

Corporate Governance Notes

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Primer literature: Corporate governance and Board Decisions, Steen and Conyon
Course Plan:

L1	Large firms	ST pp. 19-32; LP1
L2	Agency Problems and Allocation of Authority	ST pp. 35-50; LP2
L3	Shareholder Supremacy and the Role of Law	ST pp. 91-95, 112-117, 221-230; LP3
E1	Exercise 1: Novo Nordisk	ST pp. 247-252; Case material
L4	Institutional Investors & the Extended Agency Problem	ST pp. 230-232; LP4
L5	Boards	ST pp. 263-271, 273-281, 291-299; LP5
L6	Stakeholders and Labor	ST pp. 118-119, 199-213, 280-281; LP6
L7	Nordic Corporate Governance	LP7
E2	Exercise 2: Tesla	(Case material)
L8	Int CG: Continental Europe	ST pp. 135-138, 151-164; LP8
L9	Int CG: Anglo-America	ST pp. 138-151; LP9
E3	Exercise 3: Kabul Bank	Case material
L10	Kleptocrats & Corruption	ST pp. 167-174; LP10

Exam:

No case study, but only a company name will be given. Is the entity well run or badly run? What relates to the corporate governance setup? Are there any key issues (i.e. scandals, failures, recent changes) of analytical interest?

Approach is up to your discretion, but you can use the guiding questions given, or just disregard them completely.

- Contribution will not be evaluated on the students' ability to reproduce the theoretical contents of the course but rather the ability to use and apply them intelligently and creatively in a practical analysis.
- Will have to support your arguments
- Do a good job on the background research, as it will show who have detailed information (get to know the organization thoroughly, particularly the Library). Use several sources, and also consider the history of the organization.
- Ssrn.com
- You do not need to make an introduction. Only include facts that you are going to use for analysis and to conclude on.
- Pick your focus (e.g. on the incentive programs of a firm) and then don't be afraid to leave everything else out.
- Do not pick a random focus but justify why you have chosen this issue and evt. Mention different issues and why you chose this one.
- May not be as theory predicts.
- Graphs, tables etc. should be included in the appendix and then you reflect back on it.
- Theories from the textbook should not be explained, but we assume that Therese knows it.
- You will need to find your own information and sources and look into prior hand; what laws are in place, shareholder rights etc.- build your corporate governance references already.

Past exams: Novo Nordisk, Danske Bank, Cawa Bank, Kabul Bank, Facebook, Blackwater, Apple, Toyota, Google, SAS, Tesla, Canon, Northern Mining Resources. (Companies worldwide).

EXAM:

- Make pictures and graphs for Therese to look at in the appendix in the exam. Then you save a lot of space writing, when you can just refer back to tables. You can therefore instead just add more information.
- If you are going to talk about dependence, be careful in specifying the definition that you are using. Are you relying on a specific definition or are you creating your own? Be mindful of this, and the different definitions that could affect solutions.

Agency problems:

Type I: shareholders vs. managers

Type II: controlling vs. minority shareholders

Elon Musk is still a board member and he is controlling a vast majority of the shares.

Type III: shareholders vs. stakeholders

Structure

- A report, not a thesis
- Content matters
- You can write it formal like introduction – limitations – analysis – recommendation
- Or you can write more like an analytical article with headlines that reflects the content in each section – jump into the problem and write from there
- Read the task carefully

Success criteria

- Has done a **thorough job in background research**; details reveal good knowledge of the case company – The knowledge is essential, as it will come to show.
- **Has identified the relevant issue(s) and abandoned less relevant** or irrelevant ones (you do not have to state the irrelevant ones once you have identified the relevant issues.
- **Analytical text** (as oppose to a purely descriptive text), based on deduction and not speculation (i.e. with supporting evidence). Analysis based on deduction and backed by evidence.
- Follows a red line
- Strong and well-supported arguments, motivated and realistic conclusion/recommendation
- Logic and consistent use of theories, perspectives, analytical tools and models introduced in the course
- References (Use either reference you prefer, Harvard etc.).
- When you identify the relevant issue, motivate why you have chosen it (this is part of the assessment).

Bad exam:

→ Do not speculate, we direct about the problem you are identifying.

- Do not use too much space for description, which you will not be using. It has to relate to the problem and the corporation.
- Bad exams deals with problems that do not exist..
- Conclusion doesn't follow logically from analysis.
- Recommends to change owners, which is not possible (do not state impossible recommendations/scenarios).

Sources:

Social Science Research Network:

- Offers a dense and trustworthy selection of research papers

www.Ssrn.com

- Source on labor rights

→ Social protection:

→ Data; free and open access to labour statistics

<http://ilostat.ilo.org>

- Transparency International (most credible source)

<https://www.transparency.org>

- Company Law and Corporate Governance

https://ec.europa.eu/info/business-economy-euro/doing-business-eu/company-law-and-corporate-governance_en

- Publications on CG

https://ec.europa.eu/info/publications/governance-in-the-commission_en

- EUR-Lex

<https://eur-lex.europa.eu/homepage.html>

- Property Rights Index (Heritage Foundation)

<https://www.heritage.org/index/property-rights>

- Property Rights Index by (IPRI)

<https://www.internationalpropertyrightsindex.org/countries>

Disclosure of significant shareholders:

- Disclosure requirements of significant shareholders under the Transparency Directive varies across jurisdictions

https://www.esma.europa.eu/sites/default/files/library/practical_guide_major_holdings_notifications_under_transparency_directive.pdf

- Major issue following the Panama Papers; highlighted the opportunities for tax avoidance and corruption under opaque ownership structures
- Several countries have taken steps to increase transparency
- Denmark has opened the Beneficial Owner Registry
- <https://danishbusinessauthority.dk/beneficial-owners>
- <https://datacvr.virk.dk>

EU Web-page

Company Law and Corporate Governance

https://ec.europa.eu/info/business-economy-euro/doing-business-eu/company-law-and-corporate-governance_en

Publications on CG

www.ec.europa.eu/info/publications/governance-in-the-commission_en

EUR-Lex

<https://eur-lex.europa.eu/homepage.html>

Objectives:

- Explain, combine and analytically discuss theories, frameworks, models and concepts.
- Critically discuss the role of business in society, in the context of globalized markets and internationally active firms.
- Identify business challenges and opportunities arising from internal corporate governance challenges and external stakeholder pressures.
- Using the concepts and frameworks discussed in the course, sketch responses to these challenges and opportunities, and reason why those responses would pass the “good business ethics” test of critical observers.

Grading:

The final grade will be based upon identification of relevant governance issues, demonstration of analytical skills, critical and logical reasoning, consistent argumentation, application of relevant theory and supportive evidence, as well as the structure, clarity, and proficiency of the report. You are expected to demonstrate appropriate use of theories, frameworks, models, and concepts presented during the course in your analysis.

What matters?

- Ownership: are there better and worse owners?
- Boards: what constitutes an effective board?
- Managers: why don't they steal more?
- Incentives: pay for performance, good or bad?
- Company law: what legal elements make a difference?
- Politics: how could the political system influence how firms are governed?
- Business culture: what constitutes it?
- Individual's moral and immoral: how control?
- Corporate social responsibility / ethics codes: valuable control mechanisms?

- Accounting / auditing: enough transparency?
- Capital structure: how does this affect incentives?
- Market mechanisms: competition, labor market

Lecture 1: The firm

Readings:

- ST pp. 19-32;
- LP 1 (EXCERPTS FROM SMITH, 1789; BERLE & MEANS, 1932; COASE, 1937; WILLIAMSON, 1967; ALCHIAN & DEMSETZ, 1972; JENSEN & MECKLING, 1976; CHANDLER, 1977, ETC.)

Thursday 5. SEPT. '19 (11.40am)

1. THE FIRM

ST pp. 19-32; LP 1 (EXCERPTS FROM SMITH, 1789; BERLE & MEANS, 1932; COASE, 1937; WILLIAMSON, 1967; ALCHIAN & DEMSETZ, 1972; JENSEN & MECKLING, 1976; CHANDLER, 1977, ETC.)

This first lecture directs attention to questions on why large firms exist; how they arose and what benefits and costs they bring. The large firm is a post-industrial phenomenon. Its global dominance indicates significant benefits of organizing business in large entities. What are those benefits? Formulate your own answer to the question why not all economic activity is organized in large firms (or in a single giant firm that produces everything) if there is benefit in corporate size? Simply, why do we also have small firms? What determines the size of any particular firm? This lecture discusses these issues, and moreover, how size relates to corporate governance by producing different sets of problems. The most prominent problem – the agency dilemma – will then be outlined in greater detail in session two.

Corporate Governance: the control and direction of companies by ownerships, boards, incentives, company, law and other mechanisms. (*The system by which companies are directed and controlled*).

→ Mainly about the organization's board of directors (how it is composed, leadership, ethics etc).

→ About the control and direction of managers; and how managers can be controlled and directed by other more senior managers within the firm. (how we direct individuals).

→ Ensuring good decision-making and right allocation of scarce decision-making resources in society.

→ The principal and the agent (e.g. real estate agent & house seller). Control the relationship between the party that is delivering and the party that wants something delivered.

Corporate governance mechanisms:

- Law, reputation, and ethics, bonus systems, sanctions
 - Hard law, soft law, ethics, reputation, incentives, punishment.
- Obstacles: Often times, issues are handled too late.

The wealth of Nations by Adam Smith (1789)

→ The division of labor is limited by the size of the market. E.g. a porter will find that a small city is too narrow for him to afford him constant occupation. When places are scattered, people are forced to do numerous jobs instead of specializing in something and then exchanging goods/services etc.

→ Difference when watching over your own and other's money.

Berle and Means 1932: Separation of ownership and control

"How corporate governance started"

- The capital of an individual has a limit, and you need to bring in new people who bring in some capital.
- Firms become more complex, and grew out of the hands for firms, causing the separation.

Basic governance problem:

Agency problem: 'separation of ownership and control'. The owners (shareholders) entrust the agent (managers), but the two parties may have different incentives/interests. The agents act on behalf of the principal.

→ Asymmetric information between agent and principal (e.g. real estate agent & house seller) (e.g. doctor and patient), (government and citizen) → Can lead to incentives from the agent's side.

→ The problem is therefore magnified by the fact that agents often have more information than principals.

→ Monitor and align the interests between the principal and the agent.

→ Arises from the 'rule of man' (*Homo Economicus*), that you prioritize yourself first, until a certain financial standard. → **Interest divergence**, especially in firms, as there is money involved.

The extended agency problem:

- In reality, the corporate governance not only covers just the principal and agent, but many stakeholders can directly or indirectly influence the company's corporate governance.
- **Includes minority and majority owners**: *Suppliers of finance* (investors), *employees* (partners in consulting firms), *suppliers* (e.g. in the dairy industry, subsidiaries), *customers*, *The State* (e.g. China and authoritarian capitalism), *Competition* (in product, labor and capital market- the managers face tougher time with increased competition, easier to compare to the competitors and evaluate), *Social Norms*, *Intermediaries*.
- Enlightened agency theory, which takes into consideration behavioral and contextual modifications of the basic agency model.

The spice expedition to India:

Potential agency problem: 1) Company B may behave opportunistically, and take a larger margin than planned. 2) B doesn't intend to come back. Sees profit in keeping the ship 3) B says upon return he paid more than what he did for the spices. 4) B cannot evaluate quality of spices.

Returns with unsellable goods.

(Some agency costs are intentional (fraud), whilst other agency costs are not intentional)

Conclusion: Agency costs are difference in value between the firm at hand and a hypothetical firm, which no conflicts of interests.

Some sizes of firms are almost only reachable by incurring agency costs, meaning = costs of doing business.

Why establish the large firm at all then? If you incur agency problems...

The Nature of the Firm by Ronald Coase (1937)

Ronald Coase argues against Sir Arthur Salter, who mentions that the economic system is self-running and dependent on the mechanisms of supply and demand. He argues, that he provides an incomplete picture. If the production is regulated by price movements, it would mean that the market would just follow and an organization would not be necessary. But an organization is necessary.

- Resources are allocated by means of price mechanism or that the allocation is dependent on the entrepreneur-co-coordinator.
- A firm, therefore, consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur, not just the market mechanisms.
- Size: “diminishing returns to management”, allocation of resources.

Other things being equal, therefore, a firm will tend to be larger:

- (a) the less the costs of organizing and the slower these costs rise with an increase in the transactions organized.
- (b) the less likely the entrepreneur is to make mistakes and the smaller the increase in mistakes with an increase in the transactions organized.
- (c) the greater the lowering (or the less the rise) in the supply price of factors of production to firms of larger size.

Coase's calculus:

- There must be a trade-off between buying things and making things!
- Costs attached to buying from the market can be substituted for the costs of producing.

Chandler (1977), on institutionalization

Two ways to view the firm

1) The firm-oriented view

- Ensuring firm survival, which is the management's main goal
- Focus on customers, sales and expenses, accounting-oriented
- Management's main goal is to ensure firm survival
- Focus on long-term survival is dependent on the firm ability to position themselves at the market.
- Focus on customers, sales, and expenses
- Accounting-oriented

2) The owner-oriented view

- This will usually dominate the firm
- Management's main goals is to maximize the firm value

-Stakeholder-sensitive

- Management's main goal is to maximize the firm value
- Decisions concerning growth generating issues depends on the consequences they are estimated to bring to firm value
- Means that management have to take the stock market reactions into account when making decisions
- The firm is not a "charity organization"
- Stakeholder sensitive: the most profitable could be to close down

Jensen's free cash flow hypothesis:

- **Interest divergence** is an especially severe problem in firms with large free cash flows
- More cash than profitable investment opportunities = higher risk of non-value maximizing use of resources.
- Reduction of free cash (by dividends) reduces the amount of resources under managerial control, and thus, reduces the risk of managers allowing firms to grow beyond optimal size.

Takeovers as a control mechanism:

-Polly Peck example.

-A small textile company began in 1940s but purchased 58% company stock by Asil Nadir in 1980s.

-It involved into many different industries and purchasing ventures later on.

-Cash flows invested in different industries, where it does not have its core competencies, but growing its firm.

-Excess amounts of free cash flow invested in failing businesses generate a wave of takeover activity.

-A gap between the price and actual value.

-The threat of being taken over can have a disciplinarian effect on managers.

FRIDAY 6. SEPT. '19 (09.50am)

2. AGENCY PROBLEMS AND THE ALLOCATION OF AUTHORITY

ST pp. 35-50; LP 2 (EXCERPTS FROM EASTERBROOK AND FISHEL, 1989; GILSON & GORDON, 2005; GROSSMAN & HART, 1980, 1986; HANSMANN & KRAAKMAN, 1991; HART, 1995; KRAAKMAN ET AL, 2005; 54. WOODWARD, 1985, ETC.)

The agency problem is fundamental in corporate governance debates. It arises when ownership separates from control and creates a need for frameworks that can guide the exercise of authority and protection of investments. Corporate law defines the standard contract between agents and residual claimants of cash flow. We will go through agency theory and discuss the legal regimes that exist to govern corporate relationships. Most attention is directed to the limited liability corporation. What are the benefits of limited liability? What implications does limited liability have on the allocation of authority? In relation hereto, we will discuss different types of agency costs, including the double trust problem and how it affects innovation. We will also outline the basics of property rights and contract rights in relation hereto, and how corporate law complements it.

The two agency issues:

Adverse selection	Moral Hazard
<p>Adverse selection:</p> <ul style="list-style-type: none"> • Hidden knowledge, occurs when information is available to the agent but not to the principal • Once the ship leaves Copenhagen <p>→ (B will know if the ship sails optimal route or not)</p> <p>→ B knows the external prerequisites during journey; weather etc.</p> <p>→ B knows more about use of resources during trip, i.e. operating expenses</p> <p>→ B knows more about the spices quality and purchase price.</p> <p>→ B also knows his own intentions and objectives</p> <ul style="list-style-type: none"> • Information asymmetries / hidden information • Agent knows more than manager and can use this to draw benefits • Limits the principal's ability to monitor 	<p>Moral Hazard</p> <ul style="list-style-type: none"> • Hidden action- activities by the agents that cannot be observed by the principals • In India example: <ul style="list-style-type: none"> ○ B takes off elsewhere ○ B sails slower than possible ○ Pays overprice for goods ○ Negotiates a real good deal and gets more goods than agreed but keeps some to sell by himself ○ Originally an insurance term <p>Risk sharing – What could be the mechanisms?</p> <ul style="list-style-type: none"> ○ Makes the agent a partner – share costs, share profits ○ Pay for performance/payment in shares <p>Double trust problem (Cooter & Schäfer, 2011)</p>

Free transferability

- Contributes to discipline managers as poor governance is reflected in share price (and can attract raiders that replaces management)
- Under limited liability, shares are fungible (interchangable)
- Trade at same price at one market
- Allows easy sale and purchase, without respect to who the other investors are
- Exit does not destroy innovation

→ Connection with agency theory: Limited liability firms can grow very large (larger the firm, the more layers of management, and the more the agency problems in each layer).

Agency problem and ownership structure

- 1) Concentrated ownership: one, or a small group of investors, hold a majority of the shares (control rights, not cash flow rights) → Mainly Nordic countries, Asian
- 2) Dispersed ownership: no individual owner, or small group of owners, hold a majority of the shares. (Mainly in the US, ownership defined as 1% is defined as big) (Anglo-America). Typically goes with the shareholder-oriented view, and strong managerial power, as no one is challenging the manager with a dispersed ownership structure.
→ Board + managers are in one entity (one-tier boards) as opposed to the separation of board and managerial tier which you find elsewhere.

Facebook Mini-Case:

B-shares: Hold 10 votes per share

A-shares: Hold 1 vote per share

The shareholders have appr. 30% of the voting power, but under agreement they will by default always be the same as Zuckerberg's own votings.

Study questions:

- 1) What could be the underlying objectives of this uniquely negotiated deal between Zuckerberg and Facebook's high profile investors? Why do you think the investors accepted the deal?

In some ways, you could say that Zuckerberg acts as the agent, as he is the one with the knowledge of the organization and the future of Facebook, whilst the shareholders are not. The shareholders are willing to obey Zuckerberg, as the shares may be highly attractive/lucrative to hold. It is questionable whether or not people (investors) do agree upon this. He might otherwise have kept the corporation private. The cash flow rights still belong to the investors, and were perhaps satisfied.

- 2) What problems do ISS fear from this kind of governance arrangement? Could institutional investors face particular risks and difficulties because of the deal? (Hint: consider indexed funds).

Stated by the ISS as "irrevocable proxy". Proxy = vote. Means that he contracted that the vote of his shares will always be the same as his. He can attract capital externally, but the same power as himself. Likely set-up has not been seen before.

The power is consolidated by one man alone, which means that it can easily be abused.

Hubris = excessive pride or self-confidence.

- 3) Imagine that you have some capital which you aim to invest in the stock market. You consider Facebook as a potential investment opportunity. Would you invest knowing that founder Zuckerberg's power position cannot be challenged? Why? Or why not?

Ownership and Agency problems:

- Type 1: Owners- managers (classical agency problem)
- Type 2: Dominant owner vs the minority investors (we are risking that the dominant owner is pursuing his own interests which can be other interests than profit which include private benefits or control in itself, prestige, reputation access to company information, not in the interest for the investor collective. The minority can only have one interest, which is profits)

Examples of Type 2 costs:

- Controlling owner overpays himself
- Tunneling = contractual arrangements that favor the owner
- Selling control at a premium
- Private benefits, i.e. use the company jet etc.
- Agency problems between family members (hiring family members e.g.)

Reflections: Because it is costly to hold a controlling position and monitoring, some private benefits might be necessary to incentivize an individual? The costs may be smaller than the alternative (type 1).

→ Controlling investor reduces type I costs, but causes type II costs

- Type 3: Shareholders – Stakeholders (deal within the stakeholder-labor-issues section)

Path dependency:

- Attempts to explain why national systems of corporate governance differ, despite efforts to converge them.
- Explanations to why differences occur.
- Explanations to why differences persist.
- Building on path dependency idea: as things happen old doors are closed and new doors are opened.
- Path dependency occurs in two ways: through structures and through rules.

Summary:

The three types of agency problems:

Type I: shareholders vs. managers

Type II: controlling vs. minority shareholders

Type III: shareholders vs. stakeholders

What is the most serious one?

Lecture 3: Friday 13. SEPT. '19

Friday 13. SEPT. '19 (09.50)

3. SHAREHOLDER SUPREMACY AND THE ROLE OF LAW

ST pp. 91-95, 112-117, 221-230; 232-239; LP 3 (EXCERPTS FROM BAUMOL, 1990; BEBCHUK, 1999; DJANKOV ET AL, 2000; LA PORTA ET AL., 1997, 1998, 1999; EDWARDS & WEICHENREIDER, 2004; GILSON, 2005; HANSMANN & KRAAKMAN, 2001; KRAAKMAN ET AL, 2005; MORCK ET AL, 1998; 2005; MORCK & YEUNG, 2003; ROE, 1994, ETC.)

In session three we will discuss corporate ownership; its differences in type and nature, and why ownership has developed differently across the world. We start by outlining the advantages and disadvantages of different ownership structures, as well as how owner identity affects the agency problem. We then turn to the question of why patterns of ownership can be seen across nation states. Why do different ownership structures and owner identities dominate in different geographical areas? What mechanisms give rise to ownership dispersion and vice versa? The discussion is guided by nominal corporate governance literature by La Porta et al. Study their articles closely. Particularly consider the index of separation of ownership and control. Can you find common features of countries that have more or less ownership dispersion? Also re-

consider readings from earlier lectures and think about how law can incentivize and restrict corporate investors.

Terms:

Adverse Selection Problem: Asymmetric information → Importance of selecting the most competent manager, even if it means it will not be the owner of the corporation, as that manager may have more information.

Block-holder: an influential shareholder because of the significant block of the company's stock or bonds that they own. Generally, there is not a specific number of shares that defines a block-holder.

Ownership: A set of rights (and obligations) concerning assets such as user rights (usus), profit rights (usus fructus) and control rights (abusus) including rights to sell or change.
→ Confers to responsibility

Common law vs civil law:

- The legal systems are influencers on corporate governance
- Common law systems are more likely to protect property rights, including the rights or minority investors (stock market is well-developed in common law countries).

Common Law

- Based on judicial opinions
- Interpretations considered more of a guide
- Laws might be altered over a single ruling
- Laws are acquired over time
- Flexible and rich (every case has its solution)

Civil Law

- Based on codes
 - Roman empire roots ("Corpus juris civilis")
 - Literally followed
- Updates through legislation
- Rulings based on previous interpretations
- Stable, but reluctant and slow-moving (same solution for every case)

Common law: Court rule, dependant on the nature of the individual cases, and there are different solutions to that (alters a lot over a single ruling, as the cases should be handled differently from previous similar cases).

Cons: the outcomes are unpredictable

Civil law: Based on codes, which are literally followed

Pros: More predictable outcomes, and the same cases have the same outcomes

4 types of civil law

- **Code Napoléon:** France, Belgium, Italy, Romania, Spain, + former colonies
- **Austro-German:** German speaking countries, Greece, Portugal, Turkey, Japan, Korea
- **Scandinavian:** originally Denmark, Sweden, and Norway (now also Iceland and Finland)
- **Mixed:** Scotland, Netherlands, Poland, Balkans

Impact of law:

- Impact on the development of financial markets
- Impact on property rights and contractual arrangements
- Impact on minority investor protection
- Impacts the agency relationship, the nature of corporate governance also affects the agency problem.

Q: can law have a direct impact on how ownership develops (and consequently what kind of agency relationships develops), and if so, how?

The logic assumption:

- If legal origin was set up before financial outcome, then financial outcome cannot have caused legal set up
- As the legal system was put in place first, it should have an impact on the financial markets and its establishments. Logically, something must have started it.

Which initiatives would cause the ownership to go dispersed, public, private, the level of control etc?

Rafael La Porta et al(1999)

Countries with very good shareholder protection, most firms are controlled by families or the State. Equity control by financial institutions is far less common. The controlling shareholders typically have power over firms significantly in excess of their cash flow rights, primarily through the use of pyramids and participation in management.

- This research suggests that in many countries large corporations have large shareholders and, further, that these shareholders are active in corporate governance
- Most firms are most commonly controlled by families or the state
- Typically families and wealthy individuals hold control in excess of cash flow rights (exceptions found in the US and the UK)

Aim: What explains the national differences in ownership patterns?

- Could corporate law be an explanatory factor
Hypothesis: poor corporate law results in concentrated ownership

How to measure legal protection?

Poorer protection => larger deviations from one-share one-vote principle (Grossman & Hart, 1988)

Poorer protection => more pyramids and formal control structures (Wolfenson, 1988)

Anti-Director Index: How good of a protection that the law offers the investors

1) Mailed proxies allowed

-voting shares as a shareholder through mails

2) No share deposit requirement

-no need to deposit your shares before the general meetings, which you usually do before the annual meeting, meaning you would here have access to them.

3) Cumulative voting to the board is allowed

-Can put their votes into an issue they find vital

4) An 'oppressed minorities' mechanism (statutory right) is in place

-They can take the corporation to court and challenge a business decision

5) Shareholders can call XAGM at 10%

Shareholders can call at an extra annual meeting. If you gather a coalition of 10%, e.g. a proposal or board reelection.

6) Shareholders have preemptive rights that can only be removed by a shareholder vote

Existing shareholders have a first-hand right to purchase shares in the case of e.g. a merger, in order to keep the value of their own shares.

If a country fulfills one point, they will get 1 point. No countries get 6 countries.

Relationship between the protection and ownership structure

- Significant relationship between level of protection and number of widely held firms: the stronger protection the more firms are widely held
- Findings suggest that common law better enables controlling investors to divert at attractive prices
- **Q: What might be the weak spot?**
All the Nordic countries have weak systems to protect the investors.

Is the index relevant for all nations?

What alternative variables to measure minority protection? There might be other variables in other countries, that the anti-director index has overlooked.

1) Shareholder rights; expropriation of the company, overtaken by the government offers shareholders no right to pull out or power over the control or value of their shares.

- Right to make proposals to the general meeting regardless of holding stake
- Right to verbally confront management at AGM
- Right for shareholders to elect the auditor
- Right for shareholders to approve executive compensation
- Amend bylaws by simple majority

2) Governance structure; the role of government, the corruption levels, meritocracies.

- Requirements for firms to have independent board members
- Requirements to have board committees
- **CEO barred from also being chairman**
- Limitations on the number of seats a director can hold
- Minority representative on board (which countries allow minority representatives in the board)
- Limitations of cross-shareholdings (lock in the control)

3) Transparency; the stock issuance information, number of shares, distinction between A-shares and B-shares.

- Open ownership books

- Disclosure of final owner
- **Requirements on auditors**; limited auditing periods, explanatory notes, full disclosure, available for shr questions at AGM
- Other positions and holding stakes of board members disclosed
- Compensation packages disclosed on individual basis (+require shareholder approval)

*These alternatives might give a different index, different view, different numbers and rerun the study and get some different/better results for countries ranked in the lower protection.

Reconsider the legal families:

- We differ between four legal families
 - English origin (common law)
 - French origin
 - German origin
 - Scandinavian origin
- Which legal system is applied in a country is usually a consequence of occupation or colonization previous in history (path dependency + legal transplants)
- The willingness to sell equity depends on the ability to raise external capital, which depends on the size of the capital market.

Summary, descriptives:

	Common Law	French Law	German Law	Scandinavian Law	Average all countries
Capital markets	0.60	0.21	0.46	0.30	0.39
Firms/population	35.45	10	16.79	27.26	22.38
IPOs	2.23	0.2	0.12	2.14	1.17
Legal strength	3.39	1.76	2.00	2.50	2.41

Common law countries have large capital markets. German law also does. The number is per million people.

Findings in summary

- Quality of corporate law correlates with separation of ownership and control
- Control and cash flow separate more often in countries with lower minority protection (thus higher private benefits can be assumed)
- English law generally “better”
- French law generally “worst”
- Rich countries enforce law stronger
- French law have the overall lowest enforcement quality

How does theory fit reality in the Nordics?

-In reality, a very unique combination

Anglo-Saxon features

- Large and liquid stock markets
- Easy access to finance
- Many and large firms
- High number of IPOs
- Large inflow of foreign investments
- Strong transparency
- Low minority expropriation

Cont. European features

- Strong owners, weak managers
- Dual-class shares
- Pyramids, business groups
- Stakeholder orientation
- Two-tier boards
- Employee representation
- Low executive compensation

Many firms constitute of one or a few owners, who are then usually also managers.

○ **Problems with large owners:**

- 1) More risk-averse (affects corporate strategy), hence all eggs are placed in one basket
- 2) Risk of exploitation of minority investors
- 3) Succession within the family, not maximizing the shareholder value.

Tobin's Q (company performance) and Management share;

- Positive correlation in 0-5% board range; positive incentives
- Negative correlation in 5-25% board range; entrenchment effects, difficult for investors to replace the board.
- Positive correlation beyond the 25%, as company is dominated by dominant owner, who internalized- alignment between shareholder value and ownership share.

○ **Problems of the absence of large owners**

- 1) Shareholders are much weaker, even though they can turn up to annual meetings and vote, the managers arguably do not have as big incentives to keep them happy. (but Shareholder Activism does exist, such as selling off their shares and lowering firm capital). Problems with shareholder activism include 'free-riding'
- 2) Entrepreneurial shareholder activists (hedge funds and private equity firms) can influence companies.

International Corporate Governance Systems:

US: Dispersed ownership: e.g. in the company executives are held accountable by the shareholders as a whole rather than by controlling block-holders. Money-making machine. Common law.

Japan: Keiretsus. Shareholders have little to no power and are of secondary importance to the customers, employees. Civil law system.

China: Government majority ownerships by state or local governments, rule of man (the CCP). Civil law system.

India: Controlled by founders or founding families

Nordic Countries: Welfare state, unionized labor forces, rule of law, stakeholder systems. Civil law system.

Corporate ownership structure:

3 key elements

- 1) Owner identities
- 2) Ownership form
- 3) Ownership concentration

Ownership types:

- 1) Limited liability
- 2) Investor ownership
- 3) Family ownership
- 4) Bank ownership
- 5) Corporate ownership
- 6) Government ownership
- 7) Non-profit ownership

Readings for 3rd session:

Particularly consider the index of separation of ownership and control. Can you find common features of countries that have more or less ownership dispersion? Also reconsider readings from earlier lectures and think about how law can incentivize and restrict corporate investors.

Excerpts from

LA PORTA ET AL, LEGAL DETERMINANTS OF EXTERNAL FINANCE (1997)

LA PORTA ET AL, LAW AND FINANCE (1998)

LA PORTA ET AL, CORPORATE OWNERSHIP AROUND THE WORLD (1999)

ROE, POLITICAL DETERMINANTS IN CORPORATE GOVERNANCE (2003)

GILSON, CONTROLLING SHAREHOLDERS AND CORPORATE GOVERNANCE:
COMPLICATING THE COMPARATIVE TAXONOMY (2005)

HANSMANN & KRAAKMAN, THE END OF HISTORY FOR CORPORATE LAW (2001)

Lecture 4: Institutional Investors & The Extended Agency Problem

Thursday 19. SEPT. '19 (11.40)

4. INSTITUTIONAL INVESTORS & THE EXTENDED AGENCY PROBLEM

ST pp. 230-232; LP 4 (EXCERPTS FROM AGGARWAL ET AL, 2011; BAINBRIDGE, 2005; BEBCHUK, 2005; BLACK, 1992; BLAIR, 1995; BRAV ET AL, 2008 CHOI ET AL, 2010; GILSON & GORDON, 2013; GILSON & KRAAKMAN, 1991; KAHAN & ROCK, 2007; KARMEI, 2004; NORDEN & STRAND, 2011; ROMANO, 1995, 2001, ETC.)

We continue our discussions on the agency dilemma. Can agency theory be applied when institutional investors enter the scene? What is the result and what conclusions can be drawn on how allocation of authority shifts with this particular ownership category? Do institutional investors imply any particular benefit in corporate governance? What new problems can they create? Consider differences in prerequisites and agenda between different investor types. Think of the effects of globalization among institutional investors in the light of the readings from the previous session. What is your conclusion? Finally, when you have identified the limitations of institutional investors; can you imagine ways for other market participants to profit on their shortcomings? What new players arise, and how do they affect the agency problem?

Institutional investors: an entity which pools money to purchase securities, real property, and other investment assets or originate loans. Institutional investors include banks, insurance companies, pensions, hedge funds, REITs, investment advisors, endowments, and mutual funds.

Institutional Investors

- defined, organizations such as: pensions funds, mutual funds & insurance companies that **invest on behalf of their members**
- mostly **passive** investors, but respond to regulatory demands for voting
- many directly or indirectly follow **index strategies**, others have actively managed portfolios, many outsource investing to asset managers: eg Blackrock.
- will typically just hold a **few percent in an individual firm** (due to regulation and for diversification)
- can structure investments as they please (avoiding control & insider problems) = they have significant power.
- 'guardians of shareholder interests' → combined size of shareholdings in individual firm gives them **collective control** when ownership is dispersed.
- may value **shareholder value creation** more than other large shareholders.
- studies find a **positive impact of private inst. investor ownership on firm value**.
- political institutions tend to underperform
- NOTE: **window dressing**: selling off underperforming shares at years end → implies **artificial positive association** between institutional inv. and firm value.
- possibly no signif. association between governance mechanisms and inst. ownership. → however preference of paying managers less and use **performance-based compensation contracts**.
- many **Index** their portfolios: they use **market weights** as a guide for how much to invest in a given company -follow market portfolio – institution may also set limits for how much they can stray. (how large '**tracking-error**' can be.)

Indexing

positives

- simple (**cheap**) way to decide how to invest – no need for large staff
- objective: disagreements avoided by mimicking the market.
- **risk-management tool**: used to keep **idiosyncrasies** (optimism/pessimism) of fund managers in check
- theoretically founded in **modern finance**
- difficult/**impossible (?) to beat market**.

Negatives

- hard for corporate governance
- leads to diversified portfolios → impossible to exercise active ownership in all companies/up to date on them all.

- ^would not be economically rational to do so due to **free-rider problems**: other investors (who hold most shares) get most benefit, but don't share the costs.
→ result is an **undersupply of company info** in investing community. → **asymmetric information and agency problems**.
- can be subject to mean reversion in the medium and long term
- stocks that are high relative to earnings might tend to fall in the long term
- cheap stocks tend to appreciate: rationale for **value investment**: buy low and sell high
- consequence of indexing: stock that increases excessively also becomes more signif. in terms of **market weight** → inst. are obligated to buy more shares, which may fuel further price increases → can contribute to **stock market bubbles**.

Reasons for diversification

- **liquidity**: small shareholdings in large firms can be easily divested w.o. depressing stock price. (reason inst. like to invest in blue-chip companies)
- however large shareholdings in small firms can be diff. + costly to get rid of. – mandatory bid rule.
- **insider trading** – large owners may obtain company info, making it illegal for them to trade their shares – implies legal risks even by suspicion.
- small shares do not attract attention. → in case of **scandal**.. investors wont be held accountable..

Institutional Investors

General meeting (owners) -> Board -> Manager -> Employees
+ Stakeholders

Institution: those that manage other people's money

Institutional investors: pension funds, mutual funds, insurance firms, banks

Active and Passive institutions

Active institutions

- Actively managed
- Attempt to enhance the value of the portfolio by adjusting their holdings in accordance with assessments of corporate valuations
- Rationale is the belief that value can be increased by targeting weak performers

Passive institutions

- Indexed funds
- No manager
- Match the returns from a broad average of stocks
- Underlying logic: extremely difficult to outperform the market continuously

Rapid growth of institutional holdings, because

- 1) Pension capital as new pension systems were introduced
- 2) Growth of capital markets

- 3) Private savings/promotion of capitalism to general public
- 4) New products = new opportunities to make money (hedge funds, derivatives)

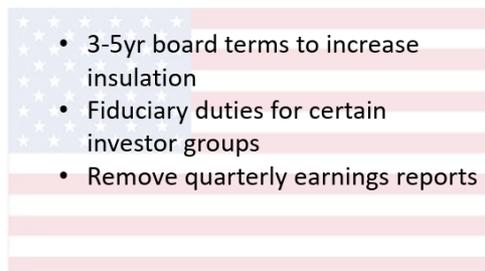
Are institutional investors the solution to agency problem? They have an incentive to monitor management closely. On the other hand, due to large size of institutions, do they have enough time to monitor all firms?

Time horizon: pension funds are accused of short-termism which contradicts sufficient monitoring. Money ends up with a long-term investor

- Evidence that the stock market is, net, short-termist is inconclusive.
- Indeed, evidence indicate undervaluation of long-term investments
- But the market also positively values investments that have a long term to fruition (R&D, capital expenditures, etc.), which would not be the case if it was dominated by myopic investors.
- Also much evidence that the long term is often overvalued, most obviously in the intermittent bubbles in technology and new industries.

Where does short-termism problem start? Managers (the US) or the investors (the EU).

Solutions suggested



Forced activism = institutional investors are required to be active monitors
 Institutions are often considered short-term on the basis of how they act.

Reasons for institutional investors to not be active within firms/monitor them

Lack of internal prerequisites?

- Fiduciary duties
- Investment objectives
- Investment strategies / horizons?
- Internal compensation structure?
- Pressure to perform on short-term basis?
- Competence?
- Resources?
- Information handling?

Lack of external prerequisites?

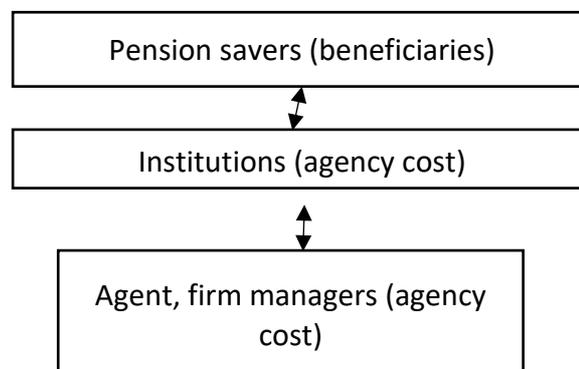
- Legal and regulatory system
- Institutional arrangements
- Free rider problems
- Collective action problems / ownership structure
- Internationalization?

Strand & Norden 2009

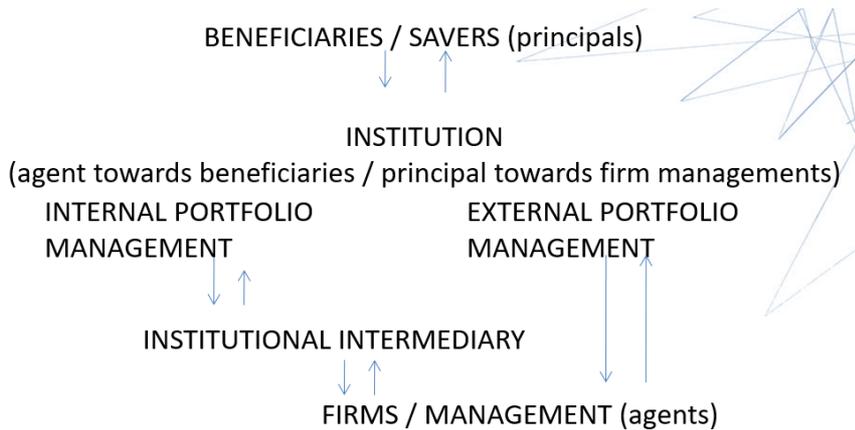
- Institutional investors have other incentives than value maximizing
- Institutions direct their activism towards firms that are
 - 1) Large in size
 - 2) Appear a lot in media
 - 3) with high proportion of institutional ownership

What is the difference between private principal and institutional principal (agency theory)?

- Institutional investor is an agent for the principal and principal to the original agent
- Perhaps institutional investors don't solve the agency problem – but just create another level of problems?



Who could benefit from the institutional weakness/conflict of interest? Intermediaries (proxy intermediary such as ISS who give recommendations about voting decisions)



Increased foreign institutional ownership and activism in Nordic firms: American activism particularly

- Systematic 'vote no'-campaigns?

Lecture 5: Boards

Friday 20. SEPT. '19 (09.50)

5. BOARDS

ST pp. 263-271, 273-281, 291-299; LP 5 (EXCERPTS FROM BHAGAT & ROMANO, 2007; GORDON, 2007; HALL, 2003; HERMALIN & WEISBACH, 2003; JENSEN & MURPHY, 2010 LANGEVOORT, 2001, ETC)

Boards constitute one of the most important pieces of the corporate governance puzzle and aims to solve agency problems on several dimensions. First, we will examine the basic questions of boards: what roles can the board take? Is there an optimal composition of directors? What are the duties of directors? How does boards affect firm performance and profitability? Agency theory literature is reconsidered once more. Directors are traditionally classified as either dependent or independent. What determines the classification, and why are independent directors considered particularly valuable? Does empirical research confirm this notion? In relation to this question, also re-consider the readings by Gilson & Kraakman (session 4); what solution do they suggest?

Summary (learning points)

- Boards are small groups who hold the decision-making authority in companies (and most other organizations)
- According to agency theory, boards exist to solve the agency problems which dispersed owners have in dealing with company managers. They are monitors elected by the shareholders.
- In management theory, boards are said to have other functions in addition to control, such as advising managers and networking.
- To exercise effective control, boards must be independent of the managers they are supposed to supervise.
- They must also be sufficiently small to allow effective decision making.

- There is little evidence that board structure has any systematic effect on company performance.

From the lecture:

Social ties:

- Small nations
- Few elite schools
- Small stock markets
- Language
- Gender
- Corruption

Shareholder-based:

- Norway and Sweden
- 3-4 largest shareholder (+potentially minority representation)
- Board chairman incl. as guest
- Shareholders make proposal to AGM

Board-based:

- 3-4 directors incl. chairman
- Evaluation of board work
- Proposal to AGM
 - Re-election
 - Election of new directors

Lecture 5.

Boards

- Central part of CG
- Monitoring
- Voted by shareholders
- Ratify managerial propositions
- Make proposals that are adopted or rejected by general meeting

Board work tasks

- Evaluation of finances
- Strategy
- Hire and fire CEO
- Executive compensation
 - Approved by AGM
- Nominate board members
 - Elected at AGM
 - National differences exist
- Stakeholder policies
- Advise executives
- Ensure the law being followed
- Risk management
- Investor relations
- Business relationships
- Networking

The control role - Monitoring function as stressed by agency theory

The consulting role - Stewardship as stressed by stewardship theory

The contact role - The networking function as stressed by resource dependence theory

Too much board efforts leads to declining marginal productivity of board work

Board composition: a hot topic

- Number of directors
 - Small board, large board
- Types of directors
 - Dependent insider
 - Dependent outsider
 - Independent
- CEO duality
 - Chairman and CEO same person
- Political connections
- Codetermination
 - Workers' representation
- Personal characteristics
 - Gender
 - Nationality
 - Age
 - Education
 - International experience

Dependent directors: Inside directors, Affiliated outside directors

Independent directors: In 1950, 20% of US directors were independent. 2/3 of 957 US listed firms had a majority independent directors in 1991. In 2005, 75% of US directors were independent.

Assumption that independent directors are more objective, therefore better at monitoring.

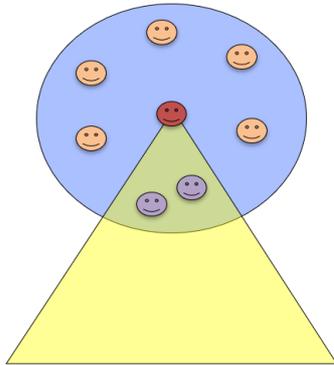
Independent, if NOT

- been an employee of the Company or group within the last five years;
- Has not, or has not had within the last three years, a material business relationship with the Company
- has not received or receives additional remuneration from the Company apart from a director's fee,
- has no close family ties with any of the Company's advisers, directors or senior employees;
- holds no cross-directorships or has no significant links with other directors through involvement in other companies or bodies;
- does not represents a single significant owner;

- has not served on the board for more than nine years from the date of their first election

Mixed results from whether independent directors lead to better performance.

CEO Duality



- Advantages
 - Less information asymmetry
 - Quicker decision process
- Disadvantages
 - Time constraints
 - Lack of financial incentive
 - Do not want board to intrude on CEOs freedom
 - Monitoring quality?
 - Executive compensation?

My notes:

The role of boards:

- According to agency theory – control, monitoring, information
- Boards and managers specialize in different stages of the decision making process
- Board: strategic
- Managers: operational
- Boards represent the shareholder collective
- Most commonly, managers develop proposals which are ratified by the board
- Board makes proposals which are adopted or rejected by the general meeting (shareholders).

Board work tasks:

- Evaluation of finances
- Strategy
- Hire and fire CEO
- Executive compensation
 - Approved by AGM
- Nominate board members
 - Elected at AGM
 - National differences exist
 - Stakeholder policies
- Advise executives
- Ensure the law being followed
- Risk management
- Investor relations
- Business relationships
- Networking

Board duties:

- Boards and directors have 4 duties
- Fiduciary duty to act in the best interest of the shareholders
- Duty of loyalty: act in accordance with the company's best interest
- Duty of fair dealing: directors may not personally take advantage of business opportunities
- Duty of care: duty to exercise the duty of loyalty with the care that can be expected from a prudent person

Alternative tasks/perspectives

Research proposes two alternatives to the agency theory to describe the role of the board:

- The control role
 - Monitoring function as stressed by agency theory
- The consulting role
 - Stewardship as stressed by stewardship theory
- The contact role
 - The networking function as stressed by resource dependence theory

Boards and CEOs

- Relationship affects board ability to solve agency problems
- Asymmetric information can be a problem
- Capable CEOs might have a personal interest in boards which can appreciate their work
- Empowered and particularly participative boards have the highest performance effects

How much board is optimal?

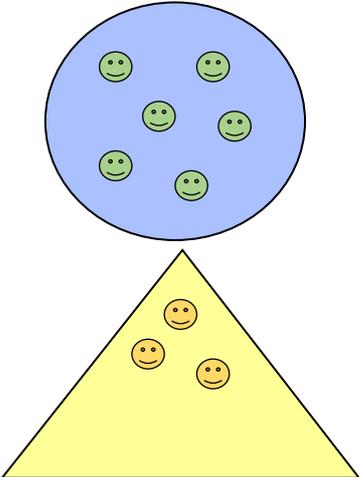
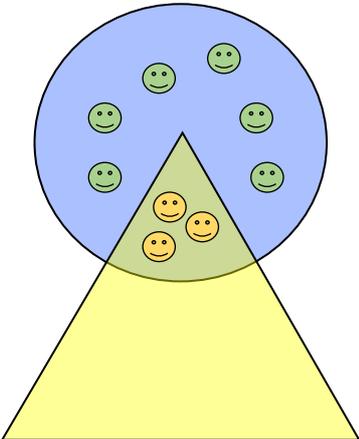
- How much board monitoring is “enough”?
- Marginal value of additional board work declines sharply and becomes negative if boards are too overloaded (Thomsen, 2008)
- Risk of overload seems to have increased
- Dysfunctional effects following:
 - Passivity
 - Delays
 - Risk aversion
 - Strategic mistakes
 - Insufficient control

What causes decline in productivity?

- Information disadvantage compared to mgmt
- Limited resources
- Group decision making
- More involvement = less objectivity
- Social and psychological effects reducing monitoring and influence

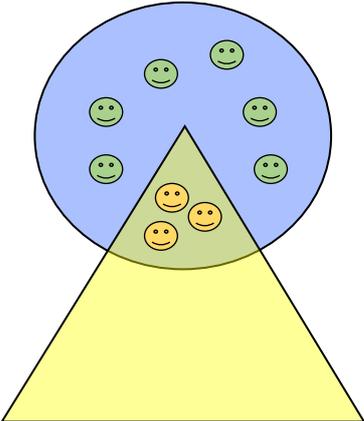
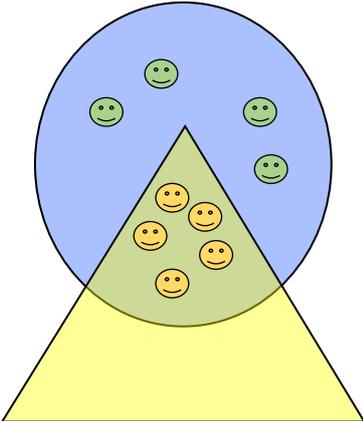
Two major types of boards

One tier board vs two-tier board:



Two types of one-tier boards

Majority executive board vs Majority non-executive board



Board composition: a hot topic

- Number of directors
 - Small board, large board
- Types of directors
 - Dependent insider
 - Dependent outsider
 - Independent
- CEO duality
 - Chairman and CEO same person
- Political connections
- Codetermination
 - Workers' representation
- Personal characteristics
 - Gender
 - Nationality
 - Age
 - Education
 - International experience

Director types

- Dependent directors
 - Inside directors
 - Affiliated outside directors
- Independent directors
 - In 1950, 20% of US directors were independent. 2/3 of 957 US listed firms had a majority independent directors in 1991. In 2005, 75% of US directors were independent.
 - From time to time a popular topic in CG

Board independence

- The most discussed aspect of board structure
- Assumption is that independent directors are more objective
- ... and therefore better at monitoring
- Argued that independent directors are more valuable as they are less committed to management, look at outside performance signals, and are less "captured" by internal happenings.
- Requirement of stock exchange to have ind. directors on board and committees
- What defines the independent director?

Definition of independence

- Directors that are not / has not:
 - been an employee of the Company or group within the last five years;
 - Has not, or has not had within the last three years, a material business relationship with the Company

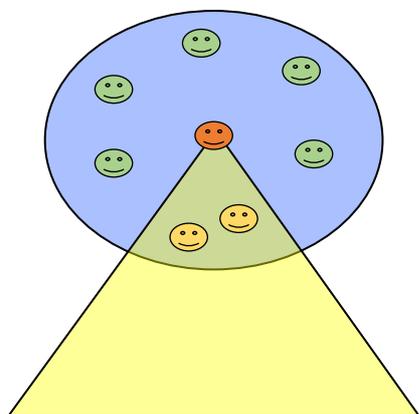
- has not received or receives additional remuneration from the Company apart from a director's fee,
- has no close family ties with any of the Company's advisers, directors or senior employees;
- holds no cross-directorships or has no significant links with other directors through involvement in other companies or bodies;
- does not represents a single significant owner;
- has not served on the board for more than nine years from the date of heir first election.

Independence and performance

- It's being argued that independent boards are better at monitoring (which should lead to higher performance) but empirical studies report mixed results
 - "Reasonable number" of ID increase performance
 - ID better at improving specific tasks (replacing CEO etc)
 - ID increase after bad performance (Hermalin & Weisbach, 1983)
 - No tendency to increase ID during 5 years prior to corporate failure (Chianti et al, 1985)
 - Conflicting evidence:
 - Firms with independent directors perform worse (Yermack, 1996)
 - And have slower growth (Bhagat and Black, 1997)
 - Results might be affected by inability to determine who is truly independent

CEO Duality

- Advantages
 - Less information asymmetry
 - Quicker decision process
- Disadvantages
 - Time constraints
 - Lack of financial incentive
 - Do not want board to intrude on CEOs freedom
 - Monitoring quality?
 - Executive compensation?



The codetermination feature

- Mandatory employee representation in several European countries
- Some claim that employee representation is essential to ensure employee investments in specific skills
- Opponents claim that codetermination put the firm at risk of becoming labor-managed and less competitive
→ Co-determination may raise agency costs.

Audit committee

- Operating committee comprised by a small number of directors
- Financial supervision; reporting and disclosure
- Closely working with the auditor; provides information etc.
- Required by stock exchanges
- Effect of Sarbanes-Oxley

Board composition and executive pay

- More independent directors = higher executive compensation packages
- How can this be explained from an agency theory perspective?
- Could compensation contracts which award managers who outperform the market or peers substitute for strong boards?

Stock options:

The stock options encourage the managers to work and look towards the future. You want the CEO to stay in the firm and stay committed in the firm. The bonuses are rewards for what you did in the past.

Pros and cons with stock options

Pro:

- Keep important employees within the firm
- Turn around managers with bad understanding of shareholder value
- Induce long term commitment

Con:

- Shares prices are not solely affected by the employees performance
- Only certain positions are rewarded
- Employees tend to become "too rich"

Takeaways from the Tesla case; the role of dependence vs Independence:

- Elon Musk takes on a peculiar role/position in the firm. He has good track records. He has made good investments for his investors.
- Lack of monitoring. High degree of dependence before his controversies and the SEC intervention.
- If the other corporate governance setups were sound in the corporation, then he would not be the problem.

- It is the combination of him together with the other mechanisms that creates something that cannot be altered without his explicit consent. That is the issue here.
 - He is not interested in governance: He has said “If you want corporate governance, then why don’t you buy 4”. He is not into it.
 - Dependence vs independence (the importance of independence)
 - Holding requirement: There is a minimum holding requirement; if you want to be a director of the board, then the articles of association state, that you need also to be a stockholder holding stocks value that is 6 times the directors’ fee. This is also a barrier of entry.
 - Index funds: If Tesla affects the index, then the index funds are forced to buy, because otherwise the Index cannot follow (?).
 - Independence creates better performance, higher level of transparency and monitoring.
-
- CEO Duality (before the changes in the board and the SEC filings, before he stepped down as the chairman).
 - After the Twitter Scandal, the SEC imposed the guidelines, Elon Musk took a step back from chairman. Reduced the Board of Directors from 11 to 7. This has had an impact.
 - It is only for 3 years that he cannot be reelected (illustrates pretty well, that the only body that could control him was the SEC). He is only the CEO, the SEC forced Musk off of the Chairman position, and also forced independent directors to be elected to the board.
→ This was in order to avoid the prosecution from the SEC, when he stated he wanted to take the company private.
 - His position makes monitoring difficult, as with a dependent board.
 - The dispersed ownership which in effect means that 85% of the minority shareholders have to form a coalition in order to stand up to Musk’s position; means that Musk has almost become institutional.
→ And still have the issue, that even if they managed to form the coalition, then the board has exclusive authority to cancel or postpone the AGM (Annual General meeting). This means, that the 85% in effect would face a difficult time doing anything.
 - Super-majority voting requirement (?).
 - The products and the batteries.
 - After stepping down as chairman, he also wrote on Twitter, which he was not allowed to. His control was then kind of taken away, which means that he could probably not write everything he wanted to.

Lecture 6: Stakeholders

Thursday 26. SEPT. '19 (11.40)

6. STAKEHOLDERS AND LABOR

ST pp. 118-119, 199-213, 280-281; LP 6 (EXCERPTS FROM BERLE, 1931; BOTERO ET AL, 2004; DODD, 1932; FALEYE, 2006; HOPT, 1994; PAGANO & VOLPIN, 2005; ROE, 2003, WILLIAMSON, 1984, ETC.)

Stakeholders constitute a very broad category of corporate constituents. Who are the stakeholders? What interests do they bring to the debate, and can they alter the view on what role

the company should play? Is it possible that the company could play another role than that stipulated by profit-maximization? How can "stakeholderism" be viewed in the light of agency theory? Does it lower or raise agency costs? Consider a classical debate between Adolph Berle and Merrick Dodd: what are their views? In Germany and Scandinavia codetermination is commonly employed as a formal mechanism to provide stakeholders (employees) with influence over the corporation. What is the main argument in favor and against of such board representation of non-shareholders?

International differences in board structure (from the Book- pages 199-213):

One-tier systems:

- Shareholders elect supervisory board members – which are part-time non-executive directors – and occasionally also a minority of executive directors to a supervisory board.
- USA, UK, China and Japan

Two-tier systems:

- Shareholders elect supervisory board members – which are part-time non-executive directors – and occasionally also a minority of executive directors to supervisory board which evaluates company performance, hires and fires the management (the executives) and must approve all major decisions.
- Germany and Scandinavia.

CSR and Stakeholders:

- It is important to align the stakeholders' interest with that of the firm's.
- It can be difficult to distinguish the important/main stakeholders.
- The board must strike the best balance between the often-competing objectives of multiple interest groups.
- E.g. trade-off between the shareholder and employee welfare, if the shareholders want a higher profit whereas and cost-cutting, meaning the employees need to be fired → Unemployment.
- We expect that the firm acts in a way that is responsible in both a legal, ethical and responsible way.
- Social responsibility encompasses the expectations that society has of organizations at a given point in time.
 - Economic
 - Legal
 - Ethics
 - Philanthropic

Climate change, resources, safer materials.

→ CSR can have a positive influence of a firm's financial performance.

Conclusions of CSR:

- The way that firms seek to voluntarily align the interests of the owners and other stakeholders with the long-term best interests of society.
- Empirical evidence is mixed
- CSR policies improve a company's product reputations, and are successful in attracting talented employees.
- The cost vs benefits of CSR are not always apparent/evident from evidence.
- **Issues:**
 - 1) Who are the stakeholders?
 - 2) How is social welfare defined?
 - 3) How do we balance competing interests? These are challenging, but worthwhile tasks.
 - 4) The role of responsibility: The sustainable business would cost more, but would people then be willing to pay, and how would they affect the profits of the business.
 - 5) The stakeholder problems do not occur truly from shareholders themselves, but from the customers etc.
 - 6) Costs vs benefits (shareholder profits) and the risks of losing customers (Ex: The Rana Plaza Collapse)
 - 7) How much are people willing to pay for products/services that are ethical and ecological.
- **Critics of CSR:**
 - 1) **Milton Friedman** was highly critical of CSR policies; believing the CEO had no right to engage in philanthropy with investors' funds.
 - Negative or zero-sum outcome at best.
 - The corporate executives have a work-task, and by doing that in the best way possible, they contribute to society.
 - Not certain that managers exercising social responsibility according to their own good would really do good.
 - Then you also contribute with taxes, (there is a social responsibility aspect to making profits), which in turn contributes to the greater society.
 - 2) Contemporary views are more sanguine (optimistic/positive), where Tirole stressed the importance of 'win-win strategies', where both the firm and the society are better off promoting CSR policies.
 - Positive sum outcome

Employee representation:

- Some countries have mandatory employee representation on company boards.
- Some argue that employee representation is vital, necessary to ensure employee investment in firm-specific skills, particularly in forms where human capital is important.
- In absence of co-determination, employees will use other, costlier ways to seek influence, such as strikes.

- But firms with high levels of employee determination run the risk of becoming labour-managed firms.
 - The firm value decreases, as more focus and power towards securing employments so labour costs are higher.
 - Performance decreases when employees are in the majority.

During Lecture:

Being accountable and taking into account:

Stakeholders to whom the firm is accountable:

- Banks, creditors
- Employees
- Auditor

Stakeholders the firms need to take into account:

- Business partners; sub-contractors, distributors
- Customers
- Environment
- Children
- Society (particularly less developed/non-democratic?). These societies do not have the same prerequisites to protect themselves.
- Other reputational agents.

Examples of different laws protecting the stakeholders. The contracts indicated on the right.

	Law	Contract
Banks, creditors	Securities, creditor rights, transparency, bankruptcy regulation	Yes
Employees	Labor law, Discrimination Law	Yes
Sub-contractors		Yes
Distributors	Transport law	Yes
Customers	Customer law, product law, marketing law	No
Competitors	Antitrust: cartels, collusion, monopoly; Licenses & patents	No
Environment	Environmental laws, omission, pollution	No
Children	Children's rights, labor law	No
Society	Taxation, insider regulation, corruption law	No
Reputational agents	Auditing regulations, accounting law, whistleblower protection	Depends on actor

Inputs and interests:

Think about what the stakeholders want in exchange.

<http://ilostat.ilo.org>

Source on labor rights

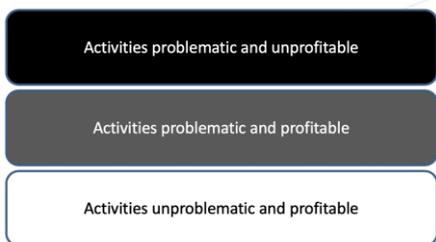
→ Social protection:

→ Data; free and open access to labour statistics
 Social protection and labor data.

<https://ilostat.ilo.org/topics/social-protection/>

	Input	Interest
Banks & creditors	Loans, venture cap...	Repayment, return on investment
Workers	Labor	Salary, employment
Sub-contractors	Production material	Payment
Distributors	Transport networks	Payment
Customers	Payment	Products & services, ethics
Competitors	Incentives to develop	
Environment	Raw material	Sustainability & protection
Society	Regulation, institutions, subsidies...	Tax, employment, growth, development
Reputational agents	Audits, ratings	Credibility, transparency, payment

Only gray zone relevant:



In the gray area; Here we might find issues; it is only a problem if there is issues with shareholders and their interests.

***Type 3 agency problem & Accidents:** conflict of interest. If both are in agreement, we do not face an agency problem.

Pure accidents cannot be agency problems. Bu accidents can occur due to wanting to maximizing profits (agency problems), and then an agency-problems will occur.

(With the cases discussed in class)

	Who are the affected stakeholders?
Volkswagen:	Customers, regulators, environment, "society"
BP Deepwater Horizon:	Environment, employees
Deutsche Bank:	Managers as employees
Samarco:	Environment, the locals, employees
Vale:	Environment, the locals, employees
Facebook:	Customers, political opponents, politicians, democracy
GE:	Environment, employees
ValuJet:	Customers, sub-contractors, employees, authorities
Rana Plaza (H&M etc):	Employees (low-wage), children (girls), low capacity government, the locals
Union Carbide:	Public in large scale, children & elderly
ExxonValdez:	Environment
Uber:	Employees, customers
Apple:	Customers
Valeant Pharma:	Sick and disabled, society
Kobe Steel:	Business partners, creators of public infrastructure, the general public

- **Distinguish between the shareholders and the stakeholders.** You could argue that the shareholders are stakeholders, but Therese prefers to keep them separate, in order to identify the agency problems further.

Stakeholders	Shareholders
<ul style="list-style-type: none"> • Stakeholders have contractual relationships with the firm that determines their compensation for contributing • Guaranteed to get something in exchange 	<ul style="list-style-type: none"> • Shareholders are residual claimants • No guarantee for return on investment • Shrs get the left-overs when everyone else has been compensated • More vulnerable to managerial misconduct • Interest less contractible • Shr-mgmt contract more incomplete than other contracts

Recap:

Type 3 agency problem: Conflict between money-making and another interest.

Small discussion exercise (the symbiotic relationship between Firm and Society):

- **What benefits does society offer the corporation?**

You get motivated, talented employees, resources, other industries, social welfare system, peaceful environment, knowledge spillovers, strong legal system, highly educated people, innovation capabilities, diversity in opportunities and jobs, stable political environments, institutions, patent rights, health care, social security, childcare.

- **What do you think is a reasonable "price" for corporations to "pay" to society in return?**

What do we charge corporations?

Providing insights and opportunities for students, decent wages, quality-products, providing capital and charity/giving back to the society, organizations. Sponsoring the educational programs,

Be responsible for their sustainable footprint (if their products or services contribute to pollution or climate change), transparency, fair opportunities, taxes, products and services, climate, worker security.

- **Does your answer change if you consider that corporations (and shareholders) pay tax (twice)?**

When paying taxes first, you in a way 'pay back' from your past, the products and education you have been given.

- **How would you consider products without doubt necessary to humanity:**

These are the firms where we really want activity. They may face a higher obligation to abide to standards, laws and moral standards, but there are also stronger laws governing the necessary products (arguably except the clothing industry).

- Drugs and medical equipment?
- Clothes?
- Food?

Discuss the difference between firms that provide something necessary, and firms that just provide something that we want?

Manne's argument, in sum:

Difficult to distinguish between the profit-incentives and the incentives to provide and contribute to the greater good and welfare of society.

→ Distinguish a purely business expenditure only alleged to have been made for the public's good from one actually made with real charitable intent

Lecture 7: Corporate Governance in the Nordics

Friday 27. SEPT. '19 (09.50)

7. NORDIC CORPORATE GOVERNANCE

LP 7 (EXCERPTS FROM BØHREN & STAUBO, 2014, 2016; ECONOMIST, 2013; GILSON, 2014; ILMONEN, 2016; LEKVALL ET AL, 2015; OXELHEIM ET AL, 2013; PIEKKARI ET AL, 2013, 2015; RANDØY ET AL, 2006; SINANI ET AL., 2008; THOMSEN, 2017 + NEWSPAPER ARTICLES)

The Nordic countries rank at the top of almost everything: from prosperity and stability, to subjective perceptions of life quality. In addition, the region's corporate and innovative record is remarkable. In the post financial crisis environment, it has been suggested that the Nordic Model could even offer guidance to "reinvent capitalism" in other parts of the world (Economist, 2013). Parallel, in theory the Nordics present a puzzling case. Re-consider Bebchuk, 1999; La Porta et al, 1997, 1998, 1999 (lecture 2): what do their theories predict in terms of Nordic corporate governance? How is reality as outlined by Agnblad et al, 2001 and others? What alternative mechanisms can explain the functioning of Nordic firms?

Nordic Corporate Governance model:

The Nordic countries rank at the top of almost everything in the world: from objective indicators of prosperity and stability, to subjective perceptions of life quality and happiness. In addition, the region's corporate and innovative record is remarkable. In the post financial crisis environment it has been suggested that the Nordic Model could even offer guidance to "reinvent capitalism" in other parts of the world (Economist, 2013). Parallel, nominal literature in the field encounters a particularly puzzling case in the Nordics. Re-consider Bebchuk, 1999; La Porta et al, 1997, 1998, 1999 (lecture 2): what do their theories predict in terms of Nordic corporate governance? How is reality as described by Agnblad et al, 2001 and others? What alternative mechanisms can explain the well-functioning of Nordic firms?

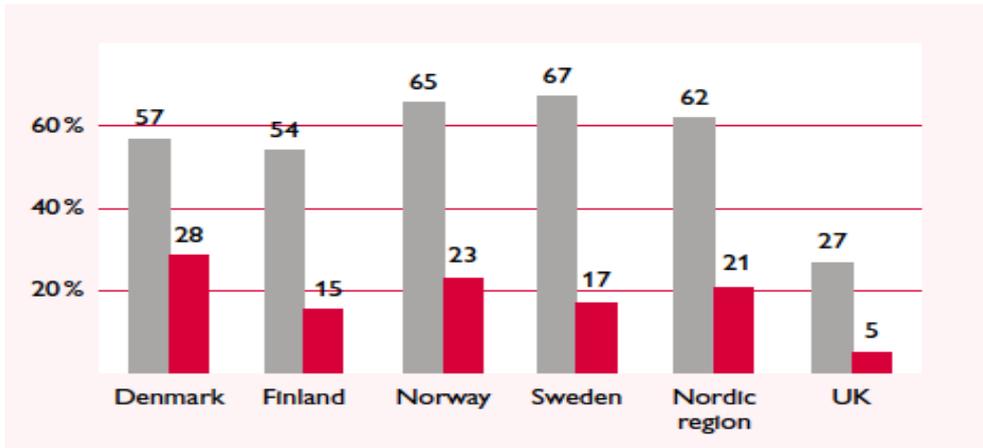
The Nordic model attracts increased interest around the world

- Mix of Economic prosperity and high living standards

The link to corporate governance

- Capitalism essential part of the Nordic model
- The Nordics were early to adopt the principles of private property, free trade, and install relevant institutions
- Allowed strong family owners to innovate at remarkable speed during industrialization

Corporate ownership

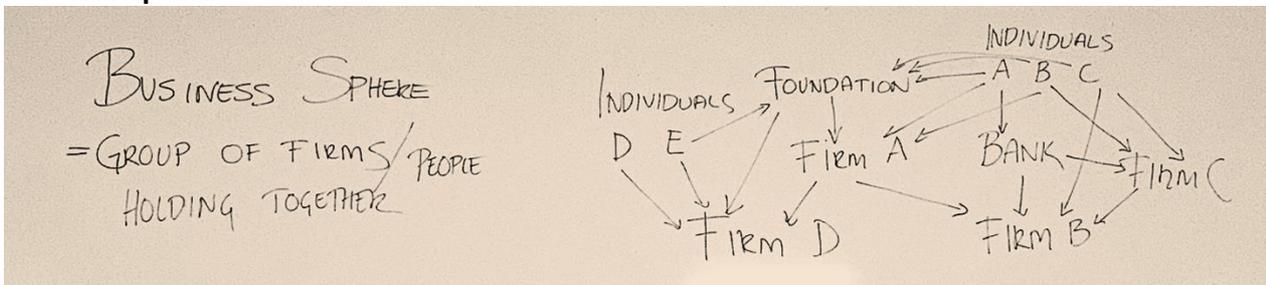


- Share of companies with an owner controlling >20% (gray)
- Share of companies with an owner controlling >50% (red)
- Block-holders are important and dominant

Significant control- enhancement

- Pyramidal structures or disps
- Holdings companies listed on stock exchange for the sole purpose to own other listed companies
- Dual class shares (although voting differences have been reduced through voluntary agreements between controlling and minority shareholders)

Business Sphere



→ Comes to show that executives, employees tend to operate within the same spheres and corporations which they hold together or share board members together with.

Theoretical predictions:

Typical Nordic features:

- Blockholdings
- Locks on control
- Stakeholder concerns
- Labor influence
- Left-wing political traditions

Should lead to:

- Small financial markets
- Low liquidity
- Limited access to external finance
- Low investor protection

- High expropriation of minority investors.

In reality...

Anglo-Saxon features

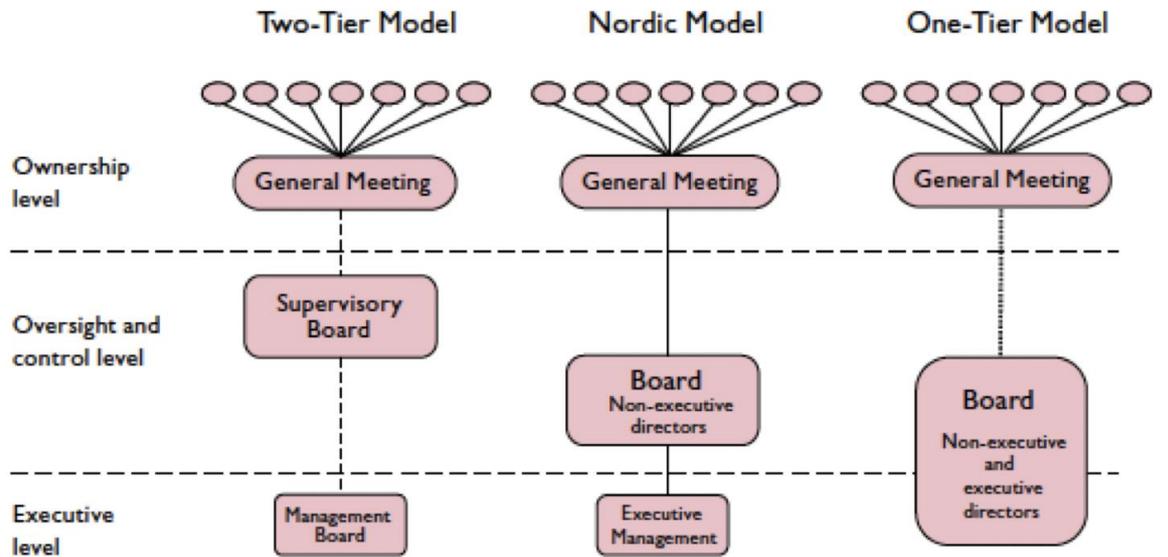
- Strong minority protection
- Large and liquid stock markets
- Easy access to finance
- Many and large firms
- High number of IPOs
- Large inflow of foreign investments
- Strong transparency
- Low minority expropriation

Continental European features

- Strong owners, weak managers
- Dual-class shares
- Pyramids, business groups
- Stakeholder orientation
- Two-tier boards
- Employee representation
- Low executive compensation

	Nordic	Germanic	Latin	Anglo-Saxon
Orientation	Market	Market	Network	Market
Countries	Denmark, Finland, Iceland, Norway, Sweden	Germany, Austria, Switzerland, NL	France, Italy, Spain, Belgium, Brazil	US, UK, Canada, Australia, New Zealand
Legal system	Civil (moderate)	Civil (weak)	Civil (weak)	Common (strong)
Code	Scandinavian	Germanic	Napoleon	
Exit/voice	Voice	Voice	Voice	Exit
Dispersion	Moderate or low	Moderate or low	Moderate or low	Extremely high
Dominating owners	Family, foundation	Banks	Family	Institutions
Stakeholders	Labor, state	Banks, labor	Oligarchic groups, state	Shareholders
Labor position	Balance of interests	Codetermination	Balance of interests	Hire and fire
Importance of stock mar.	Moderate	Moderate to high	Poor to moderate	High
Corporate control	No	No	No	Yes
Board system	Two-tier	Two-tier	One-tier/optional	One-tier
Performance pay	Low	Low	Moderate	High
Scandals/failure	Low	Low	Occurs	Major
Strengths	Stable, accountable, relatively competitive	Stable, long-term, industrial strategy	Long-term owners, industrial strategy	Liquidity, large firms, international
Weaknesses	Risk of expropriation, 'small world'	Inadequate finance, small markets	Risk of expropriation	Volatile, failures, short-termism

The Nordic Model



The annual general meeting:

- Board strictly subordinated the general meeting
- Shareholders are given extensive freedom to submit proposals, exercise voice, and vote
- “Shareholders meeting where board and management come as guests”

Majority shareholder activism

- Private negotiations
- Rarely qualified activism in the open
 - When occur it’s likely an effect of stranded negotiations
- NOR + SWE: through nomination committees – institutional investors with a business strategy to profile as responsible owners
- Foreigners: rare. Votes in absence at general meetings. Occasionally votes down a proposal due to size of aggregate holdings.

Proxy advisors

- Nordic investor services
- GES International/Investment services
- ISS Nordic branch – on European policy
 - <https://www.issgovernance.com/policy-gateway/voting-policies/>
 - Available at Canvas for you to glance through

The supervisory board

- Directors viewed as agents to look after invested assets
- Re-elected by general meeting annually but can be dismissed at any time between meetings without specific cause
 - No cumulative voting and no staggered boards
- Mostly non-executive

- No CEO duality
- Separation between board's supervisory responsibility and management's operational responsibility
- Small boards, with rights for labor to participate (not in Finland)

Board Facts:

	Tier	Minimum size	Min indep. directors	Maximal term	Indep. from major shr (if yes threshold in %)
Denmark	1+2		(50%)	(12)	Yes (50%)
Finland	1+2		(>50%)		Yes for two (10%)
Iceland	2	3	(50%)		Yes for two (10%)
Norway	1+2	3	2 (>50%)		Yes (10%)
Sweden	1+2	3	(>50%)		Yes for two (10%)

Gender and Performance:

- Little evidence that female directors increase firm performance
 - Sounds reasonable?
 - Yes. If value could be achieved simply by exchanging a male for a female the market would have realized a long time ago and fired and hired.
 - Also no evidence that performance decreases. Ahern and Dittmar (2012) some immediate short-term effects right after quota.
 - Thus, there is no extra value to be extracted from gender simply because both genders perform equally good.
- Correlations found between female directors and CSR, better management practices, environmental responsibility.
- Regardless, difficult to determine causality.
 - Do successful firms hire more women?
 - Or do women promote success?

Adams and Funk, 2011

- Female directors display significant differences in their core values:
 - More stakeholder-oriented
 - More independent, change more often, do not follow value traditions
 - Care less for power and achievement
 - Favors risk more than their male counterparts (contrary to population at large)

Firms opt out?

- Böhren & Staubo (2012) finds that many quota firms changed legal form on the threat of liquidation. In particular:
 - Small, profitable firms

- W. concentrated ownership
- And no or few female directors
- What could it imply?
 - High costs of involuntary board restructuring
 - Inefficiencies (both organizational form and board)

Increased independence

- Bøhren & Staubo, 2016
- Gender quota also increases board independence (46% -> 67%)
 - Females are less dependent than males
- Effect is strongest in firms that are
 - Young and small
 - Profitable
 - Non-listed
 - Powerful owners
- Implications?
 - This type of firm needs advice more than monitoring

Monitoring and executive compensation

- How do these features relate?
- Executive pay typically low (comp. US/Continental Europe) particularly **after taxation**
 - Average total CEO pay around \$1 million
 - Comp. low incentive pay
- Why so little incentive pay?
 - Monitoring by controlling shareholders? Boards?
 - Small firm effects
 - Social pressures in egalitarian societies (with social democratic traditions)

Lecture 8: Friday 28th September 2019

Corporate Governance in Continental Europe

- Overview of European CG systems
- Performance and firm valuation as a consequence of ownership structure
- Blockholdings in Continental Europe

The notion of the separation of ownership and control was deemed to be universally applicable. Now, there is evidence against this fact; a different system has existed in Continental Europe.

Continental Europe:

Blockholdings in Europe

- Few companies listed on the stock market; of those, remarkably high level of concentration of ownership.
- 80% of the largest 170 companies listed on stock markets in France and Germany, there is a single shareholder owning more than 25% of shares.
- The ownership of Continental European companies; primarily concentrated in the hands of two groups: families and other companies.
- Cross-shareholdings; Company A hold shares in company B, which holds shares in company C.
- Block-holdings much higher in Europe than in the USA.

→ In many countries, the median largest voting stake in listed companies is over 50%; The voting control by a large block-holder is the rule rather than the exception.

The relationship between ownership structure and firm performance in Continental Europe:

- Higher degree of separation between control and cash-flow rights
- Family control does not hamper firm performance

Pros	Cons
<ul style="list-style-type: none">• Families are long-term investors committed to the success of the firm they invest in	<ul style="list-style-type: none">• The different priorities families may have with respect to those of outside shareholders = Potential for conflicts of interest that may hinder value creation and the growth of European companies.• Control-maintenance of the companies; often resort to control-enhancing devices (dual-class shares,

pyramid, etc.) that several studies have proven to be associated with lower value-creation

Ownership by countries :

French-origin countries	German origin countries	Scandinavian origin countries
<ul style="list-style-type: none">• Tendency for more CEO positions to be held by a member of the family (descendant)• Uncommon for no family members to sit on the board		

Mixed effects:

For some countries, the family negatively affects both market valuation and operating performance. Whilst for other countries, the effect is positive for market valuation and negative for operating performance.

Summary and conclusions:

- Family owned/blockholdings are positive at the founder stage – provided the founder still exerts an active role as CEO or non-executive director.
- The family effect continues to be positive at the descendants stage; when descendants limit themselves to non-executive roles.
- The family effect continues to be at least non-negative when descendants assume the role of CEO.
- When the family is not represented on the board, family-controlled firms seem to perform worse than non-family firms.

Accountability and Convergence:

Corporate board play a central role in corporate governance and are therefore regulated in the corporate laws and corporate governance codes.

Differences in the companies;

- 1) In the details
- 2) Regarding the main issues

→ Relation to shareholder structure (dispersed or blockholding)

→ Relation to historical, political and social development (and on employee representation).

Convergence: in the corporate governance code movement

Convergence in

- Board structure
- Composition
- Functioning (one tier v. two tier, independent directors, expertise and diversity, separating the chair and the CEO functions, information streams, committees, voting and employee representation)
- Enforcement by liability rules (in cases of conflict of interest)
- Incentive structures (remuneration)
- Shareholder activism

→ Convergence due to pressure of competition, a pro-shareholder trend

Result

- 1) unstable balance between convergence and divergence.
- 2) Shareholder and stakeholder influence
- 3) European v. national rulemaking

Board composition

2 main topics for discussion:

Mix of executive & non-executive directors	Proportion of independent directors
-In some countries, there is no distinction (France)	-Treated in matter of “comply or explain” -E.U requirement; at least one member of the audit committee is independent.

Separation of Functions of Chair of Board and CEO

- Increasing trend of the separation of the two functions
- The separation is a crucial expression of the notion of the board’s role as a monitor of the management of the company; a feature of good corporate governance
- Occurs quite rarely in Continental Europe.

Board committees

Board of Directors has established committees which conduct preparatory tasks prior to decision by the full Board of Directors.

Remuneration

Remuneration as a positive incentive, traditionally in the form of stock options to align the interests of the directors with the shareholders’ interests in performance and higher stock prices, holds the directors accountable.

- No obligation under company law to use incentivized remuneration, but corporate governance codes recommend that listed companies do so.
→ Aligns the director’s interest with this of the shareholders rather than the managers’ own interests.

2 basic techniques:

- 1) Moving the competence for deciding on managers' remuneration out of the hands of the executives themselves.
- 2) Rules for the structure, content, or limits of remuneration.

→ Corporate governance codes recommends for the remuneration to be set by remuneration committees.

Parmalat example:

- Example of outright expropriation of both shareholders and creditors by a family that treated company resources as their own; represents that minor forms of expropriation are systematic in Continental Europe.
- Difference in the concentrated ownership structures and those of diffused ownership, and different measures should be taken into account.
-

Lecture:

Repetition of ownership:

- **Dispersed ownership:** no individual shr or small group of shrs control the firm. The firm is controlled by mgmt.
- **Concentrated ownership;** one or a few shareholders (individuals or org) in practice control the firm
 - Concentration is a spectrum
 - If a single owner >50%, she typically controls the firm (although needs support for decisions that require qualified majorities)
- **Below that, control depends on**
 - a) the rest of the ownership structure: can the largest owner(s) be challenged?
 - *Depends on no. of owners needed to beat largest stake, if those owners would be willing, and majority requirements.*
 - *10% corner position. Owner can block a squeeze-out.*
 - b) owners' identities: not all investors will be active
 - c) pyramidal holdings: locks in control even on small stakes
 - d) special provisions: voting caps, double voting rights etc.

Consider The ownership structure:

- **In companies where several significant owners co-exist, it can be difficult to determine who is in control**
- **Imagine A holds 15%, B holds 10% and C holds 6% and the rest is highly dispersed**
 - **A controls, given that B and C are not acting in unison**
 - **A controls with B (25%)**
 - **A controls with C (21%)**
 - **B and C control (16%)**
- **Necessary to consider owners' identities, ties, actions...**

- If more significant owners... freerider and collective action problems come into the picture
 - Some thresholds on holding stakes are particularly important
(If a single owners acquires 91% of the share acquisition, then the owner is obliged to offer the remaining shareholders to purchase their shares also, the rest of the 9%)
- It is a measure to protect the minority investors, as no one would want to buy the stocks when you have such as majority of the share; at a fair price.

Why the 10% threshold is important

- **Mandatory bids:** if a single owner has acquired 90% (95% in some jurisdictions) of the shares she:
 - a) is obliged to offer to buy the remaining shares at a “fair price” (highest price paid in the past 6-12 months)
 - EU Directive 2004/25 on takeover bids
 - Aims to protect minority investors
 - b) can force the remaining shareholders to sell, a so called “squeeze-out”
 - In some jurisdictions linked to a preceding takeover bid
 - Both technics aims to ensure that value-enhancing takeovers can take place and that value-destructing takeovers fail
 - A 10% holding stake typically blocks these scenarios and is therefore a particularly important threshold.
- Sum: In some jurisdictions, this will be possible 'by force'. Minority protection and also efficiency reasons.

Owners' identities

Important because all owners will not exercise active control regardless of stakes

- An attempt to categorize investors from an activist perspective:
- Aggressively active (short-term): activists, hedge funds
- Patiently active (long-term): families, foundations
- Routinely active: institutional investors (“vote but don't control”)
- Also don't promise to stay as owners
- Mostly passive: foreigners, minority investors
- Totally passive: some institutional investors (very small or restricted by law from activism), minority investors

Control-enhancing mechanisms

- Features that affect the practical control of a firm:
 - Dual class shares
 - Voting caps: limitation on how much power a shareholder can have = concentration of voting power is lower than that of ownership
 - Opposite of dual-class shares that enhanced voting power in relation to the ownership stake
 - Double voting rights (Florange Act in France for example...)
- More on control-enhancement in Europe later... there are several

Disclosure of significant shareholders

- Disclosure requirements varies across jurisdictions (difference in transparency; check slides for further explanation)
- Denmark has opened the Beneficial Owner Registry
- <https://danishbusinessauthority.dk/beneficial-owners>
- <https://datacvr.virk.dk>

Company	Country	Dispersed	Concentrated (by who?)
Walt Disney Co	USA	X w. small blocks	
Carrefour S.A.	France		X(Moulin family)
Volkswagen AG	Germany		X (Business: Porsche)
Porsche SE	Germany		X (families Porsche & Piech)
<u>Repsol S.A.</u>	Spain	x (w.small blocks)	
Nestle S.A.	Switzerland	x	
<u>Norsk Hydro ASA</u>	Norway		X (state)
Royal Dutch Shell PLC	UK/ <u>Netherlands</u>	X	
ArcelorMittal	Luxembourg		X (family Mittal)
Nokia Ovi	Finland	X	

Summary of ownership evaluation (for the Exam):

- Consider the jurisdiction of the company: what is the transparency requirement? Over what threshold are owners considered significant (i.e. ownership information must be made public)?
- Consider the ownership structure as such – is it obviously dispersed or concentrated? Is the information complete and trustworthy?
- Who are the owners (do they practice control?), and do they relate to one another or does the firm belong to a sphere? (if there are several owners, are there some structures leading to a blockholdings-structure).
- Read the company's annual report/website – does the firm apply one share, one vote – or are there any voting differentiations?
- Read the articles of association: are there any voting caps, double voting rights or any other special provisions that affect the control of the firm?

Then you end up with a conclusion on the ownership structure of the firm.

-If the ownership is a relevant factor; you will have to evaluate the ownership in the above.

-There are thresholds that are more or less important.

The basics of the different systems:

	Nordic	Germanic	Latin	Anglo-Saxon
Orientation	Market	Market	Network	Market
Countries	Denmark, Finland, Iceland, Norway, Sweden	Germany, Austria, Switzerland, NL	France, Italy, Spain, Belgium, Brazil	US, UK, Canada, Australia, New Zealand
Legal system	Civil (moderate)	Civil (weak)	Civil (weak)	Common (strong)
Code	Scandinavian	Germanic	Napoleon	
Exit/voice	Voice	Voice	Voice	Exit
Dispersion	Moderate or low	Moderate or low	Moderate or low	Extremely high
Dominating owners	Family, foundation	Banks	Family	Institutions
Stakeholders	Labor, state	Banks, labor	Oligarchic groups, state	Shareholders
Labor position	Balance of interests	Codetermination	Balance of interests	Hire and fire
Importance of stock mar.	Moderate	Moderate to high	Poor to moderate	High
Corporate control	No	No	No	Yes
Board system	Two-tier	Two-tier	One-tier/optional	One-tier
Performance pay	Low	Low	Moderate	High
Scandals/failure	Low	Low	Occurs	Major
Strengths	Stable, accountable, relatively competitive	Stable, long-term, industrial strategy	Long-term owners, industrial strategy	Liquidity, large firms, international
Weaknesses	Risk of expropriation, 'small world'	Inadequate finance, small markets	Risk of expropriation	Volatile, failures, short-termism

Ownership in general

- European firms characterized by significant blockholdings (see Becht & Roell, 1999; Barca & Becht, 2001; Aminadav & Papaioannou, 2018)
- Family dominance, but in some countries also common with other blockholders; state, business, foundations.
- Control mechanisms common (as you will see)

CEM's (control-enhancing mechanisms)

Multiple voting rights shares: one share type has more votes attached to it

- Dual-class shares – separate share classes
- Loyalty shares (FRA) same share class

Non-voting shares: rare. Only found in DK and IRE (one company each).

Non-voting pref. shares: often compensate absence of vote with a pref. dividend

Pyramid structures: most common in Sweden

Depository certificates: rare. 4 Dutch companies. Instrument separates vote from share which is sold to the market while a foundation keeps the vote.

Voting right ceilings: prohibits shareholders from voting above a specified threshold, regardless of how many shares she owns.

Ownership ceilings: rare except in Italy (banks 0,5-4%) and Greece. Prohibits shrs from taking a position above a certain threshold.

Golden shares (typically the government, provides some kind of VETO-right; e.g. for the government to rule the CEO etc.): priority shares with special rights for a government owner. Number not relevant, firms normally issue one. It's the rights attached to it that's interesting. Most common in Hungary in infrastructure businesses and gives the government certain veto rights etc. Also exist in Spain, Italy, Poland, Germany...

Super-majority provisions: amendments of the company charter to require a very large majority to approve important decisions.

Partnerships Ltd. by shares: hybrid between LLC's and partnerships. Partner with liability for the company's debts typically have operational power while passive shareholders provide finance at limited liability conditions.

Cross-shareholdings: rare, except in Sweden. Used to be common in Germany and France but don't exist anymore.

Shareholder agreements: Purpose is to bring their signatories to adopt a joint position with respect to certain strategic decisions.

Double voting rights:

- In 2014 France adopted the Florange Act
- Opt-out basis: firms must amend bylaws (w. shareholder approval) not to be subject to the Florange Act.

- Shares held for two consecutive years are awarded double voting power – consequence of long-termism discussions.
- Leading proxy advisors recommend do not adopt, on the basis of equal treatment of shareholders
- Bourveau et al (2019): unlikely a desirable mechanism. Firms that become subject to the DVR by default, especially if there's a blockholder, experience a decrease of foreign institutional investment and an increase in cost of capital. Moreover, the market reacts positively to successful opt-outs.
- Risk?

EU webpage

Company Law and Corporate Governance

https://ec.europa.eu/info/business-economy-euro/doing-business-eu/company-law-and-corporate-governance_en

Publications on CG

https://ec.europa.eu/info/publications/governance-in-the-commission_en

EUR-Lex (publishes all the new laws and directives adopted).

<https://eur-lex.europa.eu/homepage.html>

Lecture 9: Corporate Governance in Anglo-Saxon Countries

Corporate Governance in Anglo-Saxon Countries

- Stakeholder focus
- Board practices
- Independence

Enron:

Main issues:

- Accounting policy of not consolidating SPVs allowing the company to hide debt and losses from the investors
- The income recognition practice to record income fees for future transactions as current
- Recording revenues from sales of forward contracts that were really loans in disguise
- Fair-value accounting failed to recognize true value of investments
- Accounting for stock that was held by SPVs
- Inadequate transparency surrounding related party transactions

Systemic issues:

- Regulatory frameworks allowed Arthur Andersen to provide both consulting services and audit the annual report concerning the financial results of the advices given during consulting services
- Law and accounting rules allowed the setup of special purpose vehicles to hide debt

- The ongoing “boom culture” allowed most things as long as money kept coming in

Insider information & ethics

- A culture of dishonesty and greed: while Lay was aware of the accounting scandal and the possible collapse of the company, he continued to re-assure the market that future growth of the firm had never been more certain, and urged them to invest in Enron stock
- At the same time he off-loaded his holdings of Enron shares in secrecy
- In doing so, he took advantage of non-public information, and thus made himself guilty of insider trading

Comparative governance failures

Enron

- Agency problems type I
 - Adverse selection
 - Moral hazard
- Perpetrator: managers
- Transparency problems
- Creative accounting
- Involved board
- Auditor deficiencies

Parmalat

- Agency problems type II
 - Private benefits
 - Low minority protection
- Perpetrator: blockholder
- Transparency problems
- Creative organization building
- Involved board
- Auditor deficiencies

Failure largely about gatekeepers

- Aim to provide checks and balances (auditors, securities analysts, media etc)
- Auditors
 - Dispersed ownership: risk of being captured by managers
 - Controlled ownership: blockholder could dismiss auditor if (s)he monitors too earnestly
 - Asymmetric information?

United States corporate governance - overview

- Shareholder value prevail – the sole purpose of a firm is to make money (Friedman-view)
 - Shareholder value = (return – WACC) * invested capital
- Strong dispersion of ownership
- Strong managerial power
- Large executive compensation packages
- States compete for firms, offering different tax benefits, regulatory systems etc...

Market model base

- Many buyers and sellers
- Standard commodities - seldom dual class shares (things might be changing)
- Low transaction costs (commissions etc)
- Market clearing (exchange is centralized)
- Strong transparency
- Large and liquid markets
- Strong property rights

Shareholder value strive

- Strong property rights and minority investor protection
 - Firms' goal: maximize shareholder value (also NYSE principle)
 - Rests on fairly strict assumptions (e.g., competitive markets, own preference maximizing customers, and that no externalities, perfect information, monopolies etc exist)
 - Shareholders as residual claimants comparatively more vulnerable
 - Residual = difference btw. revenues and contractual payments
 - Last in firms' income stream (comp. employees, debt holder etc.)
- max. shareholder value max. welfare (...and part of pie for others too)

US owners

- Many shareholders holds only a small amount of shares (seldom above 5%)
- Typical Berle and Means (1932) situation:
- Separation of ownership and control
 - Shareholders elect BoD to represent them in the firm
 - Weak monitoring incentives of individual shareholders (bears full costs of monitoring but only small amount of benefits)
 - Collective action problems
 - Managers have effective control „**weak owners and strong managers**“

Institutional investors dominant owners

- Historically: individuals and households
- Today: institutions like pension funds
 - 1950: 6,1% of total outstanding equity
 - 1970: 19,4%
 - 1980: 20,4
 - 1990-2000: ~ 50%
 - **Today: roughly 75-80 % → dominant form of corporate ownership**

Board practice

- One-tier
- Primary means for shareholders to exercise control in public firms
- Assures alignment of interests
- Varying sizes (corr. with firm size (complexity))
- CEO always a member & often also chairman in US
- Committees for special issues (e.g., audit)

Board roles

	Dependent	Gray	Independent
Firm relation	Executives at the firm (typically CEO & CFO)	- Affiliated with the firm (major shareholder, large supplier, family member)	Executives from other firms, not-for-profits, universities etc.
Role	- Decision making; strategy, financing decisions		Direct advocates of shareholders Decision control (committees) Advice to <u>mgmt</u>

Independence

- It pays to have friends“ Hwang/Kim 2009 JFE
 - 87% of BoD are conventionally (neither financial nor family ties) independent
 - 62% are conventionally and socially independent
 - Socially dependent:
 - Award lower compensation executive pay
 - Stronger pay for performance sensitivity
 - Higher turnover-performance sensitivity
 - Social ties matter....and conventional definitions of independence are not sufficient
 - But....who did not study in Harvard?

Stakeholders in the US

- Less of a stakeholder perspective
- Boards have a fiduciary duty to focus on creation of shareholder value, i.e. they can be held personally responsible if acting based on other intentions
- And a duty of care, meaning the board must demonstrate that it is loyal to shareholders

Securities regulation

- Sarbanes-Oxley Act (SOX) 2002:
 - Followed the ENRON case of aggressive accounting techniques etc.
 - At the same time WorldCom and Tyco
- Major changes in the regulation of financial practice and CG
 - Increase in accountability, transparency and compliance
 - e.g., audit committee must consist of independent directors only
- (very) costly to implement
- Research: very mixed and...SOX came with intended and unintended consequences
 - Gomulya and Boeker (2012) (WP)
 - Likelihood of CEO dismal after financial misrepresentation higher after SOX
 - But incentives of directors are altered...transfer blame and stigma to the CEO easier

Lecture 10: Kleptocrats and Corruption

Kleptocrats and corruption

Exams:

Sources on property rights and the risk of corruption:

Property Rights Index (Heritage Foundation) & by (IPRI)

Property Rights Index (Heritage Foundation)

<https://www.heritage.org/index/property-rights>

Property Rights Index by (IPRI)

<https://www.internationalpropertyrightsindex.org/countries>

Anti-corruption source:

<https://www.transparency.org>

Good institutions:

... aim to secure (Djankov et al, New Comparative Economics...)

- property rights
- that investors can keep returns from their investments
- that contracts can be made
- that disputes can be solved

Ultimately encourages people to invest. Adam Smith (1776):

“in all countries where there is tolerable security, every man of common understanding will endeavor to employ whatever stock he can command... In those unfortunate countries... where men are continually afraid of the violence of their superiors, they frequently bury and conceal a great part of their stock ... in case of their being threatened with any of those disasters to which they consider themselves as at all times exposed”

Corruption

→ The vicious cycle

The vicious cycle

“Corruption chips away at democracy to produce a vicious cycle, where corruption undermines democratic institutions and, in turn, weak institutions are less able to control corruption.”

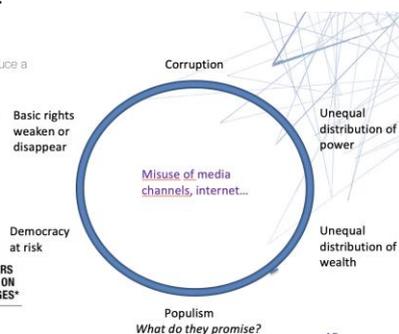
Patricia Moreira
Managing Director
Transparency International

40%

OF POPULIST LEADERS
ARE ALSO INDICTED ON
CORRUPTION CHARGES*

*See their website for Detailed Charting

nnn SWU CORPORATE/AGRI BUSINESS SCHOOL



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Two perspectives on property rights (from Djankov et al)

Thomas Hobbes (1651)

- The state's central concern is to control private disorder – the war of all against all

Charles-Louis de Secondat Montesquieu (1748)

- “Great enterprises in commerce are not found in monarchial, but republican governments... An opinion of greater certainty as to the possession of property in these [republican] states makes [merchants] undertake everything... Thinking themselves sure of what they have already acquired, they boldly expose it in order to acquire more... A general rule: a nation in slavery labors more to preserve than to acquire; a free nation, more to acquire than to preserve”

Wealth distribution:

- Relative between countries
- Relative within countries
- The wealthiest nation on Earth has the widest gap between rich and poor of any industrialized nation

Global Corruption Barometer 2013 (TI)

- Survey 114,000 respondents in 107 countries world-wide
- Aims to address people's real life experiences of corruption, for example
 - Bribes paid to societal institutions
 - Consequences of not being able to afford bribes
 - How trust in public institutions is affected by corruption

1. How do you think corruption has changed in your country?

Why corruption matters in corporate governance?

- Corruption, bribes (and theft...) **redistribute assets**
- Sometimes argued to be a small cost to pay to have an economy (Kabul Bank... not small)
- Coase: the best we can do is to embrace the existing distribution of assets, no matter how it came to be (efficiency) (there are efficiency costs when changing the society).
- Arguments against: the vicious circle... more?

Arguments against

- Obtaining cooperation from judges, jurors, policy makers in implementing rules perceived as unjust
 - Effects on trust, democracy...?
- Credibility of commitment to support existing distribution.
 - If we want property rights that are fair, then either attitudes or distribution must change

The fundamental question

- Scientific consensus that high quality institutions are necessary for (or lead to?) economic prosperity
- Twin goals: control of disorder and of dictatorship
- How achieve both?
 - **Democracy**
 - **Respect of basic rights**
 - **Alright to fail, losers get a second chance**
- How get there: big bang vs. gradualism?

Law	Politics	Owners	Board	Mgmt	Incentives	Failure	Misc.
Property rights	Political determinants	Ownership structure	Size & structure, one-tier, two-tier	Moral hazard, adverse selection	Remuneration as interest alignment	Fraud, scandals, bankruptcy	Trading vs. vertical integration
Contract rights	Firm-orientation <u>Shr-orientation</u>	Ownership identity	Composition, gender quotas	Information asymmetries	Salary & bonus (performance)	Gatekeepers; auditors, media	Pros and cons of large firms
Corporate law	Labor & unions	Control enhancements	Different roles of the board	Conflicts of interest	Problems w. stock options	Whistleblowers	Innovation, economic growth
Law enforcement	Stakeholders	Institutional investors	Fiduciary duties	Incentive mechanisms	Compensation in stock	Auditors, consultants	Stock markets, private law
<u>Limited liability</u>	Path dependency	Shareholder activism	CEO duality	Empire building	<u>Earnings mgmt</u>	Creative accounting	
Societal institutions	Corruption & bribery	Proxy advisors	Independent directors	Agency costs	Risk / reward	Earnings management	
Minority protection	Networking / small worlds	Agency problems	Codetermination	Relations & job market		<u>Special purpose entities</u>	
Soft law/ codes	Stewardship	General meetings	Committees; audit, remuneration	Stakeholder balance		Creative destruction	
Common law, civil law		Private benefits	Election, nomination	Ethics & reputation		Theft	
EU law		Short-termism		<u>Professionalisation</u>			