increasing importance in the world economy. Because they are institutionally and culturally dissimilar (Hofstede, 2001), they will be dealt with individually. More recently, the Republic of South Africa appears to have managed to join the club, so that it became BRICS. We do not consider it here, although it is an economically important country in Africa, because its economic institutions are not that divergent from liberal market economies.

Brazil

The Brazilian model of corporate governance is characterized by a high concentration of ownership (41 per cent on average for the biggest shareholder and 61 per cent of the equity capital for the top five shareholders, with a large number of family-owned firms and business groups, relatively small corporate boards with a limited number of independent directors and a majority (about 75 per cent) of outside directors nominated by controlling shareholders (Black et al., 2010; Brugni et al., 2013). This often causes conflicts among controlling and majority shareholders, with a lack of transparency since many firms do not provide financial statements and lack an audit committee (Caixe and Kreuter, 2013). As a substitute, the Brazilian legislation authorizes an independent fiscal board to investigate financial reporting by firms; however, its efficacy remains questionable (Black et al., 2010). Since the 1990s, due to a large-scale privatization program, government ownership has considerably declined.

In the light of new economic development, the Brazilian Institute of Corporate Governance has recommend new standards aiming to increase the quality of disclosed financial information by publicly held firms, differentiated in three segments: Novo Mercado (118 firms), Level 1 (16 firms) and Level 2 (38 firms). For example, included in these rules is the obligatory separation of the chairman and the CEO; however, only 40 per cent of companies listed on the Bovespa (Sao Paolo Stock

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Exchange) are included in the special listing segments for corporate governance (Brugni et al., 2013). Thus, in a comparative perspective, the Brazilian model of corporate governance is positioned in-between the shareholder and stakeholder models, sharing characteristics of both models, resulting some- times in conflicting situations such as the case of fewer independent directors mostly nominated by controlling shareholders.

Russia

After the collapse of the Soviet Union in 1991 and the election of Boris Yeltsin as president, corporate managers soon became de facto owners as a result of the Russian government's privatization program. One objective of privatization, launched in 1993, was to place shares of formerly state-owned enterprises into the hands of managers, other employees and all Russian citizens. By the time the privatization process ended in 1994, many enterprise managers had become majority or large shareholders in their firms, accumulating shares at nominal cost from other employees and the public. Many managers utilized their powerful positions to engage in self-enriching practices such as asset stripping and setting up false subsidiaries through which they channelled cash and valuable assets. Owner-managers, in addition, often crushed the rights of other shareholders by not holding shareholder meetings, deleting names from stock registers and other crude practices (McCarthy and Puffer, 2002). Not only the ownership became concentrated at the company, but also the aggregated level since the Russian assets are controlled by a group of 'oligarchs' (e.g. about 40 per cent of the Russian industry belongs to 22 largest business groups, Lazareva et al., 2009).

Banks were able to keep some control over the financial accounts of enterprises through legislation that required all enterprises to hold their accounts in a single bank, and allowed banks to intervene in decisions on how to divide up enterprise profits between consumption and investment funds. The enforcement of such measures was, however, haphazard (Litwack, 1995). Moreover, the vast majority of Russian banks did not participate actively in the privatization process. Minor participation in enterprise privatization was followed by the banks' minor involvement in corporate governance. In addition, inflation led to the popularity of short-term lending, making unnecessary and cost-ineffective any monitoring of the borrower's performance (Belyanova and Rozinsky, 1995). Industrial management control thus remained unchallenged by the banks.

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Major exceptions to this general picture of the Russian bank sector are the so-called ‘hard-currency islands’ – banks specializing in hard-currency operations (including hard- currency-denominated loans), with Russian exporters as their main customers. This small group of ‘export-sector banks’ (ESBs) has tended to overcome the Russian banks’ general inability to interfere in corporate governance. The specialization of these banks in hard- currency operations, supported by their larger-than-average size and lending capacity, has determined their capacity to exercise control over the industrial enterprises.

In general, it could be argued that ineffective and conflicting laws, lack of enforcement and a limited infrastructure for protecting shareholders’ rights help to explain Russia’s dysfunctional corporate governance system in the aftermath of the privatization process. A major example is Russian company law. This law, though defining a two-tier structure for corporate governance boards, promoted a governance structure that was strongly dominated by major shareholders. The law did not allow outsiders who did not represent the interests of the major shareholders on to the board of directors. Neither did it automatically allow representatives of insiders, such as managers or workers, on to the board unless they were also significant shareholders or their legal representatives. A shareholders’ meeting directly appoints a president and a management board head from the members of a board of directors. The auditing committee, as a supervisory board, is also appointed directly by shareholders.

One damaging result of the enormous power of the owner-managers and the consequent malpractice was that the prospect of attracting investment to Russian enterprises had all but vanished. Indeed, the implications of the privatization process in Russia virtually blocked equity market development. On the one hand, managers and employees are expected to be very conservative shareholders, reluctant to sell their shares; on the other hand, industrial shares are not as attractive as some others to potential buyers because of the low dividends they offer and the virtual impossibility of obtaining large blocks of shares. The equity market, therefore, tends to be thin and incapable of providing adequate control mechanisms (Belyanova and Rozinsky, 1995).

The 1998 economic crisis, which had a very adverse effect on Russian corporate life, made large Soviet companies aware of the fact that effective corporate governance is a crucial underpinning to business success. With the election of Vladimir Putin at the turn of the decade, and Putin’s law-and-order platform, which included steps to stabilize the economy and crack down on crime (including destructive business

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activities), Russia chose to move forward with reform of the corporate governance system. The subsequent development of institutions to support effective corporate governance was a joint effort of Putin's team and private business groups, who shared this objective. This business– government collaboration resulted in new legislation and keener enforcement, as well as a developing culture of more openness and responsibility. The combined result of these developments, together with the need to attract investment capital, as well as the prospect of benefiting more from public listing than from private plundering, motivated enterprises, among other things to:

- operate in a way that benefits all shareholders maintain a focus on long-term financial returns;
- disclose to shareholders, and the appropriate regulatory and international bodies, accurate, consolidated and timely information;
- use internationally accepted standards and accounting principles verified by an independent, qualified audit;
- disclose their ultimate ownership structure, including beneficial share ownership by executive officers, board members and any group holding more than 5 per cent;
- to have a board of directors that is elected by and accountable to the shareholders, and that includes qualified non-executive directors.

In 2002, the Russian Stock Exchange issued the Corporate Code of Conduct, recommending best practices, not enforceable by law; however, companies that did not follow the code, lost their eligibility for an A1 listing (considered the most prestigious type of listing) on the Russian Stock Exchange (Puffer and McCarthy, 2003). Nevertheless, com- plying with the new Code of Conduct revealed to be challenging since the established formal rules may conflict with current informal norms and practices in Russia. Although the independent directors are aimed for minimizing conflicts of interests while monitoring managers, their role in Russian boards is different (Berezinets et al., 2011). Directors are formally independent, but in reality have close ties with the management or the controlling shareholder (IFC, 2005), who largely nominate them, therefore, less likely to be fully independent (Buck, 2003). Therefore, due to the mass privatization process, which was driven more by speed than oriented to quality, Russian capital markets are considered to

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have underdeveloped financial institutions, weakly-protected private property rights and high country risks for foreigners (Buck, 2003). While there is still a long way to go to improve corporate governance practices in Russian business, compared with the situation in the past, it could be argued that progress has been made due to gradually development and growth of Russian capital markets that leads to getting closer to the primary goals of privatization: promoting the openness of company information disclosure and liquid capital markets as a means of disciplining the actions of enterprise decision-makers (Buck, 2003). Yet the country continues to score relatively low on various related measures. The World Bank (2013) ranks Russia 111th out of 189 countries in terms of the ease of doing business. The KPMG (2013) report concludes that business continues to be impeded by bureaucracy in the government system, its internationally noncompliant property rights legislation, the inconsistent application of laws and regulations, and a lack of transparency.

India

There has been a clear move in India to develop the corporate market to attract FDI, which is slowly increasing shareholder diversity in some companies. Even though the Indian legal system provides one of the best systems of investor protection in the world, the reality is different due to slow courts and corruption. Much of the corporate sector displays relationship- based informal control and governance mechanisms, inhibiting financing and keeping the cost of capital at high levels, even though India has a developed banking sector (Chakrabarti, Megginson and Yadav, 2007). There is significant pyramiding and tunnelling among Indian business groups due to concentrated ownership and family control; however, most of the corporate governance issues are in fact common in Asia and in other BRIC countries.

The Indian market regulator, the Securities and Exchange Board of India (SEBI), recently issued a consultative paper on the 'Review of Corporate Governance,' calling for the splitting of the roles of chairman and chief executive, disclosure of the reasons for an independent director's resignation from office, a limit on the term of appointment of independent directors, and greater involvement of institutional investors. Making radical changes seek to ensure the implementation of these corporate governance recommendations including:

- the appointment of independent directors by minority shareholders;
- independent directors to receive compulsory training and pass examinations; and

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- the adoption of a principle-based approach for certain principles.

Although the proposals emerges from the Anglo-American model, in some instances they introduce new initiatives, and the adoption of certain UK-based concepts such as 'comply- or-explain' should be expected to be adopted cautiously, given the radical nature of certain proposals. New regulatory institutions may be needed, strengthening the existing institutions and hybrid approaches adopted in Anglo-American countries. *China*[12] From 1978 onwards, the Chinese government embarked on an ambitious program of economic reform. One of the most important creations was that of the firm as an independent business entity. Under the central planning regime, China's industrial and commercial enterprises were not autonomous but were workshops and production units with no independent decision-making power. The central plan replaced the function of the market, and the conditions for the existence of a firm (as understood in market economies) were absent. All means of production were nominally owned by the state; contracts and market transactions were not needed for organizing production activities. The workshop and production units within the central input–output planning matrix have been replaced by business enterprises with independent legal status. The emergence of the company as a basic economic entity was accompanied by a process of financial reform that has turned the newly created or reorganized state-owned banks into the primary providers of finance for Chinese enterprises, replacing the old system of state budgetary grants. Most working capital needs of state-owned enterprises (SOEs) are met through bank lending. The banks were encouraged to use economic criteria for evaluating loan applications on the basis of market demand for the enterprises' output, the availability of raw materials and the profitability of investments. The transformation of the Chinese banking system into a truly commercial one, however, is proving an extremely slow pro- cess. Some party officials have been reluctant to increase the independence of the central bank and of other banks because officials have been exploiting the banks to finance their own needs. The Chinese government also continues to use the banks to siphon surplus funds from private enterprises to subsidize the losses of state enterprises. Moreover, the political upheaval and mass unemployment involved in making the banks themselves efficient further contribute to slowing the pace of progress. Hence, while banks are technically more independent, in practice they are to a large extent still acting as cashiers for the state and can hardly play a useful role in corporate governance.

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From the mid-1980s onwards, when grass-roots efforts to develop China's capital markets began spontaneously, shareholding companies were formed. To raise funds, state and collective enterprises issued various forms of shares and bonds, and informal securities trading could be found in most major Chinese cities. China's first securities and brokerage company was established in Shenzhen in 1987. In the following year, securities companies were set up in every province under the auspices of the local branches of China's central bank. By 1991, China's two official stock exchanges in Shanghai and Shenzhen were ready for full operation. Approval for a company to obtain listing on these markets, however, is determined by the government on the basis of an annual quota broken down to each province and ministry. The listing of a company is thus usually decided not on its commercial merit but for political and sectional reasons. Just like the state banking system, which supports SOEs through the debt market, the securities market in China is essentially a state securities market, conceived and operated primarily to support corporatized SOEs.

Chinese-listed companies are in the main partially privatized SOEs. That is, their major shareholder is the state in its various forms, including other SOEs. The high degree of concentrated state ownership has restricted the capacity of China's equity market to per- form a financial disciplinary role in the corporate governance of listed firms. Because of the high rate of saving and the very limited range of investment instruments available in China, individual investors in the stock market have from the beginning exhibited a highly speculative tendency with a very short investment horizon. In July 2013, China's State council published ten guidelines for financial market restructuring, focusing on the legalization of privately run banks and the regulation of private lending. In China commercial loans can only be obtained from state-owned banks, thus it is tough for private entrepreneurs and SMEs to get a loan, since these state-owned banks favour lending to government firms (Tsai, 2004). High demand for finance in the private sector provides opportunities for illegal private fundraisers, while the legal private 'lenders' are basically situated in a grey area (Zou and Adams, 2008). Since listing on the Chinese capital market is mostly a political process, the market is also described as a state securities market and is missing its disciplinary role (Zou, Pang and Zhu, 2012).

Chen et al. (2009) argue that there are four main types of ownership control in Chinese listed companies:

- state asset management bureaus (SAMBs),

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- SOEs affiliated to the central government (SOECGs),
- SOEs affiliated to the local government (SOELGs), and
- private investors.

SAMBs are shareholding institutions that have been established by the state to manage state assets. They normally invest in listed companies by owning the state shares and sometimes the legal person shares. SOECGs are generally big or nation-wide companies and are subjected to strict monitoring under the central government and the National Audit Office. Unlike SAMBs, the chairmen selection process is strict as the officials are chosen for their political ability. The main difference between SOECGs and SOELGs is that latter are con- trolled by a local government. The companies that they usually invest in are SOE spin-offs and they are the largest group of controlling shareholders of companies. Private investors can be both private companies and individuals. A dominant investor will typically become the CEO or chairman of the company. Agency problems will not steam for the dominant investor, but they will concern the minority shareholders. As private companies are not subjected to state monitoring, the dominant investor has the power to expropriate the income and assets of the company away from the minority shareholders (Chen et al. 2009).

Despite its majority ownership, the state does not exercise effective control over its companies. Control of China's companies rests primarily with the insider management and their party–ministerial associates. The Chinese government, together with the party organization, exercise influence through, for example, recruitment policy. For listed companies with the state as a majority shareholder, the pool for appointment to the positions of chief executive, most senior managers and a high proportion of the directors on the company board is restricted and subject to government influence or direct intervention. Moreover, many company executives may still have an affiliation to their previous state organization (Wymeersch, 1998).

Companies operating under the country's company law have a two-tier board. The board of directors is essentially made up of executive directors. There are few independent directors in Chinese companies. Although it is mandatory that at least one third of the board of directors to be formed of independent directors, the issue is that these directors are appointed by majority shareholders so they generally do not contradict their intentions or actions (Lin et al., 2011). In addition to the board

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of directors, Chinese companies also have a supervisory board. This board is small in size and usually has labour union and major shareholder representatives. However, it only has a loosely defined monitoring role over the board of directors and managers, and has not so far played any effective governance role. The interests of employees are safeguarded primarily by party representatives in consultation with the controlling shareholder, which is usually the state. Trade unions in China are organized hierarchically and led by the All China Federation of Trade Unions, which is the world's largest trade union with more than 190 million members. Companies with more than 25 trade union members have to set up a board, but in practice, the role of trade unions is often limited to social functions, such as events and outings.

While there has been progress in developing accounting standards, China is still a long way from achieving the degree of effectiveness and independence required for the Anglo- American model to work. It is widely believed that false accounting and financial misreporting are pervasive among Chinese SOEs and companies. However, as in other transition economies, a company's reputation for integrity and performance is often not required in order to raise capital in the stock exchange. Indeed, the unpredictable movements generated by market manipulation may, in fact, at times be applauded by some investors, who hope to profit from such speculative waves and are eager to follow the 'winners'.

Many of the shortcomings in the actual practice of corporate governance in China derive from weaknesses in the policy and institutional environment, and from peculiar cultural and political governance traditions. For example, collusion among insiders, and lack of transparency and disclosure to outsiders on the actual performance and workings of the firms have been explained as a consequence of the tradition of insiders versus out- siders with a built-in convention of secrecy among insiders. Family or clan members, as 'insiders', are expected to bear collective responsibility for promoting and safeguarding the interests of the unit. The interests of outsiders are either secondary or irrelevant. Safeguarding the interests of the unit involves maintaining confidentiality on internal affairs, and disclosures are regarded as a betrayal of the unit's interests. Also important is the impact of political governance on corporate governance. Since the Chinese system of political government itself lacks accountability and transparency, it is difficult, and perhaps incongruous, for corporate governance to be effective and institutionalized. Moreover, the market-orientated legal system, and the corporate and securities law framework in China has only been developed over the past two decades and is still relatively rudimentary and untested in many aspects.

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6.5 Codes of corporate governance

A wave of corporate scandals at the end of the 1980s promoted the emergence of codes of corporate governance as a new mode of regulating corporate governance practices, primarily in the UK and the US. Codes are a set of best practices designed to address deficiencies in the formal contracts and institutions by suggesting prescriptions on the preferred role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, and the remuneration and dismissal of directors (Haxhi and Aguilera, 2012).

By the end of April 2014, 91 countries worldwide had created at least one code (ECGI, 2014). Several studies in many countries show that the content of codes has a direct influence on firm corporate governance practices as they are considered a benchmark and regulatory tool. Although corporations are the ultimate implementers of codes, executives, directors, shareholders, proxy advisors, rating agencies and all the other stakeholders as well as public policy and regulators care about codes because they provide a metric to guide and assess governance behaviour.

Codes can be distinguished from other modes of regulation in that they are formally non-binding, issued by committees of experts, flexible in their application, built on the market mechanism for evaluation of deviations and evolutionary in nature (Haxhi and van Ees, 2010). Their voluntary and self-regulatory nature is exemplified in the widely used 'comply-or-explain' principle, which entails that while compliance with code provisions is voluntary, the disclosure of non-compliance is mandatory (Wymeersch, 2005). The practice of regulating corporate governance through formally non-binding codes or the comply-or-explain principle is supposed to be the same throughout all the EU countries; however, the meaning of this regulatory mechanism differs substantially across countries. In the Netherlands and Germany, for example, the comply-or-explain principle is amended by law, and firms have to explain non-compliance with the code's provisions (Haxhi and van Manen, 2010). In the U.K., meanwhile, the stock exchange forces code implementation (MacNeil and Li, 2006).

In short, regulating corporate governance through codes is seen as a process, where soft- law, e.g., codes, are favoured over hard law. Compliance studies in several countries find that codes have an effect on the structure and functioning of the board of directors (Alves and Mendez, 2004), reduce the agency cost of managerial

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entrenchment and enhance board oversight (Dedman, 2002), and positively impact the stock price, since markets react positively to announcements of compliance (Goncharov et al., 2006). However, unlike hard-law regulation, e.g., Sarbanes-Oxley Act of 2002 in the US, codes do not entail strict compliance (Haxhi and Aguilera, 2012).

Codes and their convergence

The current literature on corporate governance is unclear whether we are moving towards convergence in governance practices. It is essential to move the debate beyond the convergence versus divergence discussion and pay more attention to the national culture and institutions, and transnational issuers of codes as drivers of convergence. There are several transnational entities enabling the diffusion of codes, such as the World Bank or the OECD (Aguilera and Cuervo-Cazurra, 2009), which by promoting a common set of practices may indirectly be contributing to the achievement of convergence; not toward a particular model but a more general global model. In addition, Reid (2003) sees inter- nationalization forces such as globalization, market liberalization, foreign investors, and recommendations on global best practices by transnational organizations as facilitators of this confluence.

Moreover, with respect to the national cultures, Haxhi and van Ees (2010) find that the cultural values that reflect societal norms and beliefs about the integration of individuals with groups, the distribution of power, and the tolerance for uncertainty affect the issuance of codes and the identity of the issuers. Individualist cultures (Hofstede, 2001) have a stronger tendency to develop codes. In cultures with high power differences, there is a higher probability that the first issuers are from the government, directors, and professional associations; while in the opposite case, the stock exchange and investors are more likely to initiate the first code.

Furthermore, as a response to the 2008 financial crisis, a new hard law regulation saw the light in the US. The financial crisis also prompted the US Congress to expand the federal government's involvement in corporate governance. Whereas Sarbanes-Oxley Act regulated the composition and responsibilities of audit committees, the Dodd-Frank Act (The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on 21 July, 2010) requires a broad range of financial institutions to have a risk committee as well. The risk committee will be responsible for overseeing the firm's risk management practices, and the committee must have at least one risk management expert having experience with similar firms. The Federal Reserve is empowered to decide how many independent directors must serve on the

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committee. The Act includes a number of broad executive compensation reforms that are not limited to financial institutions, including a requirement that US public companies provide shareholders with a non-binding say-on-pay vote. The SEC is also required to instruct the stock exchanges to adopt new listing standards imposing enhanced independence requirements for board compensation committees. It will be interesting to see how other countries will react to these new rules enacted in the US (Haxhi and Aguilera, 2012).

The global integration of product and capital markets is leading to worldwide changes in corporate governance. However, to date there is no clear evidence that such an observable evolution would constitute actual convergence; these changes are a direct search for greater efficiency in governance system and improved legitimacy in financial markets (Haxhi and Aguilera, 2012). Local institutions, culture and politics can impede these governance changes or initiate 'hybrid' practices (Yoshikawa, Tsui-Auch, and McGuire, 2007).

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Case: The Ahold scandal

As the post-Enron wave of corporate scandals washed over the US, a common response in Europe was: it couldn't happen here. Far from having the world's best-policed markets, many European politicians claimed, the US suffered uniquely from a lethal combination of greedy and overpaid bosses, conflicted auditors and investment bankers, reliance on accounting rules not principles, and an obsession with quarterly profit numbers.

As more sensible European regulators recognize, this smugness was never justified: it is only necessary to recall scandals such as Vivendi, ABB, Elan and EM.TV. But Europe's claim of immunity from corporate sleaze was blown out of the water by the revelations that Royal Ahold of the Netherlands, the world's third-biggest food retailer, overstated its profits for 2001–02 by as much as $500m. Its chief executive and chief financial officer have both quit.

It is true that Ahold's accounting deficiencies mainly involved American subsidiaries that it bought in a decade-long acquisition binge though they also stretched to Argentina and Scandinavia. But the company's Amsterdam-based auditors, Deloitte & Touche, failed to pick the problems up in 2001, even though worries about Ahold's accounts were widely expressed in the markets. Ahold's board, far from questioning the chief executive closely, tamely extended his term for up to 7 years as recently as last spring. The Dutch market regulator admitted that it had no powers of discipline over faulty auditing.

What about the relative numbers of restatements? Because America's GAAP accounting system relies on thousands of pages of rules, it is more vulnerable to manipulation than Europe's more principles-based approach. Wall Street's excesses of the 1990s were also more egregious than Europe's. But given the largely non-existent regulation of auditors and the poor corporate governance prevalent in much of Europe, a more plausible conclusion is that Europe has had fewer accounting scandals than America mainly because nobody has seriously looked for them, not because they are not there.

This is not to say that Europe should adopt Sarbanes-Oxley. That hastily drafted law was designed for America's very different system; it precludes the two-tier boards that are common in Europe, for example. Many of the law's rules on manag- ers and boards seem unduly intrusive even for America. But statutory, independent regulation of auditors, as prescribed by Sarbanes-Oxley, makes sense everywhere.

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So do rules to stop accounting firms doing consulting work for audit clients; and it is also worth considering mandatory rotation of auditors (Deloitte had audited Ahold for 15 years). However, it is little use taking this welcome step towards tougher accounting standards, which the Europeans are urging on America in the interests of global harmonization, if there is nobody to oversee the rules. Yet the European Federation of Accountants admits that, in six EU countries, there is in effect no enforcement at all.

Bad apples and oranges

After Enron and WorldCom were followed by the bankruptcy and criminal conviction of Andersen, which had audited both companies, the remaining Big Four hinted that Andersen had been an exceptional case: a rotten apple amid a barrel of good ones. Andersen does seem to have been peculiarly culpable. Yet most of the other firms have now also been tarnished by scandal in the past year or so: KPMG over Xerox, PricewaterhouseCoopers over Tyco, Deloitte over Adelphia, for example. As companies such as Ahold go global, they run into countless national regulators and supervisors – and it is the weakest link that is always most likely to prove their (and their investors') undoing. The right response is to adopt the strongest, not the laxest, auditing regime possible. This means both enforcement of international accounting standards and tough regulation of auditors.

Questions

. 1 What explains the occurrence of the Ahold scandal?

. 2 Should the Ahold case be seen as a failure of the (Dutch) two-tier board system? Please explain your opinion of this issue.

. 3 The US$500 million overstatement was due primarily to Ahold's US subsidiaries. Would you, therefore, argue that Ahold is less a European problem than yet another US accounting failure?

. 4 Would the Ahold scandal occur typically in 'global' corporations or could a similar situation arise in companies operating in only one nation?

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6.6 Conclusions

The comparative analysis of corporate governance systems and of their institutional–cultural roots is not only useful in its own right but also for building an understanding of the impact these systems might have on competitive advantage of national industries. The comparative analysis in this chapter shows that history, politics and societal traditions shape the development of financial and corporate governance institutions. They are bound up with more economic forces. The lesson to be learned is that financial and corporate governance reforms must adapt to the unique history and social–political structure of a country. Less advanced and transitional countries cannot blindly follow the financial and corporate governance reforms of other countries.

This chapter also shows that both the Anglo-American and the Rhineland models of corporate governance have their strengths and weaknesses, which help to explain their divergent impact on industrial competitiveness. Major strengths of the Anglo-American system of corporate governance include efficiency, flexibility, and responsiveness in financial markets, and high rates of corporate profit. More explicitly, the Anglo- American system is good at re-allocating capital among sectors, funding emerging fields, shifting resources out of 'unprofitable' industries, and achieving high private returns each period, as measured by higher corporate returns (Porter, 1997). Major weaknesses of the system stem essentially from two of its features: the unitary board system and its short-termism. The unitary board system, while allowing for efficient decision-making by management, impedes effective monitoring of management performance. The election of outside directors (which happens on a voluntary basis in the UK), the use of proxy voting mechanisms, and, as in recent times, the development of shareholder advisory committees have emerged in the Anglo-American system as preferred techniques for solving many of these control problems. When these governance techniques fail, corporate control becomes entirely dependent on the market.

Theoretically, the threat of a hostile takeover should ensure that assets are controlled by those best able to manage them, and in the US and UK, with their well-developed markets for corporate control, a hostile takeover is the ultimate check on management. When shareholders fail to take an interest in the governance of a company, or when their governance proves ineffective, low-quality managers are able to remain in power or management's allegiance to the shareholder may falter. In either of these cases, a company's share price should drift lower so as to form a gap between the stock's actual price and its potential value. If the gap between a

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company's market value and its perceived potential value were to grow large enough, a takeover would ensure that control over the company's assets eventually goes to those who can earn a higher return on those assets (Lightfood, 1992).

Moreover, the unitary board system, combined with the threat of takeover, helps to explain the difficulty of the Anglo-American system with aligning the interests of private investors and corporations with those of society as a whole, including employees, suppliers and local communities. Indeed, the market for corporate control often disregards its effects on both human and social capital. Short-term capital is also argued to contribute to impeding the creation of the organizational competencies necessary for firms competing in sectors characterized by incremental innovation (Streeck, 1992). In other words, the system fails to encourage sufficient investment to secure competitive positions in existing business. It also induces investments in the wrong forms. It heavily favours acquisitions, which involve assets that can easily be valued, over internal development projects that are more difficult to value and that constitute a drag on current earnings (Porter, 1997). It is interesting to note that this regulation does not speak at all to the practice of codes, which are based on the idea that 'not one size fits all.' Also, the 2001 and 2007 crises showed that a lot of the profitability and even financial market data were manipulated. Notably in the US, court cases are still pending at the time of writing this.

Major strengths of the Rhineland model are that it encourages investment to upgrade capabilities and productivity in existing fields; it also encourages internal diversification into related fields – the kind of diversification that builds on and extends corporate strengths. The Rhineland model comes closer to optimizing long-term private and social returns. The focus on long-term corporate position – encouraged by an ownership structure and governance process that, together, incorporate the interests of employees, suppliers, customers and the local community – allows the German economy to utilize more successfully the social benefits of private investment (Porter, 1997: 12–13).

Downsides of the Rhineland model; however, are the tendency to over-invest in capacity, to produce too many products, and to maintain unprofitable businesses. Moreover, the stable, long-term relationships between banks and firms are increasingly seen as inhibiting the formation and growth of firms in new sectors. As indicated above, the long-term stable shareholder relationships typical of the Rhineland model impede the development of a large, liquid capital market. A large capital market is critical for risk capital or venture capital providers, as it creates a

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viable ‘exit option’ via initial public offering (IPO) and mergers or acquisitions (Casper, 1999). Without this exit option, it is difficult for venture capitalists to diversify risks across several investments and to create a viable refinancing mechanism.

The comparison in this chapter reveals the fact that there is no such a thing as a ‘perfect’ or the ‘best’ system. While, at present, the majority view is that the shareholder model will prevail due to the increasing dominance of institutional investors on international capital markets (Lazonick and O’Sullivan, 2000), the intense and ongoing competition between the Anglo-American and the Rhineland models in Europe provides evidence to the contrary. The impact of this competition provides few signs of change in the UK and only small step-changes, incorporating some elements of the Anglo-American model into the ‘large firm’ Rhineland model. Since national forms of corporate governance are embedded in established ‘practices’ and ‘regulatory policies’, change in one area does not involve a change in the entire system.

The example of Germany shows modifications of the existing approach to corporate governance that accommodates the new circumstances. Root-and-branch change is not found, and there is not even a consensus on the need for change, let alone a consensus on what that change should be. The attractiveness of an overall corporate governance model very much rests, not only on efficient financial markets, but also on macroeconomic performance. Here, we currently have contradictory information: the Anglo- American countries have stuck to national systems but also relied heavily on governmental bailout of technically bankrupt enterprises and governmental debt. The world growth leader, China, has combined government influence and ownership, and management of the currency exchange rate, with the adoption of capitalist forms and practices. The European countries to come best out of the crisis with a strong export surplus, Sweden and Germany, have adopted some Anglo-American practices but they also revitalize their own traditions.

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Study questions

. 1 Explain the main differences between the 'shareholder' and the 'stakeholder' models of corporate governance.

. 2 What is the broad definition of corporate governance?

. 3 What do you understand by 'effective corporate governance'?

. 4 Explain how the German accounting system differs from the US one.

. 5 Explain the main differences between the Anglo-American and the Rhineland model of corporate governance.

. 6 What is meant by the terms 'exit' and 'voice' in the governance area?

. 7 What are the main strong and weak points of the Japanese system of corporate governance?

. 8 Explain why the take-over option of the Anglo-American model of corporate governance has militated against enterprise growth from small to medium size.

. 9 Is the German model converging towards the Anglo-American model of corporate governance? Give reasons for your argument.

. 10 Would it be economically beneficial for the German model to converge towards the Anglo-American model?

. 11 Explain the effects of globalization forces on corporate governance systems.

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Further reading

Aoki, M. and Kim, H.-K. (1995) Corporate Governance in Transitional Economies. Washington, DC: World Bank. An interesting book paying special attention to insider control, the possible role of banks in corporate governance, and the desirability of taking a comparative analytic approach to finding solutions.

Hopt, K.J., Kanda, H., Roe, M.J., Wymeersch, E. and Prigge, S. (1998) Comparative Corporate Governance: The State of the Art and Emerging Research. Oxford: Oxford University Press. An interesting book that explains a wide range of corporate governance topics in different countries.

Jürgens, U., Naumann, K. and Rupp, J. (2000) Shareholder value in an adverse environment: the German case. Economy and Society 29(1), 54–79. This article provides an interesting analysis of the ability of the German corporate governance system to change in the direction of shareholder value.

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Sheard, P. (1998) Japanese corporate governance in comparative perspective. Journal of Japanese Trade and Industry 1, 7–11.

This article offers a brief but critical comparative analysis of the Japanese and Anglo-American systems of corporate governance.

Zhuang, J., Edwards, D. and Capulong, V.A. (2001) Corporate Governance and Finance in East Asia: a Study of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand. Manila, Philippines: Asian Development Bank.

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Notes

1 Bankruptcy regulation militates against relationship banking in that any bank that intervenes in order to assist a customer in difficulties is likely to have its seniority as a debtor reduced. These laws are based on the principle that creditors of any bankrupt company should be treated equally, but the effect of this is to provide a fairly powerful disincentive to active intervention. Insider trading legislation militates against active institutional shareholders, because if they obtain price-sensitive information as a result of involvement in a company they cannot trade without infringing insider trading legislation. As a consequence, corporate restructuring occurs through takeovers, as shareholders are tempted to accept bid premia and sell or 'exit' rather than become actively involved in the rescue by 'voicing' concern about the performance of management.

2 For an extended overview of the measures that have been taken to make the capital markets more attractive in Germany, see Schaede (2000).

3 This case draws on Nowak (2001).

4 German banks have the ability to exercise proxy votes at the shareholders' meetings of the AGs on behalf of shareholders who have deposited their shares with the banks for safekeeping.

5 See Baums (1994) for an elaborate explanation of the composition and functioning of the supervisory board.

6 Japanese banks were not selective in lending money and lent to dubious companies. Morally hazardous behavior is behavior without an appropriate level of care.

7 Zaitekumeans profit-seeking financial activity by the corporate treasury departments of large Japanese companies, which has resulted in an uncoupling of financial policies and financial executive decisions from overall corporate strategy.

8 Marketcapitalization,alsocalledmarketvalue,isthenumberofsharesinexistencemultipliedbythe share price.

9 Extracts from 'Italy needs are naissance in corporate and market regulation', Business Week, 2 February 2004.

10 The Dutch law on works councils requires firms with 35 employees or more to install a works council.

11 Under the normal regime, the establishment of a supervisory board is optional. In such a case, the members of the supervisory board are appointed by the general

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meeting of shareholders. The latter is endowed with considerably more power than it would be under the structure regime since it retains a number of important decision rights.

12 The majority of the information in this case is based on OnKitTam (2002), Eu(1996) and Lin(2001).

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