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Cambridge University Press
978-1-107-04056-4 - Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms: A Research Project Promoted by Emittenti Titoli S.p.A.
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Excerpt
More information

# 1

# Corporate boards, incentive pay and shareholder activism in Europe: main issues and policy perspectives

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## 1. Introduction*

### *1.1. Purpose and scope*

In this chapter, we offer an overview of the present volume, placing the same in the context of recent European Union (EU) reforms and of corporate governance theory and summarising the main outcomes of the following chapters. In addition, we offer some policy perspectives – as to boards, incentive pay and shareholder activism – based on the theoretical and empirical outcomes of the research project of which this volume is the product. In drawing this broad picture, we underline particularly that variances in ownership structures of listed companies and in the adoption of either a shareholder value or a stakeholder approach have pervasive implications for corporate governance issues. For example, board composition criteria may reflect a stakeholder orientation, such as that found in the German codetermination system (Schmidt 2004). Also the board's function, the role of independent directors and incentive pay arrangements may vary depending on whether diffuse shareholders or blockholders own the company. Similarly, diffuse ownership companies represent the natural setting for shareholder activism, which may not be a cost-effective solution in controlled corporations.[1]

* The analysis across the volume refers to EU and Member State regulation as of 15 January 2013.

[1] Within this context, it is debated whether additional reform, aimed at stimulating activism of institutional investors (such as, for instance, the adoption of cumulative, proportional or slate voting in corporate elections), may be useful (see Section 6.3.2. below and Chapter 8).

In general, we assume that boards are an essential mechanism for directing the company and monitoring the agency costs of management, while incentive pay is important to align the interests of professional managers with those of shareholders. Moreover, we assume that shareholder activism can work as a useful complement to these governance mechanisms by exercising pressure on boards and holding them accountable for the performance of their monitoring functions. However, the effectiveness of similar mechanisms depends on a variety of factors, including the quality of corporate law and its enforcement, the degree to which private codes of best practice are complied with, and the institutional context in which boards and shareholders operate. In particular, ownership structures in a given system or company affect the equilibrium between the corporate governance mechanisms that we analyse in this volume. While mainstream global corporate governance is heavily influenced by the model of the Berle and Means corporation, an analysis of the European context requires a less biased approach in order to catch the richness of governance models and diversified experiences (as particularly shown by the study of family firms in Chapter 3).

In the remainder of this Chapter, we introduce recent reform initiatives and the variety of corporate governance systems in Europe, sketching out the alternative between shareholder and stakeholder governance and the specificities of bank governance. In Section 2, we outline the main tools for controlling agency costs, including market mechanisms, corporate law, codes of best practice and the 'comply or explain' approach, and bank prudential regulation. In Section 3, we analyse the impact of ownership structures on agency costs and comment on Chapter 3 on family firms in Europe. In Section 4, we examine the theory and practice of boards, in light of EU law and soft law and of the analysis in Chapters 4 and 5 on board size, independence and gender diversity and also of the limitations inherent to a 'law and economics' approach. In Section 5, we examine the theory and practice of incentive pay, in light of EU soft law and banking regulation, and summarise the outcomes of an empirical analysis on pay practices in large European listed companies included in Chapter 6. In Section 6, we analyse shareholder activism in Europe and summarise the outcomes of two empirical contributions (one on activism in the EU and the United States (US), the other on activism in Italian corporate elections) contained in Chapters 7 and 8. In Section 7, we outline some policy considerations on the topics considered in the previous four sections. Section 8 draws some general conclusions.

## *1.2. EU reform*

In the present section, we review the legal reforms that have affected EU corporate governance since the beginning of the current century. These reforms addressed the main corporate governance failures which governments and legislators identified in the 2001–2 corporate scandals and the 2008 financial crisis (Enriques and Volpin 2007; Bainbridge 2012). Similar failures affected both the internal governance structures of corporations – including those relating to the audit of accounts – and the essential mechanisms for capital market efficiency, such as securities underwriters, financial analysts and rating agencies (Gilson and Kraakman 2003; Skeel 2011). This chapter focuses mainly on corporate boards and shareholders, in line with the remainder of this volume. Indeed, boards have a key governance role and perform monitoring and advisory tasks with respect to firms' managers. Shareholders have fundamental governance rights, including that of appointing the board, which derive from their function as residual risk-bearers. In line with recent Commission Green Papers, this chapter and the whole volume take into consideration both shareholder activism (which occurs mainly in diffuse ownership companies) and the protection of minority shareholders (which typically concerns controlled corporations).

### 1.2.1. After Enron

The 'new economy' bubble highlighted serious corporate governance shortcomings, mainly related to internal controls, executive remuneration and external auditors (Coffee 2005). Corporate frauds and accounting failures had been made easier by lack of appropriate internal controls for which the firms' managers and directors were generally responsible. Moreover, stock options and other incentives were aggressively resorted to, contributing to managers manipulating share prices through false information relative to their firms' financial performance. The auditors and other gatekeepers, such as investment bankers, business lawyers and rating agencies, largely contributed to the first crisis of this century (i.e. the corporate scandals era), by covering frauds and aiding insolvent companies to conceal their true financial conditions (Coffee 2002; Gordon 2002; Miller 2004; Ferrarini and Giudici 2006).

Wide reforms were sought both at EU and domestic levels, often modelled along the US Sarbanes-Oxley Act, which had, however, been enacted in a remarkably brief period, with minimal legislative processing (Bainbridge 2012). The European response to the financial scandals was relatively less hasty, given that the epicentre of the 2001–2 turmoil had been the US, and also considering the more complex political process for EU legislation. Moreover, the final response in Europe was not as strong and pervasive as that in the US (Ferrarini et al. 2004). The EU Action Plan was out in the 2003 Communication from the Commission on *Modernising Company Law and Enhancing Corporate Governance in the European Union*,[2] which was prepared on the basis of a report by the High Level Group of company law experts appointed by Commissioner Bolkestein and chaired by Jaap Winter (the Winter Report).[3] The Commission's Action Plan envisaged four main pillars for corporate governance reform.

(i) The first referred to *enhancing corporate governance disclosure*, with the argument that more than forty corporate governance codes had been adopted in Europe, their contents being widely convergent; however, 'information barriers' undermined shareholders' ability to evaluate the governance of companies. The Commission proposed that companies be required to include in their annual reports and accounts a comprehensive corporate governance statement covering the key elements of their corporate governance structures and practices. This statement should carry a reference to a code on corporate governance, designated for use at national level that the company complies with, or in relation to which it explains deviations. This proposal led to the adoption in 2006 of the new Article 46a of Directive 78/660/EEC on the annual accounts of certain types of companies, which required companies with securities admitted to a regulated market to publish a corporate governance statement in their annual report.[4] The content and implementation of the EU 'comply or explain' principle are

[2] See Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, Brussels, 21.5.2003, COM(2003) 284 final.

[3] See the Report by the High Level Group of Company Law Experts, *A Modern Regulatory Framework for Company Law in Europe*, Brussels, 4 November 2002.

[4] See Article 1, para. 7 of Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, O.J. 16.8.2006, L 224/1.

analysed briefly in the following paragraph, and more extensively in Chapter 2.

(ii) The second pillar contemplated *strengthening shareholders' rights* in terms of both electronic access to information and procedural rights (to ask questions, table resolutions, vote *in absentia*, and participate in general meetings via electronic means). The Commission proposed that the facilities relevant for the exercise of similar rights should be offered to shareholders throughout the EU, while specific problems related to cross-border voting should be resolved urgently. This led to the adoption of the Shareholder Rights Directive,[5] which is analysed briefly in Section 6 and in Chapter 7.

(iii) The third pillar involved *modernising the board of directors*. First, as to board composition, non-executive or supervisory directors who, in the majority, are independent, should take decisions in key areas where executive directors have conflicts of interest – such as remuneration and supervision of the audit of company accounts. Second, the directors' remuneration regime should require disclosure of remuneration policy and remuneration details of individual directors in the annual accounts; prior approval by the shareholder meeting of share and share option schemes in which directors participate; and proper recognition in the annual accounts of the costs of such schemes for the company. Third, the collective responsibility of all board members for key financial and non-financial statements should be clearly recognised under national legal systems.

The proposals relative to board composition found detailed specification in the Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board[6] (commented upon briefly under Section 4.2.); the proposals relative to directors' remuneration found specification in the Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (see Section 5.2. and Chapter 6); and those on collective responsibility

[5] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies, O.J. 14.7.2007, L 184/17.
[6] O.J. 25.2.2005, L 52/51.

were translated into Articles 50b and 50c of Directive 78/660/EEC on the annual accounts of certain types of companies.[7]

(iv) The fourth pillar involved *co-ordinating corporate governance efforts of Member States*, with reference both to the development of national corporate governance codes and to the monitoring and enforcement of compliance and disclosure (a topic dealt with in Chapter 2).

These four pillars fundamentally marked two areas for corporate governance reform – boards and shareholder rights – which are interconnected to the extent that companies are run in the interest of shareholders and the latter monitor board governance and appoint and remove directors. The Commission further suggested two main paths for EU reform, which were subsequently implemented through directives or recommendations: *disclosure* of corporate governance structures and functioning (including those concerning directors' remuneration); and *setting of standards* for board and remuneration practices, and for shareholders' information and rights.

### 1.2.2. The recent financial crisis

It is uncertain whether and to what extent corporate governance contributed to the recent financial crisis. While policymakers generally offer a positive answer (Kirkpatrick 2009), the topic is still debated amongst academics. For sure, a distinction should be made between financial institutions – banks in particular – and other companies, given that the former were at the epicentre of the financial crisis, both in the US and in Europe, while non-financial companies were affected by the crisis but did not show risk-management or other governance failures similar to those experienced by financial institutions (Cheffins 2009). Moreover, empirical research has proven that banks which failed in the crisis had adopted 'good' corporate governance standards (Beltratti and Stulz 2012). However, other research has shown that banks which fared better in the crisis had better risk-management systems in place, suggesting that the criteria defining 'good' governance need to be reconsidered (Ellul and Yerramilli 2012). The European Commission sided with governments and international organisations arguing that corporate governance had failed in the crisis, but appropriately distinguished

[7] See Article 1, para. 8 of Directive 2006/46/EC (n. 4 above), inserting a new Section 10A (Duty and liability for drawing up and publishing the annual accounts and the annual report) in the Directive on annual accounts.

between financial institutions and other firms. Therefore, two Green Papers were published, one in 2010 on *Corporate Governance in Financial Institutions and Remuneration policies*[8] and the other in 2011 on *The EU Corporate Governance Framework*.[9]

The 2010 Green Paper was part of a programme for reforming the regulatory and supervisory framework of financial markets announced in a Commission Communication of 4 March 2009,[10] which was based on the conclusions of the de Larosière Report.[11] In the Green Paper's introduction, the Commission stated:

> As highlighted by the de Larosière report, it is clear that boards of directors, like supervisory authorities, rarely comprehended either the nature or scale of the risks they were facing. In many cases, the shareholders did not properly perform their role as owners of the companies. Although corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed significantly to excessive risk-taking on the part of financial institutions.

This statement helps understand the remaining contents of the Green Paper, which include the role and composition of the (supervisory) board; risk management as a key aspect of corporate governance; and appropriate shareholder monitoring and the role of supervisory authorities with respect to the internal governance of financial institutions. We pay some attention to the specificities of bank governance in Section 1.3.2. and to the role of banking regulation and supervision in Section 2.4. However, the discussion found in the 2010 Green Paper largely overlaps with the analysis developed in the 2011 Green Paper, so that they can be bundled in our analysis.

Indeed, the 2011 Green Paper extends the arguments applicable to financial institutions to other firms, assuming that 'corporate governance is one means to curb harmful short-termism and excessive risk-taking' for firms in general and suggesting that the Green Paper should 'assess the effectiveness of the current corporate governance framework for European companies.' Similar to the 2003 Commission Communication on *Modernising Company Law*, the 2011 Green Paper focuses on the *board of directors*, emphasising that 'effective boards are needed to challenge executive management'; on *shareholders*, arguing

8 COM(2010) 284 final. 9 COM(2011) 164 final. 10 COM(2009) 114 final.
11 Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009, available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

that they must 'engage with companies and hold management to account for its performance'; and on the *'comply or explain' approach*, claiming that the informative quality of explanations published by companies is 'not satisfactory' and the monitoring of the codes' application is 'insufficient'. We shall make specific references to the 2011 Green Paper throughout the present chapter, highlighting some of its main features in connection with the individual topics touched upon in our analysis.

### *1.3. Varieties of corporate governance*

As anticipated, variances in European corporate governance are important and depend mainly on the ownership structures of listed companies and the national systems' adherence to either a shareholder or a stakeholder approach (Hansmann and Kraakman 2001; Clarke and Chanlat 2009; Kraakman et al. 2009). In this Section, we outline the key differences between shareholder and stakeholder governance, focusing on scholarly definitions and positions taken by EU policy documents. We also present the core specificities of bank governance, which determine the regulation and supervision of board structures and functions, and the reorientation of the relevant criteria for the protection of stakeholders (depositors) and the financial system (systemic risk) rather than for mere shareholder wealth maximisation.

#### 1.3.1. Shareholder v. stakeholder governance

There is no clear-cut, generally accepted definition of corporate governance. Many definitions are found in the academic literature and in codes of best practice, but differences, though rarely spelled out, are substantial. The dominant approach in the financial literature (Tirole 2006) focuses on the relationship between firms and suppliers of funds (debt and equity). An oft-cited work argues that 'corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return to their investment' (Shleifer and Vishny 1997). In other words, corporate governance concerns how corporate insiders can credibly commit to return funds to investors, so as to attract outside financing. Suppliers of debt and equity may benefit from several control mechanisms, based on either *legal protection* (through contract and/or regulation) or *sheer power* deriving from concentration of claims.

A similar view is sometimes criticised as being too narrow, for other stakeholders (employees, clients, local communities) have an interest in how the firm is run (Blair 1995; Blair and Stout 2001). Becht et al. (2002) offer a broad definition under which 'corporate governance is concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders.' These definitions imply that corporate governance is a 'common agency' problem, involving an agent (the Chief Executive Officer, CEO) and multiple principals (shareholders, creditors, employees, clients). Since the firm is a nexus of contracts (Jensen and Meckling 1976) and contracts are incomplete, managerial discretion arises and governance mechanisms are needed to allocate power and create incentives. However, the presence of multiple principals blurs corporate objectives and may ultimately compound agency problems, providing the management with an *ad hoc* rationale to explain any decision whatsoever (Williamson 1985; Tirole 2006). In a similar setting, regulation may shift part of the discretionary powers to the regulator, who will find a 'political' solution to these trade-offs.

Recent EU policy documents are rather ambivalent and fluctuate between the two approaches. The 2011 Green Paper remarks that corporate governance is traditionally defined (a) as the system by which companies are directed and controlled and (b) as a set of relationships between a company's management, its board, its shareholders and other stakeholders. The first part of the definition echoes the shareholder approach already followed in the UK by the Cadbury Report, which emphasises the respective roles and responsibilities of boards and shareholders. The board should set the company's strategic aims, provide the leadership to put them into effect, supervise the management of the business and report to the shareholders. Shareholders appoint (and possibly remove) the directors. Under this approach, corporate governance centres on the agency relation between boards (agents) and shareholders (principals). Other stakeholders are protected by contracts and/or regulation (concerning bankruptcy, competition, labour, etc.), rather than by traditional corporate governance institutions. However, shareholder primacy has come under closer scrutiny in the last few years, particularly in financial institutions, where corporate governance arrangements have been criticised for distorting managerial incentives and/or contributing to the financial crisis (Kirkpatrick 2009; Beltratti and Stulz 2012; Fahlenbrach and Stulz 2011; Admati et al. 2012; Becht et al. 2012).

The second part of the Green Paper's definition reflects a stakeholder view, similar to that found in the Organization for Economic Co-operation and Devolopment (OECD) Principles of Corporate Governance. These Principles highlight that (a) different classes of shareholders may exist and need to be treated in an equitable manner and (b) other stakeholders may possess rights established by law or through mutual agreements, which may also extend to corporate governance institutions (e.g. employees may obtain board representation and have a say in specific corporate decisions). From a similar perspective, corporate governance institutions do not exclusively concern the relationship between managers and (undifferentiated) shareholders. Rather, they must solve the potential trade-offs between different kinds of agency problems, which may justify regulating, for instance, the composition and role of the board of directors.

The question therefore arises whether and to what extent the board and/or shareholders' powers should be regulated to reflect other stakeholders' interest. From a comparative perspective, the answers to this question are diverse, as shown by the fact that workers' participation in boards is required in some countries, while special rules have been adopted internationally for the corporate governance of financial institutions. In general, corporate governance institutions vary considerably across countries and types of firms, with differences that are persistent and largely dependent on specific institutional contexts (Bebchuk and Roe 1999).

### 1.3.2. Bank governance

Banks are different from other firms for several reasons that matter from a corporate governance perspective (Adams and Mehran 2003; Macey and O'Hara 2003; Mülbert 2010; Ferrarini and Ungureanu 2011). First, they are more influential than other firms, with the consequence that the conflict between shareholders and fixed claimants, which is present in all corporations, is more acute. Second, banks' liabilities are largely issued as demand deposits, while their assets, such as loans, have longer maturities. The mismatch between liquid liabilities and illiquid assets may become a problem in a crisis situation, as we saw vividly in the recent financial turmoil, when bank runs took place at large institutions, threatening the stability of the whole financial system. Third, despite contributing to the prevention of bank runs, deposit insurance generates moral hazard by incentivising shareholders and managers of insured institutions to engage in excessive risk taking (Corrigan 1982; 2000). Moral hazard is exacerbated when a bank approaches insolvency, because shareholders do not internalise the losses from risky investments, but