PRINCIPLES AND PRACTICES OF CORPORATE GOVERNANCE

in the Global Economy

Alessandro Minichilli
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Introduction

More than twenty years after the debate on corporate governance issues started, the question arises as to whether and to what extent the evidence from the numerous studies and researches on the subject can be considered conclusive. In-deed, the corporate scandals at the beginning of the last decade, and especially the recent financial and economic crisis now widespread on a global scale, have strongly reinvigorated the discussion on the "problem" of corporate governance, albeit from different perspectives. On the one hand, the corporate scandals involving large listed companies all over the world – in Germany, France, Italy, South Korea, Japan and so on – have decisively highlighted the need for increasingly stringent and effective governance rules and mechanisms. The primary effect has been a substantial change in the composition and functioning of the main governance bodies, as well as in the overall institutional architecture of the company. On the other hand, the deep crisis of the last decade, with the consequent impacts first in the financial markets and then in the real economy, has seriously questioned the presumed supremacy of some models of ownership and governance of companies – first of all that of the public company. As a result, the main consequence has been to produce a series of success and "selection" factors of companies that have been – and will be – able to go through the crisis unscathed, if not even strengthened. Many of these factors seem to refer to the ownership, its characteristics, the consequent choices of governance and management that characterize the various forms of ownership, if not even to the possible "re-allocations" of ownership that the market volatility (for listed companies), the need for capital (for private ones), or a combination of these factors, certainly favor.

Starting from these premises, and especially from the fact that many of the studies of both management and corporate governance have often considered the ownership structure of a company an "exogenous variable", the book intends to reverse the perspective, placing ownership at the center of all relevant choices that the company makes. In particular, it addresses the "problem" of governance from the ownership perspective, and in a broader and more articulated sense than Anglo-Saxon studies. In this context, in the first part of the book we analyze the relationship between ownership, governance, and corporate strategy, with a dual objective. On the one hand, we aim to identify the consistency relationships between the governance structure of the company and its results, because of its centrality with respect to many of the strategic choices that companies make. In this analysis, particular attention is paid to the reading (or rather, to the "re-reading") of the key variables of the board of directors according to the ownership and its characteristics. On the other hand, the objective

is to consider possible variants to the "basic scheme", going to investigate the role of ownership, governance and management from a contingency perspective, i.e. in different types of companies. Specifically, public companies, multi-national enterprises, state-owned enterprises, and especially family-owned companies are analyzed.

The second part of the book analyzes, in a number of countries, different economic and business systems and their role in defining the type of corporate governance that has emerged. The assumption is that national business and economic cultures as well as historical, economic, juridical, and institutional dimensions play a crucial role in shaping the debate triggered by the corporate scandals and the implementation of corporate governance. The panorama includes the major European economies (Germany, France, Italy), Japan, a series of emerging economies (Argentina, Brazil, India and China) and two countries that exemplify well the complex transition, albeit between many limits and compromises, from a centralized economy to a market economy (Russia and Poland). The focus is on the medium to long-term trajectories that led to the preparation of the first corporate governance codes and the subsequent amendments. Particular emphasis is placed on the economic-institutional dynamics and on the numerous legislative and self-regulatory measures adopted to meet the different needs of corporate governance codes according to mechanisms of transparency and accountability. For each national case, the role of the business and financial communities is also clarified, as well as their role in pushing – but in some initial phases even in slowing down – the debate and the initiatives to get the definition of the guidelines and, finally, the texts containing the model of corporate governance and its most relevant features. The launch and implementation of codes has not put an end to corporate scandals, nor has it loosened discussions to refine these texts and make them increasingly binding. The debates and the continuous reforms that emerged from the progressive implementation of more tuned versions of corporate governance are in line with the needs of a society that has become more sensitive to the different aspects of this crucial topic. They include the relationship between management and ownership, between big and small shareholders and their rights, between companies and the economic, social, cultural and environmental frameworks in which they operate.

In the end, the work represents the synthesis of a path of study and researches that has lasted more than a decade, which has had as its leitmotif the analysis of the configurations of ownership, governance and management of companies in different contexts, from that of fragmented ownership of the public company to that of family ownership. However, the book is also the result of a long teaching experience with generations of students. Their numerous and stimulating questions have been the basis of our attempt to offer some answers. It is more than likely that these answers will give rise to further questions. If this will be the case, we will be sure that we have carried out our work in the best possible way.

The authors would like to warmly thank Dr. Maria Lucia Passador for her support as a teaching assistant in these last years and for her help in the preparation and the editing of most of the case studies that are included in the book.

1 Corporate Governance. Why, When, and How?

1.1 One vote, one share, and the problem of substantive democracy

"Corporate governance is old, only the phrase is new," writes Bob Tricker in his well-known textbook.[1] His words can be enriched with something else. In Washington, in Pennsylvania Avenue, there is the US National Archives Building, a neoclassical construction, which was part of a planning urbanistic project of the 1920-1930s. Outside the building, there is a statue, called "Study the past." A few words serve to explain the importance of that study: "What is past is prologue," a quotation by William Shakespeare from *The Tempest*. These words ought to be added to those written by Tricker. The present is prepared by the past. Its features and choices depend on what has been previously done.

The concept of corporate governance has a dialectic relation with the issue of democracy. It is not by chance that most of the discussions about shareholders rights and the first practices to guarantee them goes back to early decades of the economic and institutional history of United States. The American political elites developed some of the most relevant debates about democracy, when in Europe – with the exception of United Kingdom – the democratic institutions had to struggle to born, to survive, and even more important to work in the best way. Old European social and economic elites and their political representatives were giving a very limited meaning to the rules of democracy. However, in the United States the discussion about democracy in business and in particular in stock companies presented some unexpected aspect that *prima facie* could be contradictory. The equivalence of one head-one vote coming from the political conception of democracy struggled in the real economy with the substantive – not the formal, which by principle and by law did not exist – differences existing among citizens. Some were richer than others were; some could buy more shares than others could. The myth of democracy that accompanied the formulation of the American constitution and its amendments, and the debates about the best practices to implement it, was facing a huge obstacle when they entered into the world of business. How to combine the different rights of the citizens

[1] Tricker, B. (2015), *Corporate Governance. Principles, Policies, and Practices*, 3rd ed., Oxford, Oxford University Press (p. 6).

with the need to avoid too big social and economic differences that could endanger the social and political stability of the country?

Literature on the history of shareholders' voting rights shows that the formal democratic right one share-one vote was common and generalized. On the opposite, it has been the result of a long and controversial series of discussions and of different practices. The prevailing inspiration was linked to social conceptions of the firm that in the second part of the nineteenth century disappeared.[2] One of the most famous examples brings us to one of the first post-colonial State, Virginia. There, in 1830s, the lawmakers introduced a voting scale method to limit the "privileges" – in fact the different incomes and investments capabilities – among the shareholders. The law approved in 1836 concerning the shareholders of manufacturing corporations established the voting rights in this way: one vote for each share up to 15, one vote for every five shares from 15 to 100, and one vote for each increment of 20 shares above 100 shares.[3] This seems to be an important exception, although not the only one. A research by Henry Hansmann and Mariana Pargendler has shown that manufacturing industry was the sector where this kind of restriction were relatively more frequent in US until 1860s. "Only one out of 135 manufacturing corporations chartered by special act in Connecticut through 1856 adopted voting restrictions. Similarly, restricted voting schemes were present in only 2% of the manufacturing corporations chartered in New York between 1790 and 1825 and 5% of such firms incorporated in New Jersey between 1790 and 1867."[4] Other studies have noticed that such a method was quite common across all industries, without being never the majority of the cases. In nineteenth-century Connecticut, about 50% of charters and banking corporations adopted the voting restrictions. The forms could vary from a graduated voting scale to an absolute cap on the number of votes per shareholder. Similarly, nearly one-half of early New Jersey banks adopted a graduated voting scale.[5] In New York State this kind of restrictions were not so frequent (an accepted evaluation affirms that just one-fourth banks had voting restrictions). At the national level, there were more: 53% of banks adopted restricted voting between 1790 and 1859. In addition, other service sectors were using the same method.[6] Eric Hilt studied the case of New York and noticed, for instance, that restricted voting rules were almost generalized in New York turnpike companies.[7]

[2] Dunlavy, C.A. (2006), "Social conceptions of the corporation: Insights from the history of shareholder voting rights," *Washington and Lee Law Review*, 63(4), 1347-1388.

[3] Dunlavy, C.A. (1998), "Corporate governance in late 19th century Europe and the U.S.: The case of shareholder voting rights," in K.J. Hopt, H. Kanda, M.J. Roe, E. Wymeersch, & S. Prigge (eds.), *Comparative Corporate Governance. The State of the Art and Emerging Research*, Oxford, Oxford University Press, 5-40.

[4] Hansmann, H. & Pargendler, M. (2014), "The evolution of shareholder voting rights: Separation of ownership and consumption," *Yale Law Journal*, 123(4), 948-1013.

[5] Dreier, A. (1995), *Shareholder Voting Rules in 19th Century American Corporations: Law, Economics and Ideology*, unpublished manuscript.

[6] Hansmann & Pargendler (2014).

[7] Hilt, E. (2013), "Shareholder voting rights in early American corporations," *Business History*, 55(4), 620-635.

However, his research also permitted to discover some other important aspects of the early American stock companies. The firms, usually controlled by a stockholder and/or by the members of the board, encouraged the small shareholders to join the company with some information about the voting rights. Despite the high concentration of the ownership structure, the number of small shareholders was very important.[8] Previous studies also detected the early forms of managerial experience. The progressive specialization of firm also implied the use of professionals to manage certain aspects of the company. In certain sectors, like insurance, this was quite indispensable. However, certain functions, especially the financial ones, required also in the manufacturing firms (for instance the textile companies), some early forms of managerial professionalism.[9]

All these restrictions and discussions about the different forms to reduce the power of the biggest shareholders became obsolete after 1865. The huge economic development of post-Civil War period produced a situation where the legislation was always late compared to the original initiative of the new big corporations. The boom of the railway constructions and the immense economic and financial power of the railway companies pushed many States to provide special conditions for the incorporation of the companies. A competition started among the States in the late 1880s and the 1890s: offering legal residence to the companies in exchange of franchise taxes. This was particularly true because of the many novelties concerning the form and the character of the companies. New forms of firms raised, while other declined. The formal trust died. The new powerful actor was the holding company, a firm that could control horizontally several other companies of the same sector or vertically by integrating different segments of the productive process.[10]

These changes were also reflecting – and the response to – the depression of the 1870-80s. While American society was changing with the new waves of immigrants, the big business was establishing new hierarchies among sectors in the American economy. The rise of big business in many sectors, from the railways to the heavy industry, from oil to manufacturing industry, changed the country and not only from the GDP point of view. Some reactions were necessary. The power of the new companies and of their owners scared a part of American society. Critics and attacks against the new giants of the economy were very frequent and even popular, considering the success of the humor magazine *Puck*, which regularly ridiculed the biggest industrialists and bankers of that period (Vanderbilt, Morgan, Carnegie, Rockefeller, etc.) together with some politicians and other members of the American social

[8] Hilt, E. (2008), "When did ownership separate from control? Corporate governance in the early nineteenth century," *Journal of Economic History*, 68(3), 645-685.

[9] Chandler, A.D. Jr (1978), "The United States: Evolution of enterprise," in P. Mathias & M. Postan (eds.), *The Cambridge Economic History of Europe, Volume 7: The Industrial Economies: Capital, Labour and Enterprise, Part 2: The United States, Japan and Russia*, Cambridge, Cambridge University Press, 70-75.

[10] Atack, J. & Passel, P. (1994), *A New Economic View of American History*, 2nd ed., New York-London, W.W. Norton & Co., 481-487.

élites.[11] However, the campaign led to some important result. In 1887, the Interstate Commerce Act put a stop to cartelization of the railways sector. A few years later, a social and political coalition of small farmers (still influenced by the values of the old pioneers that enlarged the Frontier going west), big cities' shopkeepers and members of the Democratic Party succeeded in the first law that introduced precise norms against excessive concentration of market power. In 1890, the Congress approved the Sherman Act, known as the first antitrust law. In reality, in the following years and decades the law was interpreted as an anti-cartelization law, inspired by the principles of fair competition, an expression that was also too candid for the immense strength of the new big players of the American economy.[12] The American contradictory paradox started in those years. On the one hand, the strong push towards economic growth, on the other one, the need of regulations – a special cocktail that was served in that period just in the United States.

The concentration of economic power was not the only aspect of this period. From the point of view of the firm and of the corporate governance, the separation of ownership and management has been the most relevant consequence of the huge economic development of the country in the last decades of the nineteenth century. Per se, as we have noticed before, this was not completely new. The novelty was the generalization of the process. The second industrial revolution, which created new capital-intensive sectors, the technological changes introduced in the old ones, and the beginning of the mass production and distribution implied a wide managerialization of the companies.[13]

This transformation of the American firms produced many consequences for the shareholders. The increasing financial resources necessary to develop the activities of the firms need the intervention of many shareholders, most of whom were just small investors without the possibility to play any role in the firm. On the other side, there were big shareholders (financiers, founders of the company, and members of the founder's family) that were extremely interested in the concrete choices of the management and that were frequently interfering with the regular managerial activities. The potential conflict between (very influential) shareholders and managers – between principal and agent, according agency theory – was born, as well as its huge literature, inaugurated by Jensen and Meckling, discussing the problem.[14]

[11] Kahn, M.A. & West, R.S. (2014), *What Fools These Mortals Be! The Story of Puck, America's First and Most Influential Magazine of Color Political Cartoons*, San Diego, IDW Publishing.

[12] Stigler, G.J. (1991), "The origins of the Sherman Act," in T.E. Sullivan (ed.), *The Political Economy of the Sherman Act: The First One Hundred Years*, New York, Oxford University Press, 1991, pp. 32-38; Amatori, F. & Colli, A. (2011), *Business History. Complexities and Comparisons*, London, Routledge, 68-84.

[13] Chandler, A.D. Jr (1977), *The Visible Hand: The Managerial Revolution in American Business*, Cambridge (MA), Harvard University Press.

[14] Jensen, M.C. & Meckling, W.H. (1976), "Theory of the firm: Managerial behavior, agency costs and ownership structure," *Journal of Financial Economics*, 3(4), 305-360.

1.2 Towards regulation, disclosure, and transparency

However, apart from exceptions, this conflict did not explode in the following decades. The growth of American economy until World War I and the so-called "roaring 1920s" permitted to avoid any dispute. Until 1929, managers were considered a sort of King Midas: shareholders remained passive as dividends were regularly distributed. Many companies introduced new financial products on the one hand to reinforce the ownership structure and the biggest shareholders, on the other one to raise new financial resources among the public. The one share-one vote rule was widespread. However, from the early 1920s, since the corporate law did not require it, the companies started to introduce the multiple vote shares and the nonvoting shares. This behavior led to opposition from the public, as well as the academic community. In 1926, the New York Stock Exchange refused to list a company that issued nonvoting stock for the first time.[15]

The dramatic crisis of 1929 completely changed the situation. The managers of stock companies were now criticized under many points of view. The insufficient amount of information as well as its low quality, the lack of transparency of the decision process – too much concentrated frequently just in one person – paved the way for the first scientifically based discussion about the management and its relation with the shareholders. In 1931, Adolph Berle, a professor at the Columbia School of Law, published an article where he affirmed that "all powers granted to a corporation or the management of a corporation (...) are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears." He was convinced that corporations were simply instruments for advancing and protecting shareholders' interests and that corporate law should be interpreted to reflect this principle. He suggested that any other account of corporations' function and purpose would "defeat the very object and nature of the corporation itself."[16]

One year later, he reinforced his point of view in a book he published with Gardiner Means. In their monography, they highlighted, for the first time, the huge power reached by big corporations, comparing them to State. The conflict moved at the level of regulation between the two powers, the political and the economic one. They held the view that corporate powers are powers in trust for shareholders and nobody else, but admitted that a conflict could emerge. The central question for them was whether there was any justification for assumption that those in control of a modern corporation were choosing to operate it in the interests of the owners – the classic agency dilemma. Their answer opened the door to a seminal discussion: "it depend on the degree to which the self-interest of those in control may run parallel to the

[15] Choper, J.H., Coffee, J.C., & Gilson, R.J. (2000), *Cases and Materials on Corporations*, 5th ed., Gaithersburg, Aspen Law & Business (p. 565); Lund, D.S. (2017), *Nonvoting Shares and Efficient Corporate Governance*, University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 828.

[16] Berle, A.A. (1931), "Corporate powers as powers in trust," *Harvard Law Review*, 44(7), 1049-1074.

interests of ownership and, insofar as they differ, on the checks on the use of power which may be established by political, economic, or social conditions (...). If we are to assume that the desire for personal profit is the prime force motivating control, we must conclude that the interests of control are different from and often radically opposed to those of ownership; that the owners most emphatically will not be served by a profit-seeking controlling group."[17]

Merrick Dodd, a professor at Harvard Law School, discussed that opinion. He challenged Berle's position on a crucial point, when he wrote "there is in fact a growing feeling not only that business has responsibilities to the community but that our corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfil those responsibilities." In this framework, he introduced the concept of "social responsibility," a concept that would be developed many decades later. For him, that implied that if corporate managers paid more attention to the needs of their employees and consumers, this would ultimately benefit shareholders.[18] Their ideas would have received a larger formalization thirty years later with the famous book by Marris on managerial capitalism.[19]

The debate between the two academics did not inflame very much, but was not without any consequence.[20] The New Deal reforms that started in 1933 brought an important novelty also for the corporate community. In 1934, the Congress passed the law that established the first stock exchange independent authority, the Security Exchange Commission (SEC) that for the first time constrained the exercise of corporate power and inculcated a greater sense of public responsibility into corporate managers. The new institution, whose first chairman was Joseph P. Kennedy (the father of the John Fitzgerald Kennedy), introduced a stricter regulation for the listed companies and to uniform disclosure of information.[21] However, a recent paper reveals that not all consequences of the creation of SEC were positive. If the situation of the capital market was now more transparent and the quality and quantity of information thanks to quarterly report of the listed companies increased significantly, from the point of view of corporate governance the effects seem to go into another direction. The creation of the SEC "may have imposed "too much," governance on some firms, but (...) they were able to offset the governance imposed on them." The research permits the authors to affirm: "one of the most significant effects of the creation of the SEC was to cause the boards of affected firms to become less independent. An independent board and an independent chairman appear to have been more valuable in the pre-SEC era compared to in the post-SEC period. There is also some evidence that board governance was affected more broadly as the creation of the SEC resulted in larger boards and less local director monitoring."[22]

[17] Berle, A.A. & Means, G.C. (1932), *The Modern Corporation and Private Property*, Transaction Publishers, 113-114.

[18] Dodd, E.M. (1932), "For whom are corporate managers trustees," *Harvard Law Review*, 45(7), 1145-1163.

[19] Marris, R.L. (1964), *The Economic Theory of 'Managerial' Capitalism*, London, Macmillan.

[20] Weiner, J.L. (1964), "The Berle-Dodd dialogue on the concept of the corporation," *Columbia Law Review*, 64(8), 1458-1467.

[21] Stigler, G.J. (1964), "Public regulation of the securities markets," *Journal of Business*, 37(2), 117-142; Williams C.A. (1999), "The securities and exchange commission and corporate social transparency," *Harvard Law Review*, 112(6), 1215-1242.

However, the implementation of the rules took some time, while the general economic situation changed very much after World War II. The American economy was booming again as well as all the western partners of United States. Discussions and new reforms of corporate law and corporate governance started again only in the early 1970s, when the economic cycle was sinking. A litigious climate dominated United States, because shareholders of failed companies were asking for legal compensation from the former directors and from the auditors. In 1972, SEC required all listed companies to create audit committees that should dialogue with external audit committees.[23]

In Europe, the discussion about homogenize corporate law and company statutes was an effect of the integration process. In 1972, the European Commission presented a draft directive that had the purpose to establish a uniform model of statute and a model of corporate governance. The proposal was to introduce the two-tier system in the countries where the companies were managed just by one. The social protests and the requests of the workers' movement in many Western European countries of the late 1960s-early 1970s pushed the Commission to introduce also the proposal of the co-determination model in those years adopted just by some industrial sectors in Germany. The reactions to the draft were not positive. The topic disappeared from the European agenda until the early 2000s when a new formal proposal was finally accepted also by the European Parliament. The aim was to have a European model of company. The new firm's name was *Societas Europaea* (Latin words for European company), a public company registered in accordance with the corporate law of the European Union. It was introduced in 2004 with the Council Regulation on the Statute for a European Company. The companies willing to adopt this form were free to have the one-tier or the two-tier system. In 2005, the norm added the inclusion of the employees' representative in case the firm adopted the supervisory board.[24]

United Kingdom, which joined the European Union in 1973, did not appreciated the proposal of the European Commission. During that decade, before the arrival to the power of Margaret Thatcher, many debates took place in Great Britain about the rules concerning public companies and their social responsibility. Moreover, some of the suggestions raised by that draft of the European Commission and from the Ger-

[22] Avedian, A., Cronqvist, H., & Weidenmier, M. (2015), *Corporate Governance and the Creation of the SEC*, Swedish House of Finance Research Paper No. 15-03 (pp. 22-23).

[23] Tricker (2015, p. 9).

[24] Hirte, H. & Teichmann, C. (eds.) (2013), *The European Private Company – Societas Privata Europaea (SPE)*, Berlin, De Gruyter. Among the most famous European companies that adopted the *Societas Europaea's* statute there are Airbus, Allianz, BASF, E. ON, Fresenius, LVMH Moët Hennessy Louis Vuitton, SAP, Schneider Electric, and Unibail-Rodamco.

man law on Co-determination, approved by the Bundestag in 1976, found an echo in the Report of the Committee of Inquiry on Industrial Democracy of 1977.[25]

Other critical reports and enquiries on UK companies were showing that the quality of company law and of the firm's behavior was still to be improved. The neo-liberal wind of the late 1970s and the 1980s with the new mainstream about the "superiority" of the market and the de-regulation – both in United States and the United Kingdom – did not eliminate the quest for rules and for a better protection of shareholders' rights and interests. For instance, in 1985 a US Treasury Commission was set up to analyze fraudulent financial reports. The final document published by the Commission let to the establishment of the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative that studied the causal factors that can lead to fraudulent financial reporting. It also developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.[26]

1.3 Discovering and reforming "continent" Corporate Governance

Many companies' collapses and many scandals occurred in the 1980s and the early 1990s. Their impact on the international public opinion was very strong. On the other hand, the end of Cold War and the first effects of the privatization process in many countries gave the impression – and certainly the hope – that a new start was not only possible but also necessary. United States and United Kingdom, mainly because of the size and importance of their capital markets and stock exchanges, were the countries where all these tensions and pressures were stronger. In 1991, the Financial Reporting Council, the London Stock Exchange, and the accountancy profession established a special committee in London. The chairman was Adrian Cadbury, until 1989 the chairman of Cadbury Schweppes and director of the Bank of England since 1970. The increasing lack of confidence of the investors in the honesty and accountability of listed companies was at the origins of the Committee's initiative. In addition, during its works two other sudden financial collapses (wallpaper group Coloroll and Asil Nadir's Polly Peck consortium) contributed to exacerbate the climate because neither of these sudden failures was at all foreshadowed in their apparently healthy published accounts. Moreover, two other scandals shocked the financial: the collapse of the Bank of Credit and Commerce International as well as the emerging of its widespread criminal practices, and the posthumous discovery of Robert Maxwell's appropriation of £440 million from his companies' pension funds as the Maxwell Group filed for bankruptcy in 1992.[27]

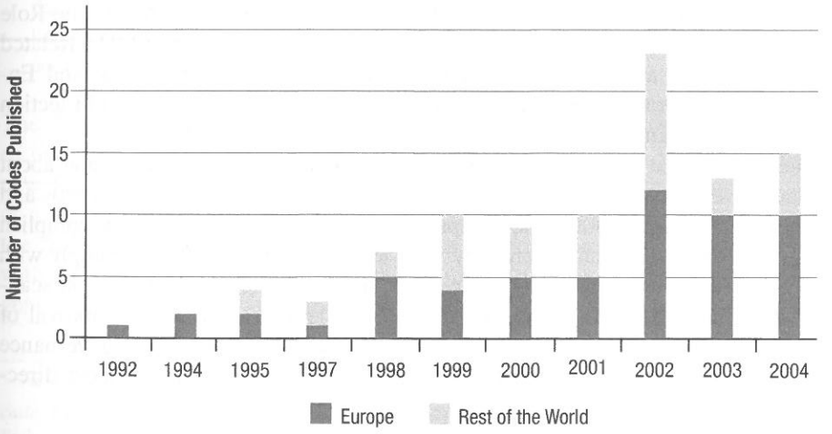
[25] Lorber, P. & Neal, A.C. (2002), "Financial participation of workers and the role of social partners: United Kingdom experience," in M. Biagi (ed.), *Quality of Work and Employee Involvement in Europe*, The Hague, Kluwer Law International, 195-218.

[26] https://www.coso.org/Pages/aboutus.aspx; Tricker (2015, pp. 11-12).

[27] Spira, L.F. & Slinn, J. (2013), *The Cadbury Committee: A History*, Oxford, Oxford University Press.

In 1992, the Cadbury Committee published its Report, which can be considered the first code of good corporate governance practices. The main points concerned the implementation of a wider use of independent directors. Moreover, an audit committee was introduced, as well as a precise list of different responsibilities of the chairman and of the board. Another sensitive point was the introduction of a remuneration committee to establish the rewards of the top managers and the members of the board and of a nomination committee to prepare the list of the new board's members. Finally, the listed companies had to comply with the code; moreover, if they did not comply with, they were requested to explain why. One can perceive the influence of the Cadbury Report in many other similar initiatives that took place in the same years. In some cases, like in some other Anglo-Saxon countries such as Australia, Canada, but also in South Africa and in Hong Kong (just before the British administration left the city), the echoes were quite visible and positive and many similar recommendations were adopted. In others, like France as we will see in another chapter, there was a more dialectic relationship.[28] However, in the following years the influence of the Cadbury Report went well beyond the Anglo-Saxon countries that adopted codes of corporate governance. In the first twelve years after the publication of the Cadbury Report, fifty-two codes were introduced and reformed (many times in some cases) in Europe and forty-two in the rest of the world, as **Figure 1.1** shows.

Figure 1.1 Number of corporate governance codes published by year (1992-2014)



Source: Own elaboration based on https://ecgi.global/content/codes

[28] http://cadbury.cjbs.archios.info/report.

In Great Britain, the code was emended in 1995 by another committee, chaired by Richard Greenbury (chairman and CEO of Marks & Spencer). It just reinforced the instruments towards making managers more accountable. In 1998, another Committee chaired by Sir Ronald Hampel, chairman and managing director of ICI, concentrated on a new topic: the goal of boards of directors should be to make shareholders rich, not just to make managers accountable. The mainstream of the shareholder's value was actually very effective, but its negative consequences were not yet visible.[29] However, the comments of *The Economist* were not so enthusiastic. On one hand, the magazine said the "yet the corporate governance movement continues to focus on narrow rules and regulations, to the point where producing rulebooks for boardrooms has become something of a cottage industry." On the other hand, it recognized that the reforms urged by institutional investors in America and Britain for the past few year – "such as increasing the number of outside (non-executive) directors, and having someone besides the chief executive chair the board – are clearly worthwhile. Although there is no proof yet that such changes improve share-price performance, the change of tone in many boardrooms suggests that they will eventually."[30]

In 1998-99, the OECD summarized many aspects of the discussions and of the different results of the implementation of the first codes of corporate governance in a publication that became a sort of guide for the "late-comer countries" in this subject. Many emerging economies and the BRIC countries used the OECD *Principles of Corporate Governance* when they established the first codes of corporate governance. In addition, this document was emended a couple of times, before and after the economic and financial crisis, in 2004 and in 2015. In addition, the OECD Corporate Governance Committee launched a thematic review process designed to facilitate the effective implementation of the Principles. In the last years it published many reports on Board Practices: Incentives and Governing Risks (2011), The Role of Institutional Investors in Promoting Good Corporate Governance (2011), Related Party Transactions and Minority Shareholder Rights (2012), Supervision and Enforcement in Corporate Governance (2013), Board Member Nomination and Election (2013), and Risk Management and Corporate Governance (2014).[31]

United States that have been for decades the frontrunner of any discussion about corporate governance did not introduce a real code for many years. In the 1990s and even more in the early 2000s, the companies were simply requested go accomplish the company law of the state where they were legally incorporated and "comply with the generally accepted accounting principles," abridged as GAAP. The Enron scandal of 2001 induced the Congress to reinforce the legislation with the approval of the Sarbanes-Oxley Act, which requires more severe rules of corporate governance for all the listed companies, underlining much more the role of independent direc-

[29] Lazonik, W. & O'Sullivan, M. (2000), "Maximizing shareholder value: A new ideology for corporate governance," *Economy and Society*, 29(1), 13-35.

[30] "Reforming the firm (1997)," *The Economist*, August 7.

[31] All the reports and different versions of the OECD *Principles of Corporate Governance* can be downloaded from: https://www.oecd.org/corporate/principles-corporate-governance.htm.

tors and stressing very much the role of audit committee. External audit firms were also requested to avoid too much familiarity because of long-term contracts and relations with the same firms, introducing a rotation system. The Blue Ribbon Commission, created by the National Association of Corporate Directors, had suggested the same things one year before. However, the myth of the rationality of the markets was still dominating Wall Street. The alternative opinions were not considered until September 2008, when the subprime crisis, started about one year before, suddenly cancelled not only the trust in many giants of the finance, but pushed the US administration to intervene like a classic Colbertist state to avoid a systemic crisis, injecting into the financial system $700 billion.[32] All the aspects of the corporate governance were concerned – and to some extent put at risk. One can start with the role of the big shareholders, the professional capabilities of the board and the abuse of moral hazard. However, there were also the non-independence of many independent directors, and the dubious independence of the external auditors. Another very delicate point, also because of the impressive impact it had on the public opinion, concerned the excessive salaries of the banking top managers that led their financial institutions to the crisis if not at survival's risk. Finally yet importantly, one must mention the role of rating agencies. The US Financial Crisis Inquiry Commission, which investigated the origins and responsibilities of the financial crisis in the United States, was extremely severe in its judgement about the rating agencies:

> The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.[33]

The European Commission intervened in the discussion about the consequences of the crisis over the corporate governance. In April 2010, Michel Barnier, the new Commissioner for Internal Market and Services, announced the publication of a *Green Paper*. The aim was to start a "real debate at the European level" over the "role and governance of auditors." In his opinion, because of urgency connected with the financial crisis, governments had so far "focused their attention on the urgent measures necessary to stabilize the markets," and then on the role of major eco-

[32] Stiglitz, J.E. (2003), *The Roaring Nineties: A New History of the World's Most Prosperous Decade*, New York, W.W. Norton & Co.; Fox, J. (2009), *The Myth of the Rational Market. A History of Risk, Reward, and Delusion on Wall Street*, New York, Harper Business; Roubini, N. & Mihm, S. (2010), *Crisis Economics. A Crash Course in the Future of Finance*, London, Penguin Press; Tooze, A. (2018), *Crashed. How a Decade of Financial Crisis Changed the World*, London, Allen Lane.

[33] *The Financial Crisis Inquiry Report. Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, submitted by the Financial Crisis Inquiry Commission pursuant to Public Law 111-21, January 2011, p. XXV.

nomic and financial reasons that provoked it. In Barnier's opinion, the crisis did not really question the role of auditors. The *Green Paper* entitled "Audit Policy: Lessons from the Crisis" was issued on 13th of October 2010. The document's intentions were to not only make auditing a more relevant issue, but also to make clear that the Commission was "keen to assume leadership at the international level on this debate and will seek close co-operation from its global partners within the Financial Stability Board and the G20." The consultation stimulated great interest, with 688 responses being received by the Commission. Moreover, a Commission staff-working document was issued in November 2010 with the title *Corporate Governance in Financial Institutions: Lessons to be drawn from the Current Financial Crisis, Best Practices Accompanying Document to the Green Paper Corporate Governance in Financial Institutions and Remuneration Policies*. In this document, the main issues were strictly linked to the core of the corporate governance. The document stressed how to improve the functioning and the composition of boards of financial institutions in order to enhance their supervision of senior management. It also underlined how to establish a risk culture at all levels of a financial institution in order to ensure that long-term interests of the business are taken into account. The involvement of shareholders, financial supervisors and external auditors in corporate governance was also considered, as well as how to change the remuneration policies in companies in order to discourage excessive risk taking.[34] The Greek crisis and its consequences on the European agenda did not really permit this document to get the audience it deserved.

The OECD was even more critical on corporate governance: "the financial crisis revealed severe shortcomings in corporate governance. When most needed, existing standards failed to provide the checks and balances that companies need in order to cultivate sound business practices."[35] One of its first report issued after the crisis stated that "corporate governance arrangements did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer-term interests." For these reasons, and for many others, "the current turmoil suggests a need for the OECD to re-examine the adequacy of its corporate governance principles in these key areas."[36]

[34] *Opinion of the European Economic and Social Committee on the 'Green Paper — The EU Corporate Governance Framework'*, COM(2011) 164 final, 28 January 2012; for an analysis of the first green paper see Humphrey, C., Kausar, A., Loft, A., & Woods, M. (2011), "Regulating audit beyond the crisis: A critical discussion of the EU Green Paper," *European Accounting Review*, 20(3), 431-457.

[35] https://www.oecd.org/daf/ca/corporategovernanceprinciples/corporategovernanceandthefinancialcrisis.htm.

[36] Kirkpatrick, G. (2009), "The corporate governance lessons from the financial crisis," in *OECD Journal: Financial Market Trends*, 2009(1).

Debates went on and not only at the headquarters of OECD. In 2016, 13 of America's most prominent chief executives, convened by Jamie Dimon of JPMorgan Chase and Warren Buffett of Berkshire Hathaway, and included the likes of General Electric and General Motors, as well as Vanguard and T. Rowe Price, two of the most important fund manager published a report with the title "Common-sense principles of corporate governance," containing seventy-seven suggestions. The document appeared in the most important newspaper. The *Financial Times* hosted it in a special page (most probably paid by the group). The document says how big companies should be led, how they should communicate with their shareholders, and how large investment firms should fulfil their own responsibilities. "Much of the report – wrote *The Economist* – is devoted to the role of directors, in theory the apex of a company but in reality often an assembly of dim bulbs with bright names that serve as an appendage of the CEO." The text suggest that directors should be "shareholder oriented," with diverse backgrounds and skills, undistracted by excessive other commitments. The final comment of *The Economist* was essential: "None of the bigwigs' suggestions are particularly exceptional. They may not soften the hearts of those who are fundamentally opposed to business. But any attempt to meet concerns that companies are feckless and undeserving of trust is worthwhile."[37]

At the beginning of 2019, Senator Elisabeth Warren, a Democratic presidential candidate, unveiled a proposal that would transform corporate America. The project would force large US companies to modify their current state charters with a federal one that pushes companies be run for the benefit of all stakeholders, not just stockholders. In addition, her proposal contains also an aspect that would transform US corporations in a sort of German firms, because it would also give workers the right to elect 40% of each board of directors. There are many aspects that may provoke some discussions. For instance, the *Financial Times* put the question "whether such reforms could be accommodated under the current arrangement by which American states charter corporations. The Securities and Exchange Commission could circumvent this by requiring reforms at companies whose shares or debt are publicly traded. But that would still leave out the growing number of corporations that are owned by private equity firms and wealthy individuals." However, its final comment was more than open-minded: the proposal "deserves credit for starting a wider political discussion of these corporate governance issues. Given the broad dissatisfaction with capitalism, such issues should already be at the top of the agenda."[38]

In summer 2019, the CEOs of some of the largest US corporations connected with the American Business Roundtable, an association of chief executive officers of America's leading companies, made an important announcement. On the one hand, they reaffirmed that "the long-held view that maximizing shareholder value is the defining corporate goal." On the other one, they added an important element that im-

[37] The text can be downloaded from: https://www.governanceprinciples.org/. For a comment, see "Change, or else (2016)," *The Economist*, July 30.

[38] Pearlstein, S. (2019), "Save capitalism by freeing companies to try new models. Politicians should make it easier to nominate board directors," *Financial Times*, January 20.

plies a more inclusive vision that takes account of other stakeholders. They explicitly stated, "broader interests such as those of employees, the environment and customers is intended to set a new standard for companies across the US." The *Financial Times* comment was that this "wider approach to corporate purpose should create a more sustainable and inclusive form of capitalism."[39] The consequences for corporate governance will probably be quite relevant in the future.

Two among the most important international financial media show that they do not have any prejudices in discussing all kind of proposals that could allow to improve corporate governance and making it more effective, and to enlarge the vision on the purposes of the firm. The business and financial community seems also ready. The political institutions, by tradition, prefer the self-regulation approach that has been – and still is – largely predominant in most of the countries that adopted codes of corporate governance.

The Covid-19 pandemic crisis opened up other Pandora's boxes. For years, investors have emphasized governance worries, such as around board composition, while environmental concerns climbed up the agenda after the 2015 Paris agreement to tackle climate change. "Now the 'S' [in ESG, Environmental, Social, Governance] is coming to the fore," affirms Sébastien Thevoux-Chabuel, a portfolio manager at Comgest, the French asset manager.[40] Moreover, the global pandemic has forced an abrupt rethink of a responsible capitalism agenda that had started when the teenage climate change activist Greta Thunberg captured the audience at the Davos World Economic Forum conference, launching the slogan "stakeholders for a cohesive and sustainable world." First class companies such as Armani, LVHM, and Marriot hotel group took various initiatives to show their social involvement in the greatest economic, social, and health crisis of the last hundred years. The proposals of the American Business roundtable made in summer 2019 became urgent everywhere. Amra Balic, head of BlackRock's investment stewardship team for Europe, the Middle East and Africa, declared to the *Financial Times*: "If you asked anyone who was in the sustainability or ESG space a year or two years ago, they would tell you that somehow the 's' [for 'social'] has not been given much visibility. Covid-19 has changed that substantially, and very, very quickly." Employees' wellbeing "is clearly at this time something they [corporations] need to focus on," she added.[41]

[39] "Business must act on a new corporate purpose (2019)," *Financial Times*, August 19.

[40] "Coronavirus forces investor rethink on social issues (2020)," *Financial Times*, April 30.

[41] Wiggins, K. (2020), "Now is the time to emerge as a corporate 'saint' not 'sinner'," *Financial Times*, May 11.

Part One:
Governance and Management

2 Ownership, Governance, and Management of Companies

2.1 What is corporate governance?

Despite more than two decades of intense debate among academics, managers, entrepreneurs and the business community at large, there are still various understandings of what is meant by corporate governance. One of the most classical definitions is that of Zingales (1998, p. 3), who refers to corporate governance as a "complex set of rules and constraints that configure the ex post distribution mode of the value generated by the company."[1] On a different note, Gillan and Starks (1998, p. 4) define corporate governance as a "set of laws, rules, and factors that discipline the management of a company."[2] With regard to the goals of CG, Sheridan and Kendall (1992) state that "good corporate governance consists of a system of structuring, operating, and controlling a company so as to achieve the following:

1. Fulfil the long-term strategic goal of the owners. (...)
2. Consider and care for the interests of employees, past, present and future. (...)
3. Take account of the needs of the environment and the local community. (...)
4. Work to maintain excellent relations with both customers and suppliers. (...)
5. Maintain proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities."[3]

The Cadbury Committee (1992) defined corporate governance as "the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholder's role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

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[1] Zingales, L. (1998), "Survival of the Fittest or the Fattest? Exit and Financing in the Trucking Industry," *The Journal of Finance*, 53(3), 905-938.

[2] Gillan, S.L. & Starks, L.T. (1998), "A survey of shareholder activism: Motivation and empirical evidence," *Contemporary Finance Digest*, 2(3), 10-34.

[3] Sheridan, T. & Kendall, N. (1992), *Corporate Governance: An Action Plan for Profitability and Business Success*, London, Pitman Pub.

Looking at the interests involved in the process, Shleifer and Vishny (1997, p. 2) state that "Corporate governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investment."[4] They start from the assumption that it is not obvious that shareholders get anything back when they start putting their money in, and have little to contribute to the enterprise afterward. Entrepreneurs need to be assured that they will get a return on their capital, and corporate governance mechanisms provide this assurance. This line of thought is opposed to the advocates of the liberal policies initiated by the Reagan and Thatcher governments in the 1980s, according to which corporate governance reforms are unnecessary. Indeed, in the long run, market competition would force firms to minimize costs, and as part of this cost minimization, to adopt rules, including corporate governance mechanisms, enabling them to raise external capital at the lowest cost. While market competition is probably the most powerful force toward economic efficiency, the corporate scandals of the 2000s show that market competition alone cannot solve the problem of corporate governance.

Despite the variety of contributions in this field, all the definitions proposed on this issue share a concept of corporate governance which includes everything that allows a company to be managed profitably and efficiently. In this view, the goal of corporate governance is for resources to be used in a productive way, so that the expectations of the different stakeholders are met. Moreover, scholars converge in dividing the scope of corporate governance into two large dimensions (Gillan 2006):[5]

- *an internal dimension*: relating to the ways in which power is assigned and shared within the company, and
- *an external dimension*: which includes the rules and institutions in charge of protecting the investors and regulating contacts between the company and its stakeholders.

The internal dimension analyzes the role, the composition, and the functioning of the board of directors (see Chapter 3 for more details), the incentives established by management, and the structure of ownership, as well as the internal audit system. The external dimension, on the other hand, includes the set of laws and regulations aimed at protecting investors, and stakeholders in general, against opportunistic behavior by the top management team. In the external dimension, we also include the capital market and the market for corporate control.

The subject of the current work is the internal dimension of corporate governance, which comprises three main actors: the owners, the board of directors, and the management of the company.[6] For this reason, in this book we adopt the following definition of corporate governance: the activity of "management" and "control" carried out by the owners of property rights and by the persons they designate to be their representatives in the top management, and especially on the board of directors. Based on this definition, we deal with the following issues:

- what are "ownership rights" (right to make decisions and to dispose of income and assets);
- who has the right and the duty to exercise these rights;
- according to which rules, which structures, and which processes are these rights exercised;
- what objectives and what possible results for the life of the companies (birth, development, transformation, transfer, termination) do they have;
- and, more generally, what relation to civil and social progress.

[4] Shleifer, A. & Vishny, R. (1997), "A survey of corporate governance," *The Journal of Finance*, 52(2), 737-783.

[5] Gillan, S.L. (2006), "Recent developments in corporate governance: An overview," *Journal of Corporate Finance*, 12(3), 381-402.

[6] Sciascia, S., Mazzola, P., Astrachan, J.H., & Pieper, T.M. (2013), "Family involvement in the board of directors: Effects on sales internationalization," *Journal of Small Business Management*, 51(1), 83-99.

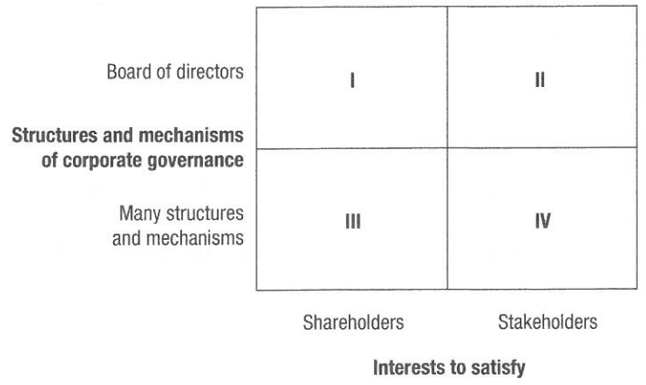
2.2 The different perspectives of corporate governance

The different definitions of corporate governance examined in the previous section differ both on the variety of interests considered in the process (i.e., the stakeholders involved in company), and on the numbers of structures and mechanisms involved in managing and controlling the company. With regard to the first aspect, the interests that must be satisfied range from those of the shareholders (who are uniquely worthy of protection, according to neoclassical theory), to all stakeholders involved in the company, whose interests must be reconciled through the management of the company. With regard to the second aspect, there are two extreme positions: 1) the board of directors is the only body responsible for facing and solving corporate governance problems; and 2) there is a various and complex set of structures with the aim of protecting the different interests that converge in the company (**Figure 2.1**).

Cross-referencing the two dimensions, we obtain a matrix into which we can place the different definitions of corporate governance examined in the first section; the four quadrants make it possible to identify several perspectives on corporate governance. On the two opposite sides, we have the "narrow" and the "broad" views of corporate governance.

In the first quadrant, there are all the studies that consider only the shareholders' interests relevant and worthy of protection and that see the board of directors as the only body in charge of governance activity. Indeed, the relationship between the other stakeholders and the company are to be efficiently managed and protected by market forces. In this view, the task of regulating any conflict of interests between shareholders and managers is assigned to the board of directors. According to this view, the only three groups involved are: 1) shareholders, who provide equity capital and have the right to appoint their representatives on the board of directors; 2) the directors, who have fiduciary duties towards the shareholders and must verify that the managers are working in their interests; and 3) the managers,

Figure 2.1 The different perspectives of corporate governance



Source: Zattoni, A. (2015), *Corporate governance*, Milan, Egea (p. 37).

who must manage the company so as to achieve the objectives set by the board of directors.

This is the narrow view of corporate governance, understood from the Anglo-Saxon perspective, and indicating the set of governance mechanisms of a large listed company, usually with a widespread shareholder base, and strongly posing the problem of protecting the interests of small shareholders against potential abuses resulting from managerial discretion.

This perspective typically deals with the following issues, which will be discussed in details in the following sections: 1) the "agency problem" of corporate governance, which originates from the separation between ownership and control of the company; 2) the public company as the most widespread ownership model in countries characterized by market capitalism; 3) the origins of "bad governance;" 4) the typical evidences of "bad governance;" and 5) the ritual responses to the problem of "bad governance."

In the second quadrant, various categories of stakeholders are considered to be worthy of protection (and not just the shareholders of the company), even though the board of directors still remains the only mechanism of corporate governance. In the third quadrant, there are those definitions of corporate governance that include several internal and external mechanisms in the corporate governance activity. While in the narrow view of corporate governance the questions are related essentially to the structure and functioning of the board of directors (which will be examined in detail in Chapter 3), or to the ownership rights of shareholders, in a broader view of corporate governance it refers to "the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how risks and re-

turn from the activities they undertake are allocated. These arrangements include corporation law and boardroom practices, obviously, but they also include aspects of corporate finance, securities and bankruptcy law, laws governing the behavior of financial institutions, labor relations practices, contract law and theory, property rights, compensation systems, and internal information and control systems." (Blair, 1995)

Finally, the fourth quadrant recognizes a much broader perspective of corporate governance. This view of corporate governance questions several assumptions at the core of the previous perspectives: 1) the implicit hypothesis that corporate governance is particularly relevant (if not exclusively) in the context of large public companies in U.S. or U.K.; 2) the assumption that the board of directors is the supreme governance body; and 3) the exclusive attention to the protection of the shareholders' interests. The following fundamental aspects characterize this perspective of corporate governance, which we have adopted in this work:

a) the company should be managed in order to satisfy the interests and requests of numerous categories of stakeholders, and the corporate governance mechanisms should involve the interaction of numerous elements inside and outside the company;[7]
b) consideration should be given to ownership and managerial models different from the traditional one, such as those characterized by: 1) a different distribution of ownership rights between the various parties involved in the company; and 2) different managerial models, with various and possible overlaps between owners, directors, and managers of companies, with all the implications that this entails in terms of transparency, efficiency, and fairness; and
c) the model should include other actors in the game, in addition to those already mentioned and introduced previously.

In this regard, we can refer to a generic company listed on the stock exchange. Especially in countries with concentrated ownership structures (see Chapter 6 for a detailed discussion), the role of the shareholders' meeting is particularly relevant as it is the place where the interests of the various categories of owners can be reconciled – through a variety of possible arrangements that may be regulated by shareholders' agreements, voting agreements, or blocking agreements – ensuring that the governance of the company is exerted in the name and in the interest of the shareholders. In this regard, the definition of "shareholders" requires more attention, as they are no longer homogenous. There is a great difference between "large and active shareholders" and "small shareholders:" the first are actively involved in managerial functions, while the latter are not active and seek protection. As a result, the main issue concerning the "interests of shareholders" is striking the right balance between setting limits to "managerial discretion" (tolerating the power of

[7] See Zattoni (2015).

large shareholders) and "small shareholder protection" (limiting the concentration of voting power).

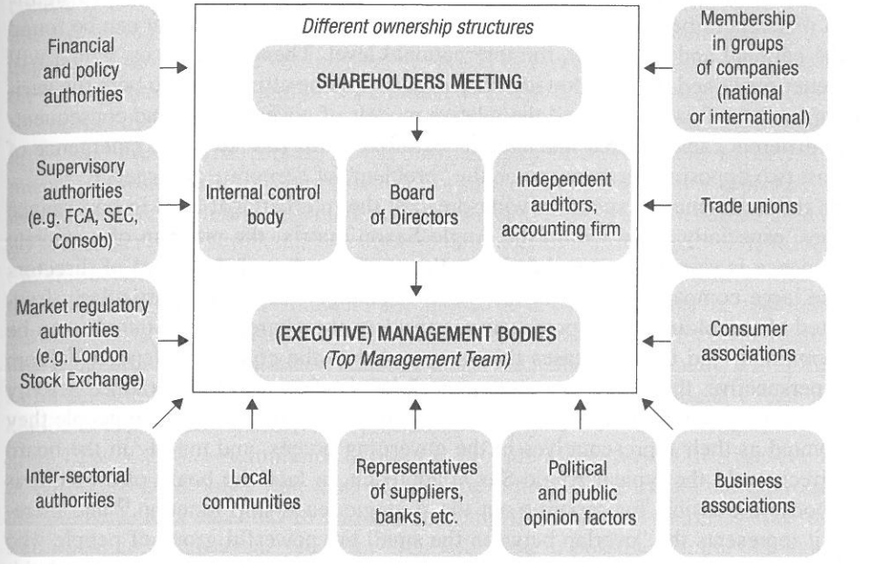
The picture becomes more complex where we consider the various bodies and structures for monitoring the interests of all shareholders and stakeholders, including national securities commissions which are responsible for financial regulation of securities products within a particular country (e.g., the Financial Conduct Authority in the U.K., the Securities and Exchange Commission in the U.S., etc.). Their powers and responsibilities vary greatly from country to country, but generally cover the setting of rules, as well as enforcing them, for financial intermediaries and stock exchanges. According to different national regulations, each company has an internal body in charge of supervising the company's activities (i.e., the internal audit committee in the one-tier model, the supervisory board in the two-tier model, the board of statutory auditors in Italy, etc.) in order to ensure that they are carried out in compliance with the law, the company bylaws, and proper management practices. Moreover, in listed companies, the accounting control is usually entrusted to an auditor or to an auditing firm. The purpose of the audit is therefore to ensure more complete and reliable financial statement information, by delegating the accounting control function to specialized companies, technically qualified and subject to more intense supervisory oversight.

The role of all the external bodies is better defined when the company operates, for example, in a highly regulated sector (such as credit, insurance, energy, gas, or telecommunications). In these cases, the behavior and strategic choices will be influenced not so much (and not only) by the governance bodies, but also and mainly by the regulatory authorities (or "sector authorities," such as the authority for telecommunications). In addition, there are the "intersectoral authorities," such as the competition authority and the privacy authority, which influence the behavior of all companies. Furthermore, all companies are subject to audits by various inspection and policing agencies: financial police, labor inspectors, local health authorities, and so on.

Last but not least, there is the central role played in corporate governance decisions by various associations of particular stakeholders. These include trade unions, various and varied consumer associations, and business associations. Clearly, if the company is part of a group of companies, it is necessary to pay attention to the influence exercised by the parent company, especially if it is a subsidiary. This is even more important in the case of multinational companies, with numerous national "branches" operating in different countries and subject to different local regulations – and especially if it is listed on the respective stock exchanges of the various countries.

The adoption of a broader perspective therefore makes it possible to consider a variety of actors often underestimated by the traditional perspective to the problem of corporate governance. Although the goal of the current work is not to describe this model in detail (for a comprehensive representation see **Figure 2.2**), this model aims to highlight the complexity of the converging interests of a modern capitalist company.

Figure 2.2 Overview of ownership, governance, and management bodies in a broader perspective



Source: Minichilli, A. (2012), *Proprietà, governo e direzione delle imprese*, Milan, Egea (p. 49).

2.3 The "traditional" corporate governance problem

Although attention to the issue of corporate governance is explicitly or implicitly rooted both in the economic and business studies in general[8] or more specifically on the issue of corporate governance[9] – as well as in the first international studies on the separation between ownership and control of companies[10], the proliferation of the debate on this topic is much more recent, and linked especially to the waves of corporate scandals which erupted in the early 2000s. This debate has drawn grow-

[8] In this regard, see, among others: Coda, V. (2010), *Entrepreneurial Values and Strategic Management: Essays in Management Theory*, Basingstoke, Palgrave Macmillan.

[9] Fiori, G. (2003), *Corporate governance e qualità dell'informazione esterna d'impresa*, Milan, Giuffré; Turnbull, S. (1997), "Corporate Governance: Its Scope, Concerns and Theories," *Corporate Governance: An International Review*, 5(4), 180-205; Tricker, R.I. (1987), "Improving the Board's Effectiveness," Journal of General Management, 12(3), 5-20; Zattoni (2015).

[10] Berle, A.A. & Means, G.C. (1932), *The Modern Corporation and Private Property*, New York, Macmillan.

ing attention to the problem of corporate governance, which has become increasingly important not only for scholars on the subject, but also for entrepreneurs, managers, and policy-makers.

However, in the face of this growing and widespread interest, there are still significant differences between the different conceptions of the problem that can be found at the national and, above all, the international level. These differences, which will be better explained in the following chapters, seem to be attributable to both the variety of models of capitalism and the relative models of governance,[11] and consequently to different capitalist and managerial "cultures." This has led to the emergence of at least two opposing perspectives on the "problem" of corporate governance.

In the traditional perspective, widespread at the international level in governance studies, especially those within the Anglo-Saxon matrix, the problem of corporate governance is essentially translated into the configuration of the board of directors in the large companies listed on the Stock Exchange which have particularly fragmented shareholding. This perspective considers the shareholders' interests to be predominant, and in some cases this is extended to the company's lenders.[12] From this perspective, the "corporate governance" label refers to the governance activity carried out by the property rights' owners of the companies, and by the people they appointed as their representatives in the governing bodies, and mainly in the board of directors. In the typical Anglo-Saxon approach, in fact, the board of directors is the body responsible for carrying out the strategic leadership function,[13] and therefore it represents the "overlap between the small but powerful group of people who lead the company, and a huge, widespread, but relatively helpless group of shareholders who simply hope that the company is managed in the best way."[14] This approach is encouraged by fragmented ownership in countries such as the United States and the United Kingdom, which have often represented the best empirical field for studies on corporate governance.

Even if it is fascinating, this perspective is based on hypotheses that restrict its widespread application to different contexts. Firstly, the excessive emphasis on separation between ownership and control, and on mechanisms – such as the board of directors – to align the interests of owners and managers, makes this type of approach particularly suitable for large public companies in the United States and the United Kingdom. However, large companies operating in many of the other major industrialized countries often have much more concentrated ownership structures, with a controlling shareholder, a block-holding family, or a coalition of controlling shareholders.[15] Secondly, if we accept a broad interpretation of the problem of corporate

[11] Charkham, J.P. & Ploix, H., *Keeping Better Company. Corporate Governance Ten Years On*, Oxford, Oxford University Press, 2005.

[12] Shleifer & Vishny (1997).

[13] Zattoni (2015).

[14] Monks, R.A.G. & Minow, N. (1995), *Corporate Governance, Cambridge*, Blackwell (p. 178).

[15] Pedersen, T., & Thomsen, S. (1997), "European patterns of corporate ownership: A Twelve-country study," *Journal of International Business Studies*, 28(4), 759-778; Thomsen, S., & Pedersen, T. (2000), "Ownership structure and economic performance in the largest European companies," *Strategic Management Journal*, 21(6), 689-705.

governance, and its results in terms of profitability, growth, competitiveness, or simply "survival" of enterprises, we understand how the actors involved go beyond the governing body (the board of directors) and the ownership of the company. On the contrary, as highlighted in a great deal of research, especially international research, the probability of the company being "managed in the best possible way" seems to depend not so much, and not only, on the board of directors, but also, and primarily, on the top management and on its characteristics in terms of power and relations.[16] Moreover, the traditional perspective considers shareholders, and more generally those who provide risk capital, as the only category of stakeholders whose interests must be considered in the processes of corporate governance. This approach, even if implicitly or explicitly accepted in the view of the most industrialized countries, no longer appears comprehensive enough, and seems anachronistic with respect to the characteristics and needs of the modern companies. In this regard, it should be noted that the recent deep financial and industrial crisis is altering the relationships between the different stakeholders (employees, customers, suppliers, local communities, trade union representatives, national states, etc.), and the company, with processes for selecting and rewarding the best, most respectful, fair, and socially responsible companies, processes that have no precedent.

In light of these assumptions, in order to provide a new way to interpret the issue of corporate governance that goes beyond the limits of the traditional approach to the problem, it is essential to start by defining the essential characteristics of the traditional approach to the problem. This will make it possible, on the one hand, to identify the main "assumptions" underlying the problem of corporate governance, which nevertheless persist in many self-discipline or self-regulation codes in many countries around the world, even those with a non-English matrix; on the other hand, it will allow us to lay the theoretical foundations for understanding the broad perspective proposed here, in all its complexity and in its various articulations.

2.4 The public company and the agency theory

The problem of corporate governance, although often broader than originally understood by the term corporate governance,[17] is rooted in the phenomenon of the so-called public company.[18] Born to permit the progressive separation between own-

[16] Finkelstein, S., Hambrick, D.C., & Cannella, A.A. (2009), *Strategic Leadership: Theory and Research on Executives, Top Management Teams, and Boards*, Oxford, Oxford University Press.

[17] See in this respect, among others, Shleifer & Vishny (1997).

[18] In Anglo-Saxon countries, a public company is generally defined as a company listed on the stock exchange. This is due to the clear prevalence – among listed companies – of companies with widespread shareholding, and therefore without controlling shareholders. The same interpretation is not correct in many countries of continental Europe, such as Spain, France, Italy, Greece, or Germany itself, where of-

ership and control – which is necessary to allow companies to grow in size by separating legal responsibility for the company itself from that of its lenders[19] – the public company is now the most widespread proprietary model in countries characterized by market capitalism, especially the United States and the United Kingdom. Unlike in many countries characterized by family or relational capitalism models, the public company represents a listed company with fragmented and passive ownership, in which none of the shareholders has sufficient incentive, interest, and power to play an active role in the governance of the company.

This context strongly raises the issue of excessive managerial discretion, such as the propensity of many chief executive officers – especially in the large U.S. corporations of the 1970s and '80s – to perpetuate themselves and all the members of the board of directors in their respective positions. This trend, fueled by the propensity of small shareholders, and often also institutional investors, to "vote with their feet" (exit) in the event of disagreement with company management policies, appears less marked today than in the past, due to strong pressures linked to the diffusion of the principles and best practices of good corporate governance.[20] In this sense, the characteristics of the relationship between owners and managers in the public company have inspired many good governance practices. In particular, the question was (is): which structures, which rules, and which mechanisms (internal and external to the company) can ensure that the board of directors operates in an active, intelligent, far-sighted, honest, and fair manner, with the aim of ensuring the correct exercise of direct and delegated power by directors and managers?

This is because, especially where there is a marked separation between ownership and control, the improper and harmful exercise of powers and delegated power by directors and managers can lead both to "hidden" (but no less serious) consequences such as inefficiency, failure to meet profitability and development expectations, collusion, etc., or can result in serious corporate crises.

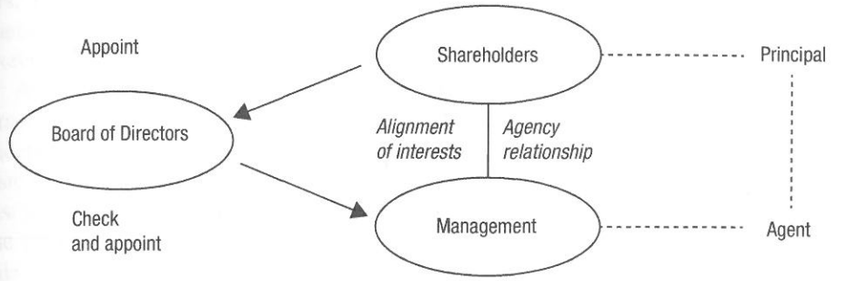
In answering this question, many of the classical studies of corporate governance are based on the theory of agency, with the aim of identifying the determinants of the relationship between the owners of the property rights (shareholders), and those who exercise the prerogatives associated with those property rights (managers). The agency relationship, in fact, can be defined as "a contract under which a person (the principal) entrusts another person (the agent) to perform a certain service, which includes a power, in favor of the agent, to take decisions in the name of, and on behalf

ten a predominant group of listed companies (i.e., "public" in Anglo-Saxon terminology) are instead controlled by a controlling shareholder, be it the State or, more frequently, an entrepreneurial family.

[19] Berle & Means (1932).

[20] This can be seen: Aguilera, R.V. & Jackson, G. (2003), "The cross national diversity of corporate governance: Dimensions and determinants," *Academy of Management Review*, 28(3), 447-465; Aguilera, R.V. & Cuervo-Cazurra, A. (2004), "Codes of good governance worldwide: What is the trigger?" *Organization Studies*, 25(3), 417-446; Zattoni, A. & Cuomo, F. (2008), "Why Adopt Codes of Good Governance? A comparison of institutional and efficiency perspectives," *Corporate Governance: An International Review*, 16(1), 1-15.

Figure 2.3 The "basic scheme" of the relationship between ownership, managers and board of directors according to agency theory



Source: Minichilli (2012, p. 24).

of, the principal."[21] However, where both the principal (shareholder) and the agent (manager) tend to maximize their utility, it is likely that the agent will not always act in the principal's sole interest, as would be required by the agency relationship described above. It follows that it will be in the principal's interest to put in place protective action, reducing the divergence between his own interests and those of the agent. This can be done in different ways, essentially through monitoring actions, by requiring the agent to provide precise guarantees, or by granting incentives to the agent (stock options or stock granting). Since each of these modes inevitably produces costs (so-called "agency costs"), a corporate governance structure is efficient if it produces particularly low agency costs.

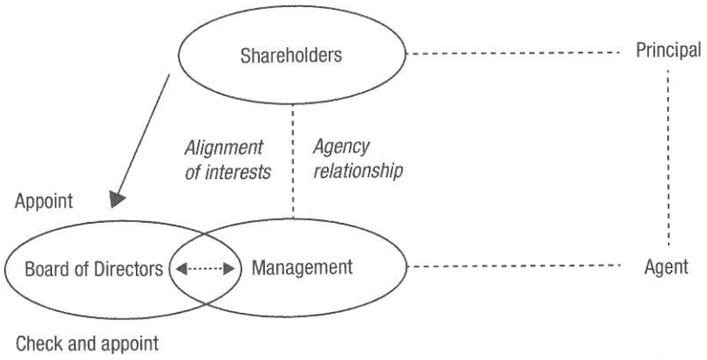
In this context, the role of the board of directors appears to be central. A board which is correctly appointed and configured – with the majority (if not the totality) of independent directors – represents the best guarantee of a balanced relationship between shareholders and managers, proper control of the job carried out by managers, and an alignment of the different types of interests. The mechanism described above, which represents the "basic scheme" of the relationship between ownership, managers, and governance bodies according to agency theory, is shown in **Figure 2.3**.

2.4.1 A first variant of the agency's basic scheme

Despite the theoretical clarity and practical implications implicit in the "basic scheme" of agency theory, the relationship between ownership, management, and the board of directors appears much more complex in reality than that described above.

[21] Jensen, M.C. & Meckling, W.H. (1976), "Theory of the firm: Managerial behavior, agency costs and ownership structure," *Journal of Financial Economics*, 3(4), 305-360.

Figure 2.4 A first variant: the overlap between the board of directors and management



Source: Minichilli (2012, p. 25).

Although the board of directors is the body that controls managerial behavior, it is also the governing body of the company, and for this reason it is called upon to carry out a series of actions to support senior management in making the most important decisions for the management of the company itself. This makes it unrealistic for the board to be totally independent of management. Independence, which is a fundamental requirement for the proper exercise of control, would make their support for management less effective, and would also make it difficult to perform the dual roles of checks and balances. In fact, according to a widespread line of thought, the function of the board of directors should be, on the one hand, to "control" and, on the other, to "support" top management, with the dual aim of containing the causes and manifestations of wrongful behavior by managers, but also to create value for shareholders' benefit.[22] This means that in practice boards are made up of a variable mix of internal (executive) and external (independent) directors, which is an important first variant of the basic scheme of agency theory (**Figure 2.4**).

Based on these observations, therefore, it is relevant to understand the "optimal" degree of overlap or, alternatively, of separation, between the governing and controlling body (the board of directors), and the executive body (the management). This is necessary to avoid the risk of a "domain" being established by management, which has for a long time denied the board of directors both the function of governance and guidance of the company and – more worryingly – the function of control over the

[22] Stiles, P. & Taylor, B. (2002), *Boards at Work. How Directors View Their Roles and Responsibilities*, Oxford, Oxford University Press.

job performance of senior management.[23] As indicated by the managerial hegemony theory,[24] this is a circumstance that seriously compromises the agency relationship between shareholders and managers, causing increasing agency costs for shareholders. This is due to the impossibility of carrying out an effective monitoring of the management by the board of directors, which – in the event of a large number of executive directors – would be in a position to "monitor itself."

After twenty years of debate and efforts to disseminate good corporate governance practices, however, the situation now has changed. As recent data show, the presence of independent directors has reached the level of 85% in the 500 largest (by capitalization) listed U.S. companies (S&P 500),[25] and increased by four percentage points over the last ten-year period. The situation is less comforting in France, Italy, and Spain, where the presence of independent advisers stands at 58%, 51%, and 45% respectively.[26] In this regard, however – as already mentioned previously, and as will be better explained later – the lower level of independence of boards in these countries seems to be motivated by the radically different ownership structures of companies, even large ones.

2.4.2 A second variant of the agency's basic scheme

A second, more radical variant of the basic agency scheme, particularly widespread in countries with companies that have a high concentration of ownership, such as those of continental Europe, and Italy in particular, is that which sees an overlap not only between the governance and the executive bodies, but also between these two bodies and the ownership of the company. In these circumstances, such as is typical of family-owned companies, the overlap between ownership, control, and management seems to present multiple "lights and shadows," generating a still-unresolved tension, even from a theoretical point of view.[27]

On the one hand, the theoretical elaboration of the agency paradigm seems to indicate that the convergence of interests between the ownership – or at least a part of it – and the management of the company, produces a substantial alignment of interests,[28] even making superfluous the role of control exercised by the board. On the

[23] As mentioned above, this is the situation that occurred between the 1970s and 1980s in the vast majority of the boards of the large U.S. corporations.

[24] Stiles & Taylor (2002).

[25] Spencer Stuart, *2018 Board Index (United States)*.

[26] Spencer Stuart, *2018 Board Index (Italy)*.

[27] Minichilli, A., Corbetta, G., & Macmillan, I.C. (2010), "Top management teams in family controlled companies: 'Familiness,' 'faultlines,' and the impact on financial performance," *Journal of Management Studies*, 47(2), 205-222; Vandebeek, A., Voordeckers, W., Lambrechts, F., & Huybrechts, J. (2016), "Board role performance and faultlines in family firms: The moderating role of formal board evaluation," *Journal of Family Business Strategy*, 7(4), 249-259.

[28] See, among others: Fama, E.F. (1980), "Agency problems and the theory of the firm," *Journal of Political Economy*, 88(2), 288-307; Fama, E. & Jensen M.C. (1983), "Separation of ownership and control," *Journal of Law and Economics*, 26(2), 301-325; Jensen & Meckling (1976).

other hand, however, the characteristics of family control, with the associated risks of "altruistic behavior" by the family towards its members,[29] in addition to the typical risk aversion of many entrepreneurial families in the face of strategic decisions such as acquisitions, diversification, opening up of share capital, etc.,[30] seem to highlight the negative aspects of family involvement in the business.

Moreover, the differentiation between "sub-groups" of shareholders, directors, and managers, generated by the overlap between ownership, control, and management of the company, is potentially a further source of concern. For example, the relationship between the controlling (or majority) shareholders and minority shareholders, especially when the company is not listed, is particularly complex, generating the so-called "owner-owner" or "principal-principal problem."[31] This problem, which is substantiated by the misalignment of interests and incentives between different groups or "classes" of owners – both with regard to specific strategic choices, and especially with regard to the short or long-term orientation of these choices – characterizes all situations in which the ownership structure allows a blockholder (majority shareholder) – this can be a family, the state, a venture capitalist, etc. – to oppose the interests of small minority shareholders.

Similarly, potential conflicts of interest and incentives between independent directors and ownership representatives on the board can lead to anomalies in the overall governance structure of the company. This situation, which is typical, for example, of both family-owned and state-controlled enterprises, generates a clear distortion in the control mechanism according to which "controllers" (independent advisers) are appointed by the "controlled" people (the majority shareholder), although they are equally and jointly responsible for the fate of the company. This anomaly happens not only in the case of the control function of the board of directors, but also in that of support for the management, after often making the effective contribution of outside directors difficult, especially where the main strategic decisions are taken by the controlling shareholders.

[29] Schulze, W.S., Lubatkin, M.H., Dino, R.N., & Buchholtz, A.K. (2001), "Agency relationships in family firms: Theory and evidence," *Organization Science*, 12(2), 99-116; Schulze W.S., Lubatkin, M.H., & Dino, R.N. (2003), "Exploring the agency consequences of ownership dispersion among the directors of private family firms," *Academy of Management Journal*, 46(2), 179-194.

[30] See, among others: Morck, R. & Yeung, B. (2003), "Agency problems in large family business groups," *Entrepreneurship Theory & Practice*, 27(4), 367-382; Gomez-Mejia, L.R, Makri, M., & Kintana, M.L. (2010), "Diversification decisions in family controlled firms," *Journal of Management Studies*, 47(2), 223-252; Zahra, S.A. (2005), "Entrepreneurial risk taking in family firms," *Family Business Review*, 18(1), 23-40; Gomez-Mejia, L.R., Patel, P.C., & Zellweger, T.M. (2018), "In the horns of the dilemma: Socioemotional wealth, financial wealth, and acquisitions in family firms," *Journal of Management*, 44(4), 1369-1397.

[31] In this regard see: Claessens, S., Djankov, S., Fan, J.P.H., & Lang, L.H.P. (2002), "Disentangling the incentive and entrenchment effects of large shareholdings," *Journal of Finance*, 57(6), 2741-2771; Cronqvist, H., & Nilsson, M. (2003), "Agency costs of controlling minority shareholders," *Journal of Financial and Quantitative Analysis*, 38(4), 695-719; Young, M.N., Peng, M.W., Ahlstrom, D., Bruton, G.D., & Jiang, Y. (2008), "Corporate governance in emerging economies: A review of the principal-principal perspective," *Journal of Management Studies*, 45, 196-220.

Finally, the coexistence of "owners" and "external" managers can be difficult to configure in such a way as to ensure the harmonious governance of the company. This is the case, for example, with managers appointed by the government in state-owned or state-controlled enterprises (SOEs); they seem to have political sanction and great power within the company, which can hardly be equal to that of "technical" managers.[32] But this problem is also and often the case with family managers, compared to managers who do not belong to the controlling family. Their ownership power, and internal legitimacy, as well as the sense of belonging to the company that typically characterizes family executives, seem to create the conditions for conflicts between family and non-family members (on methods, strategic objectives, etc.), or simply to generate a feeling of exclusion of non-family members harmful for the company. In this regard, in fact, it has recently been demonstrated that the coexistence of family and non-family managers, especially in large family-managed companies, can represent an element of conflict able to impact negatively on the performance of the company.[33] This leads us to suggest, in this specific case, how the managerialization process of a family company should be accomplished quickly, in order to avoid long periods of transition and coexistence between owner managers and non-owner managers. In general, however, this situation – as with the others reported above – seems to advise caution in the interpretation tout court suggested by agency theory's scheme about the natural alignment of interests in companies where the overlap between ownership and management is more pronounced. The mechanism described above is shown in **Figure 2.5**.

Given the importance of this subject for the purposes of this work, we will return to it extensively at a later point.

2.5 The origins of "bad governance"

Despite the conceptual clarity about agency theory and its possible variants, people may wonder what the deep origins of bad governance are, and what are its manifestations. This is particularly important for understanding the conditions for the proper exercise of governance activity, and above all, the actors and bodies involved in guaranteeing this result. In this regard, the following is a list of circumstances – some of which are general in nature, others specifically related to the governance of the company – that could potentially lead to opportunistic and deviant behavior by directors and managers. General circumstances include, among others:[34]

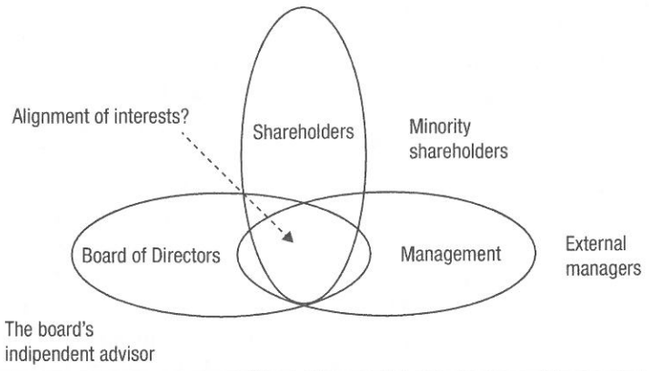
- *Human nature*, and in particular, intelligence, energy, and honesty (or dishonesty). Although human nature may seem exogenous in some respects to the pat-

[32] Ernst & Young (2010), *Government as In Best Class Shareholders.*

[33] Minichilli, Corbetta & Macmillan (2010).

[34] See in this respect, among others: Airoldi, G., Brunetti, G., & Coda, V. (2005), *Corso di economia aziendale*, Bologna, Il mulino.

Figure 2.5 A second variant: the overlap between ownership, the board of directors, and management of the company



Source: Minichilli (2012, p. 29).

terns and models of governance of modern enterprise, to quote Herbert Simon, in the social sciences "nothing is more fundamental in defining our research agenda and informing our research methods, than our vision of nature and the human behaviors we are investigating."[35] In this sense, although the propensity towards opportunistic behavior varies considerably among different individuals, and also in different cultures,[36] the tendency of the human person – in the words of Michel Crozier – is "to take advantage, in every circumstance, of all the means available to pursue one's own privilege."[37]

- *The different risk appetites of directors and managers.* Contrary to what is assumed by economic theories, in the face of the same circumstances, different individuals (decision-makers) can adopt very different behaviors, not only in order to pursue their own self-interests, but also because of different propensities to take risks, depending on their own personalities or by context. According to a recent variant of the agency theory, called the "behavioral agency model" (BAM),[38] indeed, some of the purely economic arguments offered by the agency theory seem inadequate to explain strategic decisions and behaviors such as diversification, internationalization, the propensity to invest in R&D, etc. This is particularly true in some particular contexts, such as that of family-owned companies, where the

[35] Simon, H. (1985), "Human Nature in Politics: The dialogue of psychology with political science," *American Political Science Review*, 79, 293-304.

[36] See, among others, Williamson, O.E. (1979), "Transaction-cost economics: The governance of contractual relations," *Journal of Law and Economics*, 22, 233-261.

[37] Crozier, M. (1964), *The Bureaucratic Phenomenon*, Chicago, Chicago University Press (p. 194).

[38] Wiseman, R.M. & Gomez-Mejia, L.R. (1998), "A behavioral model of managerial risk taking," *Academy of Management Review*, 23(1), 133-153.

family decision-maker is motivated by a complex set of incentives that characterize his risk propensity, including the social and emotional aspects (of belonging to the family).[39]

- *Limited rationality, information asymmetry, the impossibility of complete contracts, and uncertainty.* In the context of studies on human nature, it has been pointed out that the limited rationality (*bounded rationality*)[40] of individuals determines conditions of information asymmetry between the actors involved, which makes it impossible to define complete contracts, and thus ensure conditions of uncertainty.[41] Hence, the need to inspire relationships of trust between the different actors, which, however, contrast with people's opportunistic tendencies, as mentioned above.

Among the more specific origins of bad governance, however, there are the following:

- *The separation between ownership and control.* As mentioned above, and as clearly proposed by the agency theory, the separation between ownership and control is absolutely one of the most favorable conditions for the emergence of opportunistic behavior. This is mainly due to the considerable concentration of power in the hands of executives, especially in public companies, where various factors converge, including the temptation of directors and managers to pursue personal objectives, enormous information complexity (and asymmetry), and the consequent intrinsic difficulty in controlling such behavior.
- *The leverage effect of "private benefits/public costs" and the vicious circle.* One consequence of the separation between ownership and control, especially in large and very large companies such as U.S. corporations, is to produce a strong leverage effect between the magnitude of private benefits obtained by directors and managers in cases of opportunistic (if not fraudulent) behavior, and the distribution of the "costs" of such benefits among a very large number of small shareholders. This leads, on the one hand, to a strong incentive towards opportunistic behavior, and on the other hand, to the objective difficulty of small shareholders detecting such behavior due to the relatively low cost incurred and informa-

[39] This further variant of the behavioral agency model, which will be discussed in detail in Chapter 6, appears to be particularly suited to the context of family-owned enterprises, and is called *Socio-Emotional Wealth* (SEW). To this regard, see: Berrone, P., Cruz, C., & Gomez-Mejia, L.R. (2012), "Socioemotional wealth in family firms: Theoretical dimensions, assessment approaches, and agenda for future research," *Family Business Review*, 25(3), 258-279; Gomez-Mejia, L.R., Cruz, C., Berrone, P., & De Castro, J. (2011), "The bind that ties: Socioemotional wealth preservation in family firms," *Academy of Management Annals*, 5(1), 653-707; Gomez-Mejia, L.R., Haynes, K.T., Nunez-Nickel, M., Jacobson, K.J.L., & Moyano Fuentes, J. (2007), "Socioemotional wealth and business risks in family-controlled firms: Evidence from Spanish olive oil mills," *Administrative Science Quarterly*, 52(1), 106-137.

[40] Simon (1985, p. 303).

[41] Alchian, A.A. & Demsets, H. (1972), "Production, information costs, and economic organization," *The American Economic Review*, 62(5), 777-795.

tion asymmetries with the management, until serious and manifest consequences appear. The difficulty in effectively monitoring such behavior, and the management's awareness that in the vast majority of cases the extraction of private benefits will remain "hidden," also determines a tendency to generate a vicious circle, with a real "snowball effect."[42]

- *Imperfect markets*. Although many financial scholars believe that the problem of governance can and should largely be solved by acting on the markets (of goods, capital, directors, and corporate control),[43] the recent financial crisis shows how different degrees of efficiency and transparency of the different markets, as well as the lack of truly effective and homogeneous regulation on a global scale, make it difficult to delegate the problem of corporate governance to the mere – and exclusive – functioning of the markets.
- *The inherent weakness of all formal and bureaucratic controls*. Despite the continuous evolution of legislation and regulation, and the increased bureaucratic burden for companies due to the proliferation of formal control systems and mechanisms, bureaucratic and formal controls continue to show weaknesses. The reasons for the intrinsic weakness of the controls can be found precisely in the phenomena mentioned above, namely, the impossibility of drawing up complete contracts (and therefore the impossibility of establishing comprehensive controls), the separation between ownership and control – which makes it difficult for representatives of property rights' owners (i.e., the members of the board of directors) to carry out their control function – and information asymmetry, which makes it easy to hide what is the exclusive knowledge of key players in the company.

2.6 The signs of "bad governance"

From the above considerations, it should now be clear that signs of bad corporate governance are represented by all those circumstances in which directors and managers, deviating from their agency mandate, damage the interests of the owners in order to prioritize their own interests. Although the case history of opportunistic behavior is virtually infinite, along with manifestations of problems of economic governance in a company, the following are some of the "standard circumstances" most frequently discussed in the literature:

- *Empire building*, i.e., the tendency, especially on the part of top executives of a company,[44] to favor dimensional growth over the profitability of the company, often taking excessive risks in order to increase their personal power (and employability in the "managerial market"[45]); their remuneration (usually linked to the size of the company[46]); various other kinds of benefits; and their personal power and prestige,[47] as well as to satisfy an often-uncontrollable narcissistic aptitude.[48] The ability to "build an empire" is also explained by the *free-cash flow theory*,[49] according to which companies with high cash flows and low investment opportunities will tend to go beyond their optimal size, since the temptation to grow would be far greater for many managers than the search for efficient investment for the available cash flows.
- *Shirking*, i.e., favoring low-risk personal strategies, restricting personal commitment and tensions. This type of behavior is based on the assumption that the overall value produced by the company is the result of teamwork, which makes it difficult, if not impossible, to identify individual contributions, and therefore the relative rewards. This has the effect of tempting managers, and especially those who are more uncertain about the contribution they make to the company (first of all, the CEO), to "relax" by delegating the execution of the work to others.[50]
- *Personal enrichment*, often pursued through unfair practices, at least ethically, if not legally. These include the use of hierarchical power in order to obtain salaries and benefits outside the market; the use of personal relationships and connivance within the company in order to steal funds; or the use of privileged information to carry out profitable transactions with related parties in a conflict of interest. Although the issue of transactions with related parties is subject to increasingly stringent regulations, the personal enrichment of managers through such transactions has always been an exemplary result of opportunistic behavior. In the simplest form, a manager can set up an independent legal entity, which he owns himself or through trustees, in order to sell products and services of the company he works for at very advantageous prices or, conversely, to provide through his own entity consultancy, or other kind of services to the company he works for, at higher prices. Even more dramatic is the case in which the manager decides to

[42] This was the case with Enron and with Parmalat, which shared the same tendency of their respective leaders to hide their losses in their balance sheets (due to their managerial errors), and not disclose them except in the face of the company's manifest insolvency.

[43] Shleifer & Vishny (1997).

[44] Primarily, by the chief executive officer.

[45] Fama (1980).

[46] Bebchuk, L.A. & Fried, J.M. (2003), "Executive compensation as an agency problem," *Journal of Economic Perspectives*, 17, 71-92; Pepper, A. & Gore, J. (2015), "Behavioral agency theory: New foundations for theorizing about executive compensation," *Journal of Management*, 41(4), 1045-1068.

[47] Williamson, O. (1974), *Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm*, London, Kershaw Publishing.

[48] Chatterjee, A. & Hambrick, D.C. (2007), "It's all about me: Narcissistic CEOs and their effects on company strategy and performance," *Administrative Science Quarterly*, 52, 351-386; Wales, W.J., Patel, P.C., & Lumpkin, G.T. (2013), "In pursuit of greatness: CEO narcissism, entrepreneurial orientation, and firm performance variance," *Journal of Management Studies*, 50(6), 1041-1069.

[49] Cambrea, D.R., Guarneri, L., & Quarato, F. (2017), "The role of family control and growth opportunity in affecting the investment-cash flow sensitivity," *European Journal of Economics, Finance and Administrative Sciences*, 95, 31-44.

[50] Alchian & Demsets (1972).

exchange the company's assets instead of the outputs. This is the case with Korean *chaebols*, where some of the subsidiaries were often sold to the relatives of the *chaebol*'s founder at extremely advantageous prices; but it is also the case with pyramid schemes in Italy, where intra-group assets have been sold at prices that are detrimental to the value of shares, and therefore to the interests of the shareholders of the counterparty.[51]

- *Entrenchment*, i.e., the erection of barriers against the risk of hostile takeovers and of the subsequent removal of top management.[52] The mechanism of "entrenchment" and resistance carried out by top management, especially where it is no longer of benefit to the company, is one of the most expensive manifestations – and sometimes difficult to quantify in economic terms – of the agency problem. Among the various mechanisms by which managers protect themselves from the risks of removal, are anti-raid clauses,[53] golden parachutes,[54] and shareholders' agreements.
- *Excessive focus on short-term results*, with the aim of presenting the best possible results to the financial markets (window dressing), sacrificing the company's medium- and long-term performance if necessary. This attitude, which is widespread among U.S. CEOs, rewards short-term results by increasing top management salaries (if linked to the company's results), and creating the conditions for alternative – and possibly more prestigious – jobs for managers.
- *Transfer of benefits to third parties* who, although not necessarily illegally (for example, the phenomenon of "nepotism"[55] in companies, including listed companies, under family control), risk compromising the future of the company and its success, such as when a manager is selected only because he belongs to the controlling family, and not for his consolidated managerial profile.

[51] Shleifer & Vishny (1997).

[52] Baysinger, B.D. & Butler, H.N. (1985), "Anti-takeover amendments, managerial entrenchment, and the contractual theory of the corporation," *Virginia Law Review*, 71(8), 1257-1303.

[53] Among the most widespread clauses against hostile takeovers, especially among American corporations, there are (Zattoni 2015):

- *Supermajority amendments*, i.e., requiring majorities of more than 50% of the voting rights in the event of attempts to acquire control of the company through a hostile takeover;
- *Staggered boards*, i.e., the definition of rules establishing *ex-ante* a gradual and staggered change over time for the members of the board of directors;
- The *fair price amendment*, i.e., the imposition on the corporate raider to acquire all the shares of the target company at the same price as the takeover bid of the controlling interest;
- *Poison pills*, i.e., the right of the target company to issue shares at a particularly low price to the company's shareholders (with the exception of the corporate raider) if a particular investor exceeds a certain percentage of the risk capital.

[54] *Golden parachutes* are special clauses in top management contracts that involve the payment of large sums of money or penalties in the event of a change of control group or dismissal. In some cases, the parachute is extended to the entire management (*silver parachute*) or even to all employees (*tin parachute*).

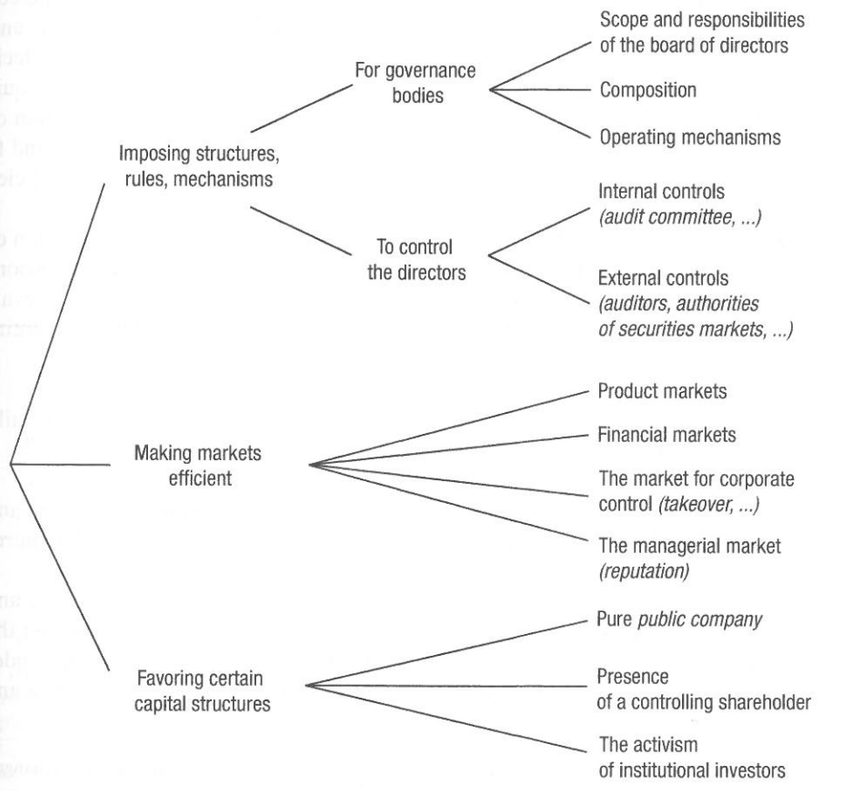
[55] Schulze, Lubatkin, Dino, & Buchholtz (2001).

2.7 Responses to the problem of "bad governance"

In the "traditional" or restricted perspective adopted so far, various mechanisms can mitigate the tendency of top management to pursue its own interests to the detriment of those of shareholders. These mechanisms can be classified into three different categories, depending on the different goals pursued, and in particular: 1) imposing structures, rules, and operating mechanisms on the governing bodies; 2) make the markets efficient and letting them act as regulators; and 3) giving preference to certain capital structures.

An initial classification of these mechanisms is represented in **Figure 2.6**, which will be discussed below.

Figure 2.6 The multiple answers to the problem of bad corporate governance



Source: Minichilli (2012, p. 37).

2.7.1 Imposing structures, rules, and mechanisms

An initial response to the problem of bad corporate governance, widely considered in both national and international literature, as well as in the various self-regulation codes in the field of corporate governance,[56] is to impose structures, rules, and operating mechanisms: a) for the board of directors; and b) for the internal and external control systems of directors.

As is well known, the Board of Directors (BoD) is the main mechanism for exercising control over management. In doing so, it is important that there is, on the one hand, a clear definition of its tasks and responsibilities and, on the other hand, that it is characterized by a composition and structure that allow its proper functioning. With regard to the definition of the scope of action and the set of tasks of the board of directors, the articles of several company bylaws identify the following macro-areas of activity:[57]

- *To make the basic decisions for the company*, including various, relevant choices of configuration of its economic activity, such as: a) definition of the goods and services to be produced; b) choices of sizing of the production capacity; c) decisions of diversification and related procedures (by internal lines or through acquisitions); d) choices of internationalization and related procedures; e) definition of general policies regarding organizational structure and personnel policies; and f) choices regarding the financial structure of the company, and its related policies of indebtedness.
- *Selecting, encouraging, and evaluating top management*, through the selection of the chief executive officer; the definition of his or her areas of action and responsibility; the determination of his or her remuneration and any incentives; the evaluation of his or her job; and control over the conduct of the CEO and the entire top management team.

With regard to the structure and functioning of the board of directors, especially with respect to listed companies, the literature focuses on the following aspects:[58]

- *the composition of the board of directors*, i.e., how many directors to appoint and with which individual characteristics, including the basic assessment of requirements for independence;
- *the structure of the board of directors*, with particular reference to the figure and role played by the chairman; the overlapping of offices and powers between the chairman and the chief executive officer (or managing directors); the lead independent director; and the presence and characteristics in terms of structure and composition of the typical internal corporate governance committees (audit committee, remuneration committee, and nomination committee); and
- *the way in which the board of directors operates*, which includes aspects such as providing information to directors; the frequency and manner in which meetings are held; the decision-making style of individual directors and especially of the board as a whole; the evaluation or self-assessment of the board's performance; etc.

In the context of the structures, rules, and mechanisms for control of the directors, on the other hand, the following categories should be considered:

- *The internal control system*, which is based on both the laws and regulations embedded in the legal framework of the country in which the company operates. Usually three different corporate governance systems are identified for joint-stock companies:
  - *the two-tier system*, typical of the German tradition, divides the company's administration into two different bodies, the management board (whose members are subject to the same responsibilities as directors), and the supervisory board, appointed by the shareholders' meeting. Generally, the supervisory board is in charge of guiding and monitoring the management board;
  - *the one-tier system*, typical of the English-speaking country tradition, assigns the management of the company to a single board, the board of directors, among whose members a control committee is appointed;
  - *the ordinary system*, typical of the Italian tradition, requires the presence of a management board (a sole director or a board of directors whose number of members is determined by the shareholders' meeting), and a control body (the board of statutory auditors). The board of statutory auditors consists of five members, and is in charge of monitoring the proper administration (i.e., the organizational, administrative, and accounting set-up of the company).
- *The system of external controls*, which refers to the role of independent auditors, including the time limits for their office imposed by law in several countries,[59] as well as the role of the supervisory authority for the proper functioning of the market (SEC in the United States, Consob in Italy, etc.). The main activities carried

[56] Including the Code of Coporate Governance for Companies listed on the Italian Stock Exchange.

[57] See Airoldi, Brunetti, & Coda (2005); Zattoni (2015).

[58] This is an initial and concise list, with reference to the fuller discussion in Chapter 3, which is devoted entirely to the composition, structure, and functioning of the board of directors.

[59] For instance, in the United States, audit partner rotation is recommended in Title II, Section 203 of the "Sarbanes-Oxley" law, *116 Stat. 773* (Audit Partner Rotation). The European Commission has issued a recommendation: "Statutory Auditors' Independence in the EU, A Set of Fundamental Principles" which only requires partner rotation on listed clients after seven years. No countries within the EU, with the exception of Italy, currently have a system of mandatory audit firm rotation. Indeed, in Italy, according to art. 18, paragraph 4 of Law 262/2005, the term of office of the independent auditors is six years, renewable only once, and cannot be renewed unless at least three years have elapsed from the date of termination of the previous term. In the event of renewal, the person responsible for the audit shall be replaced by another person.

out by Consob in Italy include: a) supervision of issuers (listed companies) and independent auditors; b) supervision of markets; c) supervision of financial intermediaries; d) sanctions and precautionary measures; e) interpretative regulatory activity and international developments; and f) reports on the internal management and external relations.

2.7.2 Making markets efficient

A second answer to the problem of corporate governance, traditionally considered the fundamental reference in financial studies, is to make markets efficient and let them act as regulators. These include different types of markets:

- *The market for goods and services*: this is the simplest and most traditional form of market, although it has now changed profoundly compared to the past due to the phenomenon of internationalization and globalization of consumers and consumption behavior. The hypothesis underlying "real" markets is that the company exists in order to produce goods and services considered satisfactory, and that therefore those companies (and their management) that demonstrate the ability to interpret the needs of their consumers survive, thus generating value for the company itself and for its shareholders.
- *Financial markets*: according to supporters of the idea of the "perfect efficiency" of financial markets, the equity performance of a company represents the best possible measure of the value created for shareholders. This measure should be particularly reliable because it is not based on the current value of the company and its current performance, but, above all, on investors' expectations of future performance. The availability of such an accurate measure of value has the merit of two kinds of "discipline" for management. On the one hand, share value is a measure of management performance, and therefore constitutes the "wake-up call" for shareholders to suggest the replacement of one or more of the directors and managers of the company. On the other hand, this would align managers with the objective of maximizing share value, where their remuneration is linked to the value of the shares through equity incentive plans.
- *The market for corporate control*:[60] the market for corporate control has the task of assigning ownership of the company to those who are able to generate greater value through better management. This market is activated (or should be activated) when a company is managed inefficiently, resulting in a stock performance well below its potential. In this case, the conditions are created for a transfer of control rights to third parties, both in a "friendly" (with spontaneous mergers) and in a "hostile" way. Among the hostile ways of reallocating corporate control there are:

[60] See Zattoni (2015).

  - *the battle for proxies*, which occurs when a shareholder of the company, not satisfied with the performance of the board of directors, presents an alternative list of candidates to that proposed by the management, trying to persuade the other shareholders to vote for their list; and
  - *the hostile takeover*, in which the corporate raider makes a public takeover of the entire capital of the company, or a significant part of it, at a fixed price. If the takeover is successful, the climber takes control of the company, and with it the possibility of appointing a new board and a new CEO.
- *The managerial market*: the managerial market, which aims at the future employability of directors and managers, should represent one of the most powerful mechanisms to discipline managerial opportunism. According to the theory of economic rationality, it is very unlikely that a manager would run the risk of having his or her misconduct being discovered, since this would preclude future employment opportunities; thus this creates a powerful reputational deterrent.[61]

Despite the clearly fascinating nature of the theories underlying the functioning of the markets, and the complex mechanism of "rewards" and "sanctions" for managerial behavior that they imply, thanks to the recent financial crisis, the markets have not met these important expectations. Leaving aside the market for goods and services, the "failure" of the financial markets seems to have entailed at least two orders of consequences. On the one hand, the enormous decline in the value of shares experienced during the crisis by all companies, healthy and not, in different sectors, and with different earnings performance, has diminished the ability of equity value to "measure" the quality of management, detaching share prices from the actual value produced by the company. On the other hand, the collapse of trust in the markets has made it difficult for companies to use them to collect fresh risk capital, which would have been very useful in limiting the debt that companies had to take on in facing the financial crisis.

From the point of view of the market for corporate control, while it is true that the "selection" between virtuous companies, and inefficient companies with high potential, is still quite limited, offering limited information to potential "buyers," it is also true that the drastic reduction in share prices has created a unique historical opportunity for significant reallocations of corporate control. However, with few exceptions, a reallocation of control in such a way that could encourage the possibility of consolidating the position of some companies – at least in certain industries – once out of the crisis, has not occurred. This is especially the case in state-owned enterprises or in sectors considered strategic for various countries, demonstrating once again the supremacy of politics over the force of the markets.

Similar considerations apply to the management market. Although attention to executive behavior grew substantially during the crisis, especially in the banking and financial sector, there is still a lack of full awareness – at least in Italy, and proba-

[61] Fama (1980).

bly in other countries in continental Europe – of the importance of ethical and forward-looking company leadership.

2.7.3 Favoring certain capital structures

A third set of responses to the problem of corporate governance, which is complementary to, but not a substitute for, rules and mechanisms of governance and market action, is the possibility of "favoring" certain capital structures over others. In this sense, the debate over the "supremacy" of the model of the pure public company versus concentrated ownership in the hands of a blockholder, has once again become topical.

On the one hand, the company with widespread shareholding seems to be able to guarantee some indisputable advantages, including the possibility of growing in size much more easily than the company with concentrated ownership, its gains in competitiveness arising from economies of scale. At the same time, although more exposed to the problem of managerial discretion, this type of enterprise would also ensure a better and clearer separation of roles (owners, directors, and managers), thus allowing a less ambiguous functioning of the overall system of governance.

On the other hand, the company controlled by a blockholder, be it an entrepreneur, an entrepreneurial family, a group of subjects linked by a shareholders' agreement, a bank, or a company inserted in a pyramidal group, should eliminate the problem of misalignment of interests between shareholders and managers. The presence of shareholders dominant enough to have an incentive to play an active and direct role in corporate governance decisions, and the presence of representatives of the controlling shareholder on the various governance levels (especially in the board of directors and management), should in fact ensure that the agency problem is almost completely overcome.

Moreover, companies with blocks of concentrated shareholders, and, in particular, family-controlled companies, appear to have been more resilient during the crisis in several respects. According to recent research on medium and large Italian family businesses, family firms have shown greater "resilience" under the pressures of the crisis, demonstrating a propensity for family entrepreneurs to capitalize and invest that seems to set the conditions for their future growth and profitability. All this without sacrificing employment, confirming the attention paid to "human capital" by entrepreneurial families, and in general, their long-term orientation to all the strategic decisions and the entire financial structure of their companies.[62] At the same time, however, as introduced earlier, this comes at the cost of increased ambiguity in

[62] Minichilli, A., Brogi, M., & Calabrò, A. (2016), "Weathering the storm: Family ownership, governance, and performance through the financial and economic crisis," *Corporate Governance: An International Review*, 24(6), 552-568.

the system of governance, due to overlapping roles and responsibilities, and especially potential conflicts between controlling and minority shareholders.

This does not mean that ownership can be "forced by law." On the contrary, a major study of the major industrialized countries, carried out at the end of the 1990s, unequivocally demonstrated that concentration of ownership is a "response" to the lack of legal protection for shareholders and investors.[63] In other words, concentration of ownership plays a replacement role for the markets, representing the "best" form of ownership in contexts characterized by poorly-developed financial markets, an inefficient judiciary, and a lack of transparency of accounting standards. As will be better explained in the next chapters, certain "types" of ownership structures are more likely to fit well in certain contexts, and not in others.

Beyond the debate on the supremacy of one or other model of control and governance of companies, it seems useful to offer a final consideration on the growing phenomenon of "shareholder activism," born in the Anglo-Saxon context, but which promises to expand even in capitalist countries dominated by family-controlled companies, or with an intensive state role in the economy. As is well-known, under the Anglo-Saxon capitalism model, the main shareholders of large listed companies are represented by institutional investors, i.e., mutual funds and pension funds primarily. However, while up to the middle of the last decade, the managerial policy of institutional investors appeared to be inspired by a logic of "active" management of the securities portfolio (the so-called Wall Street Walk), characterized by the sale of securities of overvalued companies and the purchase of securities of undervalued companies, during the 1990s this strategy of institutional investors underwent a major change.[64] The new policy, which relies on regular pressure on the top management of companies in order to change their strategic choices and governance, is characterized by investor activism aimed at making proposals, pressuring the board of directors or the CEO of the company, and censuring and fighting cases of overcompensation of top management. This new method of operating is considered a new model for protection of owners' interests, particularly useful in overcoming the problems of companies' fragmented ownership structure, but also (and potentially) in counterbalancing the excessive power in the hands of the controlling shareholders, by creating a healthy dialectic even at the ownership level.

[63] La Porta, Lopez-De-Silanes, Shleifer, & Vishny (1998).
[64] See Zattoni (2015).

Case study Enron, the history of an unexpected bankruptcy

On December 2, 2001, Enron Corp., the seventh largest multinational company in the United States, went bankrupt. Born in 1985 from the merger between InterNorth Inc. and Houston Natural Gas (a company founded by Kenneth Lay, who was president of Enron until a few months before the bankruptcy). Enron in its early years was mainly responsible for distributing natural gas in the United States, connecting producers upstream in the supply chain, with local utilities downstream, through about 37,000 miles of pipelines. Taking advantage of the deregulation of the industry, in the early 1990s Enron radically changed its business formula, transforming itself from a company that owned the gas transport network into a gas "bank," dedicated to intermediation between producers and users, and carrying out risk-management activities on contracts for the supply of electricity, natural gas, and water. From the mid-1980s to the end of 1999, income grew by 300%, to $130 billion. The value of its shares had increased by 700% in the 1989-1999 decade, reaching $90 per share.

The transformation of the business began at the end of the 1980s with a number of deregulatory measures. In particular, the issuing of Order 436 in 1986 by the Federal Energy Regulatory Commission (FERC) triggered a major deregulation process: natural gas producers could now contract directly with users without having to establish supply contracts with transmission companies. The latter, on the other hand, had to provide their distribution capacity to all operators who requested it, at fixed rates and on a first-come first-served basis, until the pipelines were saturated. Enron's innovative idea was to act as an intermediary between producers and distributors, offering financial services to hedge against the risk that emerged from price volatility and supply uncertainty, by setting up a new organizational unit for risk intermediation and management: Enron Gas Services (EGS). In addition, a significant factor behind Enron's growth was the substantial public funding it received to support its expansion projects (including $3.6 billion from U.S. agencies such as the Overseas Private Investment Corporation and the Export-Import Bank). Such relations with the U.S. federal government continued through 2000, when George W. Bush, who had long-standing personal ties with Kenneth Lay (Bush called him "Kenny Boy" as a sign of close friendship), was elected President of the United States.

Growth and diversification in the 1990s

During the 1990s, Enron's activities became increasingly risky. Derivative trading was often used not only to hedge positions with suppliers and customers, but also for speculative activities in the financial markets. The turning point was 1990, when Kenneth Lay recruited Jeffrey Skilling, a former McKinsey consultant, to lead the new Enron Gas Services (EGS) business unit. Skilling immediately solicited the help of Andrew Fastow, who was promoted to Chief Financial Officer (CFO) in 1998, to build up over time a large network of subsidiaries, the Special Purpose Entities (SPE), which financially supported development at a low cost. It was here that the frauds arose: Enron asked for huge loans from banks, which were transferred to the SPEs (there were more than 800), which were essentially empty boxes run by Fastow, who used the money for buying and selling derivatives at inflated prices with Enron itself.

Skilling was also the first to understand the enormous potential arising from the liberalization of the gas and energy markets. He proposed a revolutionary idea: fixed-term contracts for gas, an idea that in 1996 led the Fortune magazine to designate Enron as the world's most innovative company. In 1997, Enron announced its first commodity transaction using derivative products. In the following years, Enron was accused of manipulating energy prices on more than one occasion during peaks in demand (for example, during the electricity crisis in the state of California in 2000).

Additional risks resulted from Enron's increased diversification into unrelated businesses and significant expansion in developing countries, which were characterized by very high risks. In 1999, Enron decided to enter the digital world by setting up EnronOnLine, an Internet interface through which it could instantly access the company's intermediation services.

In the late 1990s, Enron's stocks had a multiple price-earnings of about 60, about three times the industry average. The euphoric climate of the new economy favored development, and the extraordinary performance of stocks increased market expectations, generating very strong pressure on Enron's management, which was called upon to maintain the current positive trend. On December 28, 2000, its shares were valued at around $85. The sustained growth in share prices had a dramatic impact on the earnings of Kenneth Lay and Jeffrey Skilling. In 1999, Lay earned a bonus of $3.9 million, in addition to the basic salary of $1.2 million. Jeffrey Skilling earned a bonus of $3 million, in addition to his basic salary of $850,000. However, these fees were low compared to the value of their stock options. In 1999, the exercise of options by Lay and Skilling resulted in gains of $43.8 million and $46.4 million respectively.

Storm on the horizon

From the end of 1999 to the beginning of 2001, the first problems for Enron began to appear: some of the initiatives launched in previous years did not meet expectations. Serious management mistakes had undermined the water business, but the biggest problem was the plant at Dabhol, India, which was the world's largest combined-cycle power plant, whose construction had contributed to feeding Enron's image of greatness in the eyes of Wall Street. This project proved too expensive and not economically viable, which is why, at the beginning of 2001, the state of Maharashtra declared that it could not comply with the terms of the contract for purchasing of energy produced by this plant.

Although energy was Enron's core business, the main focus of the financial community was on its activities related to the so-called new economy. At the end of the year, investors' minds were excited at the announcement of an agreement with Blockbuster. With the agreement, Enron would have access to Blockbuster's huge multimedia library, with the aim of becoming the first on-demand TV operator in the United States. But the results of this agreement would only materialize years later. Thus, Enron decided to set up a complex financial structure to anticipate revenues over time, establishing a non-consolidated company called Braveheart with a minimum contribution of risk capital from external shareholders. Enron sold the agreement with Blockbuster to Braveheart, receiving in exchange cash profits of about $115 million. Braveheart, under the leadership of Enron, stipulated an agreement with an investment bank, exchanging cash flows over time: the investment bank anticipated $115 million immediately, and Braveheart undertook to return in the future most of the profits deriving from the agreement with Blockbuster. If the initiative with Blockbuster failed, Enron, as the guarantor of the agreement, would have to immediately return the $115 million advance to the investment bank.

Jeffrey Skilling assumes command

In February 2001, Kenneth Lay left his position as CEO to take over as Chairman of the Board of Directors, and Jeffrey Skilling became CEO of the energy giant. Already at the beginning of the year, the first doubts about Enron's ability to generate its promised value began circulating. Enron's shares were traded at a profit multiple much higher than its competitors, but now, with the cooling of the enthusiasm of the new economy, no one could any longer find well-founded reasons for such price overestimation. In an article published on March 5, 2001, entitled "Is Enron overpriced?" a Fortune journalist suggested that the answer was yes. In addition, in the same month, the withdrawal of the agreement with Blockbuster activated the contractual clauses, requiring Enron to make an immediate payment of $115 million.

Sudden resignation: Kenneth Lay's return to driving Enron

On August 14, 2001, Jeffrey Skilling suddenly resigned after having run the company for only six months. The official reasons given were of a "personal nature." Kenneth Lay returned to the lead, in an attempt to revive the company, although doubts and uncertainties had already reduced the share value to $30 (compared to 90 in August 2000, and 60 in April 2001). On October 16, results for the third quarter were presented. On the advice of Vinson & Elkins (a law firm specializing in energy

companies), Enron announced a $1 billion reduction in net profits, inclusive of its bad investment in new businesses. After the announcement, the stock accelerated its fall even more.
On October 22, Enron announced that the SEC had requested more information on "related party transactions." Shortly thereafter, on October 31, the SEC launched an official investigation into Enron's situation. However, doubts also began to weigh on the Chairman of the SEC, Harvey Pitt: he had previously provided his legal services to Arthur Andersen, the company that certified Enron's financial statements. When the SEC announced its formal investigation, Enron's stock price fell to $20.65 (–21% in one day).
Although analysts did not seem to notice the signs of crisis throughout 2001, still recommending Enron stock as a "strong buy," in those years investment banks were accustomed to rewarding analysts who were able to generate new business opportunities, including for their consulting divisions. The link between consulting and market analysis activities gave rise to favorable or indulgent evaluations for client companies. One analyst revealed that Enron had an unwritten rule that consultancy projects should be assigned to banks whose analysts made more compliant recommendations.
On November 6, stock prices fell below $10 following the news that Enron, in financial distress, was looking for new funding. The financial statements for the period 1997-2011 were adjusted, and a new revenue estimate was released on November 8. Over the following days, Enron met the financing banks to take stock of the situation. In that meeting, Enron stated that, compared to the more than $10 billion in debt on its consolidated balance sheet, it owed another $25 billion on its off-balance sheet accounts.
On November 9, Dynegy Inc. – Enron's historic competitor – announced an agreement to buy Enron for about $8 billion. This operation was motivated by the possibility that it could acquire Enron's strategic assets at a discount price, and take over the leading brokerage company for electricity and natural gas. If the transaction were concluded, Lay would get a payment of $20 million for each of the three years remaining at the end of the contract – although he declared that he would not exercise this right. But the rescue of Enron never took place: on November 28, Dynegy withdrew from the purchase, and Enron's shares collapsed below a dollar. On December 2, Enron filed for protection from its creditors under Chapter 11 bankruptcy law.
For several years, since 1997, there had been systematic fraudulent accounting, and the real Enron was a much smaller, much more risky, and less profitable entity, than it had been made to appear.

Accounting manipulations

The accounting firm Arthur Andersen was responsible for certifying that Enron's accounts were accurate. Founded as a company that only conducted audits and certified financial statements, in the 1990s it began to develop – along with the other major accounting firms, the so-called "big five" – a management-consulting business. The high fees resulting from the consultancy services made the accounting firms dependent, to some degree, on the same firms they had to audit. One of the most complex aspects concerned the evaluation and accounting of Volumetric Production Payments (VPPs): these were contracts with third parties, of a financial nature, which constituted the vital center of Enron Gas Services. Originally, the VPPs consisted of financing that Enron granted to small natural gas producers, in exchange for a future flow of gas that Enron resold to its customers, thereby acquiring new cash. In 1991, Enron was granted exceptional permission to account for these assets on a "mark-to-market" basis. This method involved valuing the assets in the balance sheet at market value, with the consequence producing a particularly volatile, and therefore risky and uncertain, income statement.
In order to overcome the great uncertainty induced by the "mark-to-market" method, and not wanting to give up the gains from investments in the new economy, in the second half of the 1990s Enron began to set up an intricate network of partnerships outside its consolidated balance sheet – the "Special Purpose Entities" – with the aim of reducing both the group's losses and debts. Some of these, called Raptors, acted as external guarantors for Enron in the event of impairment of financial assets shown in its financial statements; however, the Raptors were capitalized through Enron's

own shares, through a complex network of shareholdings, and could not function as independent entities able to intervene with cash in case of negative events.
Several investment banks were put under pressure by Enron's top management to invest in partnerships, so as not to lose their fees of tens of thousands of dollars. But Enron's financial statements indicated partnerships as early as the 1990s, and some Andersen executives had begun to raise doubts internally about the lawfulness and propriety of the accounts and partnerships established by the energy giant. In 2001, doubts about the accounting structures reached Arthur Andersen's partners, who wondered whether it was appropriate to keep such a risky client. At the end of the meeting, they decided to continue with the certification activity, but listed actions that Enron would have to take to mitigate the risks (including the creation of a special committee for the review of some partnerships). On December 12, Arthur Andersen's CEO admitted for the first time publicly that his company had made mistakes in auditing Enron's accounts, but also said that Enron had concealed relevant information. On January 10, 2002, Arthur Andersen's legal department sent a statement to the SEC and the Department of Justice announcing the destruction of certain Enron documents by its employees. A few months later Arthur Andersen failed, like Enron, because of lack of trust by its investors and customers.

The board of directors of Enron

Intervention by the board of directors in the Enron affair had been slow and, according to some, not very stringent. However, in previous years, when decisions on external partnerships and SPEs had to be taken, many observers thought that the board of directors had not fulfilled its supervisory role. At least formally, the board of directors had a high profile and was well organized internally into committees. Yet, despite this, the board was not able to decipher the tangled network of off-balance sheet transactions that camouflaged the reality of the company. It is likely that the financial expertise of the directors, while respecting the minimum requirements imposed by the SEC, was in fact not sufficient for them to fully understand the complex financial structure of Enron and its related partnerships. However, it is also possible that the dual relationship between the directors and the company played an important role. As of February 2001, three out of six members of the Internal Audit Committee had been compensated with Enron shares totaling more than $7.5 million. These considerations supported the comments of those who, due to Enron's bankruptcy, were clamoring for greater discipline to ensure real independence of the directors from the top management of American companies.

How did it end?

On January 9, 2002, the United States Department of Justice announced the opening of a criminal investigation into Enron. The top-notch investigation would take five years. Among the targets was the Arthur Andersen auditing firm, eventually found guilty of the destruction of documents related to Enron, and sentenced to pay a fine of one and a half million dollars, along with the loss of its license to certify financial statements of listed companies. The trial opened in Houston on January 30, 2006. Kenneth Lay, who refused to appear in front of the Senate Committee investigating Enron, invoking the Fifth Amendment right not to testify, was found guilty at trial of conspiracy and fraud, but he died of heart attack before sentencing. In the same year, Jeffrey Skilling, the "brains" of the financial fraud, was sentenced to 24 years' imprisonment (later reduced to 14). Andrew Fastow, former financial director, was sentenced to only six years' imprisonment after agreeing with the prosecution to give testimony that led to Skilling's conviction.
Enron's shareholders, the victims of the biggest accounting scandal in American history, would be awarded $7.2 billion in compensation from the investment banks involved in the scandal: the largest contributions came from CIBC ($2.4 billion), JP Morgan Chase ($2.2 billion), and Citigroup ($2 billion). It is estimated that each ordinary shareholder of Enron has received compensation of $6.8 per share.

Table 2.1 Board of directors and committees (Financial report 2000)

Director	Executive committee	Audit committee	Finance committee	Compensation committee	Nomination committee
Robert Belfer *(New York)* Chairman, Belco Oil & Gas Corp.	X		X		
Norman P. Blake Jr. *(Colorado)* Chairman, President and CEO, Comdisco, Inc. Former CEO and Secretary General Usa Olympic Committee			X	X	
Ronnie C. Chan *(Hong Kong)* Chairman, Hang Lung Group		X	X		
John H. Duncan *(Houston, Texas)* Former Chairman of the Executive Committee of Gulf & Western Industries Inc	X			X	
Wendy L. Gramm *(Washington, D.C.)* Director of the Regulatory Studies Program of the Mercatus Center at George Mason University Former Chairman U.S. Commodity Future Trading Commission		X			X
Ken L. Harrison *(Portland, Oregon)* Former Chairman and CEO, Portland General Electric Company					
Robert K. Jaedicke *(Santa Clara, California)* Professor of Accounting (Emeritus) and Former Dean, Graduate School of Business, Stanford University		X		X	
Kenneth L. Lay *(Houston, Texas)* Chairman, Enron Corp.	X				
Charles A. Lemaistre *(San Antonio, Texas)* President Emeritus, University of Texas M.D. Anderson Cancer Center	X			X	
John Mendelsohn *(Houston, Texas)* President, University of Texas M.D. Anderson Cancer Center		X			X
Jerome J. Meyer *(Caledonia, Minnesota)* Chairman, Tektronix Inc.			X		X
Paulo V. Ferraz Pereira *(Rio de Janeiro, Brazil)* Executive Vice President of Group Bozano Former President and COO, Meridional Financial Group Former President and CEO, State Bank of Rio de Janeiro, Brazil		X	X		
Frank Savage *(Stamford, Connecticut)* Chairman, Alliance Capital Management International (a division of Alliance Capital Management L.P.)			X	X	
Jeffrey Skilling *(Houston, Texas)* President and CEO, Enron corp.	X				
John A. Urquhart *(Fairfield, Connecticut)* Senior Advisor to the Chairman, Enron Corp. President of John A. Urquhart Associates Former Senior Vice President of Industrial and Power System Generale Electric Company			X		
John Wakeham *(London, England)* Former U.K. Secretary of State for Energy, and Leader of the Houses of Lords and Commons		X			X
Herbert S. Winokur Jr. *(Greenwich, Connecticut)* Former Senior Executive Vice President, Penn Central Corporation	X		X		

3 Corporate Governance Mechanisms: The Board of Directors. Past, Present, and Future

3.1 The role of the board of directors in company governance

The Board of Directors (BoD) is the central body in the corporate governance system of a company, and represents the interface between those who provide financial resources (shareholders) and those who use those resources to create value.[1] This definition is essentially based on the traditional perspective described in Chapter 2. According to this vision, the board of directors of a company is entrusted with the primary responsibility for controlling the management on behalf of the multitude of small shareholders who are unable – due to their skills, convenience, or will – to directly and efficiently exercise the property rights they hold. This approach is based on the arguments presented above regarding agency theory, and emphasizes the supervisory role of the board.[2]

In its control role, the main objective of the board of directors is to safeguard the interests of shareholders and, from a broader perspective, other stakeholders, by carefully monitoring top management in order to prevent any opportunistic behavior. The control role usually consists of the following activities:[3]

- evaluation of the results achieved by the company (income, competitive, and social performance);
- verification of the validity of the decisions taken by the top managers of the company;
- control of compliance with the rules and regulations in force;
- verification of the effectiveness of internal reporting; and
- evaluation of the main corporate players, in particular, the CEO.

Although some scholars believe that the control function is less important in companies with concentrated ownership – where constant monitoring of senior manage-

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[1] Monks, R.A.G., & Minow, N. (2011), *Corporate Governance*, 5th ed., Chichester, John Wiley & Sons.

[2] By the way, see: Minichilli, A., Zattoni, A., Nielsen, S., & Huse, M. (2012), "Board task performance: An exploration of micro- and macro-level determinants of board effectiveness," *Journal of Organizational Behavior*, 33(2), 193-215.

[3] Huse, M. (2018), *Value-Creating Boards: Challenges for Future Practice and Research*, Cambridge, Cambridge University; Zattoni (2015).

ment by the controlling shareholder should ensure the alignment between the interests of ownership and management,[4] the board's controlling role today takes on increasingly broad meanings and contours. As will be seen later in the analysis of the Corporate Governance Code, for example, the board of directors is responsible for the fairness and transparency, including accounting, of everything that happens in the company, and must ensure effective control mechanisms at all levels of the hierarchy.[5] In particular, the board should carry out a robust assessment of the current and respective risks of the company, providing in the annual report a fully description of its main risks, and the procedures in place to identify emerging risks, as well as an explanation of how these risks are being managed or mitigated. Moreover, the board should monitor and review, at least annually, the company's risk management and internal control systems, which should also include financial, operational, and compliance controls.[6]

According to some scholars, however, the emphasis placed on the control role carries the risk of reducing the board's activity to a mere supervisory activity, so that it would represent a kind of "watchdog" for senior management.[7] The set of tasks and functions assigned to the board of directors appears to be much broader than its control role. From the managerial perspective, for example, there is a widespread belief that the board of directors should also play a role of service, which enhances the contribution of the directors to the strategic decision-making process usually conducted by the management, and, in general, to guidance of the company.[8] In particular, the various tasks commonly allotted to the board of directors include:[9]

- contributing to the strategic decision-making process of the company;
- examining and approving strategic and industrial plans;
- examining and approving important strategic decisions, and extraordinary operations in general (such as transformations, mergers, acquisitions, demergers, etc.);
- making choices related to the financial structure of the company, in particular related to the size and characteristics of its debt;
- defining the remuneration policies of top management (as far as the board of directors is concerned);
- defining the fundamental rules of corporate governance, as well as the guidelines for the governance of the firm.

[4] Cfr. Fama, E. & Jensen, M.C. (1983), "Separation of ownership and control," *Journal of Law and Economics*, 26, 301-325.

[5] Flowers, G. & Tiscini, R. (eds.) (2005), *Corporate Governance, Accounting regulations and transparency of corporate information*, Milan, FrancoAngeli.

[6] Provisions 28-29-30 of the UK Corporate Governance Code 2018.

[7] Monks & Minow (2011).

[8] See: Huse (2018).

[9] Stiles & Taylor (2002); Zahra, S.A. & Pearce II, J.A. (1989), "Boards of directors and corporate financial performance: A review and integrative model," *Journal of Management,* 15(2), 291-334.

From this perspective, the board of directors plays a dual role of checks and balances for the management. On the one hand, it "controls," and on the other hand, it "supports" the top management in eliminating the causes and manifestations of misconduct by managers, especially in promoting the long-term sustainable success of the company in generating value for shareholders.[10] The board's contribution to the strategic decision-making process can take place in various ways. It may consist of defining the aims and policies of the company, or – as argued by management scholars – of contributing to the formulation of strategy at the corporate level, and evaluating the decisions and strategic actions of top management, without entering into the process of formulating strategy (which is the responsibility of the company's senior management).[11]

The board of directors' servicing role actually extends its boundaries beyond the strategic participation function. From a strictly strategic and managerial point of view, in fact, it includes an environmental management function (or networking), which consists of establishing and managing relations between the company and external entities. This function is usually carried out through co-opting representatives of other companies, financial institutions, or the political world onto the board, in order to acquire information and resources, but above all, to obtain the support and legitimacy necessary to achieve the ultimate goals of the company.[12] This activity aims to create a privileged link between the company and its environment of reference, with the objective of ensuring access to critical resources, encouraging the commitment of important external decision-makers, and ultimately contributing to the legitimacy of the company with its stakeholders.

These first, brief considerations on the centrality of the board of directors in the governance of a company, and on the roles it is called upon to play, make quite clear why scholars, entrepreneurs, shareholders, regulatory authorities, and financial markets seek to guarantee a proper composition, structure, and functioning of the board. This trend is now widely reflected in the literature, practice, and regulation at the in-

[10] According to the UK Corporate Governance Code 2018, under the first chapter "Board Leadership and Company Purpose," the board should:

- establish the company's purpose, values, and strategy, and satisfy itself that these and its culture are aligned;
- ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them;
- establish a framework of prudent and effective controls, which enable risk to be assessed and managed;
- ensure effective engagement with shareholders, and encourage participation from stakeholders; and
- ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success.

[11] Andrews, K. (1980), "Directors' responsibility for corporate strategy," *Harvard Business Review*, Nov.-Dec., 174-184; Stiles & Taylor (2002).

[12] Zattoni (2015).

ternational level – especially through the well-known forms of corporate governance codes – and will be discussed extensively later.

3.2 The international corporate governance codes

Although, from a theoretical point of view, the board of directors has always been considered the central mechanism of a company's governance system in its dual role of checks and balances, the corporate scandals of the past decade have raised doubts about the effectiveness of boards in these two roles. Some of the principal American scholars have long advanced the idea that boards were substantially passive, simply "ratifying" (rubber-stamping) decisions already discussed and approved by the top management of the company.[13] Academics and observers from all over the world have spread this belief. It can be effectively summed up in the provocative assessment by Harvard professor Jay Lorsch on the effectiveness of the boards of directors of the great American companies: namely, that boards – at least up to the mid-1990s – are (or rather, they have been) nothing less than "pawns in the hands of the management."[14] This provocative assertion, combined with the other conditions mentioned above, has provided a significant boost in attention to the issue of corporate governance, with the aim of transforming boards of directors from "pawns" in the hands of management – or "ornaments on the company Christmas trees" – to centers of decision-making and power. The result of this debate can be found in the development of a set of principles, rules, and best practices, aimed at making the board a corporate body of effective control and guidance for the company.

The dissemination of corporate governance practices has been fueled by the codification of principles and rules of functioning for boards of directors, which are contained in the numerous editions and variants of corporate governance codes that each industrialized country has proposed over the last twenty years. These have almost exclusively concerned companies that access public savings,[15] because of the greater obligations for transparency and fairness that these board of directors have toward the investing public.

As we have seen in Chapter 1, the proliferation of codes is commonly traced back to the 1992 Cadbury Report, prepared by Sir Adrian Cadbury after some major corporate scandals in the UK.[16] The proliferation of codes following the Cadbury Report affected all major European countries in just a few years, and fueled an unprecedented debate about the composition and structure of the board of directors on the old continent. There has been a rapid spread of corporate governance codes as a tool by European stock exchanges not only to ensure greater transparency and fairness in the application and respect of the principles of good governance, but especially to encourage the spread of some practices which, up to the mid-1990s, existed exclusively in the Anglo-Saxon context.

These codes represented the regulatory reference point around which the debate on the composition, structure, and functioning of the board of directors, as well as the overall design of the company system of governance, has revolved. There has also been a process of convergence of the different codes towards similar and shared approaches, to the point that some have even identified a process of mere replication of Anglo-Saxon codes in other European countries.

The alleged convergence towards an Anglo-Saxon model has often raised concerns, since it cannot take into account the national specificities, which result from the different configurations of ownership structures. Others, perhaps more reasonably, observe that the increasing similarity between the codes is the result of a functional convergence in behavior, which inevitably results in convergence in regulations. Indeed, a careful analysis of the different codes in the major European countries shows only a superficial similarity, while substantial differences remain between those countries that adopt a corporate governance system of one level (one-tier system), and those that adopt a system at two levels (two-tier system); there are also substantial differences even in the "philosophy" of application of the code. For this reason, we will be focusing in this chapter on the British code, while we will be comparing the other ones in the second part of the book.

3.2.1 One example: The UK Corporate Governance Code and its evolution

The first version of the UK Corporate Governance Code (the Cadbury Report) was born in 1992 as a response to major corporate scandals associated with governance failures in the UK; it was published by a committee chaired by Sir Adrian Cadbury. The committee was formed in 1991 after Polly Peck, a major UK company, went insolvent after years of falsifying its financial reports. Initially limited to preventing financial fraud, the code was later expanded to corporate governance practices through a consolidation and refinement of a number of different reports and codes on good corporate governance. The final version covered financial, auditing, and corporate governance matters, and contained the following three basic recommendations:

[13] Mizruchi, M.S. (1983), "Who controls whom? An examination of the relation between management and boards of directors in large American corporations," *The Academy of Management Review*, 8, 426-435.

[14] Lorsch, J.W. (1989), *Pawns or Potentates*, Boston, Harvard Business School Press.

[15] Indeed, there is a growing tendency to issue codes of good governance also for unlisted companies, and in particular family companies, of which the first and most authoritative example is represented by the Buysse Code in Belgium, entitled *Corporate governance: Recommendations for non-listed enterprises*.

[16] The first example of a corporate governance code actually dates back to the late 1970s in the United States, in response to the waves of hostile *takeovers* of those years. It was called *The role and composition of the board of directors of the large publicly owned companies*.

- the separation between the CEO and chairman of companies;
- the minimum numbers of non-executive directors should be three, and two of them should have no financial or personal ties with the executive directors; and
- each company should have an audit committee composed of non-executive directors.

Although the recommendations contained in the first edition of the Cadbury Code reflected contemporary "best practices," they certainly represented an epochal turning point in the debate on corporate governance in Europe and around the world; these principles were added to the Listing Rules of the London Stock Exchange in 1994.

Although the code has always been freely applicable to listed companies according to the "comply or explain" principle, it presented for the first time a series of innovative recommendations regarding the board configuration of companies that access public savings. In particular, the code was based (and is still based) on the theory that the protection of shareholders' interests requires a reduction in agency costs and, consequently, in the cost of risk capital.

Over the following years, under pressure from Prime Minister John Major, another committee, chaired by chairman of Marks & Spencer Sir Richard Greenbury, was set up on the issue of executive compensation; in July 1995 the Greenbury Report was published. This report recommended further changes to the principles of the Cadbury Code, among which were: 1) the introduction of a remuneration committee composed without executive directors; and 2) that the compensation of directors should be related to long-term performance, and their contracts should be disclosed and renegotiated each year. Moreover, as suggested by the Greenbury Report, the Cadbury Code was updated after three years, and in 1998 the Hampel Report suggested that the Cadbury and Greenbury principles be consolidated into a single Code. Among the innovations proposed in the "Combined Code" were the introduction of the chairman as the "leader" of non-executive directors, and the disclosure of all kinds of remuneration, including pensions.

By 2003, a number of other reports were issued, and more revisions of the Code were published, adding sections on remuneration, risk management, internal control, and audit committees. In particular, the Review of the role and effectiveness of non-executive directors (or the "Higgs review" produced by a commission chaired by Derek Higgs in 2003), reviewed the role and effectiveness of both non-executive directors and the audit committee, and called for improving and strengthening the existing Combined Code.[17] In particular, the existing approach to the corporate governance obligation to "comply or explain" was strengthened, and more stringent criteria for the board composition and evaluation of independent directors were appended, removing some of the discretion that the Code allowed. The revision followed the U.S. scandals involving Enron, WorldCom, and Tyco, as a result of which the

[17] See the Higgs report DBERR and the full text of Combined Code published in 2006.

U.S. opted for legislation under the Sarbanes-Oxley Act. Shortly after the collapse of Northern Rock and the 2008 financial crisis, the Walker Review produced a report focused on the banking industry, which included recommendations for all companies.[18]

3.2.2 The new 2018 edition of the UK Corporate Governance Code

The last phase of the evolutionary path of the UK Corporate Governance Code is represented by the very recent, new edition issued in July 2018 (the 2018 Code), published by the Financial Reporting Council (FRC) – the independent regulator in the UK and Ireland. This code applies to accounting periods beginning on or after January 1, 2019, and replaces the 2016 version. The new Code was issued along with a revised Guidance on Board Effectiveness (Guidance) which supplements the 2018 Code by suggesting good practices to assist companies in applying the 2018 code's principles, and reporting on their application of those principles. The Financial Reporting Council (FRC) revised some of the Principles and Provisions of the 2018 Code in light of feedback received during the consultation process of the Green Paper.[19]

The new English code has been thoroughly revised with the goal of simplifying it as much as possible. It is now visibly leaner, with a structure limited to "principles" and "provisions;" the intermediate level of the "supporting principles" has been removed, and some have been incorporated into the new principles or provisions, while others have been moved to the FRC's Guidance on Board Effectiveness. This streamlining has also led to the elimination of a significant number of more detailed recommendations, and strengthened the guidelines in order to incentivize adherence to the recommended best practices. Moreover, the 2018 Code put greater emphasis on relationships between companies, shareholders, and stakeholders, promoting the importance of establishing a corporate culture that is aligned with the company's purpose and business strategy. In its revised version the Code now has five sections:

1. Board leadership and purpose
2. Division of responsibilities
3. Composition, succession, and evaluation
4. Audit, risk, and internal control
5. Remuneration

The majority of changes have been made to the first three sections, which broadly correlate to Sections A (Leadership), and B (Effectiveness of the 2016 version of the Code). Section E (Relations with shareholders) has been integrated within Section 1

[18] Walker, D. (2009), *A review of corporate governance in UK banks and other financial industry entities.*

[19] Department for Business, Energy and Industrial Strategy, Corporate Governance Reform Green Paper, November 2016.

(Board leadership and purpose) of the 2018 Code to give greater prominence to this aspect of corporate governance. Section 4 (Audit, risk, and internal control) remains largely unchanged, reflecting the fact that this section of the 2016 Code had been amended recently. Schedule A of the 2016 Code has been removed, and where appropriate, incorporated into Section 5 (Remuneration). According to the FRC,[20] the main changes of the 2018 Code include:

- *Workforce and stakeholder engagement.* Greater board engagement with the workforce is required to understand their views. The Code asks boards to describe in their annual report how the stakeholders' interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making. Section 172 obliges directors to have regard for the range of stakeholders and interests when complying with their duty to promote the success of the company, including the interests of the company's employees; the need to foster business relationships with suppliers, customers, and others; and the impact of the company's operations on the community, the environment, and other matters. In relation to the workforce, three recommended methods of engagement are set out in the Code (to be used either alone or in combination), according to the size of the company: 1) a director appointed from the workforce; 2) a formal workforce advisory panel; and 3) a designated non-executive director.
- *Culture.* Boards are asked to create a culture aligned with the company's purpose, values, and strategy.
- *Succession and diversity.* There is a great emphasis on the need to refresh boards and undertake succession planning. To facilitate effective succession planning, the chair should not remain in his or her post beyond nine years from the date of their first appointment. Moreover, boards are expected to have the right mix of skills and experience, constructive criticism, to promote diversity, and to strengthen the criteria concerning independence of the non-executive directors. The 2018 Code also introduces changes for nominating committees: boards are expected to disclose more information on their composition and their evaluation, and there is an emphasis on the importance of external board evaluation for all companies.
- *Remuneration and long-term incentive plans.* The 2018 Code emphasizes that remuneration committees should take into account workforce remuneration and related policies when setting the remuneration policy for the executive directors. Moreover, the 2018 Code also targets formulaic calculations of performance-related pay. Remuneration committees will now be expected to apply discretion in cases where formulaic outcomes are not justified. With regard to long-term incentive plans, the 2018 Code extends the recommended minimum aggregate vesting and post-vesting holding period for executive share awards from three years to five years, with the aim of ensuring that directors' incentives are better aligned with the long-term interests of the company and shareholders.
- *Significant shareholder dissent at general meetings.* The 2018 Code sets out how companies are expected to respond when 20% or more of shareholder votes are cast against a board recommendation for a resolution. In this situation, companies will be expected to explain the actions they intend to take to consult shareholders in order to understand the reasons behind the dissent.
- *Companies below the FTSE 350.* Until the revision, smaller companies benefited from a number of less stringent requirements. Now their position has been brought into line with the FTSE 350 in some areas, among which are the annual renewal of directors, the number of independent directors, the need for externally-facilitated board evaluations, and the composition of audit committee.

[20] "A UK Corporate Governance Code that is fit for the future (2018)," *Financial Reporting Council*, July 16.

3.3 The characteristics of the board of directors

The recommendations for the creation of an effective board of directors have led to a set of principles and rules particularly on aspects relating to the composition, structure, and functioning of the board. With regard to composition, some of the aspects on which both the corporate governance codes and international debate have focused are the number of directors (the size of the board), the "types" of directors, and the diversity among them. With respect to structure, on the other hand, some typical indicators are the separation of roles between the chairman and the CEO (the CEO duality), and the presence of a senior independent director, but above all, the presence and characteristics of the committees within the board of directors (remuneration, appointments, and internal control). With regard to functioning, some of the aspects relate to the information for to the board of directors, the number and duration of meetings, the succession plan for top management and for the CEO, and the implementation of a procedure for the periodic evaluation of the board's work as a collective body, conducted by the CEO and by individual directors. The assumption underlying these requirements is that the board functions more effectively when there are certain characteristics that qualify its independence and competence. In other words, there is an implicit belief that certain structures can guide the behavior of the board members, and consequently contribute to efficient and ethically correct behavior by the company, as well as assembling the resources and skills necessary for a long-term development strategy.

3.3.1 The composition

In line with what has been introduced previously, an analysis of the composition of the board of directors represents a "picture" of its characteristics in their various aspects. The first one concerns the number of directors, i.e., the size of the board. Although international trends indicate that the optimal size of a board of directors ranges approxi-

mately from 8 to 15 directors,[21] such clear-cut assumptions are likely to be misleading. The number of members of the board of directors depends on a number of circumstances, including the size of the company, its ownership structure, the demands for independence and variety of the directors, and sometimes even the sector in which the company operates.[22] In general, it can be argued that a too small board of directors may sacrifice variety in ideas and debate in favor of easier coordination and streamlined decision-making. On the other hand, too large boards of directors may generate information redundancy, reduced decision-making capacity, and substantial board free-riding.

According to a study by Spencer Stuart, the average number of board members is shrinking in several countries around the world, as has happened in the United States, where the average number of board members among the S&P 500 has gone from 15 members in 1988, to 10.8 in 2018 (**Table 3.1**). This figure is comparable to that of the main European countries. Only France and Germany have boards of directors larger than average.[23]

Table 3.1 Size of the board of directors

Country	2014	2015	2016	2017	2018
Belgium	10.2	10.3	10.4	10.1	10.0
France	14.0	14.3	13.9	13.9	13.7
Germany	14.0	16.2	14.1	16.3	13.8
Italy	12.2	11.9	11.6	11.5	11.5
Netherlands	9.5	10.7	9.2	8.3	9.3
Spain	11.4	10.9	10.8	11.0	10.9
Sweden	9.9	9.7	9.9	10.9	10.6
Switzerland	10.6	10.3	10.5	10.6	9.2
UK	10.5	10.3	10.2	10.1	10.1
USA	10.8	10.8	10.8	10.8	10.8

Source: Spencer Stuart, UK Board Index 2014-2018.

[21] Monks & Minow (2011).

[22] It is quite normal for larger, listed companies with articulated ownership structures and operating in highly competitive sectors to have more directors. On the contrary, small companies, with few legal and regulatory requirements regarding the independence and diversity of directors, with simple and homogeneous ownership structures and operating in sectors that are not very competitive, will need a much smaller number and variety of directors.

[23] For Germany, all the following indicators on the board of directors relate to the Supervisory Board.

The second aspect of the board composition concerns the analysis of the different "types" of directors, and their mix within the board. This concern stems from the trend, especially in the United States in the seventies and eighties, of the board being dominated by the management of the company through the preponderant – if not exclusive – presence of executives among its members. For this reason, the corporate governance codes have identified different types of board members and called for their balanced representation on the board of directors.

The main categories of board members are therefore:

- *the chairman* (or *chairperson* or *chair*): a member who leads the board and is responsible for the overall effectiveness of the company. He/she should demonstrate objective judgment and promote a culture of openness and debate around the table. In addition, the chair facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely, and clear information.[24] Moreover, the chair is pivotal in creating the conditions for overall board effectiveness, ensuring that the board has effective decision-making processes and provides sufficient questioning of major proposals.[25]
- *the Chief Executive Officer* (CEO): a director who has received extensive powers from the board of directors on all aspects of the management of the company (in the case of only one), or on specific aspects (in the case of there being more than one CEO). In some cases, it is also possible that there will be more than one CEO with the same scope of authority in order to spread management responsibility (the variety of reasons for this will be discussed in detail below). As the most senior executive director, the CEO is responsible for proposing company strategy and for its success. In many cases, however, the corporate bylaws places limits on the CEO's discretion, identifying precise quantitative limits in the performance of the company's standard operations, beyond which authorization of the full board of directors is necessary.
- *internal directors* (or *executive directors*): internal directors who are members of the board of directors with executive functions within the company. These directors bring their specific skills to board discussions, contributing to informed

[24] *Cf.* Principle "F" of the UK Corporate Governance Code 2018.

[25] According to the Guidance on Board Effectiveness 2018, the chair's role includes:

- setting a board agenda primarily focused on strategy, performance, value creation, culture, stakeholders, and accountability, and ensuring that issues relevant to these areas are reserved for board decision;
- shaping the culture in the boardroom;
- encouraging all board members to engage in board and committee meetings by drawing on their skills, experience, and knowledge;
- fostering relationships based on trust, mutual respect, and open communication – both in and outside the boardroom – between non-executive directors and the executive team;
- developing a productive working relationship with the chief executive, providing support and advice, while respecting executive responsibility;
- providing guidance and mentoring to new directors as appropriate;
- leading the annual board evaluation, with support from the senior independent director as appropriate, and acting on the results;
- considering having regular externally facilitated board evaluations.

decision-making with a deep operational knowledge of the company and a high degree of involvement. As with the size of the board of directors, it is not possible to establish an optimal relationship between internal and external directors. In this sense, the Code does not identify a given number of executive directors, stating that the board should include an appropriate combination of executive and non-executive directors, such that no one individual or small group of individuals dominates the board's decision-making.[26]

- *external directors* (or *non-executive directors*): non-executive members of the board of directors, i.e., directors without delegated or management functions within the company or the group to which they belong.[27] Non-executive directors enrich the board's discussion with skills formed outside the company, of a general strategic or particular technical nature. These skills allow them to analyze the different topics from different perspectives and, therefore, contribute to fostering the dialogue that is a feature of collegial, thoughtful, and conscious decision-making by the board. It is important that non-executive directors have sufficient time available to discharge their responsibilities effectively. They should devote time to developing their knowledge and skills to ensure that they continue to make a positive contribution to the board.[28] In particular, the contribution of non-executive directors is thought to be of particular benefit where the interests of executives and shareholders of the company may not coincide. In this case, the role of the non-executive directors could also be to oversee potential agency problems between ownership (and in particular, minority shareholders) and management.
- *independent directors*: directors who, in addition to being external to the company, meet the requirements of independence. In other words, they are professionals in other companies, academics, business consultants, entrepreneurs, or politicians and/or local government representatives, who do not have a substantial economic relationship or employment affiliation with the company in which they serve as independent advisers.[29] The UK Corporate Governance Code, unlike other international corporate governance codes, provides stringent quantitative guidance on the presence of independent directors. In particular, the 2018 revision of the Code mandated that at least half the board, excluding the chair, should be independent non-executive directors.[30] Previously, this requirement applied only to FTSE 350 companies; smaller companies needed at least two independent non-executive directors. Moreover, often the recommendation of the codes is that the chair should also be independent.[31]

[26] *Cf.* Principle "G" of the UK Corporate Governance Code 2018.

[27] Again, it may be useful to reflect on some data. A survey by Spencer Stuart in the United States has shown that in 1/3 of the S&P 500, the only inside director *is* the CEO. In Italy, taking as reference companies of the FTSE MIB, Mid Cap and Small Cap, executive directors represent 20.3% of the total, while in the UK, in the first 150 companies of the FTSE excluding investment trusts, they constitute 35.1%.

[28] *Cf.* supporting principles 75 and 76 of the Guidance on Board Effectiveness 2018.

[29] According to Provision 10 of the UK Corporate Governance Code 2018, the board should identify in the annual report each non-executive director it considers to be independent. Circumstances which are likely to impair, or could appear to impair, a non-executive director's independence include, but are not limited to, whether a director:

- is or has been an employee of the company or group within the last five years;
- has, or has had within the last three years, a material business relationship with the company, either directly or as a partner, shareholder, director, or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors, or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies; and
- represents a significant shareholder; or has served on the board for more than nine years from the date of their first appointment.

Where any of these or other relevant circumstances apply, and the board nonetheless considers that the non-executive director is independent, a clear explanation should be provided.

[30] Provision 11 of the UK Corporate Governance Code 2018.

[31] Provision 9 of the UK Corporate Governance Code 2018.

[32] According to goals regarding the portion of independent shareholder representatives. Source: Spencer Stuart Smart Index 2014 and following years.

[33] Non-executives only. Source: Spencer Stuart Smart Index 2014 and following years.

The incidence of independent directors, historically lower than that of external advisers, has followed a rising trend in European countries, reaching in most cases more than 50%. However, the incidence percentages widely in the main countries examined, with extremes ranging from 45% in Spain, to situations in the United States, Switzerland, or the Netherlands, in which almost all of the board of directors is composed of directors qualified as independent (**Table 3.2**).

Table 3.2 Percentage of independent directors

Country	2014	2015	2016	2017	2018
Belgium	41	43.3	44.8	45.9	49.2
France	62	58.0	69.0	69.1	58.0
Germany[32]	43	60.0	60.0	60.0	60.0
Italy	50	49.2	50.1	51.0	51.0
Netherlands	62	66.8	60.0	83.6	87.1[33]
Spain	38	39.0	43.0	44.0	45.0
Sweden	53	62.0	63.7	69.6	69.1
Switzerland	85	88.3	88.0	84.0	83.2
UK	60	60.5	61.1	61.4	61.3
USA	84	84.0	84.0	85.0	85.0

Source: Spencer Stuart, UK Board Index 2014-2018.

A third element highlighted in management studies regarding the composition of the board of directors is the diversity of directors. Diversity can be understood as involving various dimensions. The first relates to the mix of skills and knowledge, which is one of the most important elements, and stems from the fact that it is not conceivable that any one board member has all the skills that a modern board needs. The presence of budget experts, other financial experts, others with a marked strategic vision, etc., is necessary. Diversity in the boardroom can have a positive effect on the quality of decision-making by reducing the risk of group-think. With input from shareholders, boards need to decide which aspects of diversity are important in the context of the business and its needs.[34] Diversity can also be understood in demographic terms, for example, including differences in age, gender and nationality. In this sense, one of the most topical aspects in the debate on demographic diversity within the board of directors is the presence of women, which is one of the most controversial aspects both in the literature and in the reality of companies. According to the prevailing literature, gender diversity has the benefit of contributing to the quality and intensity of the debate, improving the climate and internal cohesion among the directors, and bringing a variety of skills and decision-making styles that has the great merit of ensuring a more informed and dynamic decision-making style.[35]

Driven by the introduction of policies that aim to increase the presence of women in political and corporate positions, a growing literature has explored gender differences in economic behavior and their implications for organizations over recent years. Some recent studies show that the presence of women at the top of the corporate hierarchy, as well as the interactions between women in governance and CEO positions,[36] affect corporate performance positively.[37]

The average age of directors is rather advanced and is homogeneous internationally; it is about 60 years. It has increased in recent years (in 2007, for example, it was 56 years), showing a low turnover rate (**Table 3.3**).[38]

Female presence on boards of directors, on the other hand, is decidedly more variable. On the one hand, in countries such as France and the United States – and recently also in Italy – as opposed to Spain or the UK, almost all of the largest listed companies have at least one female representative on the board of directors.

[34] *Cf.* supporting principle 88 of the Guidance on Board Effectiveness 2018.

[35] In this regard, see: Kirsch, A. (2018), "The gender composition of corporate boards: A review and research agenda," *The Leadership Quarterly*, 29(2), 346-364; Torchia, M., Calabro, A., & Huse, M. (2011), "Women directors on corporate boards: From tokenism to critical mass," *Journal of Business Ethics*, 102, 299-317.

[36] In this regard, see: Amore, M.D., Garofalo, O., & Minichilli, A. (2014), "Gender interactions within the family firm," *Management Science*, 60(5), 1083-1097.

[37] In this regard, see: Post, C., & Byron, K. (2015), "Women on boards and firm financial performance: A meta-analysis," *Academy of Management Journal*, 58(5), 1546-1571.

[38] Spencer Stuart (2018), *2018 Board Index*.

Table 3.3 Average age of all directors (executive and non-executive)

Country	2014	2015	2016	2017	2018
Belgium	n.a.	56.9	57.5	57.7	57.7
France	60.0	59.7	58.6	58.8	58.9
Germany	56.7	n.a.	n.a.	61.0	58.0
Italy	59.2	58.9	58.8	58.4	58.0
Netherlands	59.6	58.7	59.4	61.0	61.5
Spain	59.5	60.0	59.6	60.4	60.3
Sweden	57.4	57.3	57.6	57.8	58.9
Switzerland	60.8	60.5	61.1	61.1	59.9
UK	57.5	57.5	57.8	56.8	59.0
USA	n.a.	n.a.	n.a.	62.6	n.a.

Source: Spencer Stuart, UK Board Index 2014-2018.

Table 3.4 Incidence of women on the board

Country	2014	2015	2016	2017	2018
Belgium	17.9	24.2	27.0	30.4	32.1
France[39]	31.0	34.3	38.8	42.0	42.5
Germany	n.a.	n.a.	n.a.	28.7	32.0
Italy	17.3	22.4	26.4	31.0	32.3
Netherlands	16.9	21.6	20.0	30.4	21.6
Spain	13.0	14.0	16.0	17.0	19.5
Sweden	30.2	35.0	36.0	38.3[40]	39.0
Switzerland	15.6	19.0	20.5	22.2	22.6
UK	20.6	23.0	24.4	25.5	27.5
USA	18.6	19.8	21.3	22.2	24.0

Source: Spencer Stuart, UK Board Index 2014-2018.

[39] According to Afep/Medef corporate governance code

[40] Excludes employee representatives.

On the other hand, the percentage of female advisers among the total number of advisers is very variable. It stands at around 20% in Spain, the Netherlands, Switzerland, and the USA, with peaks of around 40% in France and Sweden. Overall, although the data show considerable progress over the last decade – at the beginning of which it was rare to achieve double-digit ratios – gender equality has not yet been achieved in any of the countries analyzed (**Table 3.4**).

At the same time, the percentage of foreign directors is very low in countries such as Italy and Spain, which have a more "domestic" economy, while it rises considerably in the United Kingdom, France, and Switzerland, which are characterized by a culture and the presence of more multinational companies. Although it is heterogeneous, in Europe there is still a greater tendency to benefit from the contributions of professionals from other countries; this phenomenon shows percentages markedly higher than even just 10 years ago. On the contrary, in the USA the percentage is around 8%, probably due to the very large internal management market (**Table 3.5**).

A third dimension of diversity is represented by the professional backgrounds of board members. Professional experience is the logical antecedent of certain behaviors, skills, and discussion styles. According to this hypothesis, there will therefore be a difference between the approaches of academics, consultants, business managers, banks, lawyers, politicians, public administrators, etc.[41] Again, there are no

Table 3.5 Percentage of foreign directors on boards

Country	2014	2015	2016	2017	2018
Belgium	29.0	32.6	31.8	31.2	30.4
France	31.0	33.0	35.0	37.0	35.0
Germany	n.a.	n.a.	n.a.	31.0	25.3
Italy	7.0	7.7	9.4	9.4	10.1
Netherlands	43.0	42.7	36.0	57.0	39.0
Spain	10.8	12.5	15.3	19.0	19.8
Sweden	18.0	24.0	25.2	30.9[42]	33.6
Switzerland	59.3	62.0	60.0	59.0	51.7
UK	33.4	32.1	33.1	32.3	33.3
USA[43]	8.1	n.a.	8.1	7.0	8.2

Source: Spencer Stuart, UK Board Index 2014-2018.

[41] If we analyze the professional backgrounds of non-executive directors, for example, 32.7% comes from financial services, 29.2% from industrial companies. Most of them were in a general management, a CEO or divisional CEO position (74.2%), while a further 16.1% of the executive directors had experience as CFOs or in the Audit function. Source: Spencer Stuart, *UK Board Index 2018*.

[42] Excludes employee representatives.

[43] Top 200 only of S&P 500 companies.

universal and shared best practices. The consequence of the diversity of age, gender, professional background, and skills is the expected diversity in leadership styles, as well as in the level of power and personal influence that each board member exerts. In this way, there will be charismatic leaders, leaders recognized for their competence, advisors who are influential because of external relationships and the contacts that they can bring to the board of directors, etc.

To summarize these indicators – some of which are more established (the number and mix of directors), while others are only recently drawing attention (gender diversity) – we can see that the composition of board of directors has been "shaped" by the corporate governance codes. However, there is a substantial alignment in the main aspects of the board composition (especially in terms of average size and average age of directors), against differences in terms of independent directors.

If we consider some summary data on the Italian situation starting from 2006, the year in which the third edition of the code came into force, we can observe trends that are substantially stable with respect to both the size of the board of directors and the incidence of non-executive directors. On the contrary, since 2012 the incidence of independent directors has started to grow, a symptom of an increased – even substantial – independence of these advisers in recent years. The "picture" of gender diversity is much sharper: the law on "pink quotas" that came into force in 2012 has shown its effects, and the presence of women on the boards of listed companies has increased by more than 20 percentage points between 2012 and 2018, rising from 11.6% to 32.3%.

3.3.2 The structure

The appointment of a group of experienced and competent people is the first step towards the design of an effective board of directors. In addition to the composition of boards, both management studies and governance codes have paid great attention to the structure of the board. In particular, this is particularly true for issues – some traditional, and others fueled by the fervent debate of recent years – such as the separation of the roles of chairman and CEO, the appointment of a senior independent director (or lead independent director), and especially the establishment of (sub)committees within the board of directors.

The separation of the roles of chairman and CEO (in international terminology, the overlap of roles between chairman and CEO is commonly referred to as CEO duality)[44] is one of the most widespread recommendations in the governance codes of all countries where there is a debate on the rules of corporate governance. There

[44] For this reason, the recommendation of the codes is usually to avoid situations of CEO duality. According to the Provision 9 of the UK Corporate Governance Code 2018: "The roles of chair and chief executive should not be exercised by the same individual. A chief executive should not become chair of the same company. If, exceptionally, this is proposed by the board, major shareholders should be consulted ahead of the appointment. The board should set out its reasons to all shareholders at the time of the appointment, and also publish these on the company website."

are several reasons for this. First, the overlap between chairman and CEO leads to an excessive concentration of power in the hands of the same person, limiting the independence of the board of directors from the top management of the company. Secondly, the two positions require different skills and abilities, i.e., a more analytical and strategic profile for the chairman of the board, and a more operational and managerial profile for the CEO. Finally, the figure of the chairman of the board of directors should be an organizational reference point for ensuring the proper functioning of the board of directors, assuming a leadership position within the team of directors, and carrying out activities of coordination and management of the work. Clearly, these are activities that require time and dedication, and therefore are difficult to reconcile with the work commitments of a CEO. However, there are also voices in favor of a joint structure, with the two positions centralized in the same person. The supporters of this structure are, above all, the top executives of the company, who see the overlap between the chairman and CEO as an opportunity to express clear leadership both within the board of directors and outside it, conveying a sense of unified direction to the various stakeholders. Again, the situation varies a lot within the countries we have analyzed. In Germany, the Netherlands, Switzerland, Belgium, Sweden, and the UK, the phenomenon of CEO duality is practically non-existent, while in countries such as France, Spain, and the USA it is widespread, occurring in about 50% of companies, although it has shown a downward trend in recent years (**Table 3.6**).

Most corporate governance codes indicate that the positions of chairman and CEO should be separated. If this does not occur, the solution proposed by some corporate

Table 3.6 Percentage of companies with CEO duality[45]

Country	2014	2015	2016	2017	2018
Belgium	5	7.5	5.6	1.7	1.7
France	68	62.5	55.0	52.5	52.5
Germany	0	0.0	0.0	n.a.	0.0
Italy	22	22.0	18.0	19.0	17.0
Netherlands	4	44.8	2.0[45]	4.0	0.0
Spain	65	57.0	66.0	66.0	54.0
Sweden	2	0.0	2.0	4.0	4.0
Switzerland	5	0.0	0.0	0.0	0.0
UK	0	1.3	0.7	0.67	0.7
USA	53	52.0	52.0	49.0	49.9

Source: Spencer Stuart, UK Board Index 2014-2018.

[45] Excludes the combined chairman/CEO role on executive board of two-tier boards.

governance codes – such as the Italian one – is to identify a lead independent director.[46] A similar figure (senior independent director) is provided for by the UK Corporate Governance Code, which always contemplates his appointment.[47]

The senior independent director is an independent director who is assigned particular tasks, including chairing meetings of external advisers, assessing the CEO (and possibly also of the chairman, as in the case of the UK), and discussing aspects of the operation of the board with the chairman himself.

In this regard, the tendency to "conform" to the corporate governance codes can be seen by observing the spread, in varying degrees, of the figure of the Senior Independent Director (SID), which was introduced at the beginning of the twenty-first century in most of the corporate governance codes. In particular, the countries with a high incidence of companies with CEO duality (mostly France, Spain and the USA) are also those that – in accordance with the provisions of the Code – have appointed the SID. The only exception is the UK, which provides for the appointment of the SID regardless of CEO duality situations, and almost all companies have adopted this provision of the Code.

Table 3.7 Percentage of companies with senior independent director (SID)

Country	2014	2015	2016	2017	2018
Belgium	n.a.	0.0	0.0	1.7	1.7
France	70	70.0	43.0	48.0	52.5
Germany	n.a.	0.0	n.a.	n.a.	0.0
Italy	44	43.0	n.a.	39.0	34.0
Netherlands	12	60.0	6.0	16.0	6.0
Spain	21	27.0	56.0	63.0	68.0
Sweden	n.a.	0.0	2.0	4.0	4.0
Switzerland	15	20.0	0.0	15.0	25.0
UK	100	98.7	99.3	99.3	97.3
USA	90	89.0	86.0	85.0	80.0

Source: Spencer Stuart, UK Board Index 2014-2018.

[46] In this respect, application criterion 2.C.3. of the Italian Code states that in the following cases, the board designates an independent director as lead independent director, who represents a point of reference and coordination of the requests and contributions of non-executive directors and, in particular, of those who are independent. In particular, the chairman of the board of directors is the chief executive officer of the company; the position of chairman is held by the person who controls the issuer; and it is required by the majority of independent directors in companies belonging to the FTSE-Mib index.

[47] According to Provision 12 of the UK Corporate Governance Code 2018, "the board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chair and serve as an intermediary for the other directors and shareholders."

From the point of view of the board's structure, however, the most important issue is represented by the opportunity, emphasized by the corporate governance codes, to set up committees within the board of directors in order to facilitate the operation of the board on specific issues. In accordance with prevailing international rules, it is considered appropriate to establish at least three committees within the board of directors. The first one is the audit committee, which monitors the work of the executives and the proper functioning of the board of directors. The internal control committee is usually responsible for all examinations, to ensure the independence and effectiveness of the functioning of the internal and external auditing system.[48] To carry out this role in the best way, the committee should be composed of at least three independent directors (two in cases of companies below the FTSE 350). Moreover, according to the 2018 revision of the Code, the committee may no longer include the company chairman as a member of the audit committee, and at least one member must have recent and relevant financial experience. Finally, the committee as a whole shall have competence relevant to the sector in which the company operates.[49]

The second committee is the remuneration committee, which is entrusted with defining the remuneration policies for the managing directors and for the directors with particular positions, as well as the definition of the guidelines for the remuneration

[48] According to the Provision 24 of the UK Corporate Governance Code 2018, the main roles and responsibilities of the audit committee should include:

- monitoring the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgments contained in them;
- providing advice (where requested by the board) on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy;
- reviewing the company's internal financial controls and internal control and risk management systems, unless expressly addressed by a separate board risk committee composed of independent non-executive directors, or by the board itself;
- monitoring and reviewing the effectiveness of the company's internal audit function or, where there is not one, considering annually whether there is a need for one and making a recommendation to the board;
- conducting the tender process and making recommendations to the board, about the appointment, reappointment and removal of the external auditor, and approving the remuneration and terms of engagement of the external auditor;
- reviewing and monitoring the external auditor's independence and objectivity;
- reviewing the effectiveness of the external audit process, taking into consideration relevant UK professional and regulatory requirements;
- developing and implementing policy on the engagement of the external auditor to supply non-audit services, ensuring there is prior approval of non-audit services, considering the impact this may have on independence, taking into account the relevant regulations and ethical guidance in this regard, and reporting to the board on any improvement or action required; and
- reporting to the board on how it has discharged its responsibilities.

[49] Provision 24 of the UK Corporate Governance Code 2018.

of the company's senior managers.[50] The remuneration of managers and directors is considered by many to be a fundamental mechanism of corporate governance, especially if integrated with incentive mechanisms (e.g., stock options or stock granting), capable of aligning the interests of the company's shareholders and those who actually manage the company.[51] According to the UK Code, remuneration policies and practices should be designed to support company strategy and to promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful implementation of the company's long-term strategy.[52]

As for its composition, the Code requires that the remuneration committee also should be composed of at least three independent directors (with a reduced minimum membership of two in cases of companies below the FTSE 350). In addition, the chairman of the board can be a member of the remuneration committee only if he/she is independent, and, in any case, he/she cannot chair the committee. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.[53]

The third committee provided for in the code of board practices is the nomination committee. This committee should, at least in principle, be responsible for the process of selecting new directors, checking the skills gap within the board, and, in some cases, for evaluating the board itself. According to the approach advocated by the vast majority of corporate governance codes, the nomination committee should manage both the selection of directors and presenting the proposed appointments to the shareholders' meeting, in order to prevent the recruitment of directors exclusively from people associated with the managing director and/or the chairman, or within the controlling family. In particular, the UK Corporate Governance Code requires that all directors should be subject to annual re-election, and the activity of the nomination committee should include oversight of: i) the process used in relation to appointments, its approach to succession planning, and how both support developing

[50] According to the Provision 33 of the UK Corporate Governance Code 2018, "the remuneration committee should have delegated responsibility for determining the policy for executive director remuneration and setting remuneration for the chair, executive directors and senior management. It should review workforce remuneration and related policies and the alignment of incentives and rewards with culture, taking these into account when setting the policy for executive director remuneration."

[51] According to the Provision 36 of the UK Corporate Governance Code 2018, "remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. Share awards granted for this purpose should be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more. The remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares." Moreover, "remuneration schemes and policies should enable the use of discretion to override formulaic outcomes" (Provision 37), and "notice or contract periods should be one year or less. If it is necessary to offer longer periods to new directors recruited from outside the company, such periods should be reduced to one year or less after the initial period." (Provision 39)

[52] Principle "P" of the UK Corporate Governance Code 2018.

[53] Provision 32 of the UK Corporate Governance Code 2018.

a diverse pipeline; ii) how the board evaluation has been conducted, the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence board composition; iii) the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives; and iv) the gender balance of those in the senior management and their direct reports.[54] Furthermore, it is recommended that the same nomination committee should evaluate the possible provision of a succession plan for executive directors, and in particular, for the CEO, by providing information in the report on corporate governance. To this end, it is common practice that, in addition to relying on the expertise of its members, this committee makes use of external resources, such as executive search companies specializing in the search for directors of a particular profile. For instance, the UK Corporate Governance Code prescribes that open advertising and/or an external search consultant should generally be used for the appointment of the chair and non-executive directors.[55]

In countries with concentrated ownership, the nomination committee is not as prevalent as the other two committees recommended by best practices.[56] In this regard, the editorial committee of the Italian code declares that it is aware that the nomination committee has a particularly important function in situations characterized by high shareholding dispersion, but has less importance in companies with more concentrated ownership. In these cases, the selection remains primarily the responsibility of the shareholders' meeting, which by law has the task of appointing and dismissing the directors, possibly using the mechanism of lists. However, the international trend is to encourage the spread of this committee into companies characterized by a high degree of ownership concentration. The committee is proposed to take a consultative and proactive role in identifying the optimal composition of the board, indicating the professional figures who can accomplish its proper and effective functioning and, eventually, contribute to the preparation of the succession plan for the executive directors.[57]

3.3.3 The working style

Both the literature and practice at the international level have paid great attention to the composition and structure of the board of directors as potential indicators of its ability to effectively perform the control and service roles for which it is responsible. Recently, however, some scholars have questioned the potential of these formal and structural aspects to ensure good corporate governance. To the contrary, the emphasis on the composition and structure of the board, along with lack of attention to its functioning, are considered among the main limitations of research on boards of directors.[58] In light of these considerations, it is appropriate also to reflect on "soft" aspects related to the functioning of the board, including the characteristics of its meetings, the provision of information to the directors, and their decision-making style and involvement in the strategic management process of the company.

As regards the characteristics of the meetings, some simple process indicators within the board of directors can be seen in the number and average duration of its meetings. Again, as with the other quantitative parameters examined above, it is difficult to establish benchmarks for the number and duration of board meetings. In general, a high number of short meetings avoids long and tiring discussions, and therefore facilitates the overall efficiency of the meeting; on the other hand, a small number of longer meetings minimizes travel, but makes updates on the business situation less frequent. The issue is clear, and concerns the actual amount of time that the members are willing to devote to meetings of the board of directors, and the chairman's effectiveness in soliciting active and continuous participation in the life and decisions of the company. This is also to avoid, in the event of a very small number of meetings, the belief that decisions are in fact taken outside the board, and just formally ratified during official meetings.[59] This does not mean that a high number of meetings per year is an indicator of good governance; on the contrary, an excessive number of meetings is traditionally recognized as an indicator of a company in crisis.[60] Beyond these considerations, in the absence of exceptional circumstances, boards should meet at least six times a year and the duration of the meetings should be on average half a day. Therefore, including the time dedicated to the preparation of the meetings, a director should dedicate at least 10 working days a year to the company.

As shown in **Table 3.8**, in all European countries the average number of meetings of the board of directors reflects best practices, even if the situation is quite varied. The average number of meetings in Germany and the UK is around seven while in Italy and Spain the number of meetings is almost double that recommended under normal conditions.

[54] Provision 23 of the UK Corporate Governance Code 2018.

[55] Provision 20 of the UK Corporate Governance Code 2018.

[56] According to Spencer Stuart's Listed Companies Observatory, in Italy, the country with the highest concentration of ownership, 74% of listed companies have a nomination committee (separated or combined with the remuneration committee). This is not in line with what happens in France, the UK, and the USA, where almost all listed companies have a committee for the appointment of directors (separate from the remuneration committee).

[57] Comment on principle 5 of the 2018 Italian Corporate Governance Code.

[58] See, among others: Daily, C.M., Dalton, D.R., & Cannella, A.A. (2003), "Corporate Governance: Decades of Dialogue and Data," *Academy of Management Review*, 28(3), 371-382; Roberts, J., McNulty, T. & Stiles, P. (2005), "Beyond agency conceptions of the work of the non-executive director: Creating accountability in the boardroom," *British Journal of Management*, 16, 5-26.

[59] Huse (2018).

[60] Lorsch, J.W. (1989), *Pawns or Potentates*, Boston, Harvard Business School Press.

Table 3.8 Average number of meetings

Country	2014	2015	2016	2017	2018
Belgium	n.a.	9.5	8.6	8.4	8.4
France	8.3	9.0	9.0	9.0	9.1
Germany	6.1	6.5	6.7	6.7	6.8
Italy	10.5	11.1	11.6	11.6	11.2
Netherlands	8.5	8.5	11.6	7.4	7.4
Spain	10.4	10.7	11.3	10.8	11.1
Sweden	10.1	9.4	9.2	9.9	10.3
Switzerland	8.3	9.9	11.1	9.0	7.6
UK	7.6	7.6	7.7	8.8	7.3
USA	8.1	8.1	8.4	8.2	8.0

Source: Spencer Stuart, UK Board Index 2014-2018.

The quality of the meetings of the board of directors is determined not only by the time devoted to them, but also by the information made available to the directors, and by the consequent possibility of starting a fruitful debate. The quality and timeliness of the information is in fact crucial for the productivity and efficiency of the meetings. In terms of characteristics and quality, the information distributed to the members of a board of directors should contain data on company performance, compared with budget objectives, the results achieved by competitors, and the results of the previous year. As far as quality is concerned, the information should be both concise and comprehensive, i.e., it should be designed so that board members can easily understand it before each meeting. This is particularly the case when future investment strategy needs to be discussed. In such cases, incomplete or unnecessarily redundant information may render marginal the contribution of external directors. The information to the board should also be timely. Brief, clear, and comprehensive documents have no value if distributed late, or worse, if distributed only on the day of the meeting. It is therefore important that the information is sent to the directors reasonably in advance, estimated to be least four or five working days before the meeting, so that the directors have time to read it, formulate questions, and identify the issues to be explored during the meeting.

However, the availability of time, and of accurate, concise, and timely information, is only one prerequisite for the proper functioning of the board of directors. In fact, the board's decision-making style represents perhaps most the relevant aspect of the process. In this sense, the decision-making style of a modern board of directors can be examined along various dimensions. One aspect of the greatest interest is to evaluate the democratic nature of the debate, which depends essentially on the corporate culture, the openness to external contributions, and the attitude of executives and owners towards an open confrontation. The risk is that the role of external and independent advisers will be relegated to mere formal representation, aimed at meeting the requirements of the code rather than taking advantage of the contribution they can certainly make. An open discussion is also a precondition for a certain level of creativity within the board.

In this sense, the decision-making style of a board of directors is largely influenced by the leadership style of the chairman, above all, but also of the CEO and any senior independent director. In particular, the task of the chairman of the board of directors is to create a climate of openness and active participation in which all members of the board are encouraged to participate critically in the discussions.[61] In this direction, it is essential that the chairman defines an agenda consistent with the objectives of the meeting, one that stimulates the sharing of information, that moderates the debate, and that favors the presentation of projects by executives, in concert with the CEO. The role of the chairperson is relevant not only during meetings, but also in the period between board meetings. Moreover, another task of the chairman is to maintain relations with the members of the board and to encourage dialogue with them, with each other, and with the company's executives, even during periods when there are no formal meetings of the board of directors.[62]

In this regard, although the recommendations of the corporate governance codes in terms of the composition and structure of the board of directors prove to be important preconditions for ensuring the proper functioning of a modern board of directors, the development of an adequate managerial culture, or rather good governance, that determines the way in which people work together.[63] In this sense, and in line with what has been introduced above, beyond the various possible structural indicators – as well as the functioning of the board of directors – the "human component" appears to be the most relevant aspect in building an effective board. This points to the following guidelines for the development of an effective "culture" within a modern board of directors:[64]

- *Create a climate of trust* by sharing important information with directors, and ensuring their motivation through careful rotation of small groups of directors within different committees so that they spend time together, working side by side on more operational aspects as well;
- *Stimulate a culture of "open dissent"* in order to force even the "silent" directors to take a position on the different topics covered in the meetings. From the point of view of the CEO, the creation of this culture requires him/her to accept the opinions, even critical ones, of other directors in an appropriate way, remember-

[61] Huse (2018).
[62] *Ibidem*.
[63] Sonnenfeld, J.A. (2002), "What makes great boards great," *Harvard Business Review*, 80(9), 106-113.
[64] Sonnenfeld (2002).

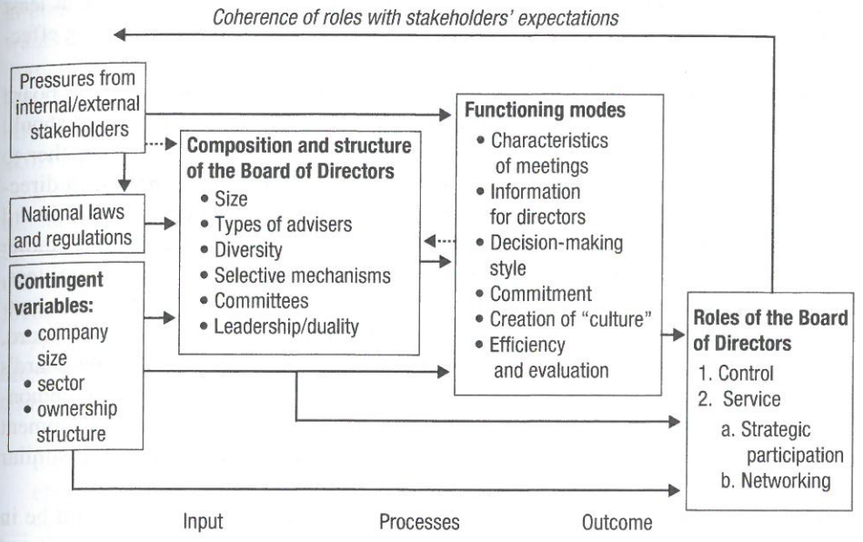
ing that dissent is profoundly different from disloyalty; from the point of view of other directors, especially if independent, this means accepting a position on the board only if you do not feel you're in danger of conforming to the opinions of the CEO (or the chairman, especially if a member of the controlling family), or you are willing to leave the board when it requires "obedience;"

- *Use a "fluid" range of roles*, preventing directors from being trapped in "stereotyped" positions, and asking them to make a creative effort to develop alternative scenarios, carve out creative roles within the board, and create new roles by challenging prevailing practices;
- *Ensure individual accountability*, entrusting directors to provide constant and detailed information to the rest of the board, both on strategic aspects and even more on strictly operational ones. This may involve, for example, collecting external data, meeting with the company's most important customers, visiting production plants and possible sales outlets anonymously, or cultivating external relations that may prove critical to the company's success.
- *Evaluate the performance of the board of directors*, with particular attention to the quality of the discussion during the meetings, the credibility of the various relationships, the ability to manage interpersonal conflicts, etc. The evaluation of the board, which will be discussed in detail below, may concern both the entire board of directors and individual directors. In this circumstance, it is suggested that the evaluation go beyond reputation and resume, paying particular attention to initiative and critical spirit, as well as the energy expended carrying out his/her own role.

In other words, a careful evaluation of the areas of strength and weakness of the board is one of the fundamental requirements in order to create a cohesive and efficient working group. In this regard, a further recommendation, more and more widespread, especially on the boards of directors of U.S. companies, is to rely on the concrete experience of the board of directors, as well as on guidance from best practices, in order to create a real "manual" containing the "rules of operation" of the board of directors. This manual should be a fundamental guide for new directors, perhaps as a basis for their induction meetings, but also a useful reminder for veteran directors, and a tool to make the company's approach to the board of directors' processes explicit to the world outside.[65] **Figure 3.1** summarizes the aspects of the structure, composition, and functioning of a modern board of directors as described so far.

[65] Huse (2007); Leblanc, R. & Gillies, J. (2005), *Inside the Boardroom. How Boards Really Work and the Coming Revolution in Corporate Governance*, Toronto, John Wiley & Sons Canada.

Figure 3.1 A summary scheme of the composition, structure, and functioning of a modern board of directors



Source: Minichilli (2012, p. 135).

3.4 The board evaluation

One topic that has always aroused great interest, but also often conflicting reactions, is the evaluation of the board of directors. In the broadest sense, the practice of evaluating (or, more often, self-assessing) the board should pursue objectives such as instilling discipline among board members, increasing the overall efficiency of the board, ensuring continuous monitoring of processes, and increasing external accountability. The adoption of a formalized board evaluation system has been the subject of debate over the last decade, but its explicit provision in all corporate governance codes has enabled the systematic adoption of tools and models for evaluating the board's work in all major industrialized countries. Among the reasons that have hindered its adoption we can mention: i) the habit of companies to carry out "vertical" evaluations (the board evaluates the top management, which evaluates the lower level managers, etc.); ii) the substantial unwillingness of directors to be evaluated, since the office of director represents in most cases the high point in the career of a manager, consultant, academic, etc.; and iii) the risk of collusion in the case of peer evaluation, and of self-celebratory attitudes in the case of self-evaluation.

Nowadays a board's self-assessment is an established reality in the European and U.S. context, with the most use in countries where it has been a widespread practice for years, such as France, the UK, and the USA, where it is used in close to 100% of companies. In particular, best practices require conducting a self-evaluation at least annually to determine to what extent the board and its committees are working effectively.[66]

The UK Governance Code recommends assessing the collegiality of the board and that of individual directors. In particular, annual evaluation of the board should consider its composition, diversity, and how effectively members work together to achieve objectives, while individual evaluations should consider whether each director contributes effectively, including with reference to the time dedicated to board activity and committees. Moreover, the UK Governance Code recommends stating in the annual report how the performance evaluation of the board, its committees, and its individual directors has been conducted.[67] Based on UK principles, the outcomes from the board evaluation should be shared with and discussed by the board, and the chair should act on the results of the evaluation by recognizing the board's strengths and addressing any weaknesses. Furthermore, each director should demonstrate commitment to his/her own role and take appropriate action when development needs have been identified. In other countries, the Governance Codes have similar requirements.

More recent is the debate on the type of assessment, i.e., whether it should be in the form of self-evaluation, or should involve an external actor (externally-facilitated board evaluation).[68] Indeed, in many companies, the board assessment is carried out by the chairman, but this approach often lacks independence and objectivity. In other cases, an experienced independent director (e.g., the senior independent director) could be asked to lead this job. Others give this responsibility to the audit committee, or decide to set up a new special committee. Self-assessment requires a lot of effort in terms of time, agreement on its goals, and honesty from each director, including

[66] In particular, principle 21 of the UK Corporate Governance Code 2018 states that "There should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors."

[67] In particular, principle 21 of the UK Corporate Governance Code 2018 states that "The annual report should describe the work of the nomination committee, including:

- the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline;
- how the board evaluation has been conducted, the nature and extent of an external evaluator's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence board composition;
- the policy on diversity and inclusion, its objectives and linkage to company strategy, how it has been implemented and progress on achieving the objectives; and
- the gender balance of those in the senior management and their direct reports.

[68] In particular, principle 21 of the UK Corporate Governance Code 2018 states: "The chair should consider having a regular externally facilitated board evaluation. In FTSE 350 companies this should happen at least every three years."

the chairman; and, the real concern is how rigorous this internally-driven evaluation approach will be.

While self-evaluation is useful for encouraging directors to reflect on their personal contributions to board activities, self-assessment is inappropriate when the board wants an objective view of the individual's performance. One way is a peer-evaluation. When board members evaluate each other, it is possible to get a more rounded picture of the strengths and weaknesses of each director and their contribution to the effectiveness of the board. It can also be useful in identifying gaps in knowledge and skills on the board.

Even though up until a few years ago many directors had difficulty in accepting the idea of having their own performance assessed, today few directors hold these opinions; governance practices have shifted their attention toward the possible evaluation models available to the board. The majority of research available on this topic focused on "what" should be evaluated (e.g., the content of the evaluation).

According to the UK principles, board evaluations (externally or internally facilitated) should explore how effective the board is as a unit, as well as the quality of the contributions made by individual directors. They should also evaluate:[69]

- the mix of skills, experience, and knowledge on the board and its committees, its challenges and opportunities, and the principal risks facing the company;
- succession and development plans;
- key board relationships, particularly those between chair/chief executive, chair/senior independent director, chair/company secretary, and executive/non-executive directors;
- quality of the general information provided on the company and its performance;
- quality of presentations to the board and quality of discussion around individual proposals; and
- effectiveness and clarity of the decision-making processes.

For this reason, an externally facilitated independent assessment has become more common in recent years, where an external evaluator is invited to lead the assessment process. The nature and extent of an external evaluator's contact with the board and individual directors play a crucial role in this process, since questionnaire-based external evaluations are unlikely to reveal the real dynamics in the boardroom. Thus, the external evaluator should also meet with the executive team in order to capture their views. In recent years, this practice has started to strengthen, despite the fact that it is still carried out by a minority of companies. In particular, the assessment is performed by external evaluators in 44% of UK companies, and in 30% of Spanish and Italian companies (**Table 3.9**).

[69] Principle 113 of the UK "Guidance on Board Effectiveness".

Table 3.9 Percentage of companies that conducted an external board evaluation

Country	2014	2015	2016	2017	2018
Belgium	n.a.	1.9	11.1	8.6	5
France[70]	35	30.0	23.0	40.0	30
Germany	15	23.3	22.4	17.0	17
Italy	27	35.0	29.0	28.0	38
Netherlands	20	28.0	28.0	20.0	30
Spain	n.a.	15.0	21.0	30.0	34
Sweden	n.a.	11.0	10.0	12.0	17
Switzerland	0	5.0	5.0	15.0	4
UK	40	43.3	43.3	43.3	44
USA[71]	n.a.	n.a.	3.0	2.0	9

Source: Spencer Stuart, UK Board Index 2014-2018.

As an example, a survey was carried out on the board evaluations by Italian listed companies. The 2017 board reviews of 237 Italian listed companies were examined, including 51 financial companies and 186 industrial companies. Out of these, 70.9% of companies carried out a board evaluation, facilitated by an external consultant in 22% of cases. The survey aimed to understand the board's perception of the balance between compliance and business. It emerged that 22% of companies indicated areas for specific improvements in the corporate governance report; the three most relevant themes were: i) the formulation and discussion of strategy; ii) informal meetings and induction programs; and iii) the establishment of a succession plan (see **Table 3.10**).

3.4.1 Five different international approaches for board evaluations

The OECD report identifies five international practices for board evaluations across 20 countries around the world:

- *Countries without Board Evaluation Regulations.* Among the countries analyzed, only China has not yet introduced any rules or best practices on board evaluation. The only thing close to an implicit assessment of the supervisory board's performance is shown by the members' commitment to the long-term welfare of the company, measured through three standards: 1) duty of care; 2) duty of loyalty to exclude self-dealing transactions, personal use of corporate assets, and usurpation of corporate opportunities; and 3) duty of good faith and fair dealing. Companies can also introduce evaluation provisions in their articles of association and by-laws. Major companies in China are increasingly starting to incorporate general "board evaluation" information in their annual reports, including how independent directors have performed their duties and voted in board's meetings, as well as the number of meetings held, and items discussed by board committees.
- *Countries with Emerging Board Evaluation Practices.* The second group of countries is that with emerging evaluation practices, such as Israel. In this country, only banks have a legal requirement to carry out evaluations, but companies are gradually introducing new practices – encouraged by both consultancy firms and the need for transparency in external markets.
- *Countries with Implicit Board Evaluation Requirements.* The third group of countries is that with implicit evaluation requirements, such as Poland and Turkey. Companies in Turkey are strongly urged to produce a written document for the annual shareholders' meeting, covering information about their monitoring activities, and the number and attendance levels of supervisory board meetings. In Poland, there is a similar self-assessment mechanism of the supervisory board. Despite these practices, in both countries there is no evidence that such requirements are leading to more frequent and in-depth board evaluation processes.

70 80% of the CAC 40 companies perform an external evaluation at least every three years.
71 Percentage of S&P 500 boards that disclose.

Table 3.10 Results of a board review conducted by Italian listed firms

Main issues covered by the board review	Total	MTA	STAR	Financial companies	Industrial companies
Formulation and discussion of the strategy	15%	13%	21%	13%	16%
Informal meetings and Induction Program	15%	16%	13%	18%	13%
Establishment of a succession plan	15%	12%	25%	16%	15%
Business knowledge	8%	10%	4%	5%	10%
Criticalities and improvements Committees	7%	7%	4%	11%	4%
Human resources	5%	6%	0%	8%	3%
Remuneration of directors and TMT	2%	2%	0%	3%	1%
Organization and organizational structure	1%	1%	0%	3%	0%
Other improvements or insights	32%	32%	33%	24%	37%

- *Countries with Board Evaluation Principles in their Corporate Governance Codes.* Most countries have now incorporated board evaluation principles into their corporate governance codes, securities regulations, and company laws. Among these, we found Japan, Switzerland, Germany, Austria, Hungary, The Netherlands, Italy, France, the United Kingdom, Luxemburg, Singapore, South Africa, and Brazil. Specifically, Japan adopted a corporate governance code in 2015 that includes principles on the evaluation of board effectiveness.[72] The same happened in Switzerland.[73] Similarly, other countries under the German Civil Law umbrella, such as Germany, Austria, and Hungary, only include extremely general standards of board effectiveness and evaluation. The German code specifies that "the Supervisory Board shall examine the efficiency of its activities on a regular basis," while the assessment of individual board members is not recommended. The Austrian code prescribes, in addition, the frequency of the evaluation.[74] Overall, the percentage of companies submitting themselves to an external board assessment is consistently lower than in the countries that incorporate more detailed evaluation provisions into their corporate governance codes. Among others, The Netherlands, Italy, France, and the United Kingdom provide examples of more detailed assessment requirements. Frequency of board assessment ranges from every year for Italy, the Netherlands, the United Kingdom and France, to every two years for Luxemburg. As in the United Kingdom, France also recommends that an external consultant be involved at least every three years. France, Italy, the Netherlands, Luxemburg, and the United Kingdom also recommend performing an assessment of individual board members. In addition, the codes of both France and the United Kingdom put an emphasis on the evaluation of the chairman's performance. All the five countries' codes then ask for the disclosure of the evaluation results in the annual report. While the frequent assessment of boards and their members has become widespread practice in European countries adopting detailed codes, the process is spreading to Asian, African, and South American countries. For instance, Singapore's code recommends the formal assessment of both the board and its individual members, the establishment of objective performance criteria by the committee in charge of the evaluation process, and the disclosure of the assessment results in the annual report. Similarly, the code of South Africa includes the above provisions based on board self-assessment and additionally recommends the involvement of an external consultant every three years, as in the United Kingdom.

[72] Each year the board should analyze and evaluate its effectiveness as a whole, taking into consideration the relevant matters, including the self-evaluations of each director. A summary of the results should be disclosed.

[73] The 2014 corporate governance code states that "The Board of Directors should self-evaluate its own performance and that of its committees annually."

[74] The corporate governance states that: "The supervisory board shall discuss the efficiency of its activities annually, in particular, its organization and work procedures (self-evaluation)."

- *Countries with Board Evaluation Rules and Regulations.* While other countries adopt a "comply-or-explain" approach, under which deviations from best practices are accepted, a fifth approach consists in explicitly laying out legally binding rules and procedures. For instance, India, Spain, and the United States have a legal requirement to perform annual board effectiveness evaluations.[75] India's regulations are aligned with those of the United States. Since 2013, The Companies Act requires listed companies to disclose their annual evaluation process regarding the board, its committees, and individual directors, whose evaluation is carried out by the nomination and remuneration committee.[76]

3.4.2 Good practices: The WWWH questions

The OECD report identifies four main questions that best practices around the world should answer concerning board evaluations.[77]

When should a board be evaluated? Traditionally, board evaluations are carried out once a year. Nevertheless, the frequency of evaluation should be firm-specific and may vary depending upon the company's life stage, sector, or culture. It should also be carried out when a company has particular needs or is facing financial difficulties. For instance, when accounting issues occur, or the stock price is underperforming, financial expertise – obtained by appointing new independent directors – may be needed (as happened, for instance, in the case of Groupon[78]). Overall, evaluations may be needed more frequently – even continuously in a process of constant improvement – but reporting of the results may only be necessary once a year.

What should be evaluated? In most countries, the evaluation process includes the board, its members, and the board committees. The goal of the evaluation is to ensure that processes enabling the board to deliver effective and meaningful strategic advice are put in place. However, reviews are often limited to a ritualist approach aimed at formal compliance rather than being a value-adding practice. To avoid this risk, companies should integrate a broader range of considerations into their evaluation, including the following key areas:

[75] NYSE listing rules in the U.S. state that: "Board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively."

[76] With the 2015 SEBI (Listing Obligations and Disclosure Requirements) Regulations, the evaluation of each individual director's performance, including the independent directors and chairperson of the board and the board's various committees, is required. In the same year, the Institute of Companies Secretaries of India (ICSI) published a "Guide to Board Evaluation" to help companies comply with the new rules.

[77] OECD (2018), *Board Evaluation: Overview of International Practices.*

[78] Groupon experienced accounting troubles in 2012 in their post-IPO phase. Among the measures taken to respond to the heavy criticism of its reporting practices, Groupon decided to appoint two new directors with extensive experience in accounting and finance.

1. Quality of the monitoring and risk-management role;
2. Quality of the strategic and other business-related advice;
3. Board dynamics and board members' pro-active participation; and the
4. Diversity of the board.

Who should conduct the evaluation? While it is important that all board members be actively involved in the evaluation process, some structure should also be established. In particular, the chairman, the lead independent board member, or a board committee should be responsible explicitly for the process of involving the right people, ensuring members' engagement, delivering individual feedback, exploring potential technologies. and managing expectations. Evaluators should explicitly present different options and identify the one best tailored to the firm's needs.
How should the evaluation be disclosed? Disclosure of evaluation information should address the process and its functioning as well as cover the major results, but should not disclose individual assessment results or personal information. Current practices often favor a formalistic compliance style, while companies should adopt a more open disclosure style that pushes beyond the compliance approach, including an action plan.[79]

Table 3.11 presents an effective summary of evaluation and reporting practices across different countries according to the above questions.

3.5 The future challenges

As described in the previous sections, the past decade has been largely characterized by debate on the composition, structure, and functioning of boards of directors, widely reflected in corporate governance codes and increasingly in the self-assessments of the board. However, the need for governance bodies and mechanisms to adapt to the often-rigid and prescriptive provisions of the various international codes and regulations has often led to an excessive emphasis on compliance, i.e., compliance with principles and rules tout-court regardless of whether they are actually internalized, or even effective. Research has shown that the governance indicators related to board structure, the independence of directors, and the functioning of various committees are not the best predictors of good governance. On the other hand, some "soft" indicators, such as the working relationship between directors or the directors' knowledge of the company, can be good predictors of sound governance and of the board's effectiveness.

After more than twenty years of regulation in the field of good practices, the directors seem to have acquired a greater power to supervise management, but this is

[79] The 2015 Ranstad report is a good example of open disclosure which goes beyond a formalistic compliance style. It can be found at: https://www.randstad.com/investor-relations/results-and-reports/randstad-annual-report-archive/randstad-annual-report-2015.pdf.

Table 3.11 The WWWH questions in some European countries

	France	Italy	Luxemburg	Netherlands	United Kingdom
When	Annually (formal evaluation once every three years)	Annually	Every two years	Annually	Annually
What	The composition of the board Dynamics The individual contribution of each director Chairman of the board	The composition of the board Dynamics The individual contribution of each director	The composition of the board Dynamics	The composition of the board Dynamics The individual contribution of each director	The composition of the board Dynamics The individual contribution of each director Chairman of the board
Who	Nomination Committee/ Independent director (with help of external consultant)	The board (chairman)	The board	Chairman	Independent directors (external consultant once every three years)
How (disclosure)	Annual Report	Annual Report	Annual Report	Annual Report	Annual Report

Source: OECD (2018), Board Evaluation: Overview of International Practices. https://www.oecd.org/daf/ca/Evaluating-Boards-of-Directors-2018.pdf.

only a precondition for a change not only in the "form" but also in the "substance" of the culture and the practices of modern boards. In particular:[80]

- *Excessive focus on compliance means tighter agendas.* While the increasing demands of legislation and regulations have led to a significant increase in the workload for directors, the amount of time available to them has remained virtually unchanged.[81] The additional time required for the work of the *audit* committees after the introduction of the Sarbanes-Oxley Act in 2002 and the Dodd-Frank

[80] Lorsch, J.W. & Clark, R.C. (2008), "Leading from the boardroom," *Harvard Business Review*, 86(4), 104-111.

[81] As noted above, the average number of meetings, although slightly increasing, has remained broadly stable over the last decade.

(Wall Street Reform and Consumer Protection) Act in the United States in 2010 is worth mentioning. Moreover, since these issues are essentially linked to verification and compliance with rules and procedures, they are not very consistent with the leadership role – including from a strategic point of view – that a modern board of directors should play. In many cases, this has resulted in a reduction in time available for the work of the committees, which is often completed quickly and without an effective connection with the board as a whole. It has also resulted in a substantial reduction in the time available for dealing with business issues, which then are confined to mere approval and ratification by the board. Recent research revealed that board members of listed companies often spend 80% of their time at board meetings discussing issues related to past performance and regulatory compliance.[82]

- *The board's relationship with management has changed.* While in the past, directors have typically relied on senior management for all their information about the company and delegated the task of strategic guidance to senior management, the current focus on compliance is significantly redesigning their role. In particular, directors focus on verifying the "correctness" of management actions – taking less for granted, and carefully scrutinizing the behavior of managers in search of illegalities or "misdeeds" – rather than on the "goodness" of such actions. In practice, there is an important substitution effect, so while directors have become more hands-on in the area of compliance, they have also become much more hands-off in the area of strategic planning.
- *The pressure for immediate and measurable results is strengthening short-termism.* The obsession of top managers with quarterly results – especially in capitalist models characterized by the supremacy of financial markets – has traditionally limited the ability of the board of directors to plan for the long term. Unfortunately, despite the fact that many of the directors avow increasing attention to strategic issues, the reality is that very often the scraps of time dedicated to these issues are dedicated to "tactics," rather than to real strategies. In this sense, the increasing complexity of modern enterprises, together with the "jungle" of procedural duties and obligations, makes it unlikely that an independent adviser will actually gather information on the long-term strategies of the enterprise, unless this aspect is actually treated as a priority by the board as a whole. The relevant role of boards in giving informal advice and strategic support to senior management is empirically supported in *Forbes* magazine's "100 most innovative companies in the world," published in its 2014-2016 editions. These surveys indicate a major role of boards in the creation of new products and processes.

The above considerations highlight the risk that the proliferation of semi-automatic rules, and mechanisms for assessing their compliance, will deprive the board of one of its fundamental functions in addition to its control function, i.e., that of long-

[82] OECD (2018), *Board Evaluation: Overview of International Practices.*

term strategic support for the company. At the same time, however, the awareness of these limitations is a fundamental step toward a board of directors "regaining" its role of leadership in the company, getting back to effectively performing an authentic function of checks and balances, after a long period obsessively devoted to control (checks). In order to do this, however, it is necessary for the directors to assume, both individually and collectively, a long-term vision that is functional for the long-term development and success of the company. This can be done through the following steps:[83]

- *Define and manage the company for the long term.* This is a process that begins with a shared understanding between the directors and senior managers, of what is meant by "long term." Too often, in fact, discussion about a specific strategic issue such as an acquisition or a divestment represent an intervention into the long-term strategies of the company. Such actions represent strategic decisions with long-term organizational impact, but they do not replace the need for the board to create its own long-term vision. Indeed, the main concern is the emphasis on short-term performance, due to the great pressure to meet quarterly expectations of the financial markets. Some companies have decided to face a delisting process in order to focus on the long term, and thus be free to focus on innovation and investments. The last case of delisting in Italy was that of the Damiani family, which became the sole owner of the Italian jewelry fashion house thanks to the public purchase offer launched at the end of December 2018. Also Elon Musk, Tesla's CEO, tweeted on August, 7, 2018: "Am considering taking Tesla private at $420. Funding secured;" but the plan was cancelled two weeks later at a board meeting. Since Mr. Musk announced his plan to delist Tesla, its share price had dropped by 20%. Even if short-termism cannot be avoided completely, one solution to mitigate this concern could be to rely more on earnings guidance, namely the practice of providing a preview of company results to financial analysts. Furthermore, companies may also disclose their long-term objectives, based, for instance, on the number of new products to be launched on the market.
- *Give priority to human capital.* If the board should be in charge of leading the company for the long run, the best mix of skills and perspectives are needed within the boardroom. To reach this goal, best practices recommend several requirements, such as gender and background diversity, as well as age and term limits. Even if these practices are useful for achieving an optimal board composition, it is also true that often the individual director's contribution is not related to age or tenure. For example, people retired from their full-time employment can be good board members since they have more time and experience to devote to their job on the board. One good practice, as widely discussed above, regards the board evaluations. In particular, it is necessary to move from internal evaluations

[83] Lorsch & Clark (2008).

conducted by the chairman or lead director, to evaluations which engage an independent third party. Furthermore, it is believed that a modern board should be concerned with guiding the development process of a new generation of top executives, by creating a pool of potential successors to the position of CEO.

- *Take leadership in strategic discussions.* Along with long-term financial discipline, the board should also ensure strong leadership for the long-term strategic management of the company. Although this can be achieved in a number of ways, numerous successful experiences show that "residential" meetings (lasting two or three days), possibly together with the management of the company, represent an extraordinarily effective way to force directors to consider only the long-term implications of management proposals, without taking into account the short-term implications of certain decisions.
- *Give shareholders a voice.* This principle involves a different conceptualization of the board's role. In particular, it should guarantee a reasonable process whereby shareholders assume a role in the corporate decisions. It may happen that a board has a different vision, but its fiduciary duty imposes a duty to give shareholders the final decision. This new perspective is particularly relevant in countries where companies are still trying to achieve the right balance of power between boards and shareholders, moving from the rivalry between them to respect for their roles in the interest of the company.

The above considerations, although partial and limited compared to the potential variety of board configurations, represent an initial set of suggestions on which each board should base a serious evaluation or self-assessment, in order to further develop its potential. Some of these preliminary considerations will be discussed in more detail in the following chapters, where particular types of companies with related specific needs will be taken into account. To give a sense of this, consider the importance of leadership succession planning by a family-owned business, i.e., the centrality of long-term strategic planning in sectors typically dominated by state-controlled enterprises such as military aviation, defense, etc. These considerations further strengthen and qualify the contingency perspective taken in this work, confirming that there is no set of universal rules that a modern board should follow, but rather a set of general principles that, case by case, should inspire the roles and the composition of the board of directors.

Case study **Corporate governance in Unilever**

With a turnover of €40.5 billion in 2008, Unilever is one of the largest consumer goods companies in the world. It has over 400 brands in its portfolio and operates in more than 150 countries. The controlling shareholders are two listed companies: Unilever Holland (NV) and Unilever UK (PLC). They have operated as if they were a single company since the foundation of the group in 1930. They have the same directors and adopt the same accounting principles. Moreover, since 1946, an equalization agreement has regulated the mutual rights of the shareholders of NV and PLC.
Unilever has two main business segments: Foods and Home, and Personal Care. Most of the brands, such as Knorr, Lipton, Dove, and Cif are leaders in their respective markets. The top competitor of Unilever is Procter & Gamble, a USA-based company whose turnover was $85.5 billion (€ 57.5 billion) in 2008. Procter & Gamble is a worldwide market leader and the owner of brands such as Vicks, Pantene, Dash, Gillette, and Pampers.

Board of directors

The corporate governance structure of Unilever has followed changes and developments in the regulations of the two countries in which the company still has its registered offices (NL and UK), and the differences between the regulations in the two countries have led to specific needs. Until 2002-03, non-executive directors were widely recognized and common among the boards of directors of British companies, while they did not represent an element of good governance in the Netherlands. Conversely, the supervisory board – typical of the dualistic models common in large parts of Northern Europe (including the Netherlands) – was not allowed in England. For these reasons, the corporate governance in Unilever represented an attempt to comply with different needs and regulations. In particular, Unilever introduced advisory directors who were to have a strong element of independence, carrying out, at the same time, the typical functions of the supervisory board members and non-executive directors. These advisory directors were seated on both boards, replacing supervisory directors in the Netherlands and non-executive directors in the United Kingdom. Since they had to cover both roles, a particular artifice was adopted: the advisory directors did not have the right to vote. In January 2002, the Unilever board of directors consisted of 8 executive directors and 12 independent/advisory directors, for a total of 20 directors.
The boards of NV and PLC comprise the same persons who are elected by the NV and PLC companies during their annual shareholders' meeting and they remain in office one year. Executive directors apply for reelection, and they retire from their duties when they are 62. Advisory directors are chosen with respect to their experience and international background, and they were all considered independent by Unilever. They are nominated by the board of directors for 3 or 4 years, and they can be reelected for another 3 years, upon considerations of the analyses and proposals of the nomination committee. As anticipated, they do not have voting rights, and therefore they are not legally responsible for the board decisions.

Committees

There are several committees within Unilever's board of directors:

- *Executive committee*: it is responsible for setting priorities and general corporate objectives; allocating resources; developing and monitoring divisional strategies and plans; identifying and exploring the opportunities generated by economies of scale and scope; managing external relations at the corporate level; and developing future leaders. Among its members, are the presidents of NV and PLC, the director of the foods and home division, the director of the personal care division, the head of corporate development, the chief financial officer and the personnel director. Committee members are appointed annually by all the directors. This committee meets formally once a month and is chaired alternately by the president of NV or PLC;

Table 3.12 Unilever's Board of Directors, January 2003

Name (age)	Position	Appointment	Ex	Au	CR	EA&CRC	No	Re
Executive								
Antony Burgmans (56)	Chairman of Unilever N.V., Vice-Chairman of Unilever P.L.C. from 4/05/1999	08/05/1991	X				X	
Niall FitzGerald KBE (57)	Chairman of Unilever PLC and Vice-Chairman of Unilever N.V from 01/09/1996	20/05/1987	X				X	
RHP Markham (56)	Financial Director from 04/08/2000	06/05/1998	X(*)		X			
Clive Butler (56)	Corporate Development Director from 01/01/2001	06/05/1992	X					
Patrick Cescau (54)	Foods Director from 01/01/2001	04/05/1999	X		X			
KB Dadiseth (57)	Home & Personal Care Director from 01/01/2001	03/05/2000	X		X			
AR van Heemstra (56)	Personnel Director from 03/05/2000	03/05/2000	X		X			
CB Strauss (60)	President, Home & Personal Care North America and Global Prestige Business. Chairman, North America Committee	03/05/2000	X					
Advisory								
Lord Brittan	Chairman & Vice-Chairman of UBS Warbug Ltd.	2000				X		
Baroness Chalker	Director of Freeplay Energy PLC	1998				(*)		
Bertrand Collomb	Chairman and CEO of Lafarge S.A. Director of Vivendi Universal, TotalFinaElf, and Atco	1994					X	X
Professor Wim Dik	Professor at Delft University of Technology. Chairman	2001				X		
Oscar Fanjul	Honorary Chairman of Repsol-YPF S.A. Director of Marsh & McLennan Companies, the London Stock Exchange, ACERINOX S.A.	1996		X				
Claudio X. Gonzalez	Chairman and CEO of Kimberly-Clark de Mexico S.A.	1998		X				
Hilmar Kopper	Chairman, Supervisory Board of DaimlerChrysler AG. Non-executive director of Xerox Corp.	1998		X(*)				
Senator George J. Mitchell	Partner of the law firm Piper Rudnik, Director of Walt Disney Company, Federal Express Corp.	1998				X		
Charles R. Shoemate	Left in 2003. Director of CIGNA Corp., International Paper Company, and Chevron Texaco Corporation	2001				X		
The Lord Simon of Highbury CBE	Member, Advisory Board of LEK Consulting and International Advisory Council of Fortis	2000					X	X
Jeroen van der Veer	President of Royal Dutch Petroleum Company	2002					X	X

Ex (executive committee), Au (audit committee), CR (corporate risk committee), EARC (external affairs and corporate relation committee), Re (Remuneration Committee), No (Nomination committee). (*) Chairman.

Source: Unilever Annual Report.

- *Audit committee*: it supports the board of directors in assessing risk management and control of the external environment, preparing financial statements, and administrating business management. It also monitors the internal audit procedures. It is composed by three advisory directors, and its meetings are also attended by the chief financial officer, the general counsel, the controller, the chief auditor, and the external auditors. The chief auditor and the external auditors have direct access to the audit committee. The committee meets an average of three times a year;
- *Corporate risk committee*: it assists the board of directors in ensuring effective risk management and the efficiency of internal control systems. The committee reports not only to the board of directors, but also to the executive committee and the audit committee. It is composed of the chief financial officer, the director of the food and home division, the director of the personal care division, the personnel director, the general counsel, the chief auditor and the controller. The corporate risk committee meets on average twice per year;
- *External affairs and corporate relations committee* (EACRC): it is responsible for the code of business conduct and informing the board about all relevant external issues, including those related to corporate social responsibility (CSR). Composed of five advisory directors, this committee met four times in 2002;
- *Remuneration committee*: it reviews the remuneration of the executive directors and is responsible for the stock incentive plans for executive directors. The committee develops specific remuneration packages for each director. It is composed of four advisory directors;
- *Nomination committee*: it proposes to the board of directors possible candidates suitable to be appointed as directors, advisory directors, and members of the executive committee. It is composed of three advisory directors and the presidents of NV and PLC;
- *Routine business committee*: its purpose is managing routine business when needed. It consists of two directors and some senior executives and corporate executives.

Remuneration

The aim of Unilever's remuneration policy is attracting, motivating, and maintaining the best managers, paying them based on results achieved. Levels of remuneration are reviewed annually by the remuneration committee in light of external expert advice, which assesses competitive levels of remuneration paid by other major international companies. Executive director compensation is composed of fixed remuneration, benefits, annual performance-related bonuses, long-term incentives (stock options), and pension provisions. The advisory directors receive a fixed annual remuneration (of about €55,000) and reimbursement for expenses incurred in attending the shareholders' meetings. They receive no other form of remuneration as advisory directors, nor do they have an employment contract. The total compensation for the board members is about $17 million: $8 million for salaries, $1.3 million for benefits, and $8 million for performance related payments.

4 The Ownership Structure and Related Governance Models

4.1 The characteristics of ownership structures

The ownership structure represents the first important variable to be investigated in defining the variety of corporate governance models. Consideration of the different kinds of ownership and its characteristics, often underestimated in Anglo-Saxon corporate governance studies, is a necessary way to build an overall model of corporate governance that is applicable in different contexts. Despite the fact that this work embraces an extended conception of the corporate governance, which considers the influence of a rather broad range of stakeholders on the company's basic strategic decisions, the study of ownership and its forms represents an essential starting point.

4.1.1 Ownership concentration

Within the capitalist model, we can distinguish two important characteristics of the ownership structure, which together define its nature. They are the degree of ownership concentration in the hands of one or a few persons, and the identity of any controlling shareholder. As regards the first aspect, an analysis of the degree of ownership concentration refers to two different but complementary aspects: 1) the number of shareholders, and 2) the share of equity capital held by each of them. Joint consideration of these elements makes it possible for us to identify some hypothetical "emblematic cases."[1]

- *A company with only one shareholder, who owns all of the equity capital (100% of the shares).* This is an extreme case, but at the same time the most widespread one. It involves companies that are often not large in size, and in which ownership rights are concentrated in the hands of a single person who typically exercises both the functions of governance and the management. The spread of this type of ownership is due to the tendency of entrepreneurs, and especially company founders, to avoid selling shares to others. At the same time, however, despite the fact that only about one third of these companies survive a generational change

[1] This is a personal reworking of information provided by Airoldi, Brunetti, & Coda (2005, p. 552).

– or in general, the transfer of ownership to someone else – the model of the founder-entrepreneur continues to be the most widespread in many countries in the world.

- *The private company with several shareholders.* This is an equally widespread form of enterprise, characterized by the equity capital being shared by a variable number of people both in number (two in the simplest case, several dozen in the most complex cases), and in type.[2] In this respect, owners may be: i) all members of the same controlling family, possibly belonging to different generations; ii) coalitions of controlling families (two or more, each possibly with several generations involved); iii) mixed coalitions of families and other entities, such as other enterprises or private equity; or iv) mixed coalitions of legal entities such as the state or other government, institutional, or private investors. In general, the opening up of capital to a number of players is a mandatory step for many companies, both to be able to pursue the objective of growth, and to guarantee its survival. For these reasons, these are often larger companies, with more complex strategies and with an articulated product range. Clearly, the enormous variety of possible combinations, both in the number and type of owners, as well as in the amount of the shares held by each owner, means that this category includes companies of all sizes, from small companies controlled by two brothers or two families, to very large (unlisted) multinational companies.
- *A company listed on the stock exchange with a controlling shareholder (or blockholder).* A first category of listed company that is very widespread throughout continental Europe is one with a large number of minor shareholders and a single shareholder who possesses a sufficient percentage of shares to allow him/her to appoint the majority (or all) of the board of directors. In this respect, it is not necessary to hold an absolute majority of the capital shares (50%+1) in order to be the blockholder, since it is sufficient for the controlling shareholder to hold the majority of the voting rights usually represented at shareholders' meetings. In other words, even if, in principle, ownership rights belong indiscriminately and uniformly to all owners of shares, the fragmentation of ownership guaranteed by the listing on the stock exchange determines the conditions for a (controlling) shareholder to exercise ownership rights more immediately than other "minority" shareholders, even if they often hold a majority (relative or absolute) of the capital as a whole. This is even more true when the fragmentation of ownership among minority shareholders increases, since the "costs" associated with the exercise of ownership rights are often far greater for a small shareholder than the "benefits" derived from good governance of the company. Thus, where there is no other person with a significant stake in the equity capital, a controlling shareholder can exercise control with 10% or less of the shares,[3] even though much research into family-owned companies has traditionally considered ownership of 25% of the capital to be a threshold for ensuring stable control of a listed company.[4] The greater complexity of ownership is clearly also reflected in the greater organizational complexity and size (and, in some cases, very large size). However, it is not possible to say *ex ante* that a listed company is large: in many countries it is common to find unlisted companies with a significantly larger size, and strategic and organizational complexity, than those listed on the stock exchange.
- *A listed company controlled by another company or by a shareholders' agreement.* A variant of the previous model is represented by the company listed on the stock exchange where a controlling shareholder is represented not by a single individual or a family, but by another company or by physical entities, legal entities, or various combinations of these, linked together by a shareholders' agreement.[5] The first circumstance is common, for example, in the case of local subsidiaries of multinational companies or of pyramid groups. The shareholders' agreement is a way in which a group of individuals who individually would not have the strength to control the company, decide to be contractually bound in the exercise of their voting rights for a certain period of time, and for the explicit purpose of reaching the "critical mass" necessary to stabilize control of the company itself.
- *The company is listed on the stock exchange without a controlling shareholder,* i.e., with a large number of shareholders who cannot (because of the small number of shares held), or do not want (the case with many institutional investors), to participate directly in the governance of the company, and in the appointment of representatives to the governance bodies. This is the case with the Anglo-Saxon public company described above, where the need to operate on a large scale has

[2] In fact, in addition to the "number" and "type" of owners, consideration should also be given to the *distribution of ownership rights*, albeit within certain limits, in an uneven manner. These are, for example, special categories of shares with limited voting rights in general meetings, for example (savings shares), or shares with "special" voting rights (for example, the so-called "*golden share*" in certain state-controlled companies).

[3] Empirical research in the U.S., for example, usually considers thresholds between 5% and 10% of risk capital as sufficient to ensure control of a company. In this regard, see Anderson, R.C. & Reeb, D.M. (2003), "Founding-family ownership and firm performance: Evidence from the S&P 500," *Journal of Finance*, 58(3), 1301-1328; Villalonga ,B. & Amit, R. (2006), "How do family ownership, control and management affect firm value?" *Journal of Financial Economics*, 80(2), 385-417.

[4] For instance, see Miller, D., Minichilli, A., & Corbetta, G. (2013), "Is family leadership always beneficial?" *Strategic Management Journal*, 34(5), 553-571.

[5] A shareholders' agreement is an agreement between shareholders of the company. Among its advantages, the greater stability of the company and the possibility of a more effective defense of shareholders' interests. On the other hand, one of the main disadvantages is the limited effect to the third parties, as the agreement produces its effects only between the parties (who signed the agreement) and not towards third parties, Shareholders' agreements vary enormously between different countries and different regulations. However, they are expected to regulate the main following matters: i) the ownership and voting rights of the shares in the company; ii) control and management of the company, which may include power for certain shareholders to designate individual for election to the board of directors or imposing super-majority voting requirements for "reserved matters"; iii) making provision for the resolution of any future disputes between shareholders; and iv) protecting the competitive interests of the company (for instance, restrictions on a shareholder's ability to be involved in a company business).

often led or leads to progressive separation between ownership and control of the company, with a very low level of ownership concentration, but with great power concentrated in the hands of the company's management.

The analysis of the degree of ownership concentration is therefore of fundamental importance for understanding and evaluating the way in which ownership rights are exercised, as well as what overall governance model a company is likely to adopt, and its results in terms of the effectiveness of governance action and success in the market. In this regard, studies, especially at international level, on the concentration of ownership have devoted much attention to trying to understand whether the presence of a controlling shareholder (the so-called *blockholder*[6]), despite its various forms, represents a solution to the problem of agency, or on the contrary, can even exacerbate it. This debate, which follows what was introduced in Chapter 2 about the pros and cons underlying a particular variant of the agency's theory, seeks to understand, for example, whether the ownership concentration, and in particular the presence of a blockholder, is beneficial or detrimental to the performance of a company. In this regard, the results of the study by Thomsen, Pedersen, and Kvist are of particular interest. Starting from the inconsistency of results of previous studies, they have concluded the following.[7]

- The relationship between ownership concentration in the hands of a blockholder and the performance of the company is influenced by the type of legal and governance system in which the company operates. In other words, a judgment on the effectiveness and appropriateness of a particular proprietary model cannot be made in the abstract, but should be based on its *fit* with the legal and institutional context in which the company operates.
- The concentration of ownership tends to be "endogenous" with respect to the context being investigated. In particular, the probability that a company is owned by a blockholder is significantly higher in civil law countries (such as typically European ones) than in common law countries (the Anglo-Saxon countries). For this reason, it is important to evaluate the effects on performance in homogeneous contexts, i.e., taking into account the considerable influence of the context in the analyses.
- Based on these considerations, it has been observed that while in Anglo-Saxon market economies the presence of a blockholder does not seem to have an effect on the value of the company, the results are more ambiguous in the European context. In particular, study results show support for both the positive view of concentrated control, according to which there would be a greater alignment of interest between ownership and management, and for the negative view, which instead emphasizes the possible conflict of interests between the controlling shareholder (the blockholder) and minority shareholders (small shareholders with small shares of the capital). More specifically, as Thomsen and Pedersen found in a study of the 435 largest European companies,[8] the relationship between ownership concentration and firm performance appears to be positive but curvilinear (reverse "U"), indicating that beyond a certain level of ownership concentration, this relationship becomes negative. This they attribute to the potential extraction of benefits by the blockholder, as well as to the blockholder's potential divergence of interests from minority shareholders.

[6] The name "blockholder" derives from the fact that there is a subject or an entity that holds a quantity of shares such as to act as a "block" for the control by other subjects.

[7] Thomsen, S., Pedersen, T., & Kvist, H.K. (2006), "Blockholder ownership: Effects on firm value in market and control-based governance systems," *Journal of Corporate Finance*, 12, 246-269.

4.1.2 Owner identity

A second important characteristic of the ownership structure, besides ownership concentration, is that of the identity of the controlling shareholder or blockholder (so-called owner identity). The identification of the nature of the shareholder is fundamental to understanding his dominant economic objectives, which will presumably be guided by a contextual assessment of the costs and benefits associated with the nature of the ownership. Among the various possible types of shareholders, one of the most established in the literature is that proposed by Thomsen and Pedersen.[9]

- *Families or individuals.* As mentioned above, families and individuals often play the dual role of owners and managers. This means that they represent the only category of shareholders who act in their own name and on their own behalf, and not through representatives, thus favoring a natural alignment of interests. At the same time, the loyalty of family members to their business allows them to partially overcome the problem of managerial incentives, thereby creating better basic conditions for the business's profitability. At the same time, however, other factors, such as the ability of family ownership to erect barriers against hostile takeovers, may produce negative effects due to entrenchment, especially where the family plays a massive managerial role. Moreover, as families or individuals typically invest a large fraction of their wealth in the business, family-owned enterprises are potentially more risk-averse than managerial enterprises. However, this risk aversion disappears where there is a higher-ranking risk, namely that of the family losing control of the business. In other words, family ownership has a "variable structure" as to propensity to risk, showing how entrepreneurial families are *risk-averse* or *risk-taking* depending on the consequences of taking a

[8] Thomsen, S. & Pedersen, T. (2000), "Ownership structure and economic performance in large European companies," *Strategic Management Journal*, 21, 689-705.

[9] Thomsen & Pedersen (2000); Pedersen, T. & Thomsen, S. (2003), "Ownership structure and value of the largest european firms: The importance of owner identity," *Journal of Management and Governance*, 7, 27-55.

certain risk.[10] In this regard, there are many studies that highlight the positive and negative aspects of family ownership, and the problems associated with it. In addition to entrenchment and risk aversion, family businesses are often accused of excessive "familism." This translates into problems of succession, nepotism, and differences within the family over the objectives to be pursued, which leads some scholars – especially in finance – to associate the prevalence of family businesses with "underdeveloped" financial systems (i.e., with low investor protection). We will return to this subject later on.

- *Institutional investors.* A second large category of "owners" is represented by a broad category of financial institutions, which mainly includes mutual funds, pension funds, and insurance companies. As will be seen in more detail below, this is an ownership model that is particularly widespread in the Anglo-Saxon countries, and therefore associated with greater market efficiency. Ownership by institutional investors implies a greater propensity to risk, a relatively long-term horizon, and a close relationship between the company and its management. In addition, the fact of owning a large portfolio of shares, as well as being regularly rated on the basis of their financial performance, makes institutional investors particularly oriented towards the creation of shareholder value.
- These characteristics, which are positive in themselves, nevertheless conceal potential pitfalls. The strong orientation towards firm performance, in fact, would force managers of investment funds to make short-term choices – often leading them to exit investments in lower-performing companies, rather than to exercise the voice through activism – thus reversing the tendency toward long-term orientation that should be the natural consequence of having an institutional investor as a shareholder in the company. At the same time, however, the fact that institutional investors represent a "specialized" category of owners means that, where favorable conditions are created, their intervention in questions of corporate governance can be incisive, often in a positive sense. In this regard, consider the large U.S. pension funds (including TIAA-CREF[11] and CalPERS[12]), which can raise awareness among companies in which they invest on issues such as employment and welfare. Think also of the trend towards greater "activism" by institutional investors on corporate governance questions over the last decade. Finally, the fact that many institutional investors are subject to special regulation and supervision by governments (the same applies also to banks, which will be discussed in the next point), means that there is less probability to extract private benefits, leading many to consider this type of ownership the optimal substitute for the presence of a blockholder, with which it retains some similar characteristics without the limitations.

[10] See Gomez-Mejia, L.R., Patel, P.C., & Zellweger, T.M. (2018), "In the horns of the dilemma: Socioemotional wealth, financial wealth, and acquisitions in family firms," *Journal of Management*, 44(4), 1369-1397.

[11] *Teachers Insurance and Annuity Association – College Retirement Equities Fund.*

[12] *California Public Employees' Retirement System.*

- *Banks.* Although corporate ownership by banks is not widespread, and in some cases is prohibited, especially in Anglo-Saxon countries, it plays a very important role in countries under German law, and, as will be seen below, also in the Japanese model of *keiretsu*. In these contexts, the bank plays a key role in providing a range of financial services to industrial enterprises, making use of the privileged access to capital, information, and all other assistance and advisory services that modern banks offer. As a result, numerous studies have shown that there is a positive relationship between the presence of a bank among company shareholders, and its performance, as well as the fact that companies and groups with strong bank ties are less likely to be subject to credit restrictions. Moreover, as mentioned above, the close regulation of banks by national central banks, and by the various national and supranational supervisory and regulatory bodies means that fraudulent, or simply opportunistic, behavior is strongly inhibited. At the same time, however, ownership by banks has some limitations, such as a greater aversion to risk compared to other institutional investors, and a lower propensity to intervene directly in management questions.
- *Enterprises.* Another category of owners is shareholding by other companies in the form of cross-shareholdings, i.e., control within a group of companies. This commonality of shareholders can be a significant benefit if the two companies (the participant and the investee) operate in related businesses, thus facilitating each other's access to valuable technologies, or in exploiting common resources and platforms. This circumstance can manifest itself in "vertical" relations in different phases of the production chain, in which the two firms involved benefit from access to specific assets and technologies, as well as from a high frequency of transactions. The relationship between the parent company (headquarters), and the various subsidiaries in the various markets (subsidiaries), which distribute products and services designed and manufactured by the parent company, is also very common, and the parent company will clearly have a strong incentive to transfer ownership resources to its subsidiaries.
- At the same time, the existence of cross-shareholdings can also act as a deterrent to hostile takeovers, making it difficult to gain dominance within groups, especially if multiple actors are involved in shareholders' agreement at different levels. This circumstance, particularly common in pyramid groups, especially if they are formed by many listed companies, may facilitate the extraction of private benefits on behalf of the controlling shareholder at the top of the corporate pyramid. In this regard, although various studies show the pros and cons of belonging to groups of companies, many scholars believe that this particular form of ownership can be an efficient solution in the early stages of a country's development, although gradually losing its appeal as financial markets develop and modernize.
- *State or other public entity.* A last important category of potential owners is the state, or other central or territorial entities and public administrations. The reasons for state intervention in ownership of companies can be manifold, and generally lie in the realm of "market failure," i.e., in the "political relevance of the good or service offered." Numerous studies have shown that public ownership is

particularly suited to meeting policy objectives such as price reductions, employment, positive externalities, and the social and technological spin-offs of business operations. At the same time, it is commonly believed that certain industrial sectors with particular strategic significance, such as energy, defense, telecommunications, and in some cases, oil extraction and refining, can and should remain in "public hands," even if this gives rise to inefficiencies, and an overall reduction in the performance of the state-owned company. The anticipated lower profitability of these companies seems to be offset by some important advantages, especially from the point of view of minority shareholders. In principle, state ownership represents a concrete protection against excessive competition, through the existence of barriers to entry often guaranteed by the regulation of the sectors in which the state typically intervenes. In addition, state ownership is likely to provide greater access to credit, thus ensuring a lower cost of capital than in the private sector, due to higher solvency guarantees.

The above considerations on the possible types of owners of companies, and in particular the controlling shareholder, are based on the assumption that the company is controlled by entities that hold shares in order to exercise their governance rights. In reality, however, there are also some companies that can be referred to in terms of non-capitalist ownership, i.e., companies in which ownership rights are not held by risk capital providers, but rather by other categories of entities.[13]

4.2 The various forms of ownership structure

Our analysis of ownership concentration and owner identity has highlighted a number of different variables to be taken into account when defining the characteristics of the ownership structure of a company. Based on these characteristics, it is possible to determine how many, and which classes, of stakeholders are considered in exercising the prerogatives of corporate governance, how large these classes are, and consequently how homogeneous (and of what kind) are the interests represented in the ownership. In this regard, the combination of these characteristics allows us to make an initial classification of the different "types" or "archetypes" of enterprise. Even though we are aware of the great variety of forms represented in reality, in fact, it seems possible to assert the existence of some "typical" ownership structures, which are often associated – as we shall see later – with "models of capitalism" that favor or inhibit their diffusion. In attempting this first classification, we will take into account not only ownership concentration and the identity of the relevant shareholder (or coalition shareholders), but also other important characteristics, such as the size of the company and alternative legal forms to the joint stock company. Given the importance of the family-controlled ownership structure, the next chapter will be entirely devoted to this type of ownership structure.

[13] See Airoldi, Brunetti, & Coda (2005).

4.2.1 Public companies

A first possibility, widely explored in the literature, is that of a listed company with widespread shareholding, which has already been discussed previously (the so-called public company), and to which all the traditional literature on Anglo-Saxon corporate governance refers. It is the typical form of ownership adopted by large companies located in countries with a high level of investor protection, and transparent, efficient, and large capital markets.[14] The large company with widespread shareholding, seems particularly suitable for competitive sectors such as chemicals, pharmaceuticals, metallurgy, etc., where it is important to increasing its size and consequently to obtaining advantages related to economies of scale and scope.[15]

As far as ownership is concerned, these companies are characterized by a low concentration of shares, and by difficulty in ascribing an "identity" to the various entities holding shares in its equity capital. An exception to this is the growing presence of institutional investors, which over time has led to a gradual change in the relationship between ownership and management. In the past a shareholder who was dissatisfied with the performance of the company – be it a small saver or an institutional investor – would react by selling his shares on the market in order to sanction the management, causing (especially in the case of large investors) a sharp reduction in share prices, and thus exposing the company to risk of takeover. In recent years, however, the growing dialogue between institutional investors and company management has led to a marked reversal of course. As previously mentioned, in fact, institutional investors have shown an increasing sensitivity to corporate governance, making themselves more and more willing to engage in constructive "collaboration" (so-called "shareholder activism"), preferring the path of creating joint value with management, to that of portfolio management. This circumstance, which in some ways creates a variant of the pure public company model, means that mutual funds or pension funds actually play the role of a potential controlling shareholder, with all that this entails in terms of positive and negative aspects, and, above all, of interest and convenience in taking part in the most important governance decisions.

From the point of view of governance, then, the maximum degree of separation between ownership and control creates the conditions for managerial opportunism. On the one hand, small investors have neither the incentive nor the skills to exercise effective control and guidance over the work of management; on the other hand, the managers, not having rights over the cash flow produced by the company, are tempt-

[14] See Zattoni (2015).

[15] Zattoni (2015). As mentioned above, however, there are exceptions to this general trend: in the automotive sector, for example, which is also characterized by strong trends towards growth in size and consolidation between smaller companies, family control continues to be surprisingly widespread.

ed to maximize their personal advantage to the detriment of maximizing the overall value of the shares, and therefore the value for small shareholders.[16] In this context, the transparency of the system of governance, and in particular the independence of the board of directors, seems vital. As a first approximation, the board of directors should be composed of an adequate number (possibly a majority) of external directors, many of whom should preferably be independent; the role of chairman should then be separated from that of the CEO; within the board, at least three committees should be set up to oversee the fundamental processes of control over the accounting and administration of the company's activities, the remuneration of top management, and the selection and appointment of directors and managers.[17] In addition, the "external" mechanisms of control described in Chapter 2, including the market for corporate control and the managerial market, as well as clearly effective oversight by audit firms and market oversight bodies, such as the FSA (Financial Services Authority) and the London Stock Exchange in the UK, should be activated.

4.2.2 Mixed coalitions

A second type of enterprise, somewhat similar to the public company, is represented by the mixed coalition. This type of company is also particularly widespread in legal and regulatory contexts where investor protection is lower, and in sectors with moderate capital intensity. Although this category of companies is not particularly codified in the literature, its differences from public companies and family-owned companies are such as to justify separate treatment.

First, the presence of various entities – including families, individuals, other businesses, private equity funds, etc. – means that there is a great heterogeneity in the ownership identity, and consequently a lower concentration of shares, which will be distributed according to different possible combinations among the various classes of subjects. These two characteristics lead to at least two types of consequences. On the one hand, it is rather likely that the presence of different types of parties holding equity capital will lead to a divergence of interests, often significant, especially if the balance between the interests represented by the different owners changes over time. Just think of the emergence of conflicts between different families, between a family and other individuals among the shareholders, or even between different branches of the same family. Think also of the entry of a private equity firm, required by prolonged conditions of "suffering" by the company, and the dual, simultaneous need to recapitalize the company and equip it with appropriate managerial skills. In all these cases, and especially with the entry of private equity, it is very likely that there will be a misalignment between the different objectives, which may include the survival of the company, its profitability, its growth, or simply the continuation of the benefits of control by one or more of the owners.

[16] See Zattoni (2015).

[17] See Airoldi & Zattoni (2005); Zattoni (2015).

A second major difference between mixed coalitions and family businesses will be the difficulty of creating a balance within the governance bodies of the various entities represented in the company's capital. This involves a much greater complexity in the design of the governance structure than in the previous case, both when the search for this balance between the different actors takes place in an informal way, and then when it is formalized in shareholders' agreements. This category includes a large number of listed and unlisted companies of very different sizes, which may have informal or formal agreements to maintain control.

The characteristics just mentioned also make it difficult to identify a prevalent strategy common to all companies belonging to this category. Because the interest and convenience of the various owners in actively participating in governance decisions will vary greatly, depending on the size of the ownership share (and also the number of parties represented in the holdings), their strategies may be very different, especially depending on the reasons for the very existence of the coalition. If the ownership coalition is a response to the need to expand in highly capital-intensive and competitive sectors, the dominant strategy will be that of growth. If, on the other hand, two companies of different nationalities were to be present in the coalition, the creation of a mixed coalition in the form of a joint venture would be the most functional for internationalization strategies.

4.2.3 Multi-National Enterprises (MNEs)

As the influence and impact of international activities on the world's gross domestic product and trade activities grows, scholars and managers are increasingly interested in understanding the complex relationships, for example, between the parent company and its subsidiaries.

A multi-national enterprise is in fact a very peculiar proprietary model. While since in many cases they are public companies at the corporate level, the objective of the system of governance is usually to guarantee the interests of minority shareholders; but at the local level governance is characterized by the search for balance between the leadership of the parent company and the autonomy of the branch. Although there is little empirical evidence in this regard, one of the major challenges in this case is considered to be how to ensure a sufficient degree of local autonomy, and at the same time have an incisive and non-intrusive leadership at the central level.

This general principle will obviously have to be elaborated according to at least two fundamental variables. First of all, it is necessary to consider the ownership structure of the parent company, which will tend to "reflect" itself in the methods and governance choices of the local subsidiaries. Thus, a parent company with widespread shareholding will tend to adopt a "managerial" style in its local branches; on the other hand, a parent company with concentrated or even family shareholding, will tend to create a structure of reporting that facilitates the control and centralization of decisions at the corporate level.

Secondly, the ownership structure of the subsidiary must also be taken into account, since it is clear that the governance bodies and mechanisms for representing the interests of the shareholders will also have to take account of minority shareholders at the "local" level where, for example, the subsidiary is listed on the stock exchange. Therefore, despite the "classic" model of the multinational branch representing only one of the possible ways of operating abroad, it is the most complex and requires the greatest attention from the point of view of the overall governance design.

In fact, there are many other ways to carry out international cross-border activities (i.e., involving several countries), which can be divided into equity and non-equity modes. From the point of view of agency theory, there also are a number of very important problems involved in understanding, for example, how a joint venture should be managed, or how certain contractual arrangements should be executed. In line with the approach we've followed so far, and within the scope of the present work, we will focus only on the methods of international expansion through Foreign Direct Investments (FDI) on the equity side, examining the methods of governance and management of the two main types of ownership with which they can be achieved:

- *Wholly-Owned Subsidiaries* (WOs), which represent the classic way of expanding abroad through the acquisition of branches with their own governance and management structure; and
- *Joint Ventures* (JVs), also known as *International Joint Ventures* (IJVs) where partners from two different countries are involved, which include all varieties of control – minority, majority or joint (obviously, the most complex case).

4.2.3.1 *Wholly-Owned Subsidiaries (WOs)*

Although the corporate governance literature is still largely focused on the governance mechanisms of a single legal entity, many companies – due to the growing need to operate in different geographical markets – now take on the configuration of Multi-National Enterprises (MNEs). In the case of local subsidiaries wholly owned by a parent company (the Wholly-Owned Subsidiaries, WOs), there are the typical problems of composition and functioning of the board of directors of the local branches, and of the connection with that of the parent company, which at the same time controls all its subsidiaries around the world. Despite the tightening of the rules of good governance at the international level, the functioning of the boards of local subsidiaries still remains an ambiguous prospect. As mentioned earlier, multinational companies represent particularly interesting and complex realities, both from the point of view of the ownership and corporate structure, and from the point of view of the governance and management models of the various local situations (the subsidiaries).

From a proprietary point of view, the two levels of analysis must be considered separately. At the corporate level (i.e., with reference to the parent company), the multinational enterprise can present the most disparate ownership structures, which

range from family control, to other forms of concentrated control (such as, for example, state control), up to a consistent, if not total, fragmentation of the shareholding structure (the public company). At the local level (the multinational subsidiary), on the other hand, irrespective of whether the local subsidiary of a multinational company is listed on the stock exchange of its country or not, there will always be control by the parent company, making this model comparable in fact to that of control with concentrated ownership.

This ownership structure should guarantee the greatest degree of convenience for the corporate level to intervene in the governance decisions of the "subsidiary." In addition, this means that subsidiaries are traditionally considered to be very competitive, particularly efficient, and above all, characterized by clear, measurable objectives, and an orientation toward maximizing share value or return for shareholders. The achievement of efficiency and competitiveness objectives of these companies is often facilitated by the clarity of the strategy to be pursued. Since these are "replicas" at the level of individual countries, or of restricted geographical areas, of successful multinational or global companies, the objective of the branches is only to dominate the local market, or in any case acquire a greater share of the same market than its direct competitors. These first considerations immediately highlight three orders of problems that must be managed in a multinational company.

The first concerns the classic agency problem in the relationship between the Wos and the parent company: in particular what mechanisms of governance should be provided for in the subsidiaries, due to the importance of strategic problems that arise at local level.[18] In doing so, the company should take into account the role of the institutional context, which is characterized by relevant actors at local level such as government agencies, regulators in various capacities, the public opinion of the host country, the presence of institutional investors, the consequent role played by banks and financial markets, etc. Analysis of all these elements can be very useful in designing a relationship between the central and local levels, which takes into account the level of autonomy and delegation, the strategic complexity, the specificity of local markets, the ways of entering the market (whether by acquisition or through organic growth), etc.

A second aspect concerns the analysis of the potential contribution of the boards of directors and executive bodies at the local branch level, including the problem of the selection and retention of directors. The objective is to identify the mechanisms of governance which are consistent with the general aspects mentioned above (and which, therefore, are compatible with the legislation, regulations, type of financial market, etc.), and which are suitable for the specific characteristics of the multinational enterprise in question.[19] In this regard, some scholars have identified four pos-

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[18] Kim, B., Prescott, J.E., & Kim, S.M. (2005), "Differentiated governance of foreign subsidiaries in transnational corporations: An agency theory perspective," *Journal of International Management*, 11, 43-66.

[19] Leksell, L. & Lindgren, U. (1982), "The board of directors in foreign subsidiaries," *Journal of International Business Studies*, 13(1), 27-38.

sible configurations of relations between central and local governance bodies, in particular:[20]

- *direct control*, in which the governance functions of the local branch (Wos) are carried out entirely or almost entirely by the parent company, with the board of directors of the subsidiary composed mainly of local managers with few concrete responsibilities;
- *dual reporting*, according to which the governance functions of the local branch are shared between the local board and that of the parent company, with the result that the Ceo of the subsidiary is subject to a double line of "reporting," both to the board of the local branch and to the headquarters;
- the *advisory board* model, which represents a variant of the direct control model. It is characterized by a board of directors composed of local persons who are not formally recognized as directors (and therefore without legal responsibility), but who hold specific roles and responsibilities towards the parent company very similar to those typical of formal boards of directors; and
- the *local board* model, in which the local subsidiary is effectively managed by a local board of directors that assumes not only its legal responsibilities, but also its strategic responsibilities towards the parent company.

A third aspect, of a more general nature than the previous ones, concerns the main challenges – also of a cultural nature – that these companies have to face because they operate in different national contexts, each of which has its own system of capitalism and its own typical structures of government. In this sense, the management of "cross-border governance" or "global governance" is one of the most important issues facing multinational companies as the main consequence of their geographical and territorial expansion.[21] According to this approach, multinational companies – especially large companies that are leaders in their industrial sectors of reference – should gradually lose their national proclivities in favor of "universal" governance and management models, gradually loosening their roots in the culture and local contexts in which they operate. In other words, it is believed that such companies should be the driving force behind a strong integration of governance and management models at the global level, helping to overcome the differences between governance models and cultures at the local level.[22]

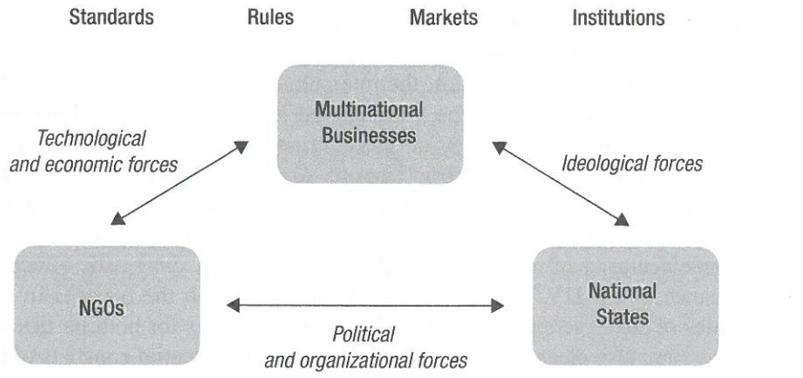
In this regard, there are various forces pushing for the definition of shared practices at the global level. Elements such as international environmental treaties, regional economic integration agreements, and OECD recommendations on corporate governance, bear witness to the emergence of a "global model of governance." In other words, even in the absence of supranational authorities with the same coercive or regulatory powers as a state, all negotiations between governments, companies, and non-governmental organizations (NGOs) are leading to the definition of governance structures – in terms of rules, norms and codes of conduct – which variously limit, facilitate, or simply direct the structures and behavior of multinational companies.[23] This is a broader meaning of corporate governance than that taken up so far in this work. It includes the interaction of multinational companies with different actors, institutions, governments, and organizations, to the point that it is multinational companies themselves that actively contribute to the creation of standards and the definition of shared rules of governance at the global level.[24] These rules derive from the set of different channels through which economic activities that take place in international contexts are regulated, coordinated, and monitored, as a result of a set of interactions between actors at the national, regional, and international levels. Among these actors, the most important are states and non-governmental organizations, as well as, of course, the companies themselves, which are part of a set of rules, regulations, institutions, and market mechanisms that are increasingly less linked to specific national contexts.[25] All these relationships are shown in **Figure 4.1**.

[20] Kiel, G.C., Hendry, K., & Nicholson, G.J. (2006), "Corporate governance options for the local subsidiaries of multinational enterprises," *Corporate Governance: An International Review*, 14(6), 568-576.

[21] Buckley, P.J. (2000), "Cross-border governance in multinational enterprises," in P.J. Buckley (ed.), *Multinational firms, cooperation and competition in the world economy*, Basingstoke, Macmillan, 289-304.

[22] Pauly, L.W. & Reich, S. (1997), "National Structures and Multinational Corporate Behavior: Enduring Differences in the Age of Globalization," *International Organization*, 51, 1-30.

Figure 4.1 The forces and actors that define global governance structures



Source: Adapted from Levy & Newell (2006, Fig. 7.1).

[23] Levy, D.L. & Newell, P. (2006), "Multinationals in Global Governance," in S. Vachani (ed.), *Transformations in Global Governance: Implications for Multinationals and Other Stakeholders*, Northampton, Elgar.

[24] Levy & Newell (2006).

[25] Levy & Newell (2006).

Despite the above considerations, empirical evidence shows that most multinational companies diverge systematically in their governance models. Some research has shown a rather limited convergence in the systems of governance and management between companies with headquarters in Germany, Japan, the United States, Italy, or Spain.[26] In other words, there appears to be a rather widespread tendency by multinational companies to adapt the governance model of their country of origin to local circumstances, without pushing themselves to design truly "global" governance models and structures. This statement is even more true in companies with ownership structures different from those of the public company, where the objective of attracting capital in different financial markets is less relevant than in companies with fractional and broad-based ownership and a strong international presence.

These characteristics are also reflected in the model of governance of multinational companies, which, especially at the level of the local branch, appears to be primarily inspired by the search for a balance between the parent company's leadership and the autonomy of the branch. The aim is to guarantee a sufficient degree of local autonomy, but at the same time an effective leadership and coordination at the central level.

4.2.3.2 *International Joint Ventures (IJVs)*

The second type of equity agreement concerns joint ventures, which typically involve two or more separate legal entities (parents), each of which participates in the initiative by going well beyond the mere role of investor, actively contributing to the strategic decision-making process. [27]

Because of these characteristics, the intercultural and inter-organizational nature of joint ventures, especially at the international level (International Joint Ventures, IJVs), often makes management of these cross-border organizations enormously complex due to their very "hybrid" nature. According to the prevailing literature on international business, the fit between partners is the only key criterion for the venture: that the strategic asymmetries, the diversity between parent companies, and the complementarity of resources and skills translate into synergistic effects for the performance of the IJV.[28] From this perspective, although the benefits in terms of economies of scale, scope, and exploration of new markets for both parties are very clear, there are also clear risks relating to, for example, potential conflicts of interest, or a lack of fit between the parties. This is, first, because the founding partners of

[26] Pauly & Reich (1997).

[27] Geringer, J.M. (1991), "Strategic determinants of partner selection criteria in international joint ventures," *Journal of International Business Studies*, 22(1), 41-62.

[28] Luo, Y. (1997), "Partner selection and venturing success: The case of joint ventures with firms in the People's Republic of China," *Organization Science*, 8(6), 648-662; Luo, Y. (2005), "Toward coopetition within a multinational enterprise: A perspective from foreign subsidiaries," *Journal of World Business*, 40, 71-90.

a joint venture are often simultaneously competitors outside the specific boundaries of the initiative; second, because they are usually dedicated to the development of a given product, the time horizon of a joint venture is never particularly long; and third, because the partners rely much more often on reputational incentives than on strictly contractual ones to defend themselves against opportunistic behavior by the other party.[29] For these reasons, the design of coordination and control mechanisms, which take into account not only the characteristics of the partners, but also all local context and regulatory conditions,[30] is crucial. These mechanisms include, in general terms:[31]

- coordination mechanisms between parent company executives and joint venture executives, such as temporary working groups;
- the role of the board of directors of the joint venture, and specifically the involvement of the directors in the strategic planning and control process;
- means for "socialization" between managers, encouraging their involvement in sessions, meetings, training, and refresher seminars organized by their parent companies;
- the definition of incentives for joint venture managers, with the aim of aligning their interests with those of their parents (hoping that they will be aligned with each other); and
- the involvement of representatives of the parent companies in senior management positions in the joint venture, including the definition of the level of autonomy it should have.

As a result, many IJVs are governed by detailed and comprehensive corporate by-laws that include all relevant aspects of governance. Among the elements usually clearly indicated in the corporate by-laws are, for example, the definition of the company's objectives, the capital structure, the voting system in the shareholders' meetings, the rules relating to the functioning of the shareholders' meeting, etc.

However, corporate by-laws are not the only relevant element for the operation (and resolution of any legal disputes) of a joint venture.[32] Others are: i) a "memorandum of understanding," in which the parties define their fundamental objectives and the collaboration agenda; ii) a "training agreement," i.e., a more detailed document

[29] McCahery, J.A. & Vermeulen, E.P. (2008), "Private equity and hedge fund activism: Explaining the differences in regulatory responses," *European Business Organization Law Review*, 9(4), 535-578.

[30] Geringer, J.H. & Hebert, L. (1989), "Control and performance of international joint ventures," *Journal of International Business Studies*, 20(2), 235-254; Hill, R.C. & Hellriegel, D. (1994), "Critical contingencies in joint venture management: Some lessons from managers," *Organization Science*, 5(4), 594-607; Mjoen, H. & Tallman, S. (1997), "Control and performance in international joint ventures," *Organization Science*, 8(3), 257-274; Nielsen, B.B. & Gudergan, S. (2012), "Exploration and exploitation fit and performance in international strategic alliances," *International Business Review*, 21(4), 558-574; Yan, A. & Luo, Y. (2016), *International Joint Ventures: Theory and Practice*, London, Routledge.

[31] Kumar, S. & Seth, A. (1998), "The design of coordination and control mechanisms for managing joint venture-parent relationships," *Strategic Management Journal*, 19, 579-599.

[32] McCahery & Vermeulen (2008).

than the memorandum of understanding, which contains all the essential elements that will form the basis of cooperation between the parties; iii) a confidentiality agreement, i.e., an agreement by which the parties prevent the disclosure of confidential information, with particular reference to the knowledge developed through the joint venture's own investments; iv) bilateral due diligence procedures, i.e., recognition of the legal, capital, and financial situation of the counterparties at the time of entering into the agreement; v) a shareholder agreement, which sets out the rights and duties of the parties, including the right of any minority partner to appoint a certain number of directors to the board, or the requirement for unanimous voting in decision-making on the capital structure; vi) an agreement on the functioning of the board of directors, which sets out the rules for voting on a set of issues at governance level; and vii) a budget agreement, as well as an operational plan for a certain period of time, by which the parties set out the financial constraints, the possibilities for expansion, and the constraints on the allocation of resources invested in the joint venture. The latter are particularly useful for avoiding possible conflicts between the joint venture partners.

4.2.4 State-Owned Enterprises (SOEs)

Although in the past there was a belief that this particular proprietary model was destined to disappear once economic development was complete, there is now an awareness that state-owned enterprises represent a solid reality, which are destined to last, and are "strategic" not only for the economies of developing countries, but also that of industrialized ones.

This ownership structure is characterized by a particularly high concentration of ownership, both in listed companies – where the percentage of floating capital is usually a minority – and especially in unlisted companies. In both cases, the objective is to maintain full control of the company, and avoid having to share important governance decisions with others. The right of control by the state is exercised by its Ministries or by public bodies, represented by political figures who have no right to the cash flows generated by the company, which belong to all citizens of the state.[33]

This circumstance requires a very particular type of representation, in which there is a special separation between ownership and control, which is similar to, but profoundly different from, what happens in public companies. In both cases the "owners" of the company appoint their own representatives in the management of the company: In the state-owned company, citizens elect the governments – national and local – which appoint the top managers of the state-owned companies; in the public company, the minority shareholders appoint the representatives on the board who in turn select the managers of the company. The difference is that in the public company, shareholders' representatives are appointed to specifically safeguard their

[33] See Zattoni (2015).

interests in the company, while in the state-owned company, political representatives are elected for a variety of general objectives, including the supervision of the management of state-owned companies.

This "distance" between the ultimate owners of the company (the community) and those who actually manage it (the managers appointed by elected political representatives), can lead to public managers showing little interest in business efficiency and, above all, toward their pursuing the interests of the political party that appointed them.[34] For these reasons, the governance structure of these companies runs the risk of not establishing a balance between the interests of the community and the mechanism of political nomination; this imbalance is amplified in the event that the company is listed on the stock exchange, with minority shareholders interested in maximizing the value of the company, rather than following "political reporting" logics of the activity carried out.

There are two main reasons for the direct intervention of the state in the capital of enterprises, according to theory: i) "allocative inefficiencies," if not a real "market failure"; and ii) the social importance of the good or service offered; namely when the State wants to encourage the use of goods and services that private enterprises can seldom provide under the same conditions (think of local public transport). On the other hand, it is possible to find a wide variety of reasons for state intervention – both in the economy in general, and in the capital of companies – which reflect the different dynamics of the various models of capitalism. Therefore, it is possible to find great heterogeneity among state-owned companies, which can deal with the most varied activities in developing countries (such as running a casino in Ghana, producing biscuits in Egypt, or assembling watches in India),[35] while they tend to be concentrated in the more complex, strategic industrial sectors in the largest and most developed Western economies. Moreover, major reports[36] by supranational organizations seem to identify a tendency, especially in advanced economies, to specialize in certain sectors of particular public interest. In this regard, research on the 157 largest state-owned companies in the world, operating in 46 different countries at different stages of economic development, shows that sectoral distribution is highly concentrated in production, and especially service sectors which provide for the general welfare. In this respect, research data shows that state ownership is still very widespread in energy (21%) and oil and gas (9%) – which together account for about one third of all SOEs – but that SOEs are also very widespread in various types of services, including transport (17%), infrastructure (a further 5%), and telecommunications (10%), despite the fact that in many industrialized countries the telecommunications sector has now been largely privatized. The incidence of SOEs in the

[34] See Zattoni (2015).

[35] World Bank (1995).

[36] OECD (2005), *Regulating Market Activities by Public Sector*; World Bank (1995), *Bureaucrats in Business: The Economics and Politics of Government Ownership*, A World Bank Policy Research Report.

manufacturing sector (9%) is mainly due to state intervention in developing countries (BRIC countries).[37]

4.2.4.1 *The governance model of SOEs*

The heterogeneity of the industrial sectors which involve SOEs, as well as the different intensity of the state presence – stronger in the developing countries and less in those with greater industrialization – are reflected in the variety of government models that state-owned companies operate under, given their different legal and regulatory contexts of reference.

A first and traditional model of governance is called the "decentralized model," or the "model of the Ministry of Industry," according to which the SOEs come under the direct purview of the appropriate Ministry for the business sector in which they operate.[38] This model, adopted, for example, by the United Kingdom until some years ago, combines the advantages of sectoral and functional specialization, with the disadvantages of excessive fragmentation of governance power between different ministries – which are not necessarily efficiently coordinated. Nevertheless, it is the model that has always guaranteed the best results in terms of performance and effectiveness of state-owned companies, especially in view of the skills induced by the ministerial specialization cited above.

An evolution of this model is the so-called "dual model," in which responsibility is shared between the Ministry responsible for the specific function and a central Ministry, in most cases the Ministry of Finance or Economy. Among its negative aspects, this model presents, an agency problem due to the sharing of the prerogatives of governance and control between two entities (multi-principal problem), while among the positive ones, is the specialization of the governance power by competence, at least with respect to one of the two Ministries of reference.[39]

A final model of governance recently adopted in many of the industrialized countries is the "centralized" model in a major Ministry, usually that of the Economy or Finance. Although this model lacks the benefits of specialization, there is the great advantage of centralizing powers and responsibilities in a single entity. In this regard, while in some countries the governance power of the state-owned enterprises is carried out directly by the Ministry of Finance with its departments or divisions, in other cases special government agencies are frequently being established with the specific task of managing the SOEs.[40] The establishment of such government agencies should partially address the problem mentioned above, ensuring a greater focus on governance issues (in terms of selection of the board, appointment of management,

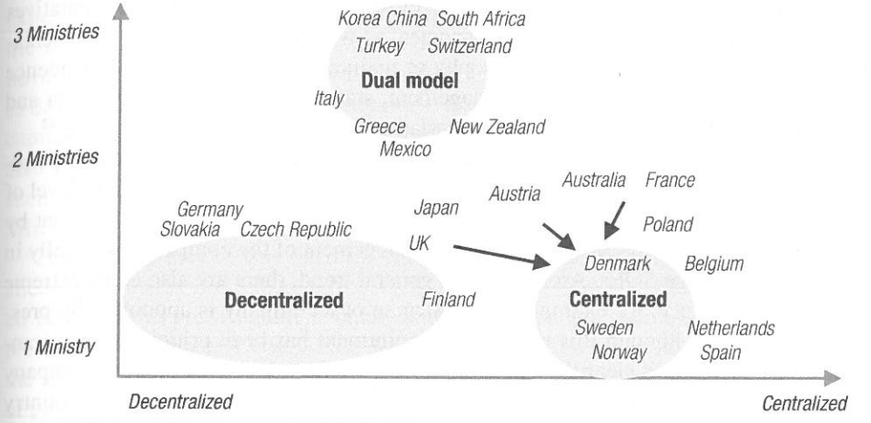
[37] Minichilli, Turrini, Valotti, & Zattoni (2010).

[38] Minichilli, Turrini, Valotti, & Zattoni (2010).

[39] Minichilli, Turrini, Valotti, & Zattoni (2010).

[40] This is the case in France, for example, with the creation in 2004 of the APE ("Agence des Participations d'Etat") or in Russia, with the creation of the "Federal Agency for State Property Management" (*Rosimushchestvo*). See Minichilli, Turrini, Valotti, & Zattoni (2010).

Figure 4.2 Governance models of state-owned enterprises in the major countries



Source: Minichilli, A., Turrini, A., Valotti, G., & Zattoni, A. (2010), *Governance of State Owned Enterprises: A Worldwide Review*, Ernst&Young – SDA Bocconi research report.

strategic direction, etc.), which problem is certainly greater where a Ministry with specific skills is lacking. For an overview of the main governance models of state-owned enterprises in the main countries, see **Figure 4.2**.

4.2.4.2 The *mechanisms for appointing the BoD and top management*

A second and important distinguishing feature of state-owned enterprises concerns the mechanisms for the appointment and composition of the board of directors and the management of the company. Again, significant differences emerge between the various countries, depending in part on the governance models (in the dual model, for example, there is likely to be representation of the two Ministries involved, while in the central model this is not necessary), but also due to different traditions, cultures, and political influences in their social life and economic activity.

In general terms, state representation on the boards of directors of SOEs varies from zero to almost all of the board, with obvious differences in terms of internal dynamics, independence from political influence, and representation of any minority shareholders. The most common practice is to have one or two representatives of the state, regardless of the size of the state participation, and therefore of its presumed influence. This is the case in Germany and Sweden, for example, and in the United Kingdom (but only if the government is not the sole shareholder).[41] Similarly, in Italy state representation usually consists of the appointment of a councilor, who is often assigned the role of mere observer without voting rights, even if with the presump-

[41] Minichilli, Turrini, Valotti, & Zattoni (2010).

tion of "informal" influence. In other cases, state representation is proportional to the share of state ownership, as in the former Soviet republics (Czech Republic, Slovakia), up to a very large representation in the case of Russia, where there are representatives of various ministries and ministerial agencies, as well as purely political representatives.[42] In line with the general philosophy of maintaining almost total independence of the board from ownership and management, state representation in Australia and the United States is not provided for in regulations and codes, nor is it a practice.[43]

State-owned enterprises are also characterized by peculiar processes of appointment of the chairman and the CEO. These processes often lack the necessary level of transparency, and suffer from strong political influence, with active involvement by the Council of Ministers in appointing top management of the company, especially in large and very large SOEs. Alongside this general trend, there are also some extreme situations. In France, for example, the chairman of a company is appointed by presidential decree. Although this system of appointment has been criticized, its advantage is that it makes it clear that the appointment of the management of the company is a political act. On the contrary, there are the cases of Germany – the only country to give formal but also substantial responsibility to the board of state-owned companies in the appointment of the CEO – and of the United Kingdom, where, however, the process is more complex. In these cases, it is the task of the chairman of the board of directors to coordinate the process of selecting the CEO and the other advisers, who are selected on the basis of knowledge and skills, not on a political basis. Political will is expressed only in the final stage of the process, when the competent Ministry selects the top management of the enterprise on the basis of recommendations previously made by the chairman of the board of directors.[44]

4.2.5 Private equity and venture capital

If a family-owned business is the typical form of ownership structure in an unlisted business, an important "variant" in terms of ownership, governance, and management of a private business is the presence of private equity or venture capital in such businesses. Although the terminology here still lacks clarity, it can be stated that: i) private equity is defined as the generic activity of investing in risk capital, including operations carried out in all the different phases of the life cycle of companies subsequent to the initial one; ii) the term venture capital refers to investment by intermediaries specializing in medium and small companies, especially in the start-up phase, with high growth potential and relative ease of exit from the investment.

Venture capital operations, although little developed (and known) in Europe, have been a critical component of innovation and development in the United States

[42] Minichilli, Turrini, Valotti, & Zattoni (2010).
[43] OECD (2005).
[44] Minichilli, Turrini, Valotti, & Zattoni (2010).

over the last two decades. Several studies have shown that companies financed by a venture capital fund produce, on average, more innovations (in relation to R&D expenditure) than other companies, and are responsible for approximately 14% of the innovations realized in the United States. Furthermore, as a result of their innovative potential, companies with venture capital show rates of sales growth up to double that of "traditional" companies. Because of these characteristics, venture capitalists tend to finance not only companies at the early development stage, but also companies in sectors with high technological content and growth potential, such as today's biotechnology sector, and a few years ago, semiconductor firms in Silicon Valley.

The peculiarities of this business model are also clearly reflected in the governance mechanisms that characterize such companies. These mechanisms are divided between the pre-investment phase and the investment management phase. The pre-investment phase is crucial for the assessment of the potential, and therefore for the success of the operation. This is the phase characterized by the direct screening of projects, which tends to classify them as "good" and "bad" according to the business plans presented by future entrepreneurs. However, since venture capitalists have a high level of expertise in assessing many potentially valuable investment opportunities, the information asymmetries between potential investors and entrepreneurs will be very small. In this respect, they will tend to use four main criteria for assessing investment opportunities:[45]

1. *the attractiveness of the project*, assessed in terms of the size of the outlet market, growth potential, product attractiveness, business strategies, and probability of purchase by consumers, as well as the competitive positioning of the company to be financed;
2. *the quality of the top management team*, both in terms of its demographic characteristics and the appropriateness of the mix of knowledge, skills, professional backgrounds, etc. to the characteristics of the business, and especially the team's past performance (projects completed, track record, etc.);
3. *the terms of the agreement*, such as, for example, the duration (and therefore of the risk) of the investment (stage financing), which allows the venture capitalist to finance the entrepreneur step by step, providing the company with only the capital necessary to reach the next target, upon the achievement of which a new tranche of the investment will be released. Despite the undoubted advantages in terms of encouraging the entrepreneur to behave efficiently, stage financing also lends itself to opportunistic behavior, often on the part of the entrepreneur himself, who will tend to take a short-term approach, with almost exclusive attention to results that can be measured immediately and their appeal (window dressing); and
4. *the financial or exit conditions of the investment*, which may take place in various ways, including: a) the sale of shares in the company through an Initial Pub-

[45] McCahery & Vermeulen (2008).

lic Offering (IPO); b) the sale of shares to other companies; c) the repurchase of shares by the company itself, through leveraged buy-back transactions; d) the sale of shares to another investor; and e) the reorganization or liquidation of the company. In this sense, while listing on the stock exchange is the main way out of such an arrangement in the United States, the presence of less-developed financial markets in Europe means that other solutions prevail.

The investment management phase then concerns the set of mechanisms governing the relationship between the venture capitalist and the entrepreneur. Among these mechanisms, a distinction is made between those which control the entrepreneur and those which support the entrepreneur.[46] Control activities are carried out mainly through the presence of representatives of the venture capitalist on the board of directors of the investee company. These representatives can obtain access to critical information such as the overall profitability of the initiative, and monthly details of the financial and earnings situation, as well as monitoring the behavior of the top management in strategic decision-making.[47] Support activities, on the other hand, include advice to the entrepreneur aiming to transfer knowledge and providing advice on critical activities (such as strategic decisions in the broad sense), but also the selection of key management personnel, support in legal or investment banking activities, as well as raising additional financial resources. The frequency of interactions between the entrepreneur and the venture capitalist will depend on a number of factors, such as the development stage of the company, the previous experience of the CEO in the sector, and the rate of technological innovation (of the company and the sector), as well as the degree of fit between the skills of the CEO and the characteristics required to compete successfully in a particular competitive environment.[48]

Many of the governance and management features of the relationship between "lender" and "borrower" also apply in the wider field of private equity. This is particularly true in light of the recent trend by these investors, who have moved from simply doing diligent research and in-depth analysis of investment opportunities – generating the greatest possible return on investment – to directly intervening in the policies and strategies of the company they are financing. This approach has gone so far to have these investors considered an integral part of the trend toward shareholder activism mentioned above.

To be specific: as in the case of a venture capital investment, a typical long-term private equity investment in a non-listed company is characterized above all by the allocation of controlling rights to the lender, rights which are in fact proportionally higher than the share of capital held. This guarantees a substantial power of control and influence over the strategic decisions of the top management of the company, but also synergistic support for key decisions. However, as in the case of venture capital investments, a large part of the success depends on the ex ante screening phase among the various available investments; that is the critical moment for assessing the effectiveness of the operation, using some of the tools mentioned above.

[46] McCahery & Vermeulen (2008).
[47] McCahery & Vermeulen (2008).
[48] McCahery & Vermeulen (2008).

4.2.6 "Non-capitalist" enterprises

In addition to the so-called "capitalist enterprises," extensively discussed above, there is another group of companies with different and specific legal and ownership forms. Although these are often types of enterprises that play a marginal and secondary role in the economy of a single country (although in some countries, such as Italy, this is not the case), they may be particularly widespread in certain sectors of economic activity, or may play an important social role. The main types of enterprises that belong to this set are:[49]

- *Cooperatives*, which can be producer and worker cooperatives, consumer cooperatives, social cooperatives, housing cooperatives, or agricultural cooperatives; ownership in cooperatives is by parties that play the dual role of capital providers and workers (in producer and worker cooperatives), or consumers (in consumer cooperatives), etc.;
- *Professional partnerships*, which are particularly widespread in the professional services sector (law firms, medical practices, consulting and auditing firms, investment banks); their capital is owned by the employee-members who are the firm's partners; and
- *Non-profit institutions*, which represent a special category of enterprise "without owners," since no person exercises control rights while receiving revenue rights at the same time.

Among these so-called "alternative" forms to the pure capitalist model, the cooperative certainly represents the most relevant case both in terms of diffusion and incidence in the overall economy of a country. Among the various cooperative forms, consider the producer and worker cooperative, in which the worker-member is in control.

First, it should be noted that the producer and worker cooperative is born where there are particular conditions, including the inefficiency of the labor market, the opportunity to produce goods and services of public and social relevance and utility, and legislation that encourages cooperation in all its forms. In this context, the cooperative is a way to respond to difficult situations, such as financial crises (lack of work is one of the factors that pushes cooperative members to join in "creating" a job), or corporate crises (some restructuring plans developed in crisis situations provide the possibility for workers to become owner-members while making heavy sacrifices). Clearly, the strategy of these particular companies is likely to be based

[49] See Zattoni (2015).

on management simplicity, business and geographical focus (many cooperatives are strictly "local" in terms of the types of services offered), and reduced diversification. This strategic orientation is also motivated by the very reason for the existence of cooperatives, which is to ensure a critical contribution to the company (work, consumption, some production factors), while ensuring mutual benefit for those who make this contribution.

On the other hand, it should also be noted that the overlapping roles of owners and workers have some significant consequences in terms of the company size, attitudes towards risk, and the overall governance structure.[50] First of all, the cooperative's capital endowment appears to be substantially restricted, since capital increases can take place only when all the workers agree to them at the same time, thus making such increases unlikely, difficult to achieve in the short term without proper planning, and above all, tied to the availability of individuals. In addition, the decision by the workers to bind to the cooperative both their financial resources (often all their available resources), and their skills, makes cooperatives show a strong aversion to risk, and give priority to stability rather than to growing or diversifying the business. This particular mix of actors and interests also determines the need for specific governance. In particular, the governance bodies of cooperatives are composed in such a way as to represent the entire social base, and not just some of the workers. This mechanism, however fascinating and conceptually correct it may be, has the serious limitation of determining a rather high complexity of governance and management when the number of partner-workers, and consequently the diversity of their interests, increases. This is a further reason, in addition to the previous ones, for requiring these entities to maintain a small size, and especially to operate with objectives other than maximizing the return on capital.

Table 4.1 provides a summary of the essential characteristics of the proposed classification between the different types of enterprises which result from different types of ownership, including the resulting different degrees of share concentration that they typically show.

[50] For a more widespread discussion of these aspects see: Airoldi & Zattoni (2005); Zattoni (2015).

Table 4.1 Essential characteristics of some possible "types" of enterprises

	Large listed company with a public shareholding (public company)	Family-owned enterprise	Mixed coalition	Subsidiary of a multinational company	State-owned enterprise	Cooperative (e.g. production and work)
Environmental and institutional context	High investor protection, large sectors	Less investor protection, less capital-intensive sectors	As in the case of family-owned enterprises	Internationalization and globalization	Capital intensive sectors, market failure, social relevance	Inefficient labor market; social relevance of products and services produced; incentive legislation
Class of stakeholder holding ownership rights	Risk capital providers	Risk capital providers	Risk capital providers	Risk capital providers	Risk capital providers	All workers
Ownership concentration	Very low	Medium-high (in listed family businesses) or very high (in private family businesses)	Medium and medium-low	Very high	Medium-high (if listed), very high (if not listed)	Very low
Identity of the controlling shareholder	None – small shareholders/savers	Controlling family (one or two)	Various actors (families, individuals, private equity funds, etc.)	Parent company	State (usually through its own ministries) or local authority	Workers
Homogeneity of interests of different categories of owners	High	Low for listed companies (controlling shareholders versus minority) High for the unlisted	Medium-low to very low	Very high	Medium-high for listed companies High for the unlisted	Very high (unitary)

	Large listed company with a public shareholding (public company)	Family-owned enterprise	Mixed coalition	Subsidiary of a multinational company	State-owned enterprise	Cooperative (e.g. production and work)
Interest and convenience by owners to actively participate in governance decisions	Very low – with the exception of active institutional investors	Mixed for listed companies (only controlling shareholders have an interest) High for private companies	Variable according to ownership share	Very high	Mixed for listed companies (only the State has an interest) High for private companies	Maximum
Main strategy	Dimensional growth	Growth within the limits of control; profitability; business diversification according to the risk	Growth compatible with maintaining "expanded" control	International expansion (by the parent company); domination of local markets (subsidiary)	Growth, taking part of a business group, diversification	Reduced complexity and range of action, low diversification
Governance	High transparency, board of directors independent of management	Family independent board of directors in listed companies, mix of family and non-family members in private companies	Balance in the representation of the various subjects	Balance between corporate management and "local" autonomy	Balance between represented interests and the "political appointment" mechanism	Collective mechanisms of interest representation

Source: Minichilli, A. (2012), *Proprietà, governo e direzione delle imprese*, Milan, Egea.

Case study **The link between ownership and strategy of car manufacturers**[51]

What has happened in the automotive world? In 2009 General Motors went bankrupt, or almost; it was saved by the American government and became a state-owned enterprise. At the same time, many changes have happened in Germany: once the State of Lower Saxony was the controlling shareholder of Volkswagen; and now? Again, in recent years, Fiat acquired 30% of Chrysler's shares simply by committing to transfer small-car technology to it. Chrysler, often close to bankruptcy in the 1980s and 1990s, was acquired by Daimler-Benz in 1998 and then, in desperation, was sold in 2007 to Cerberus Capital Investment, a private equity fund. Everyone wondered whether Sergio Marchionne, travelling between Turin and Detroit, could have succeeded where Daimler-Benz and Cerberus had failed. At the beginning of 2014, the acquisition was completed; Fiat bought 100% of Chrysler.

In the meanwhile, India's Tata acquired Jaguar and Land Rover. Volvo was sold to China's Geely Group. The Peugeot family was forced to step back into PSA: the French state and a Chinese investor intervened. Daimler-Benz, de-merged from Chrysler, entered into an alliance (mutual exchange of 3% of shares) with Renault-Nissan, a French state-owned enterprise. Although Nissan and Renault are two different legal entities, from the industrial point of view they constitute a unique group, linked through cross-shareholdings since 1999 when an alliance was created to develop a common strategy and synergies. When Renault-Nissan took control of Mitsubishi Motors, at the end of 2016, the alliance became the third most important automotive group, challenging the giant Volkswagen and Toyota. In the German-Japanese contest, the Volkswagen group is able to maintain a slight margin on Toyota, notwithstanding the "diesel-gate" scandal which emerged in autumn 2015. Nevertheless, recent acquisitions in the industry are contributing to changing the geography of the top players, which could lead to other changes over the next years. Just think about the extraordinary feat of relaunching of Peugeot Citroën group (the PSA group from 2016), which joined the top 10, thanks to the recent acquisition – in summer 2017 – of Opel by General Motors (**Table 4.2**).

"In the old days," the feeling was that in the automotive industry the money was made by designing, building, and selling good cars; now it seems that the best deals involve buying and selling car companies, good ones or not. Most of the car manufactures on the market nowadays have a very long history. They are often corporations established between the end of the nineteenth century and the beginning of the twentieth century, when the automotive industry was born. The founders were private entrepreneurs who started their companies from scratch (e.g., Henry Ford), or they aggregated various pioneer companies which were in trouble (e.g., W. Durant with General Motors) or, moving from other industries, they diversified into the automotive industry (e.g., Honda and Toyota). Chinese corporations are a rather peculiar case; they were established relatively recently and are mostly the result of JVs with western companies or, more rarely, of local independent ventures.

For many decades, the automotive corporations were "national champions" with a small portion of their sales achieved abroad; for a long time, domestic markets had been protected by high customs tariffs; in many cases, national car manufacturers represented the source of industrial development of the country. Car manufactures have gone through economic misadventures, political events, and wars which have caused changes in the ownership structures; some of them went public while others didn't; some of them went under public or bank control; some remained independent under the strict control of one family, while others entered into diversified European pyramidal groups, keiretsu or chaebol.

From the point of view of corporate strategies, even up to the 1970s, you could see a great variety of "specializations" and tendencies to occupy market niches; over those years corporations like GM, Fiat, Porsche, BMW, Honda, Toyota, and Lamborghini had completely different dimensions and target markets. To the contrary, over the last thirty years, car manufacturers have implement-

[51] Airoldi, G., Minichilli, A., & Quarato, F. (2019), *Some elements to think about*.

ed converging strategies towards greater standardization. In particular, car groups aim to present themselves to the market with a "full range" of products, from city microcars to SUVs, and from sports cars to big sedans. So, Volkswagen has started selling Rolls Royces; Mercedes produces Smart Cars; Porsche makes SUVs and GT cars, after having been a single product corporation (911 model); Audi feels the need to also sell Lamborghini; the BMW group now also includes Mini and Rolls-Royce; Ford (later Tata) deals with Jaguar and Land Rover. And so on.

Is this the outcome of the globalization trend? Policy makers state that the market is global and economies of scale are crucial, and it is difficult to make money with less than 5-6 million cars sold, and so they tend to become all the same – with the exception, of course, of the niches.

Even if strategies and dimensions are probably converging, great differences can be seen as regards ownership structure (**Table 4.3**).

Table 4.2 Turnover and worldwide sales of the first 12 car manufacturers in the world

Car manufacturers	Turnover (billions of Euro)		Net income (billions of Euro)		Worldwide sales (millions of vehicles)**	
	2008	2018	2008	2018	2008	2018
Volkswagen	117.9	243.7	4.5	10.8	6.4	10.5
Renault-Nissan*	103.0	150.3	–1.2	5.9	5.8	9.8
Toyota	157.3	242.5	–3.3	15.1	9.2	9.5
General Motors	107.0	128.4	–22.2	6.9	8.3	8.7
Hyundai-KIA	45.5	75.6	0.5	1.2	4.2	7.3
Ford Motor	103.2	140.0	–10.6	3.2	5.4	5.3
Honda	76.7	127.5	1.0	4.9	3.9	4.9
Fiat-Chrysler	59.0	110.4	0.4	3.6	4.4	4.5
PSA	61.8	63.0	–1.4	1.1	3.3	3.5
Suzuki	23.0	31.1	0.2	1.4	2.6	2.8
Mercedes Daimler	96.6	169.6	1.3	7.2	2.2	2.6
BMW	53.7	98.0	0.3	7.1	1.4	2.5

* Nissan and Renault turnover and net income data are summed together because the group does not publish a consolidated financial statement.

** Data refers to sale of cars and light commercial vehicles (LCVs).

Source: Database Orbis (bureau van dijk) and GAD (Global Auto Database).

Table 4.3 Ownership of the first 12 car manufacturers in the world

Car manufacturers	Controlling shareholder
Volkswagen	Porsche and Piech families 50.7%; Land Niedersachsen 20%
Toyota	Ownership spread between institutional investors (vertical keiretsu)
Renault-Nissan-Mitsubishi	French state owns 15% of shares (and 30% of voting rights) of Renault which, in turn, owns 44% of Nissan (and Nissan owns 15% of Renault, without voting rights), which, in turn, owns 34% of Mitsubishi Motors
Hyundai-KIA	Chaebol (Chung family)
GM	Public company, after Chapter 11 exit (USA bankruptcy procedure)
Ford	Ford family with 2% of shares and 40% of voting rights
Honda	Ownership spread between institutional investors (vertical keiretsu)
FCA	Exor 30% (Agnelli, Elkann, etc. family)
PSA	Peugeot family 14% - French state 14% - Dongfeng 14%
Suzuki	Ownership spread between institutional investors (vertical keiretsu)
Mercedes Daimler	Public company
BMW	47% Quandt family

Source: Database Orbis (bureau van dijk).

5 The Family-Controlled Firm

5.1 What are family-controlled firms?

One category of ownership structure of particular importance is represented by family-owned enterprises. Family Firm Institute (FFI) estimates show that family businesses generate from 70 to 90% of the world's annual gross domestic product (GDP).[1] In contrast to public companies, where there is a fair degree of variance of ownership structures, the vast majority of small and medium-sized "private" companies are dominated by family-controlled companies. In this type of company, the ownership concentration is certainly much higher than in the public companies, while the identity of the controlling shareholder corresponds to that of the controlling family or families.[2] Ownership concentration will be particularly high for unlisted family businesses, with concentration increasing as the size of the business decreases, and tending towards total control in smaller companies. On the contrary, the ownership concentration will be lower in listed family businesses, where control can be ensured by a share of capital that varies from 5 to 10% in the Anglo-Saxon context, to 25 to 30% in the European countries.[3] There will therefore be large unlisted family businesses, in which a family usually holds the vast majority of the equity capital, often together with minority shares held by other entities (other businesses, banks, etc.); and small and medium-sized family businesses, in which a family, or more often a first-generation entrepreneur, holds absolute control of the business.

The specific weight and social and cultural relevance of this form of ownership has led the European Union (EU) to propose a shared and univocal definition of a

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[1] See the statistics proposed by the Family Firm Institute (FFI) on this issue: www.ffi.org.

[2] Despite the many definitions in the literature (see Westhead, P. & Cowling, M. (1998), "Family firm research: The need for a methodological rethink," *Entrepreneurship Theory & Practice,* 31-56), the definitions of family businesses based on equity control tend to converge on the presence of one or two families as controlling shareholders. For a definition of family-owned businesses in the Italian context, see, among others, Amore, M.D., Minichilli, A., & Corbetta, G. (2011), "How do managerial successions shape corporate financial policies in family firms?" *Journal of Corporate Finance*, 17(4), 1016-1027.

[3] Anderson, R.C. & Reeb, D.M. (2003), "Founding-family ownership and firm performance: Evidence from the S&P 500," *Journal of Finance*, 58(3), 1301-1328; Villalonga, B. & Amit, R. (2006), "How do family ownership, control and management affect firm value?" *Journal of Financial Economics,* 80(2), 385-417; Amore, Minichilli, & Corbetta (2011).

family business: according to the EU, a business can be defined as a family business where the absolute majority (50% + 1) of the voting rights (and therefore in essence of the shares) is in the hands of the founder, his family, children, or direct descendants, and at least one representative of the family sits on the board or holds a managerial position in the business.[4] This percentage is reduced to 25% in the case of listed companies.

5.2 The distribution of family-controlled firms around the world

> "Family firms are crucially important for Europe. They make a significant contribution to Europe's GNP and employment, and tend to be great innovators, with a longer-term vision. They also tend to be firmly rooted in their regional and national culture, displaying the sort of European values that we all share."
>
> *Jose Manuel Durao Barroso*
> *Former European Commission President*

Contrary to the general belief, the existence of family businesses is not confined to developed or Latin countries. On the contrary, this type of ownership structure pervades all models of capitalism, including emerging economies and Middle and Far East countries. It is particularly widespread in non-English capitalist countries (including mainly continental Europe), where the lower degree of legal protection for investors is replaced by a greater concentration of capital in the hands of one or a few shareholders, allowing them to exercise direct control over the manager's work or – in even more frequent cases – take leadership of the company.

Family businesses in Europe play a major role, accounting for 85% of all businesses and 70% of total GDP, as well as 60% of employment (**Table 5.1**). In almost all European countries, family businesses are the backbone of capitalism: France (80%),

Table 5.1 Family firms around the world

Region	% Ff	GDP	% Employment
Europe	85%	70%	60%
North America	90%	57% US; 60% Canada	57%
Latin America	85%	60%	70%
Middle East	90%	80%	70%
Asia Pacific	85%	57% South Asia; 32% North Asia	

Source: EY Family Business Yearbook 2014.

[4] European Union (2009), *Report of the EU Commission*.

Germany (90%), Spain (83%), and Italy (85%). In Belgium, too, 83% of companies are family-owned,[5] and the importance of this ownership model led Belgium to become the first country with a code of corporate governance for unlisted companies (the Buysse Code). Among European countries, the United Kingdom has the lowest number of family businesses, which represent about 65% of industrial production, contribute 41% of GDP, and employ one third of the national workforce.

In the United States, one of the most advanced examples of financial and capital markets, family businesses account for around 90% of total businesses, and contribute to generating 57% of national GDP and employment. Moreover, despite the greater fragmentation of companies listed on the stock exchange, about 1/3 of the companies in the S&P 500 index and 1/2 of the Fortune 1000 are family-owned companies, and they record, on average, superior income performance (measured in terms of Return on Assets, ROA) and value creation (measured by the Economic Value Added, EVA) compared to other types of companies.[6] Also in large or listed companies in the world the incidence of family firms is relevant (**Table 5.2**).

The presence of entrepreneurial families, even if sometimes in less-structured forms, is also relevant in the Middle and Far East. In the Gulf States, for example, 75% of the private economy is in the hands of the 5,000 wealthiest families in the region, who control almost all business activities and create employment for 70% of the population, with management styles largely dependent on religious affiliation.[7] In Australia, on the other hand, family businesses account for 67% of the total, al-

Table 5.2 Family firms in large groups or listed companies in the world

Country	Large-sized or listed family businesses
Brazil	70% of large-sized groups
USA	35% of Fortune 500 companies
China	37% of listed companies
France	59% of large-sized groups
Italy	59% of large-sized groups
Germany	50% of listed groups
India	67% of large-sized groups

Source: Lectio inauguralis AIDAF – EY Chair in Strategic Management of Family Business in memory of Alberto Falck, March 4, 2015.

[5] Jorissen, A., Laveren, E., Martens, R., & Reheul, A.M. (2005), "Real versus sample-based differences in comparative family business research," *Family Business Review*.

[6] Anderson & Reeb (2003).

[7] Welsh, D.H. & Raven, P. (2006), "Family business in the Middle East: An exploratory study of retail management in Kuwait and Lebanon," *Family Business Review*, 19(1), 29-48.

though almost all of them are small and medium-sized.[8] The importance of family businesses is even greater in other developing countries such as Brazil, where family-owned businesses account for almost all business activities, around 90%, and employ 85% of the country's workforce, contributing 50% of GDP. The same is true of China, where family businesses control a greater share of the Asian economy than their weight in the entire business population (85%), and where the rules of governance and management are inspired by the principles of Confucianism and its ethical and religious morals.[9] In Japan, although we do not have accurate statistics, we find the oldest family business in the world (the hotel "Nishiyama Onsen Keiunkan," a 52nd-generation company with over 1,300 years of history).[10]

5.3 The peculiarities of family-controlled firms

Despite the plurality of possible models of family control, the literature agrees on some common traits among family businesses:

- *personal relationships and mutual knowledge between the different actors*, and in particular, the personal and affective nature – preceding connection through ownership and the business – of the links between family members;
- *a high level of ownership concentration*, which in turn ensures a high degree of stability in the ownership coalition or control group of the company;
- *a high level of participation by the owner family in the governance and management of the company*, characterized by an "active" attitude, not a "shareholder-investor" attitude;
- *the coexistence of economic and non-economic objectives*, fueled by the multiplicity of links between family members and the company, the resulting expectations of economic and non-economic return, and the long-term orientation that the pursuit of non-economic objectives entails;
- *a basic strategic orientation for the company permeated by the values and culture of the family owner*, in all the components related to its field of activity, its economic, competitive, and institutional purposes, as well as the management and organizational philosophy of the company;[11] and
- *the difficulty in "getting out" of the ownership structure, both financially and emotionally*, because of the difficulty in finding partners acceptable to the family owners. The result is a family-owner attitude oriented towards the continuity of the business, and the transfer of both ownership and other key roles mainly within the family and subsequent generations.

[8] KPMG (2008), *KPMG Family Business Survey*.

[9] Lee, J. (2006), "Impact of family relationships on attitudes of the second generation in family business," *Family Business Review*, 19(3), 175-191; Yan, J. & Sorenson, R., "The Effect of Confucian Values on Succession in Family Business," *Family Business Review*, 19(3), 235-250.

[10] Fortune.com (2016), January 26.

[11] Chirico, F. & Nordqvist, M. (2010), "Dynamic capabilities and trans-generational value creation in family firms: The role of organizational culture," *International Small Business Journal*, 28(5), 487-504.

These are all aspects that can be considered "ambivalent," which can turn into positive and negative aspects for the company, as well as for the controlling family. As far as diversification strategies are concerned, the attitude of family-owned companies seems to be determined mainly by their size. In other words, while small and medium enterprises appear to be opposed to business diversification – which would entail the risk of leaving the limited domain that characterizes them – their growth in size, which is often accompanied by an increase in the number of generations involved in ownership and substantial growth in the resources invested, leads to a change in the trend. For large family-owned companies, whether listed or not, focusing on a single business seems detrimental not only to the company, but also, and above all, to the family. As family assets invested in business activities grow, as well as the number and variety of family members with different attitudes, inclinations, and ambitions, it is likely that entrepreneurial families will feel a growing need to diversify risks and business portfolios.

Here are the typical traits of these types of companies that are markedly "healthy," and which therefore positively influence their performance:

- *the "patient capital" of the family, which favors long-term objectives and returns over short-term ones.*[12] This is a characteristic that involves the continuous and constant accumulation of resources, necessary to support growth, stability, and the achievement of a long-lasting strategic position. There is a high incidence of reinvested profits, as family businesses prefer to use internal resources to finance growth rather than asking for bank financing;[13]
- *the strong emotional involvement of owners, managers, and also employees of the company*, who are therefore jointly oriented towards success for the company, mitigating the risk of opportunistic behavior and the extraction of private benefits by individuals;[14]
- *a culture that favors all the actors identifying with the company*, thus reducing "turnover" (at the top and throughout), and promoting stability.[15] The progressive

[12] See, among others: Aronoff, C. (2004), "Self-Perpetuation family organization built on values: Necessary condition for long-term family business survival," *Family Business Review*, 17(1), 55-59; Arregle, J.L., Hitt, M.A., Sirmon, D.G., & Very, P. (2007), "The development of organizational social capital: Attributes of family firms," *Journal of Management Studies*, 44(1), 73-95; Zellweger, T. & Sieger, P. (2012), "Entrepreneurial orientation in long-lived family firms," *Small Business Economics*, 38(1), 67-84.

[13] Source: European Family Businesses (EFB) Institute.

[14] Chrisman, J., Chua, J., & Kellermanns, F. (2009), "Priorities, resource stocks, and performance in family and non family firms," *Entrepreneurship Theory and Practice*, 33(3), 739-760; Cennamo, C., Berrone, P., Cruz, C., & Gomez–Mejia, L.R. (2012), "Socioemotional wealth and proactive stakeholder engagement: Why family-controlled firms care more about their stakeholders," *Entrepreneurship Theory and Practice*, 36(6), 1153-1173.

[15] Astrachan, J.H., Klein, S.B., & Smyrnios, K.X. (2002), "The F-PEC scale of family influence: A proposal for solving the family business definition problem," *Family Business Review*, 15(1), 45-58;

diffusion of common values and principles such as loyalty, honesty, commitment, respect, and mutual trust favors close association between the image of the family and that of the company;
- *the accumulation of "social capital" as a moral resource for the enterprise.*[16] This is a distinctive element of particular importance for the company, which benefits from the positive values linked to family relationships, of both a personal and business nature, which represent a real moral resource in making key decisions on the future development of entrepreneurial activity;
- *the ability to generate "unique" resources.*[17] The most important resource is the human capital – the complex set of knowledge, skills, and abilities of individuals within the organizations in which they operate – which represents a kind of added value;
- *continuity of leadership, showing greater "resilience" in difficult times, as well as greater decision-making speed.*[18] The overlap between the roles of owners and top managers, on the one hand, may generate some ambiguity, but on the other hand, it represents the best guarantee of solidarity and commonality of intent between family members toward each other, and toward the company, in times of difficulty.

There are also negative aspects among the characteristics of family-controlled companies, which could pose a risk for the company itself, including:

- *the appropriation of the resources and assets of the enterprise to satisfy "parochial" family desires,*[19] especially in small enterprises where this can often occur unconsciously. But this is a phenomenon that must be identified and stopped in time;

Khanin, D., Turel, O., & Mahto, R.V. (2012), "How to increase job satisfaction and reduce turnover intentions in the family firm: The family–business embeddedness perspective," *Family Business Review*, 25(4), 391-408.

[16] Sorenson, R., Goodpaster, K., Hedberg, P., & Yu, A. (2009), "The family point of view, family social capital, and firm performance: An exploratory test," *Family Business Review*, 22(3), 239-253; Deephouse, D.L. & Jaskiewicz, P. (2013), "Do family firms have better reputations than non-family firms? An integration of socioemotional wealth and social identity theories," *Journal of management Studies*, 50(3), 337-360.

[17] Sirmon, D.G., & Hitt, M. (2003), "Managing resources: Linking unique resources, management, and wealth creation in family firms," *Entrepreneurship: Theory and Practice*, 27(4), 339-358; Sharma, P. (2008), "Commentary: Familiness: Capital stocks and flows between family and business," *Entrepreneurship Theory and Practice*, 32(6), 971-977; Zellweger, T.M., Eddleston, K.A., & Kellermanns, F.W. (2010), "Exploring the concept of familiness: Introducing family firm identity," *Journal of family business strategy*, 1(1), 54-63.

[18] Minichilli, A., Brogi, M., & Calabrò, A. (2016), "Weathering the storm: Family ownership, governance, and performance through the financial and economic crisis," *Corporate Governance: An International Review*, 24(6), 552-568.

[19] Bertrand, M. & Schoar, A. (2006), "The Role of Family in Family Firms," *Journal of Economic Perspectives*, 20(2), 73-96; Morck, R. & Yeung, B. (2003), "Agency problems in large family business groups," *Entrepreneurship Theory and Practice*, 27(3), 367-382.

- *the nepotism, the altruism of parents, and the distorted selection of management,*[20] however understandable on a human level, can profoundly undermine the chances of success, and even the continuity of the enterprise. As the complexity of the business grows, it is often necessary to consider the widest possible *pool* of candidates for leadership, avoiding aprioristic assumptions about the need to select a manager belonging to the controlling family;
- *a conservative attitude and risk aversion*, which curb innovation and strategy in favor of safeguarding accumulated assets and family privileges.[21] The consequences of this attitude could be problems of growth, competitiveness, and profitability, as well as a low propensity to invest in innovation and R&D;
- *the excessive effort expended in managing family emotions and conflicts*, which inevitably are a source of distraction from attention to business issues;[22]
- *the uncertainty and risk associated with generational turnover*, which will be discussed in more detail in section 5.5.

5.4 Family ownership in different theoretical frameworks

Several scholars have tried to examine the consequences of family involvement in businesses performance, underlining the advantages and disadvantages of the presence of strong family cultures in family firms. The main theoretical frameworks refer to the agency theory, the stewardship theory, the resource-based view (RBV), and the more recent socio-emotional wealth theory (SEW). Assuming that in any contractual relationship – and in particular in a company – there is an intrinsic conflict of interest between the principal and the agent, agency theory posits the potential for family firms, guided by family executives, to take advantage of lower agency costs because owners and managers' interests are perfectly aligned. This reduces information asymmetry and the consequent risks of opportunistic behavior by the management, and thus will benefit the internal power of the company and result in a quicker decision-making process.[23] The drawback in this situation is that family members

[20] Lubatkin, M., Schulze, W., Ling, Y., & Dino, R. (2005), "The effects of parental altruism on the governance of family managed firms," *Journal of Organizational Behavior*, 26, 313-330; Schulze, W.S., Lubatkin, M.H., Dino, R.N., & Buchholtz, A.K. (2001), "Agency relationships in family firms: Theory and evidence," *Organization Science*, 12(2), 99-116; Schulze, W.S., Lubatkin, M.H., & Dino, R.N. (2003), "Toward a theory of agency and altruism in family firms," *Journal of business venturing*, 18(4), 473-490; Kano, L. & Verbeke, A. (2018), "Family firm internationalization: Heritage assets and the impact of bifurcation bias," *Global Strategy Journal*, 8(1), 158-183.

[21] Chrisman, J.J. & Patel, P.C. (2012), "Variations in R&D investments of family and nonfamily firms: Behavioral agency and myopic loss aversion perspectives," *Academy of management Journal*, 55(4), 976-997.

[22] Barnett, T., Eddleston, K., & Kellermanns, F. (2009), "Business owners' role salience, career satisfiers, and performance-related outcomes in family versus non-family firms," *Family Business Review*, 22(1), 29-52; Ward, J.L. (2004), *Perpetuating the family business. 50 lessons learned from long-lasting successful families in business*, New York, Palgrave Macmillan.

[23] Sciascia, S. (2011), *Family resources and company results*, Milan, Giuffrè.

in leading positions can exercise their dominant influence to pursue personal interests at the expense of the company, thus generating high agency costs, to the detriment of economic results as well as the legitimate expectations of minority stakeholders. However, according to some scholars, family businesses represent the ideal context for eliminating the underlying assumptions of agency theory, i.e., egoism and the perfect rationality of individuals.

On the contrary, stewardship theory[24] highlights family members' attachment to the business, which is seen as a source of family and personal pride and an opportunity for economic wealth that has to be preserved. Stewardship is achieved by valuing family resources for the benefit of all actors involved in the company, including employees, outsiders, and future generations. This approach presupposes that there is cooperative behavior within the organization among its members (family and non-family members), and that a participative approach prevails, rather than one oriented toward the control and monitoring of managers. In order for fulfill these conditions, there must be a specific attitude by the family and all its individual members (the so-called stewardship attitude), toward ensuring that there is an intrinsic alignment of interests and values between the different actors, without the need for ad hoc mechanisms. Otherwise, it is possible, for example, that in some situations strictly economic objectives prevail, that the psychological ownership is transformed into the worst forms of altruism as discussed above, that mutual trust is lacking, and that feelings of affection are replaced by colder and more formal relationships.[25]

Studies on family firms' performance, relying on the theories we have just described, have examined the relationship between family firms' search for these benefits and their structures, and have found that the optimal conditions to benefit from agency and stewardship advantages are when the firm size is small, and ownership is highly concentrated. For instance, under these circumstances, firms with family CEOs will achieve greater performance due to the executives' deeper knowledge of the business and the owners' interests, and their stronger attachment to the business.[26]

Starting from the intrinsic limitations of the two previous theories, a completely different interpretation of family business has been proposed by the theory of resources. When applying the resource-based view[27] to the context of family businesses, some scholars have coined the term "familiness" to indicate that unique set of tangible and intangible resources that would only be available to this type of business, and that would allow such firms to build or destroy a competitive advantage.[28] Among the unique and inimitable resources of the family there are:

a) a culture based on trust and cohesion among all members;
b) the presence of the founder as an individual able to bring unique skills and abilities to the company, and often to pass them on to subsequent generations;
c) the management of human resources based on relationships;
d) the possibility of creating a family-like network of relationships between family members and other stakeholders; and
e) the long-term vision of the family, which should ensure business continuity and encourage a proper assessment of investments according to the rules of economic convenience.

In an attempt to create a more complete theoretical synthesis that adheres to the characteristics of family businesses, Gomez-Mejia and his colleagues[29] rely on a "behavioral agency model" (BAM)[30] variant of the agency theory that proposes the new perspective of socio-emotional wealth (SEW).[31] The socio-emotional wealth theory tries to reconcile the positive and negative aspects of family involvement highlighted by previous theories. From the perspective of the SEW, entrepreneurial families continuously make important decisions, establishing in each specific circumstance how much a given decision can influence their "socio-emotional endowment," i.e., the set of values, relationships, and priorities, including the continuity of the business over time and the preservation of the family dynasty. This is an assessment that often disregards the economic and financial implications of a particular choice, constantly seeking a trade-off between the risk of compromising the social and emotional endowment of the family, and that of damaging the firm performance. These considerations, according to SEW theory, do not mean to suggest that entrepreneurs and families make instinctive or irrational decisions; on the contrary, SEW theory is based on the idea that the decision-makers may be either inclined or adverse to risk, depending on the circumstances.[32]

[24] Corbetta, G. & Salvato, C. (2004), "Self-serving or self-actualizing? Models of man and agency costs in different types of family firms: A commentary on Comparing the agency costs of family and nonfamily firms: Conceptual issues and exploratory evidence," *Entrepreneurship Theory & Practice*, 28(4), 355-362; Miller, D., Le Breton-Miller, I., & Scholnick, B. (2008), "Stewardship vs. stagnation: An empirical comparison of small family and non-family businesses," *Journal of Management Studies*, 45(1), 50-78.

[25] Sciascia (2011).

[26] Miller, D., Minichilli, A., & Corbetta, G. (2013), "Is family leadership always beneficial?" *Strategic Management Journal*, 34, 553-571.

[27] Habbershon, T.G., Williams, M.L., & MacMillan, I.C. (2003), "A unified systems perspective of family firm performance," *Journal of Business Venturing*, 18(4), 451-465; Sirmon & Hitt (2003).

[28] Habbershon, T.G. & Williams, M. (1999), "A resource-based framework for assessing the strategic advantages of family firms," *Family Business Review*, 12(1), 1-25; Habbershon, Williams, & MacMillan (2003); Minichilli, A., Corbetta, G., & MacMillan, I.C. (2010), "Top management teams in family-controlled companies: 'Familiness', 'faultlines', and their impact on financial performance," *Journal of Management Studies*, 47(2), 205-222.

[29] Gomez-Mejia, L.R., Haynes, K.T., Nunez-Nickel, M., Jacobson, K.J.L., & Moyano Fuentes, J. (2007), "Socioemotional wealth and business risks in family-controlled firms: Evidence from Spanish olive oil mills," *Administrative Science Quarterly*, 52(1), 106-137.

[30] Wiseman, R.M. & Gomez-Mejia, L.R. (1998), "A behavioral agency model of managerial risk taking," *Academy of Management Review*, 23(1), 133-153.

[31] Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano Fuentes (2007); Berrone, P., Cruz, C., & Gomez-Mejia, L.R. (2012), "Socioemotional wealth in family firms: Theoretical dimensions, assessment approaches, and agenda for future research," *Family Business Review*, 25(3), 258-279.

[32] Gomez-Mejia, L.R., Campbell, J.T., Martin, G., Hoskisson, R.E., Makri, M., & Sirmon, D.G.

Although the SEW perspective may seem similar to the stewardship theory – since in both cases the essential contribution of the family in ensuring the continuity of the business is highlighted – in reality these are completely different approaches. While the stewardship approach presupposes that family members operate unconditionally for the good of the business, just because of their belonging to the family, the Sew perspective argues that family members act for the good of the business primarily as a matter of economic convenience, consisting of maximizing their socio-emotional endowment.

5.5 The corporate governance of family-controlled firms

The governance problems of these types of companies will also be very different from the previous forms of ownership structure (see Chapter 5), and are influenced by factors such as whether or not the companies are listed, whether or not there are other players in the shareholding, and whether or not there are managerial skills within the family.

In family-owned companies, the overlap of family members in ownership and governance roles raises a number of issues in relation to the role, composition, and functioning of the board of directors. Among them:

- *the overall design of the governance system of the family business*, with the more or less explicit provision for formal and informal bodies, in order to create a strong correspondence between the governance mechanisms of the ownership and those of the company;
- *the specific roles of the of directors* with respect to the particular needs of the family business. Direct experience seems to suggest that a well-functioning board of directors meets particular needs for the continuity of family-owned businesses, preventing the emergence of certain crisis factors within the ownership structure, between the owners and the company, and within the company itself;[33] and
- *the openness to non-family members*, and their expected contribution to the effective functioning of the board of directors, as discussed in the Chapter 3.

Differences emerge depending on whether the company is listed or not. While for listed companies there will be low homogeneity of interests, and only the majority shareholder has a great incentive to play an active role in the governance of the company (determining the complex "owner-owner" problem), unlisted family companies will be characterized by a high homogeneity of interests (absolute in the case of a single entrepreneur), and a consequently high interest in actively participating

(2014), "Socioemotional wealth as a mixed gamble: Revisiting family firm R&D investments with the behavioral agency model," *Entrepreneurship Theory and Practice*, 38(6), 1351-1374; Gomez-Mejia, L.R., Patel, P.C., & Zellweger, T.M. (2018), "In the horns of the dilemma: Socioemotional wealth, financial wealth, and acquisitions in family firms," *Journal of Management*, 44(4), 1369-1397.

[33] Corbetta (2010).

in the governance and management of the company. The combination of these variables will ensure that in listed family businesses, the main problem is to avoid the risk of expropriation of minority shareholders by the family, through a conspicuous presence of independent directors willing to play the role of "counterweight" to that of the ownership. On the other hand, in unlisted family businesses the problem will be primarily that of balance within the family, involving a continuous search for an appropriate mix of "internal" and "external" professionals, as well as establishing career paths and governance and management positions that are satisfactory for all family members involved in the business.

With regard to the BoD, despite the widespread skepticism about its effective governance in a concentrated shareholding company, it can make critical contributions that are often underestimated. The board of directors is not only the body that has to control the management; it also has a fundamental role of service and support to the top management, which becomes particularly critical in the context of companies with ownership in the hands of an entrepreneurial family. In these companies, in fact, the board of directors can make significant contributions, integrating any gaps in the skills of family members through the inclusion of external directors selected on the basis of their professional background.

The board of directors plays different, and in some ways even broader, articulated, and potentially useful roles in the management of the relationship between the family and the business. Among them:

- *The role of moderator*: in cases where only one person owns the majority or the whole equity capital, and simultaneously plays the role of leader within the company, a well-structured and functioning board of directors can be very useful as a counterweight to the entrepreneur, containing any excesses of power, or alternatively stimulating action where there is excess of prudence. Unlike the various consultants, the board member formally participates in the decisions and assumes full legal responsibility for them. For this reason, even if external to the controlling family, the board member needs to ask precise questions and to demand – even legally – clear and concrete answers from the entrepreneur. This is one of the most important obstacles to the widespread presence of external directors in family businesses.
- *The participatory role*: in family businesses characterized by the presence of non-managing family owners with a significant portion of the equity capital, a well-functioning board of directors can represent a means for allowing these individuals to maintain good knowledge of the business, and to participate in the major strategic decisions.
- *The role of auditor*: a well-functioning board of directors can allow its members to monitor the work of the CEO (and senior management in general), especially when the CEO is not the majority shareholder, or even a non-family member.
- *The role of facilitator*: a well-functioning board of directors can also be very useful in situations of interpersonal tension between owners who hold high amount of shares in the equity capital, or between entrepreneurs and heirs, directing the

discussion toward business problems rather than interpersonal ones, and promoting a technical-professional analysis of problems.
- *The role of governance*: finally, the role of governance consists of the ability of the board of directors to make the most important strategic decisions. This role, which is the main one in other types of enterprises, is often somewhat limited in family-owned enterprises, where the board of directors is established more for the above reasons, than to effectively manage the enterprise. However, there are some cases in which a governance role is more likely to be played. This is the case, for example, when top management roles of the company are taken on by several people, who also own all the equity capital. In these cases, the board of directors can be the body where these people focus their time, effort, and energy to discuss the typical aspects of governance activity.

5.6 The main challenges of family firms: Openness and generational change

There are two main challenges that family businesses have to face over time: opening up to external professionals, and generational change. These are very delicate processes, which must be carefully organized, but which are preparatory, if not fundamental, for the success and continuity of the company.

There is a broad consensus in the international literature on the advantages of having external directors in the governance of a family business. They concern:

- *control*, since outsiders stimulate discipline and responsibility on the part of the leaders and the management, favor the introduction of more sophisticated reporting systems, monitor conflicts of interest, and protect minority interests and other stakeholders;
- the *strategy*, given that external directors bring experience and skills to integrate the knowledge of the company, also in terms of cultural diversity; they improve the quality of decision-making processes, act as challenging interlocutors for the definition of objectives and strategies, make an impartial contribution to the evaluation of results, and strengthen the company's image;
- the *management of family-enterprise relations*, since they favor the proper formulation of these relationships, and professionally plan succession processes for the firm, the governance, and often personally train the successors. Finally, they have a more professional and less emotional style, so they can manage the tensions that can arise between family members.

These considerations reinforce the idea that family businesses should take the following into account. First, outsider directors are particularly useful in companies under stress, where the injection of external expertise seems more crucial than in other contexts. Research shows that companies with negative performance that include a non-family director, recover profitability in the three years following the non-family director's inclusion, while all companies that have included at least one non-family director for the first time, have benefited in terms of income performance.[34] For this reason, all family businesses should learn to better manage such a valuable resource, so that the benefits of the presence of outsiders in the board of directors become more widespread among entrepreneurial families. If the resistance of families to "give away" the leadership of the company to persons outside the family seems more understandable, the reasons for resistance to the presence of non-family board members are less clear.

Furthermore, family businesses should learn how to assess the contribution of external members within the board of directors, and should not just include them in the face of financial difficulties. As stated by John Ward, the professor of management who, more than anyone else, has dedicated his research to the boards of family businesses, the contribution of non-family board members is not only measurable in terms of short-term economic results, but translates into greater transparency of management, greater objectivity in the firm's decision-making processes and evaluation processes of family members, more efficient use of board time, and, as a result, a greater probability of continuity of the business over time.[35] All these aspects should suggest a rethinking of the logic of board composition, even within unlisted companies, spreading a culture of governance that goes beyond the negative conception of control that entrepreneurial families typically have of family controlled firms.

Another crucial issue for the continuity of family businesses concerns generational change. Succession at the top is always a critical event, because of its influence over the future direction and development of the business. In family-owned businesses, the transmission of the socio-emotional heritage of the controlling family is added to the need to transfer their managerial skills.[36] It is configured as a process and not as a single event, so it is important and necessary to deal with it in time and with the right tools. Depending on the underlying cause of the turnover at the top, there can be various effects on company performance. For instance, the replacement of an unsuitable leader may lead to an improvement; but in other cases it could turn out to have a completely marginal or even negative effect.

The process of succession in family-controlled companies is often a destabilizing and intrinsically negative phenomenon, due to a combination of organizational and emotional stress. There is also the possibility that the new CEO may damage harmonious relations with the main stakeholders, may not share the values of the controlling family, or may not take care to protect the social-emotional heritage of the

[34] Corbetta, G., Minichilli, A., & Quarato, F. (2012), *Report AUB Observatory, IV edition*.

[35] Ward, J.L. (1991), *Creating Effective Boards for Private Enterprises*, San Francisco, Jossey-Bass.

[36] Carney, M. (2005), "Corporate governance and competitive advantage in family-controlled firms," *Entrepreneurship Theory & Practice*, 29, 249-265; Dyer, W.G. (2006), "Examining the 'family effect' on firm performance," *Family Business Review*, 19(4), 253-273; Dyer, W.G. & Whetten, D.A. (2006), "Family firms and social responsibility: Preliminary evidence from the S&P 500," *Entrepreneurship Theory & Practice*, 30(6), 785-802; Miller, D. & Le Breton-Miller, I. (2005), *Managing for the long run*, Boston, Harvard Business School Press.

family over time. The main mechanisms that qualify managerial turnover in a family-controlled business, in a manner consistent with the objective of conserving the above-mentioned intangible assets, are: i) advance planning of the succession at the top (relay succession); ii) the existence of a mechanism of internal competition between the various candidates for the succession (horse race); and iii) the decision to recruit an outside Ceo. According to theory, these mechanisms would represent a set of conditions through which entrepreneurial families could counterbalance the negative effects of succession on the firm's performance. In particular, while succession planning and competition between candidates would serve to develop an awareness of the emotional characteristics of the family well in advance, leaving the new CEO free to focus on financial results, external recruitment would be particularly useful in preventing too much focus by family members on business continuity, which risks becoming excessive during a succession.

In summary, the results of the study show that: i) CEO succession has a negative effect on the firm's performance (the Roa "adjusted" for the sector), which is confirmed by examining different "time windows" before and after the succession;[37] ii) both the planning of the succession and competition between candidates would mitigate this negative effect, allowing the successors to "internalize" the values of the family before taking leadership of the company; iii) the decision to select an external Ceo would seem to mitigate the negative effects of succession, due to the greater "independence" of the outsider with respect to family values, and therefore his/her greater freedom to focus on economic and financial results; and iv) in general, where there is a strong presence of family members on the board, the positive effects produced by the succession mechanisms indicated above tend to disappear, due to the natural tendency of a board composed entirely of family members to emphasize the relationship between family and business rather than focus strictly on business issues.

Having established the reasons why careful planning is necessary, theory and practice indicate seven "conditions for success" that can facilitate and hopefully lead to a successful generational turnover:[38]

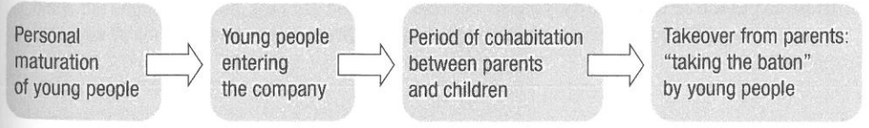
- *distinguish the business from the family.* It is necessary for the family to have a vision of the company as a distinct and relatively autonomous entity, both because that view favors external contributions of skills and capital if necessary, and because it guarantees greater family cohesion during the difficulties of the company;
- *apply a modern system of governance*, starting from a clear definition of roles, a careful attention to the composition of the board of directors, including the definition of – and compliance with – rules of accountability and the adoption of legal and institutional mechanisms (e.g., a holding company between individuals and operating companies) aimed at reducing dissension between owners in the management of companies;
- *assess competence rather than the family relationship.* Such a meritocracy requires some pain, especially because it demands an impartial assessment of family members according to performance criteria, and an analysis of skills and fit with the company and its needs, which is even better if conducted with the help of a third party;
- *define (early and well) the shared rules for change*, with adequate planning that gives priority to the company's competitiveness objectives and with adequate legal structures that allow the formation of a stable majority to avoid decision-making blocks. Planning is effective only if it is started in time, i.e., when the outgoing generation still is operating at full capacity and with a sufficiently-long time horizon;
- *prepare for the unexpected from a patrimonial point of view.* The timely provision of an adequate asset profile (availability for write-offs due to unforeseen events, the establishment of a family fund outside the company for the liquidation of the holdings of unwelcome family members or those who wish to leave the company, or the splitting-up of assets among family members) is another facilitating element;
- *planning objectives and the process.* Privileging a process view, which consists in formulating a vision of the future based on the information available in the present, and then adapting its various phases in light of the information available from time to time, rather than sticking to a rigid set of objectives, may facilitate a succession that may last decades; and
- *involving third parties* was the key to many successful successions. In order to obtain the related benefits, the outsider member must enjoy the trust of the parties involved, be patient as well as aware of the typical slowdowns this phenomenon entails, and share the basic values of the people involved in the process.

[37] In this respect, the results of Bennedsen, M., Nielsen, K., Perez-Gonzalez, F., & Wolfenzon, D. (2007), "Inside the family firm: The role of families in succession decisions and performance," *Quarterly Journal of Economics*, 122, 647-691, are widely confirmed.

[38] Corbetta, G. & Minichilli, A. (2016), *Guide to the generational passages: successful conditions, mistakes to avoid and case histories*, Assolombarda dispensa n°06/2016.

The process of generational change begins when parents become aware that they want to pass on the business to their children, either by intention or for other reasons. From that moment the planning begins and follows four phases (**Figure 5.1**).

Figure 5.1 The phases of generational change



Source: Corbetta, G. & Minichilli, A. (2016), *Guida per i passaggi generazionali: condizioni di successo, errori da evitare e case history*, Assolombarda dispensa n°06/2016.

The first, the maturation of children, is a delicate component and involves several decisions and pathways. First of all, their studies must accord with the inclinations of young people, and allow them to expand their culture and develop skills useful for the exercise of the entrepreneurial role.

After the young people complete their studies, it is recommended that they have professional experience in other companies, so that they can complete their training, experience working for a boss, and demonstrate their skills, while realistically assessing their potential. These experiences allow young people to measure their skills in an environment where the inevitable initial failures do not affect either their career or their credibility with future employees, and allow the entrepreneurial family, especially when there are several successors, to better evaluate young candidates. In this regard, a recent study concluded that the habit of passing the family firm to the firstborn is the worst financial choice for the firm, although the firstborn child would seem the natural choice for succession.

Choosing a subsequently-born child significantly increases the firm's post-succession performance, with returns on assets 39% higher than in firms that appoint a firstborn. Selecting a subsequently-born family member also turns out to be a better choice than the selection of a non-family leader. In other words, what might be considered a nepotistic choice can be beneficial to the firm, if made from among all available siblings in a large-enough family pool.[39]

In his first experiences with the family firm, it would be preferable for the young family member learn know how to absorb the "tacit knowledge" of the entrepreneur, that is, how to master the unwritten knowledge that cannot be separated from executive action. It is desirable for the successor to participate as soon as he can in some meetings between his/her parents and the firm's other stakeholders (banks, employees, suppliers, customers and so on), even if just watching and learning, without having the "right to speak."

The third step regards coexistence among the generations. This coexistence (which could even be called mentoring) could be a long-lasting one. It varies from case to case. In this stage, communication is very important, including mutual listening between parents and sons or daughters. The inability to communicate can lead to a break between the generations, and this certainly will have a negative impact on the firm's performance. The reason for this mistake often lies in the lack of self-criticism, which is driven by the huge "ego" which is common among seniors, but which also can be noticed sometimes in the younger people. The succession is considered complete when there is the total passing of the baton – where the sons take the role of the parents, who will continue to be part of the firm merely as "consultants" based on their experience over many years.

[39] Calabrò, A., Minichilli, A., Amore, M.D., & Brogi, M. (2018), "The courage to choose! Primogeniture and leadership succession in family firms," *Strategic Management Journal*, 39(7), 2014-2035.

Case study **What is an effective board?**[40]

On December 23, 2018, at 21:57, Professor Campini sat on the train coming back from Turin. He felt tired and disappointed, and closed his eyes trying to rest on the return journey to his home in Milan, Italy. However, he was too tired to sleep. What happened during the day keeps coming back into his mind. He spent the whole day at the meeting of the board of directors of the Alimenta Company, a world-renowned family-controlled company producing wines and sparkling wines of top quality with the "Made in Italy" label. The company was recently listed (in November 2017) on the UK stock market to finance its ambitious growth plans. The firm is controlled by the Limonta family with 45% of the shares, while the remaining 55% is distributed between the investment fund "McKenzie" (15%) and small individual investors (40%). Due to the recent listing, the company had to establish its first "professional" board of directors, and set up an "Investor relations" department to communicate effectively with financial investors.

Board composition

The Limonta family is now in its fourth generation. The family nucleus in the company is today composed of Marco Limonta and his son Paolo. Both of them hold executive roles in the company together with a non-family manager (Luca Busnati), who joined after the IPO to support the family managers in running the company. They are the only three executive members on a board made up of eleven people. Although both Marco and Paolo Limonta attended a course offered by the London Stock Exchange before the IPO, their knowledge of corporate governance and board functions was rather limited. Moreover, with the controlling family directly involved in the top positions of the company, it was hard for Luca Busnati to bring up any serious opposition to their leadership.

As for the non-executive members, both Antonio Devalbo and Paolo Marchetti are professionals with a close relationship with the Limonta family. The other five members are independent directors holding top executive positions in industrial companies, investment funds, or consulting firms, while the Professor Campini is from a top business school. They are all independent and are not afraid to express their thoughts and raise questions, but they all have full-time jobs with heavy workloads (**Table 5.3**).

Board structure and functioning

The meeting started at 9:00 a.m. and stretched until 18:30 p.m. The day began with the nomination committee, followed by meetings of audit and risk committee, and then the remuneration committee. During the last year, the audit committee met six times (two hours each), while the remuneration committee met three times (for 1.5 hours) to discuss the compensation of the three CEOs. The nomination committee met one time (for two hours) to discuss the appointment of Luca Busnati as a new CEO alongside the two incumbent CEOs.

After lunch, at 14:30 p.m., there was the full board meeting. The Alimenta board usually has six meetings a year, each lasting half a day. As at all the board's meetings, detailed information about decisions to be approved was circulated among directors at least seven working days before the meeting. Although they have had time to read the documents in advance, it was impossible for them to have a thorough understanding of the real issues being presented. A huge pile of documents on several topics (finances, risks, human resources, corporate governance, corporate social responsibility, the annual bonuses, etc.) has been prepared and were discussed during the meeting, but the time was so limited that it was impossible to have detailed and meaningful debate on each issue.

[40] Alessandro Minichilli and Fabio Quarato wrote this case study solely to provide material for class discussion. The authors do not intend this to illustrate either effective or ineffective handling of a managerial situation.

Professor Campini was aware that, as a matter of compliance, the agenda must address many issues, and many procedures had to be followed. But, with such limited time and such a tight agenda, the board meeting risks becoming a mere formality, just being held to meet regulatory requirements. Was there any way to enable the board to add real value to the company? Perhaps the problem was in the preparation? If board members would arrive fully prepared, they could be able to discuss the key issues and make sound decisions. On the other hand, when the CEO reported the compensation review of the company, he read the report almost word-for-word. He did not mention how the review was conducted, or what companies they selected for the benchmarking analysis. When an independent director raised a question, the CEO's answer was vague and unconvincing. Thus, all members clearly understood the "unwritten rule" of the board: be careful not to put others in a difficult position.

The situation become paradoxical when, at the end of the meeting, the chairman summarized the results of "Value Consulting," a leading consulting company in charge of complying with the requirement for an annual self-evaluation of the Alimenta board. Based on interviews with all directors, the report on the board's effectiveness stated: "Everyone is fully satisfied with the board composition and dynamics. The discussion of arguments was interesting, and information flow was sufficiently smooth. Additionally, all Committees effectively supported the board's decision-making process."

Table 5.3 Alimenta's Board of Directors

	Role	Remun. Comm.	Audit. Comm.	Nomin. Comm.	Profile
Marco Limonta	Chairman & CEO				Father
Paolo Limonta	CEO				Son
Luca Busnati	CEO				Manager with decades of experience in the field
Antonio Devalbo	Non-executive	X		X (C)	Business consultant of the Limonta family
Paolo Marchetti	Non-executive		X		Lawyer of the Limonta family
Elena Colombari	Independent				Retired manager with a long history in the Group
Guido Campini	LID		X	X	Professor of Corporate Governance
Luana Severini	Independent			X	Consultant in "Value Consulting"
Elisa Guidi	Independent	X			HR manager at another company
Luca Brivio	Independent	X (C)			Manager of the investment fund "McKenzie"
Carla Gualini	Independent		X (C)		CSR manager at another company

(C): Chairman.

The boardroom culture

Professor Campini has been just appointed a board member of Alimenta, but it seems that the board follows consolidated routines, and the situation has always been like this. However, the sales growth rates over the recent years are good, and the profitability of the company is well above its industry average. Even though there was not much to be worried about, Professor Campini started to raise some questions about the current board practice of discussing the biggest issues in private meetings with a small inner group, and leaving the minor ones to the formal board meetings. In Italy, it is quite normal that the more thorny issues are confronted in private, informal meetings, rather than during the official meetings of the board. Major agreements are reached behind closed doors, while board meetings are for compliance issues.

Professor Campini was absorbed in these thoughts when the stationmaster whistled to indicate the train's departure. He was conflicted over the situation. What was the problem with Alimenta's board? What could he do? On the other hand, if the Limonta family was not worried about this, why should he be concerned?

6 Ownership, Governance, and Strategy

6.1 The relevance of the topic

In the first part of this work, the "problem" of corporate governance was introduced from a broader perspective than it is treated in the traditional Anglo-Saxon literature. This broader vision implies the consideration of more actors than those within the mechanisms of governance. In particular, while much of the traditional literature treats the central role of the board of directors as the dual role of protecting the interests of minority shareholders, and formulating and controlling the strategic choices of the company, the perspective adopted in this work considerably broadens the board's scope of action.

Although management studies have often focused their attention on executive roles in defining effective and far-sighted strategies, the transformations taking place at the global level – which have challenged the consolidated model of capitalism – have also highlighted the central role of ownership and governance structures, in determining the fundamental strategic choices of the companies. In other words, after a long and uncontested domination by the capitalist model of widespread shareholding (the so-called public company), which has been considered by many to be the natural evolution of any entrepreneurial initiative, there is a growing tendency to openly question the supremacy of this model.

There are several reasons to support this proposition. First, over recent decades there has been an increase in the dominance of large institutional investors who, especially in the Anglo-Saxon countries, now hold about 70% of the share values on the capital markets. This phenomenon, together with the regulations introduced after serious corporate scandals (such as Enron and Parmalat) and the financial crisis of 2007, both weakened the public company model, and imposed additional "management costs" for companies that decide to go public in a regulated market. Consequently, over recent years there has been a real "rethinking" and "reinvention" of ways of doing business, introducing high-growth start-ups which have with low capital requirements (which are often met by seed-capital platforms such as SeedInvest), and are based on technologies that allow them to compete on a global level even though they are not necessarily very large. Just think about Facebook, which in 2014 Facebook bought WhatsApp – a company with just 60 employees – for $19 billion. Then there's Uber, founded in 2009 on the initiative of its founder Garett Camp, which now provides a private car transport service to millions of people every

day, and the Airbnb site, which was opened in October 2007 by Brian Chesky, and in 2016 reached over 100 million nights booked worldwide.

It would be wrong to affirm that this new model of ownership structure can be a substitute for the public company, which has and will continue be relevant, especially in sectors with high capital intensity such as utilities. However, although emblematic of the Anglo-Saxon model of capitalism, the public company no longer necessarily represents the ideal model. Even if we limit our attention to the traditional capitalist enterprises, we can see that in reality, the so-called public companies represent a limited model of ownership, especially in European countries where different ownership structures tend to prevail.

On the other hand, a principle of "variety" of ownership structures seems to be spreading, along with the visions, managerial attitudes, and business strategies that characterize each ownership structure. On closer inspection, in fact, in many European countries, most economic activities take place in entities with very different organizational forms and ownership structures. The same family-controlled companies, which had seemed destined to "evolve" into public companies in order to survive, have challenged this current of thought in recent years. In a recent article in The Economist, their growing relevance is traced to a combination of factors, including the shift in the modern economy towards areas of the world – particularly Asia – where family-controlled companies remain the dominant ownership structure. Moreover, these family-controlled companies are not just small- and medium-sized private enterprises with predominantly local relevance, as is often believed. A significant number of medium-sized and large companies listed on the stock exchange with strong international profiles are controlled by a single family.[1]

This evidence confirms that there are no "superior" forms of ownership, or that some models are more suitable than others for carrying out certain economic activities. On the contrary, similar economic activities are often carried out within different ownership structures with comparable results. For example, large automotive companies have ownership structures ranging from purely public companies to companies controlled by a single family, rather than by the state or a mixed coalition of subjects (see Chapter 4), which show corporate strategies and performance comparable to each other.[2]

Although both the literature and the practice of corporate governance have often considered the form of ownership as an "exogenous variable,"[3] a more realistic view of corporate governance requires careful consideration of ownership characteristics, for at least two reasons. First, ownership is very often the "off-spring" of the institutional and legal context to which it belongs, determining a close parallelism between

[1] In this regard, it can be shown that in Italy around 66% of companies listed on the Stock Exchange are family-controlled firms (AUB Observatory, 2018 report).

[2] See the case study "The link between ownership and strategy of car manufacturers" contained in Chapter 4.

[3] Minichilli, A. (2012), Proprietà, governo e direzione delle imprese, Milano, Egea; Aguilera, R.V., Desender, K., Bednar, M.K., & Lee, J.H. (2015), "Connecting the dots: Bringing external corporate governance into the corporate governance puzzle," *The Academy of Management Annals*, 9(1), 483-573.

models of capitalism and prevailing ownership forms.[4] Secondly, although the ownership structure is based on the "type" of shareholders (families, institutional investors, the State, other companies, private equity funds, etc.) and on the percentage of shares owned by each shareholder, it always exercises a direct or indirect influence on the strategic choices companies make, and therefore on their ability to achieve satisfactory results.

The above considerations raise some questions of considerable interest to scholars, but especially to entrepreneurs and managers. In particular, one may wonder: Which forms of ownership are best suited to the pursuit of certain strategic choices? What are the relationships between the ownership structure and the governance mechanisms? In other words, are there differences in the configuration of governance and leadership bodies between companies with different ownership structures, or does any difference rather depend on context? Are there causal relationships between the configuration choices of a company's governance bodies, and the quality and characteristics of the strategic choices it pursues? In other words, is it possible to find different "archetypes" of governance, which are characterized by different compositions, structures, and functioning of the board of directors according to their different forms of ownership, but which make equally valid contributions to the strategic decisions of the company?

This chapter will discuss the relationship between ownership, corporate governance, and strategy from the perspective of the conceptual fit between the different elements of the model that assumes such relationships, seeking to grasp the issues related to the "dynamic" evolution of governance models over time.

6.2 The relationships between ownership, governance, and strategy: A basic model

The previous questions raise two concomitant needs. On the one hand, we need to identify the characteristics and "strategic priorities" of certain ownership models with respect to others. This will allow us to understand strategic decisions taken because of the structure of corporate governance, but also (and above all) as an expression of the will and objectives of those who bear the greatest risks of the entrepreneurial activity. On the other hand, it is important to recognize a variety of combinations of "ownership x governance," which depend largely on the model of capitalism within which companies operate, but also on other non-institutional contextual conditions, both at the macro level (the competitive context), and the micro level (the performance achieved by the company). In both cases, the declared goal is to abandon a certain tendency in the literature (and practice) toward the search for

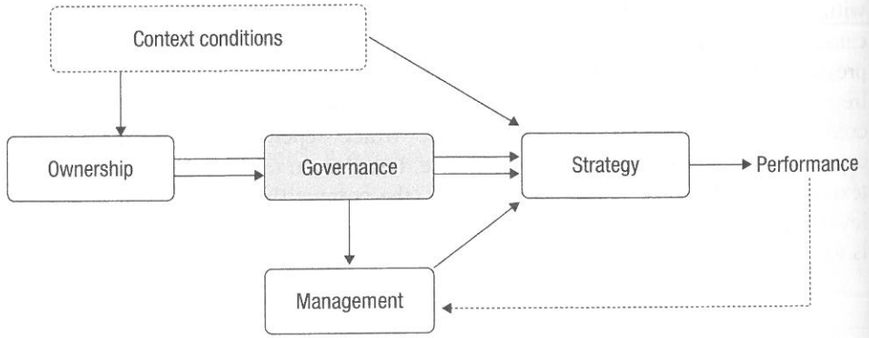
[4] Porta, R.L., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R.W. (1998), "Law and finance," *Journal of political economy*, 106(6), 1113-1155; Weimer, J. & Pape, J. (1999), "A taxonomy of systems of corporate governance," *Corporate governance: An international review*, 7(2), 152-166.

universally-valid "recipes," and to understand how the design of the overall system of governance results from a long analytical process. This process necessarily takes various elements into consideration, and identifies the most suitable solutions for a specific company based on the expectations of this particular company (and its owners).

For the characteristics just described, the theoretical model of reference is based on contingency arguments, according to which there are no higher economic configurations of universal validity; indeed consistent relationships between ownership, strategy, and governance of a particular company depend on the contextual conditions. These conditions can refer, on the one hand, to the competitive context, which can "bind," or rather "convey," certain choices in terms of company ownership and governance. Think of the capital-intensive sectors, which require large investments and large amounts of financial resources which companies are unlikely to obtain except through the capital market. However, on the other hand, the conditions can also concern the institutional context, i.e., the set of laws, regulations, and characteristics of the judicial system that strongly influence choices of corporate governance. Think about the corporate scandals that have affected many countries around the world, and the attempts by various legislators to increase the transparency of communications to the market in order to avoid a repetition of these events in the future. If these elements are recognized as valid, a causal relationship between ownership, governance, and corporate strategy seems to be established, as shown in **Figure 6.1**.

Following this model, the ownership-governance-strategy (OGS) model is characterized by the following aspects. On the one hand, the proposed model highlights the centrality of the ownership structure, which is also strongly connected to the level of efficiency of the financial markets, and to the characteristics of the capitalist model

Figure 6.1 The causal relationships between ownership, corporate governance and strategy: the OGS model



Source: Minichilli (2012, p. 197).

in which the company operates, as previously discussed. On the other hand, the model assumes the existence of causal relationships between the variables that see ownership as the ultimate determinant of the choices of company governance and management, as well as the resulting strategic choices. Moreover, this model assumes that the contextual conditions exercise a direct and specific influence on the company's strategy, regardless of the will of the governance bodies, and leading to a set of "forced choices" that the majority of companies will try to pursue. For example, think about the tension toward obtaining efficiencies and reduction of costs and investments during a period of crisis, and to the "upheavals" in the ownership structures of companies due to the opportunities or need for mergers and acquisitions between companies, for sales, for openings of capital to third parties to increase capital solidity, etc. In the following sections, each element of the model will be discussed in detail.

6.2.1 Context conditions

The first and fundamental element of the OGS model is related to the "context conditions," which have a significant, direct impact on both the choices of ownership and strategy, and on the processes that lead to the review of the relations between these elements, as well as the performance of companies. Among the primary conditions are:

- *The performance achieved.* The state of health of a company is a fundamental precondition for understanding whether the current model of ownership, governance, and strategy is consistent with the objectives that the company itself pursues, or whether it needs to be revised. In this sense, only very negative economic and financial results, or alternatively extraordinarily positive development prospects, call into question the coherence of an existing model. For example, a crisis situation in the company raises questions about the ability of management to address and solve the problems that the company is facing, and makes it necessary to thoroughly rethink its strategy. Such a rethinking can certainly take place by replacing the management (if possible), including one or more external managers (as in the case of a family business), or even considering a corporate and/or ownership restructuring, inviting in private equity or other third parties with the dual objective of raising capital and injecting new skills into the company. At the same time, if the crisis becomes deep and prolonged, the company may be subject to a hostile takeover (if listed), i.e., when the entrepreneur or the entrepreneurial family in charge is forced to sell their shares. Even particularly positive performance can lead to important rethinking of the consistency between the prevailing forms of ownership, governance, and strategy. In this regard, consider the interest which well-performing companies arouse by in potential buyers, or, in more modest terms, the need for changes in strategy that the opportunity to reinvest internal capital requires.
- *The values, interests, and resources of the current owners.* A second condition derives from the values, interests, and resources of current owners, and their per-

ception of the company's current and prospective performance. The supremacy of the family's values and interests would lead to a rather "closed" configuration of governance and management bodies, which favors the family's participation in governance over the management of the company itself, and which excludes the possibility of opening up ownership to third parties. Think also of a large state-controlled company, typically endowed with considerable resources, but with the sole objective of offering goods and services considered critical under non-discriminatory conditions to certain categories of potential customers.

- *The pressures and opportunities arising from the competitive environment.* A third particularly relevant factor is represented by the pressures and opportunities which arise from the competitive environment in terms of growth opportunities, investment, or risk aptitude by those who control the company or simply guide it. These opportunities, which increasingly become an "imperative," also imply a recognition of the resources needed to respond to these pressures, and thus also require a rethinking of the balance between strategy, ownership, and governance. Think about the opportunity to grow in international markets, to expand in sectors adjacent to the core business, or to make interesting acquisitions; in all these cases, it may be necessary to find resources, and then consider bringing in minority shareholders or increasing the level of indebtedness of the company. Similar needs, although derived from the opposite direction, arise when the competitive context imposes some choices, even painful ones, on the company in order for it to survive. Think of the choices of downsizing, focusing on the core business, selling off business units, debt restructuring, etc., to meet the needs of competitiveness and efficiency imposed by the market. In this regard, it should also be noted that these pressures and opportunities may conflict with the values and interests (and resources) of the current owners: In this case, the possible alternatives are either a change in the values of the company or the beginning of a crisis, resulting in the probable bankruptcy of the company.
- *The pressures and opportunities offered by the institutional context.* The institutional context plays a fundamental role in affecting the models of ownership and governance which are dominant in a country or in a certain model of capitalism. Several variables – including existing business law, the effectiveness of the judicial system and the level of enforcement of the law, the breadth and efficiency of financial markets, and political and cultural models, as well as the mechanisms for representing relevant stakeholders – can favor the proliferation of certain types of businesses and strategies over others. Just think of the model of the large U.S. corporation, which often operates in one or a few related markets on a very large scale, compared to the model of the listed Italian family-owned group, medium-large in size, and diversified into many unrelated businesses to meet the needs of all family branches, as well as to spread the risk which would be involved in concentrating all the family's assets in a single business.
- *The constraints and opportunities offered by other context conditions.* Context conditions are not limited to the role of the financial markets and regulations alone, but comprise all communication and transport infrastructure, the education and training system, the available technologies, etc. In other words, the characteristics of companies in terms of ownership, size, attitude towards growth, etc. are influenced by the attractiveness of the context or "country-system" in which they operate.

6.2.2 Consistency relationships between the variables of the model

Although some of the elements of this model have been presented in various ways in previous chapters, it is now appropriate to present briefly the characteristics of the three main variables, which are at the core of the model. In particular:[5]

a) *Ownership structure* is defined by the distribution of ownership rights between the various parties involved over the life of the company. Ownership rights consist of the dual right/duty to take the final decisions on the set-up, administration, transformation, and liquidation of the company, as well as the right/duty to enjoy/take on the positive/negative financial results, both in terms of income (annual profit or loss) and assets (capital gains or losses). Based on these premises, the choice of ownership structures can give rise to very different solutions. They can be classified according to different criteria: i) the classes of stakeholders with ownership rights (only capital providers or also other parties such as, for example, employees); ii) the number of roles played by the same group of persons (for instance, the overlap between blockholders and top executives); iii) the number of people belonging to each category of owners (a capital provider in the case of unlisted companies, a plurality of shareholders in the case of listed companies); iv) the interest and convenience of the owners in actively participating in shareholders' meetings (e.g., small shareholders often "vote with their feet," such as selling their shares in an exit strategy); and v) the coincidence between shareholders who make the final decisions and those who enjoy the positive results.
b) *Strategy* can be defined as the configuration of the company's activities, and encompasses both corporate and competitive choices. In defining their strategic choices, companies must normally take decisions on such aspects as the size of its economic units, the objective rate of growth, the level of appropriate risk, capital requirements, diversification, vertical integration, the degree of internationalization, their competitive baseline (price, differentiation, distinctive skills, flexibility, innovation), agreements, alliances and other forms of inter-company aggregation. Of course, the strategy of each company is closely related to the characteristics of the competitive context in which the company itself operates or plans to operate. In particular, it is a question of being aware of aspects such as the minimum size necessary to compete, the degree of industry competitiveness, the degree of risk to be faced, the variety of strategically critical contributions and specific in-

[5] See Zattoni (2015); Airoldi & Zattoni (2005).

vestments required of the various stakeholders (in particular, suppliers, employees and customers), the degree of state regulation of the market, and the transparency and efficiency of markets (financial, products, and labor markets).

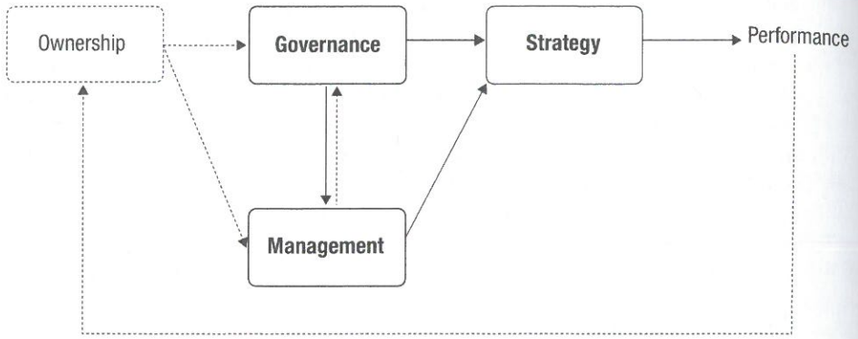
c) *Governance structure* represents the ways the company can exercise its ownership rights. It is related to the establishment of bodies (the shareholders' meeting, the board of directors, etc.), the appointment of their members, and the rules and mechanisms for the functioning of these bodies. Another important choice concerns the model of governance (traditional, dual, or monistic). The set of choices related to the management structure involves the leadership of the company, with respect to the identification of the CEO and the entire top management team, and is often strictly connected with ownership and governance characteristics. According to the above considerations, in the presence of certain context conditions, and given a level of performance that the company has achieved (feedback mechanism) or wants to achieve, the search for consistency between ownership, strategy, governance, and management of the company seems to be of fundamental importance. In fact, only a few "archetypes" or "typical combinations" of the above variables will be able to guarantee satisfactory performances over time. For instance, the following hypotheses of interdependence and coherence between the variables can be considered:
   - In a context characterized by low market efficiency and the widespread presence of family-owned companies, the listing of a company and the consequent and necessary opening-up of shareholding and top management to third parties is only appropriate where there are specific growth targets or requirements, where such objectives are compatible (and achievable) within the current competitive scenario, and where the consequences of opening up the shareholding are in line with the values and wishes of the family owners.
   - The company's growth in size increases its capital requirements and thus the number and diversity of risk capital providers, inevitably also increasing the complexity of governance. The challenge of dimensional growth, which can often be imposed by the competitive environment, requires proprietary and governance structures capable of attracting large volumes of resources from different classes of capital providers. Moreover, the dimensional and governance evolution of the company often involves a parallel and necessary "professionalization" of the top management; since often dimensional growth turns out to be sudden and not very controllable, it is very likely necessary to replace all or part of the pre-existing management, which doesn't have the skills and experience necessary to meet the changing needs of the company.
   - In particular, diversified growth strategies, through mergers and acquisitions, involve a series of changes in the coherence between ownership, strategy, and governance of the company because: a) they often require substantial financial resources, which are difficult to find without allowing third parties to join the shareholder capital, or without significantly increasing the level of indebtedness; and b) even if the ownership structure remains unchanged, there is a need to redesign the entire governance structure of the company, especially at the level of top management teams. This will clearly depend on the approach toward integration taken by the company doing the acquisition, which may retain an exclusive role as a holding company, or at the other extreme, may achieve an absolute "symbiosis" between the two pre-merger entities.[6]
   - International expansion strategies, often implemented through M&A activities, require a similar redesign of the governance and management bodies of both the corporate and local branches. In particular, while the governance and management bodies of the parent company should include advisers and managers with international experience and background, at the local level it will be necessary to establish the level of managerial autonomy that the parent company intends to grant. In the event that the parent company only wishes to maintain control of the local branch without influencing its strategic choices in the relevant competitive environment, it will tend to use a "federative" management model that preserves as much as possible the autonomous management of the branches; if, on the other hand, the plan is to give more strategic direction to the companies controlled at local level, management will probably be replaced and "central" management groups will be set up, also in order to establish a homogeneous organizational and business culture within the various companies in the group.
   - Expansion strategies through replication are effectively implemented with proprietary structures such as franchising networks. In this case, the design of governance structures must take into account the dynamism and lack of homogeneity of the competitive contexts in which the various aggregated units operate, providing for continuous management training of the individual aggregated units as the only possible means for exercising coordination and control.
   - Growth strategies that require distinct and complementary skills, but do not seek to acquisitions or mergers, are effectively implemented through strategic alliances that require managing particularly sophisticated and complex contracts, equity participation, and governance mechanisms.

6.2.3 The first variant in the case of public companies

As argued in the previous pages, the model presented in Figure 6.1 assumes that the relationships between ownership, strategic choices, and the management and governance structures of the company are essentially determined by the context conditions, the performance achieved, and the various feedback mechanisms that influence these relationships. However, the model assumes that – under the same conditions of context – there are only a certain number of possible "combinations" of successful ownership, strategy, and governance. Although it is difficult to generalize due

[6] Collis, D.J., Montgomery, C.A., Invernizzi, G., & Molteni, M. (2007), *Corporate Strategy*, Milan, McGraw Hill.

Figure 6.2 The causal relationships between ownership, governance, and strategy: the case of public companies



Source: Minichilli (2012, p. 198).

to the enormous variety of ownership, governance, and strategic configurations that companies actually exhibit, the above considerations seem to give a particular role to ownership structure in terms of consistency of the relations between ownership, strategy, and governance. Based on the above discussion, it seems that where ownership plays a "weak" role (as in the case of widespread shareholding), the governance and management bodies have almost total responsibility for strategic choices, and therefore assume significant power in the company. **Figure 6.2** describes the relationship between the ownership, governance, and strategy of public companies.

As the figure shows, where ownership is sufficiently fragmented so as to be unable to play an "active" role in the company's strategic decisions – such as in the case of U.S. public companies – governance and management bodies will take on a central and predominant role. This is the reason behind the tendency for the Anglo-Saxon literature to concentrate on the impact of the composition, structure, and functioning of the board of directors and top management on strategic decisions and financial performance.

In this regard, a first line of inquiry focused on the relationship between the composition and structure of the board, and the company's strategic choices. Some authors have investigated the relationship between the composition of the board of directors and corporate strategy decisions, showing that the greater the presence of external directors, the greater is the propensity to take risks, and consequently choose diversification.[7] In particular, some authors found that greater political, academic, and international experience of board members positively influences the level of CSR activities carried out by Chinese public firms. The board's traits clearly help connect the firm with external stakeholders, thus increasing the company's return on such initiatives.[8]

[7] Baysinger, B. & Hoskisson, R.E. (1990), "The composition of boards of directors and strategic control: Effects on corporate strategy," *Academy of Management Review*, 15(1), 72-87.

Other studies have investigated the relationships between the board composition and some specific strategic decisions, including, for example, investments in R&D and the innovative potential of the company. In particular, a recent study by Zona, Zattoni, & Minichilli (2016) confirmed some of the previous empirical evidence for smaller boards of directors dominated by insiders, while the opposite is true for larger companies, with larger boards with a greater presence of external directors showing greater innovative potential.[9]

Research by Kor (2016) showed instead that stronger and more independent boards, having a long-term vision due to their representation of shareholders' interests, favor higher investments in R&D. Among the relevant measures, the author found that having short-tenure managers, separating CEO and chairman duties, avoiding conflicts, and institutional ownership are particularly effective in promoting such investments.[10]

A second line of study, paid particular attention to the relationship between the upper echelons of the company and different outcome variables. These studies were based on the assumption that in a context of widespread ownership, the dominant role is played by the top management of the company, while the board of directors is limited to approving decisions taken by the CEO and his employees. Moreover, under these conditions, the incentives for the board's exercise of its control function are not always so strong.

Research traditionally focuses on the top management team (TMT) and its interactions, although some studies focus exclusively on the figure of the CEO. For instance, Belenzon, Shamshur, & Zarutskie (2019)[11] explored the impact of CEOs' age on firms' performance, finding that companies led by older CEOs show lower growth, sales, and performance, especially in those industries characterized by high creativity, high technology, and human capital intensity. They also found that younger CEOs are more likely to exit the business, which supports the hypothesis that they are more likely to adopt high-risk strategies than their older counterparts are. Contextually, older CEOs age is found to be correlated with the likelihood of a firm's survival.

A recent study showed that in the case of severe financial losses, the replacement of CEOs with longer tenure positively impacts performance, especially when the suc-

[8] Rao, K. & Tilt, C. (2016), "Board composition and corporate social responsibility: The role of diversity, gender, strategy and decision-making," *Journal of Business Ethics*, 138(2), 327-347.

[9] Zona, F., Zattoni, A., & Minichilli, A. (2013), "A contingency model of boards of directors and firm innovation: The moderating role of firm size," *British Journal of Management*, 24(3), 299-315.

[10] Kor, Y.Y. (2006), "Direct and interaction effects of top management team and board compositions on R&D investment strategy," *Strategic management journal*, 27(11), 1081-1099.

[11] Belenzon, S., Shamshur, A., & Zarutskie R. (2019), "CEO's age and the performance of closely held firms," *Strategy Management Journal*, 40, 917-944.

cessor is an outsider. Indeed, the longer an executive has been operating in a company, the higher is its commitment to the status quo, and hence the lower the probability of needed substantial changes being implemented. Similarly, these studies register that in struggling industries, CEOs with long industry tenure are less likely to depart from industry norms and promote the needed changes, so that the replacement of such figures with industry outsiders is beneficial to the company. Finally, this research finds that positive turnaround situations are more likely to occur when an output-oriented CEO (with aa background in sales, marketing, or product development) is replaced by a throughput-oriented CEO (with a background in operations or accounting), while the opposite tends to hurt performance. The reason is that the functional expertise of the manager will inform the framework through which issues are analyzed and solutions identified – in line with the upper echelons theory.[12]

Additional interesting insights are provided by research focusing on the complementarity and diversity levels of the TMT. Cambrea et al. (2017)[13] found that having a more heterogeneous top management team in terms of gender, international experience, and educational background is beneficial for the financial performance of fashion and luxury companies, and are seen as a source of competitive advantage.

6.2.4 The second variant in the case of controlling shareholders

A second circumstance, at the opposite extreme, concerns the configuration of the relations between ownership, governance, and strategy in companies with a controlling shareholder. Without defining the identity of the blockholder for the moment, it is evident that the presence of a strong individual in the ownership substantially alters the coherence between the variables of the model. The presence of a controlling shareholder will have two types of consequences. On the one hand, it is expected that the company's governance bodies will be designed according to the needs, wishes, and ultimately the "vision" of the owner. This justifies the fact that many unlisted family-owned companies – for which the provisions of the Corporate Governance Code do not apply – observe purely formal (or "on paper") governance bodies, which have little or no impact on the most important strategic decisions. The same applies to the top management, which is thought to be selected by the owner (whether it is an entrepreneur, a family, the state, etc.) according to his/her objectives.

Indeed, Miller and colleagues have explored the influence of strong ownership on firms' strategic initiatives and found a positive difference in financial performance when a non-family CEO leads the firm rather than a family one. Interestingly, non-family executives appear to be particularly effective in the case of ownership

[12] Chen, G. & Hambrick, D.C. (2012), "CEO replacement in turnaround situations: Executive (mis)-fit and its performance implications," *Organization Science*, 23(1), 225-243.

[13] Cambrea, D.R., Lussana, G., Quarato, F., & Varacca Capello, P. (2017), "Top management team diversity and firm performance: Empirical evidence from the fashion and luxury industry," *Corporate Ownership & Control*, 15(1-2), 325-340.

dispersion at the family level, since multiple owners monitor them. In this context, the ownership group is able to increase its monitoring capability, without substantially increasing agency costs. This confirms the idea that a more concentrated ownership limits the impact of management on strategic decisions, and ultimately performance. In addition, the authors found a negative effect when non-family CEOs act within collective leadership structures with family members rather than alone, since it is likely that a CEO embedded within the family will have to take into account the priorities of the family executives. Overall, the above results highlight the indirect effects of family ownership on firms' financial performance through the establishment of appropriate governance structure and leadership selection.[14]

On the other hand, this particular configuration of the model, characterized by less delegation and power to the governance and management bodies, suggests that the controlling shareholders have a direct impact on the strategic choices, according to their own values, objectives, and available resources.

Among the several studies focused on the effects of owners' involvement in strategic decision-making is one by Boellis et al. (2016), who explore its effects on firms' choice of establishment mode – either through greenfield investments or acquisitions – when entering a new market.[15] They found that family-managed (FM) and family-owned (FO) firms are more likely than non-family firms to prefer the less risky greenfield investment over acquisitions. Indeed, as family firms reconcile both economic and financial goals with the family-centric social goals of preserving the stock of socio-emotional wealth and transferring the business to the next generation, they tend to be more risk-adverse than non-family firms. In addition, the researchers do not find any significant differences in FO's and FM's preferences, suggesting that heterogeneity of ownership is one of the main variables in driving firms' strategy.

The second variant of the basic model, which describes the relationships between ownership, governance, and strategy of companies with controlling shareholders, is represented graphically in **Figure 6.3**.

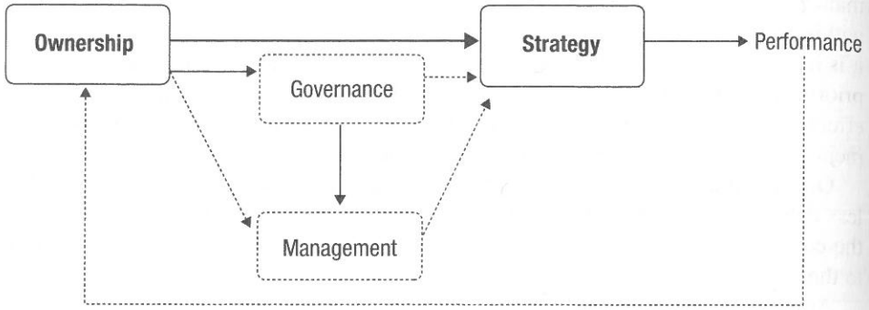
The centrality of the ownership structure with respect to companies' strategic choices recalls what has been anticipated in the chapter dealing with ownership concentration and the identity of the controlling shareholder. On the one hand, studies on ownership concentration show that the presence of a controlling shareholder produces more benefits in "Latin" countries than in Anglo-Saxon countries, albeit within certain limits.[16] The interaction of ownership configurations with an institutionally heterogenic environment has been extensively studied and provided key insights. For instance, Minichilli et al. (2016) found that the governance arrangement combining family CEO leadership with less concentrated ownership appears to have a markedly

[14] Miller, D., Le Breton-Miller, I., Minichilli, A., Corbetta, G. & Pittino, D. (2014), "When do non-family CEOs outperform in family firms. Agency and behavioral agency considerations," *Journal of Management Studies*, 51(4), 547-572.

[15] Boellis, A., Mariotti, S., Minichilli, A., & Piscitello, L. (2016), "Family involvement and firms' establishment mode choice in foreign markets," *Journal of International Business Studies*, 47(8), 929-950.

[16] Thomsen, Pedersen, & Kvist (2006).

Figure 6.3 The causal relationships between ownership, governance and corporate strategy: the case of companies with controlling shareholders



Source: Minichilli (2012, p. 201).

different impact on performance before and during an exogenous shock. While this configuration produces good performance during a crisis – almost the best among the different configurations – it is interesting to note that this configuration had the worst performance before the crisis. Conversely, the advantages of a company having a family CEO with a concentrated ownership in steady-state situations disappear during a crisis – and turn the family CEO/family-concentrated ownership arrangement into one of the worst configurations. Together, this evidence confirms the importance of considering multiple governance levels – especially in family firms – as well as the need to contextualize the conditions for the effectiveness of different governance arrangements.[17]

More recently, Miller et al. (2018) explored the choices made by publicly listed and private family firms in Italy when they were faced with the decision of strategic conformity or distinctiveness in industry financial practices. They found that private family firms are less likely to conform to industry practices than listed family firms, which must face the additional pressure of the market and its expectations. On the contrary, listed family firms, given their often-unconventional governance structure, have to show investors they have a strong adherence to sound business practices. Such issues are of less concern for private family firms, for which idiosyncratic family-based institutional pressures and stakeholders' identity issues are more salient.

[17] Minichilli, A., Brogi, M., & Calabrò, A. (2016), "Weathering the storm: Family ownership, governance, and performance through the financial and economic crisis," *Corporate Governance: An International Review*, 24(6), 552-568.

Furthermore, Miller et al. found that private family firms benefit from both high and low – but not intermediate – levels of conformity. This may be explained by the multidimensional nature of strategic decisions and imply that firms that choose a different strategy must adhere or deviate from accepted norms in a multifaceted way in order to maintain their strategic alignment. Together, this evidence confirms the importance of considering multiple governance levels – especially in family firms – as well as of precisely contextualizing the conditions for effective governance arrangements.[18]

On the other hand, however, it seems that the identity of the controlling shareholder has an effect on strategic decisions and their resulting financial results.[19] For example, an institutional investor (mutual fund, pension fund, or insurance company) will tend to operate with a greater propensity to risk, with strategic choices oriented towards the long term and the creation of value for minority shareholders. Similarly, a bank-controlled company will be more likely to pursue expansionary strategies because it has fewer restrictions on the granting of credit, and thus more cash to invest. Conversely, the circumstance in which the controlling shareholder is another company may represent an element of considerable benefit if the two companies (the parent and the subsidiary) operate in related businesses, which thus favors access to valuable technologies or exploitation of common resources and platforms.

On the other side, a controlling shareholder represented by a family will be more risk-adverse: this may translate into a lower propensity toward acquisitions, but on the other hand, into a greater degree of diversification in the case acquisitions are made.[20] Moreover, Gómez-Mejia et al. (2015) found that the more the family control increases, the less the likelihood of acquisitions – and that when family firms do decide to acquire, they opt for related targets under normal conditions, and unrelated ones in cases of underperformance. Indeed, in normal times the future financial gains brought by a diversified portfolio are trumped by the socio-emotional endowment of the family, while in times of crisis, financial concerns lead to a higher propensity for diversification.[21]

Finally, the ownership of companies by the state or local public administrations is characterized by goals and consequent strategies for reducing prices, increasing employment, and generating positive externalities through the social and technological effects of the company's operations. Considering the propensity of the State to operate in regulated sectors, the lower efficiency that is believed to derive from its pursuit

[18] Miller, D., Amore, M.D., Le Breton-Miller, I., Minichilli, A., & Quarato, F. (2018), "Strategic distinctiveness in family firms: Firm institutional heterogeneity and configurational multidimensionality," *Journal of Family Business Strategy*, 9(1), 16-26.

[19] Thomsen & Pedersen (2000); Pedersen & Thomsen (2003).

[20] Miller, D., Le Breton-Miller I., & Lester, R.H. (2010), "Family ownership and acquisition behavior in publicly traded companies," *Strategic Management Journal*, 31(2), 201-223.

[21] Gomez-Mejia, L.R., Patel, P.C., & Zellweger, T.M. (2018), "In the horns of the dilemma: Socioemotional wealth, financial wealth, and acquisitions in family firms," *Journal of Management*, 44(4), 1369-1397.

of strategies with strong social connotations seems to be counter-balanced by the advantages derived from operating in contexts characterized by the ex ante definition of tariffs – and therefore of the profitability of the enterprise – as well as by concrete protection against excessive competition.

6.3 The role of ownership in strategic choices

The analysis of possible "variants" of the OGS model can be summarized in two interrelated considerations. The first concerns the importance of ownership in the "design" of other variables; the second concerns the need to know how to interpret the fit between the reference context and the existing ownership structure, and then between this and the most likely appropriate strategic choices. The goals of this section are: a) summarize the characteristics of the ownership structures, combining the concentration aspects of the ownership, the owner identity, and the "pressures" to which a controlling shareholder of a company may be subject; b) outline the main types of strategic choices, especially at corporate level, which depend on the characteristics of ownership; and c) identify the possible relationships between the characteristics of the ownership structure and strategic choices.

6.3.1 The ownership structure: Some "dichotomies"

The ownership structures can be "classified" according to some simple dichotomies, many of which were already presented earlier.

Among those most closely related to the concentration of ownership:

- *Companies with controlling shareholders versus public companies.* This is the simplest dichotomy, which takes into account the level of ownership concentration to distinguish between companies with fragmented ownership (public companies), and those with a majority shareholder (e.g., family-controlled firms).
- *Companies with a "strong" controlling shareholder vs. a "weak" controlling shareholder.* An important specification in the previous section is the distinction between a "strong" (or absolute majority) controlling shareholder, and a shareholder with a relative (and "contestable") majority. This issue is quite relevant for listed companies, where situations of relative majority control often occur;
- *A monolithic controlling shareholder (a single individual or entity) vs. a coalition of numerous and unequal shareholders.* A further useful characteristic in defining the degree and "quality" of ownership concentration consists in the distinction between the control exercised (by absolute or relative majority) by a single shareholder, versus a coalition of various shareholders who have varying degrees of power. In this case, the presence of a shareholder coalition, brought together by the simple desire to obtain the benefits of controlling a company, may nevertheless result in a strong divergence of interests, especially when the parties

in the coalition are particularly heterogeneous (banks, insurance companies, industrial companies, technological partners, etc.), with potentially very negative effects on the strategic choices taken in the long term.

Among the dichotomies referring to the owner identity:

- *The controlling private shareholder vs. the public shareholder.* While private controlling shareholders usually have in common the desire to maximize the profitability of the company, the controlling public shareholder will be subject to strong pressure from political parties to define broader strategic objectives.
- *The "purely financial" controlling shareholder vs. the "industrial partner, customer, competitor or supplier."* A second important difference with respect to the identity of the controlling shareholder concerns its nature, i.e., whether it is a "financial" shareholder (an entity which owns the company as part of a portfolio), or a "partner, customer, competitor or supplier" shareholder, whose controlling stake in the company is for "synergistic/organizational" purposes.[22]
- *The controlling shareholder with little knowledge of the business vs. the controlling shareholder with specific skills.* This distinction is particularly relevant in order to understand the type of contribution a controlling shareholder will be able to make to the business, and to understand whether it represents "the best possible owner." On the other hand, knowledge and experience in the business actually create value only when the controlling shareholder wants to, and can, exercise these skills (think of a controlling shareholder with the right knowledge and skills, but without financial resources).
- *The controlling shareholder "with cash to burn" vs. the "leveraged" shareholder.* The availability of resources is a relevant characteristic because it allows one to predict a shareholder's strategic orientation. In particular, while a controlling shareholder with excess cash is considered more willing than others to inject new equity capital and make the necessary investments for growth, a leveraged controlling shareholder will be primarily concerned to generate income for the sole purpose of repaying debt, therefore he will put the needs arising from the company's financial structure (possibly acquired through a leveraged buyout) before those of its sustainable development.

Among the "pressures" to which a controlling shareholder may be subject in defining his or her own strategic orientation there are:

- *Pressure from stakeholders without ownership rights (authorities, workers, local communities, consumer movements, etc.).* Regardless of its characteristics in terms of ownership power (share concentration), its nature, and availability of re-

[22] For a distinction between portfolio logic and synergistic/organizational logic, see, among others, Collis, Montgomery, Invernizzi, & Molteni (2007).

sources and knowledge of the business, a controlling shareholder must also take into account important external "pressures" from other stakeholders that increasingly influence the strategic choices of companies. These include, first of all, the *authorities* in the regulated sectors, and the trade union representatives, as well as the growing importance of social responsibility policies towards consumers, local communities, etc. (corporate social responsibility) in defining the company's strategy.

- *The activism of non-controlling institutional investors.* The degree of autonomy of the controlling shareholder in making its strategic choices may vary a lot depending on the behavior of non-controlling institutional investors: they may exert pressure (voice), or they may simple pursue exit strategies. Although the first type of pressure (voice) may exert more obvious influence, the threat of exit decisions by institutional investors represents a wake-up call that a controlling shareholder must not and cannot undervalue.

6.3.2 The main corporate strategic choices

The analysis of the relationships between ownership, governance, and strategy presented in the previous sections seems to reinforce the idea that knowing the characteristics of ownership represents a precondition for understanding both the configuration of the governance bodies, and the strategic choices that a given ownership structure will be led to make. Before doing so, however, it is useful to recall some examples of corporate strategic choices that can be greatly influenced by the type of ownership structure in place. Among them:

- *International growth and expansion policies.* A first and fundamental strategic choice at the corporate level concerns the willingness of the company to invest in growth strategies. In particular, a company may opt for internal growth policies,[23] i.e., through investments in the core business, or by expanding in "adjacent" businesses.[24] Alternatively, it can opt for external growth policies, i.e., mainly through mergers and acquisitions with other companies operating in similar or even very different sectors. Acquisitions are also often the means by which a company pursues its objectives of international expansion, since they allow it to achieve significant results more quickly, and with greater certainty than if it decided to proceed along internal lines. Clearly, although intuitively acceptable, this is a decision that requires access to substantial financial resources, which depend to a large extent on the nature of the ownership of the company.
- *Decisions to diversify.* This is an array of choices aimed at diversifying the company's activities with respect to the original business, which may or may not be linked to a path of growth. First we will talk about growth through diversification, which is one possible way in which a growth path can be achieved; otherwise, in absence of growth ambitions, the reasons must be sought in the attempt to diversify risk, which is particularly relevant when the owner is a single person (an entrepreneur), or an entrepreneurial family.
- *R&D investment policies.* A third policy option is to invest in research and development (R&D) at the corporate level, in order to have an impact on the different business units (or legal entities) of the group. In this respect, R&D investment choices will be influenced by sectoral dynamics, as well as by the company's potential to use spillover effects in terms of new technologies and skills on a large set of products and services.
- *Entry into groups of companies or merger/integration with the parent company.* A conceptually different set of strategic options at the corporate level involves the possibility of joining a group of other companies that allows continuing to compete on a scale sufficiently large for the characteristics of the industry, but not attainable independently. At the same time, it is important to recall that the merger and consequent integration with the parent company brings substantial advantages in terms of corporate simplification and operational synergies.
- *Strategic alliances.* Any type of strategic alliance, whether equity (joint venture, franchising, shareholding) or non-equity (commercial affiliation, long-term contracts, etc.), aims to allow the company to enjoy the benefits of both internal development and acquisition, without having to bear the difficulties and risks that both present. The main advantages of strategic alliances include access to complementary activities, resources, and skills much more rapidly than by alternative paths; the disadvantages include the difficulty of exercising control over one's counterpart due to information asymmetries; the difficulty of operating with an actual or potential competitor; the limited guarantees that the relationship will last; the difficulty in developing the learning process; and finally, the need to develop refined legal skills to deal with problems of compliance with contracts.[25]
- *Decisions to restructure through divestments, layoffs, and disposals of non-core businesses.* One of the most traumatic policy options is the need for the company to pursue restructuring and recovery paths that re-establish conditions of efficiency and overall financial equilibrium. At the corporate level, these decisions imply the need to divest certain businesses or critical functions such as R&D; to impose layoffs, often agreed upon with trade union representatives and the workers themselves in order to save the company from probable bankruptcy; to dispose of non-core activities; and to carry out related core business refocusing and downsizing policies.
- *Choices involving corporate social responsibility (CSR) and relations with stakeholders without ownership rights.* One specific set of strategic choices at the *corporate* level, which are increasingly crucial for the survival and development of

[23] Collis, Montgomery, Invernizzi, & Molteni (2007).
[24] Zook, C. & Allen, J. (2001), *Profit from the Core*, Boston, Harvard Business School Press.
[25] Collis, Montgomery, Invernizzi, & Molteni (2007).

a company, concerns its social responsibility policies, i.e., the propensity of the company, owners, and top management towards voluntary fulfilment, which goes beyond the legal obligations and legitimate social and environmental expectations of the various stakeholders.

- *Onerous capital increases and dividend policy.* A final set of corporate strategic choices concerns the relationships between the owners and the company. In this respect, it is essential to understand whether and to what extent existing shareholders are willing to provide capital increases, which are often necessary to pursue many of the strategic options listed above. Clearly, this propensity will be influenced by the values and objectives of the current owners, as well as by their overall financial resources. In the context of these choices, it is also important to understand dividend policies, including choices relating to the payout ratio, which are fundamental to understanding the extent and methods of distribution of cash flows to current shareholders.

6.3.3 The possible relationships between ownership structures and strategic choices

From the above considerations, it seems likely that there is an optimal relationship between ownership structure and the strategic choices of companies.

Thus, the goal of this section is to discuss some relationships between the characteristics of ownership (with particular reference to the controlling shareholder), and companies' strategic choices, as briefly described above. Specifically:

- *Private controlling shareholder, strong, monolithic and with "excess cash."* The presence of a single private shareholder, with absolute majority control and substantial financial resources, creates the optimal conditions for courageous and expansive strategic choices. According to the agency theory, the interests of the company will tend to converge with the interests of those who exercise the majority of ownership rights. In this regard, the controlling shareholder with the above characteristics is generally available for additional substantial investments (including, for example, in R&D), even with medium- and long-term returns. Moreover, the presence of a strong private shareholder is certainly a useful, if not indispensable, condition for the company to make bold and even risky strategic moves, including, for example, a change of business model. The need for resources to finance such operations, then, means – at least *pro tempore* – low dividends. A "strong" controlling shareholder with substantial financial resources may be also favorable to capital increases, if they do not excessively weaken his control excessively.
- *A heavily-leveraged controlling shareholder.* A second possibility, conceptually opposite to the previous one, is that of a controlling shareholder who is heavily indebted, very often because of having made his acquisition through leveraged buy-out mechanisms. A controlling shareholder with such characteristics is likely to have a limited portion of the company's equity capital, opening up the additional possibility of "conflicts" at the ownership level (with small minority shareholders, institutional investors, or other entities that overall can get to hold large shares of the capital). Under these circumstances, the controlling shareholder's need to meet his debt payments translates into a set of conservative strategic choices, if not voluntary downsizing, with little investment, a low orientation to growth and risk, and the search for opportunities for "cash generation," especially including disposals as well as divestitures. In addition, it is highly likely that the controlling shareholder will pay high dividends, especially if the debt is held by the holding company in case of pyramidal control, leading to an extraction of private benefits to the detriment of minority shareholders. Similarly, the controlling shareholder will very often be opposed to the injection of new capital into the company, as well as to capital increases that would dilute his control, and make the dividend policy described above more difficult.
- *A strong public controlling shareholder.* A third particularly widespread ownership configuration is that characterized by public control by an entity (the state, a local public administration, etc.), with sufficient financial resources freely available. Although this circumstance does not exist at this particular historical moment, this condition initially led to the presence of the state in the shareholdings of companies. Thus, "in normal times" this specific ownership configuration may be beneficial for the strategy of the company and its stakeholders. This kind of controlling shareholder, in fact, will be able to make large investments, although they tend to be with low risk and with assured returns over the medium and long term. Moreover, public ownership means that these companies are opposed to restructuring plans, which include divestments and cutting redundancies, preferring rather to withstand inefficiencies and negative income results. Similarly, publicly controlled companies will often be led to undertake acquisitions of other companies in financial difficulties, even in unrelated businesses, to order to ensure their survival, and, above all, to preserve their employment.
- *Current (or potential) controlling shareholder, who is also a competitor, customer, or supplier.* A rather singular owner identity, able to drastically influence the strategic choices of a company, is that of a controlling shareholder that at the same time is also a potential competitor, a customer, or a supplier of the company. In all these circumstances, and especially if there are plans to acquire or merge with the parent company, the controlling shareholder will be in favor of streamlining and restructuring operations to create "synergies" between the parent company and the subsidiary, and will also be in favor of demergers and divestments of non-core activities. Different considerations apply when the controlling shareholder is a customer or supplier of the controlling company, but there are no plans for integration between the two. In such cases, especially if the subsidiary is listed on the stock market, the parent company that is a customer or supplier of the subsidiary will tend to behave as a "related party." In this way, the parent company will be required to ask for or grant privileges in business relationships to the detriment of the minority shareholders of the subsidiary, who will be expropriated of the value transferred to the parent company.

- *Purely financial, but active minority shareholders.* There are specific circumstances in which even minority shareholders can exercise considerable influence over strategic choices. This is the case for purely "financial," but especially active shareholders with minority shares in the company (such as private equity funds in a private company, or institutional investors in a listed company). For instance, they may be in favor of rationalization, simplification, restructuring, and the pursuit of efficiency. For these reasons, the presence of financial shareholders in the capital will make diversification operations more complex, because they prefer to hold mono-businesses in their portfolio, with simple and transparent ownership structures.
- *Stakeholders without ownership rights but with great influence.* A last and very special circumstance concerns the influence exercised by a particularly influential stakeholder, such as, for example, an authority in a highly regulated sector. Although this is a circumstance extraneous to our model so far, due to the non-proprietary way such a stakeholder exercises influence and control, this situation exemplifies how some actors can exert, by law, an influence even greater than the usual one exercised by the owners. Operating in a regulated sector, in fact, results in a company having a set of reduced or strongly conditioned strategic options, with possible obligations of separation (*unbundling*) between different products or services offered, and with possible strong limits to its growth in size and the exploitation of economies of scale or scope for antitrust reasons. These circumstances, which in the past were mainly attributable to state-controlled companies, are now increasingly frequent even in private companies, due to the large waves of privatizations in all Western countries over the past two decades. Think of the sectors of telephony, energy, gas supply, and all the so-called *utilities,* among others.

The above considerations represent only some of the possible correlations between ownership configurations and strategic choices; we do not claim to have exhausted the many and complex possible configurations that exist. However, these considerations represent the basis for a more in-depth analysis of certain "categories" of ownership structures, in particular public companies, subsidiaries of multinationals, state-controlled companies and family-owned companies, to which a separate chapter has been dedicated. Moreover, since in this chapter the focus has been mainly on the relationship between ownership and strategy, for the analysis of governance bodies and their configuration see Chapter 3.

6.4 The relevance and the new frontiers of corporate governance

Corporate governance is essential for the success and sustainability of a business over time, and when its mechanisms are ineffective, corporate governance produces corporate failures. In the early years of 21st century, the debate on corporate governance was fueled by the occurrence of corporate scandals that affected some large

companies in various countries. These episodes have contributed to highlighting how the governance system in place was not able to prevent the illegal practices of top managers.

To prevent mistrust on the part of savers, and thus better protect the interests of those who finance companies without being able to influence their decisions, several countries have introduced reforms to strengthen the regulatory system and punish those responsible for corporate crimes. For instance, the U.S. Congress approved the Sarbanes-Oxley Act of 2002 in response to the failures of Enron Corporation, Tyco International plc, and WorldCom, and Italy approved Law 262/2005 containing provisions for the protection of savings and the regulation of financial markets in response to the crash of Parmalat and Cirio.

Despite some benefits produced by these reforms, the corporate governance system failed to prevent the financial crisis, which broke out around the world in 2008. According to some scholars, the reforms had permitted corporations to manipulate share prices, and to abuse corporate accounting principles and practices, as well as to create and take excessive financial and business risks to maximize short-term profits.[26] A great debate ensued on the relationship between corporate governance and the financial crisis. Even though some do not agree that the governance of financial institutions played an important role in the financial crisis,[27] other scholars state that the crisis was closely associated with poor implementation of corporate governance codes and principles (OECD 2009).[28]

Many problems that caused the 2008 financial crisis have not been resolved, such as the culture of short-term profit maximization and excessive bonuses of top managers; the capitalism system itself – typically associated with the Anglo-American corporate governance model – has been called into question. Two famous scholars proposed a new approach to the problem, thinking about how to reinvent capitalism.[29] They had "a big idea" starting from the basic assumption that "a big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation . . . optimizing short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their long-term success." They state that often government and civil society addressed the social issues at the expense of business, while the companies embraced corporate social responsibility (CSR) to increase their legitimacy, remain-

[26] Clarke, B. (2011), "Where was the 'market for corporate control' when we needed it," in W. Sun, J. Stewart, & D. Pollard (eds.), *Corporate Governance and the Global Financial Crisis: International Perspectives*, Cambridge, Cambridge University Press.

[27] Cheffins, B.R. (2009), "Did corporate governance 'fail' during the 2008 stock market meltdown? The case of the S&P 500," *The Business Lawyer*, 65(1), 1-65.

[28] OECD argues that the "major failures among policy makers and corporations appear to be due to lack of implementation" of corporate governance principles (OECD 2009, p. 55), identifying four weak areas that contributed to the financial crisis: executive remuneration, risk management, board practices and the exercise of shareholder rights.

[29] Porter, M.E. & Kramer, M.R. (2011), "Creating Shared Value. How to reinvent capitalism – and unleash a wave of innovation and growth," *Harvard Business Review*, January-February.

ing stuck in the CSR mind-set. The solution that they proposed lies in the concept of "shared value,"[30] which focuses on the connection between societal and economic progress, but differs from CSR.[31]

In short, the core idea is that the entire capitalism system is in a vicious cycle, and the last 10-years' debate on the role of corporate governance in preventing financial crises allows us to state that stricter regulations are needed, especially in the finance industry, but we also need to be aware of the limits of regulations, which are often reactive rather than proactive. Hence, to prevent new financial crises in the future, the big issue for corporate governance scholars is to find the right balance between economic and social goals, and individual and community goals. Thus, the big challenge for corporate governance is how to balance and align the different interests of individuals, companies, and society; and the "shared value" approach can have a big role in this. The challenges of corporate governance are going through a sort of "investor revolution," which means more activism and engagement in company activities, and more sustainable investing, which needs increasingly to engage corporate executives on environmental, social and governance (ESG) issues.

6.4.1 Environmental, social, and governance (ESG) investing

Environmental, social, and governance (ESG) criteria refer to the three central factors used in measuring the sustainability and social impact of an investment in a company, and they are used by responsible investors to screen potential investments. Thus, we can define "ESG investing" as an investment decision-making process according to which environmental, social, and governance factors are taken into consideration alongside financial factors. Thus, ESG investing is often considered synonymous with sustainable or responsible investing.

The concept was used for the first time in 2005 in the publication of the United Nations (UN) study entitled "Who Cares Wins." The report followed the initiative launched in January 2004 by the former UN Secretary General Kofi Annan, who invited more than 50 CEOs of major financial institutions to discuss the goal of integrating ESG into the capital markets. It was the backbone of the launch of the "Principles for Responsible Investment" (PRI) initiative at the New York Stock Exchange in 2006.[32] Over the following years, investors have become increasingly interested in

[30] According to Porter & Kramer (2011), *shared value* can be defined as "policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the community in which they operate."

[31] While CSR focuses mostly on a matter of reputation, creating shared value (CSV) is strictly related to the competitive position of the company, leveraging the resources and competences of the company to create economic value by creating social value (Porter & Kramer 2011).

[32] What are the "Principles for Responsible Investment"? The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social, and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General. The six principals for Responsible Investment are the following ones.

- We will incorporate ESG issues into investment analysis and decision-making processes.
- We will be active owners and incorporate ESG issues into our ownership policies and practices.
- We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- We will promote acceptance and implementation of the Principles within the investment industry.
- We will work together to enhance our effectiveness in implementing the Principles.
- We will each report on our activities and progress towards implementing the Principles.

ESG issues. According to the report of US SIF Foundation,[33] in 2018 investors held $11.6 trillion in assets chosen according to ESG criteria, a 44% increase over the $8.1 trillion just two years earlier.

Most large investment firms are trying to integrate sustainability issues into their investment criteria, which can be synthesized in the following way:

- *Environmental criteria* consider how a company performs as a steward of nature. Environmental criteria may include a company's energy use, waste, pollution, natural resource conservation, and treatment of animals. The criteria can also be used in evaluating any environmental risks a company might face and how the company is managing those risks.
- *Social criteria* examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. For instance, does the company donate a percentage of its profits to the local community, or encourage employees to perform volunteer work there? Do the company's working conditions show a high regard for its employees' health and safety?
- *Governance criteria* deal with a company's leadership, executive pay, audits, internal controls, and shareholder rights. Indeed, investors may want to know whether a company uses accurate and transparent accounting methods. They may also want assurances that companies avoid conflicts of interest in their choice of board members, do not use political contributions to obtain unduly favorable treatment, and, of course, do not engage in illegal practices.

According to Eccles and Klimenko (2019), several factors have increased the interest of investors and portfolio managers in ESG issues:[34] 1) the size of investment firms: large investment firms are so big that modern portfolio algorithms are not able to reduce system-level risk; 2) financial returns: companies with better ESG records are likely to perform better than their competitors; 3) growing demand: pension funds are increasingly demanding sustainable investing strategies, and also high-net-worth individuals are focusing more and more on nonfinancial outcomes; 4) an evolving view of fiduciary duty: investors do not consider ESG factors that can affect financial returns as a failure of fiduciary duty; 5) trickle-down within investment firms: the ESG analysis is integrated into the fundamental financial activities carried out

[33] *Report on US Sustainable, Responsible and Impact Investing Trends 2018*, US SIF Foundation (https://www.ussif.org/files/Trends/Trends%202018%20executive%20summa ry%20FINAL.pdf).

[34] Eccles, R.G. & Klimenko, S. (2019), "The investor revolution," *Harvard Business Review*, May-June.

by analysts and portfolio managers (while in the past the ESG group was separate from portfolio managers and sector analysts); and 6) more ESG activism by investors: shareholder activism is on the rise in financial markets and ESG is increasingly becoming a focus of these interventions.

Moreover, there are regulatory requirements for reporting on ESG information. One example is the recent introduction of the European Directive on Mandatory Non-financial Reporting, which requires large companies to publish non-financial information. The European Union is strongly supporting the transition to a low-carbon, more resource-efficient, and sustainable economy; and in 2018, the European Commission adopted a package of measures implementing several key actions, in its action plan on sustainable finance.[35]

These measures aim to increase transparency, and also to create a common approach to ESG investment. Indeed, some frictions are still limiting the effective extent of the ESG investing approach. First, companies should develop better systems to measure, gather, and analyze data regarding ESG performance. Then it is necessary to establish communication standards in order to make data comparable for investing purposes. To achieve these results, companies may proceed in two directions: from the internal point of view, searching for greater management involvement, while from the external point of view, improving the shareholders' engagement. Also, company reports may play a role in efficaciously encouraging investors to change their focus from short-term financial results to long-term value creation,[36] and Directive 2014/95/EU is the first step in this direction. It requires large companies[37] to disclose information on the way they operate and manage social and environmental challenges, in their annual reports from 2018 onwards.[38]

[35] The package includes:

- A proposal for a regulation on the establishment of a framework to facilitate sustainable investment. This regulation establishes the conditions and the framework to gradually create a unified classification system ('taxonomy') on what can be considered an environmentally sustainable economic activity.
- A proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341. This regulation will introduce disclosure obligations on how institutional investors and asset managers integrate environmental, social and governance (ESG) factors in their risk processes.
- A proposal for a regulation amending the benchmark regulation. The proposed amendment will create a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks, which will provide investors with better information on the carbon footprint of their investments.

[36] In this regard, the London Stock Exchange published in 2007 the first guide to ESG reporting (https://www.lseg.com/sites/default/files/content/images/Green_Finance/ ESG/2018/February/LSEG_ESG_report_January_2018.pdf)

[37] The non-financial reporting requirement applies only to large public-interest companies with more than 500 employees. This covers approximately 6,000 large companies and groups across the EU, including listed companies, banks, insurance companies, and other companies designated by national authorities as public-interest entities.

[38] Under Directive 2014/95/EU, large companies have to publish reports on the policies they implement in relation to: 1) environmental protection; 2) social responsibility and treatment of employees; 3) respect for human rights; 4) anti-corruption and bribery; and 5) diversity on company boards (in terms of age, gender, educational and professional background).

[39] *Shareholder Activism Insight Report 2018* (www.activistinsight.com)

[40] "Shareholder Activism Is on the Rise: Caution Required (2018)," *Forbes*, December 10.

6.4.2 Investors' activism and shareholders' engagement

Shareholder activists are shareholders who acquire minority stakes in a publicly traded company in order to put public pressure on its management, and to influence board decisions. The goals of activist shareholders can be either financial – especially in the case where management is considered to be doing poorly – or non-financial, for example, to ensure workers' rights and environmental protection. The term "activist shareholder" covers a broad range of strategies, ranging from hostile battles to cooperative discussions with the company's board of directors. The methods of activist shareholders may range from dialogue with managers, to formal proposals, or even more aggressive tactics to force changes, like the use of social media, threatening companies with lawsuits, or involving other activists.

For this reason, most CEOs are afraid of activist shareholders, but some CEOs appreciate their actions because they are useful for inspiring change, like spin-offs, replacing board members, increasing dividends, promoting share buybacks, or even pushing sale of the company. Companies are forced to explain their reasons and strategy, even when they refuse to follow the activist shareholders' advice. The origins of the shareholder activist can be traced to the late 1920s, when Benjamin Graham – who has come down in history as the father of value investing – discovered that a company in which he owned a small stake had a huge amount of cash invested in securities. Graham began a campaign demanding that the company sell the securities and give back money to shareholders, thus launching the era of activist investing.

In later decades, especially from 1980 onwards, activism became more hostile, as investors such as Carl Icahn and Nelson Peltz (see below for more details) tried to carry out takeovers and buyouts; the press also had a role in pushing their activism. By the 1990s, even managers of pension funds such as CalPERS were engaging in campaigns, and today hedge funds and asset management companies are the face of activist investing. We are talking about really big players, including Blackrock (with more than $6 trillion in assets under management), the Vanguard Group (with $5.3 trillion AUM), and certain institutional funds which have started public campaigns to leverage their influence on firms, and pressure management for change.

According to a 2018 report by Activist Insight,[39] the number of companies around the globe receiving governance-related proposals from activists has steadily increased, with the increase averaging about 11% over the last four years, and with campaigns targeting 805 companies worldwide in 2017. The expansion is also geographical; today approximately 20% of all activist shareholder funds are located outside Anglophone countries.[40]

Historically, large institutional investors pursued financial-only strategies with a low profile in governance, but today a new generation of activist shareholders is on the rise. They are starting to exert their voice in corporate boardrooms, and recently have succeeded in several battles. For instance, the Elliott Management Fund run by billionaire Paul Singer, one of the world's biggest activist investors with around $35 billion in assets under management, has launched a number of campaigns in Europe in recent months. In 2018, together with the Swedish fund Cevian, it carried out a campaign to break up ThyssenKrupp, culminating in the resignation of both its chairman and chief executive officer. The German group was forced to split into two independently traded public companies (the industrial goods business was separated from the steel and marine ones, creating ThyssenKrupp Industrials and ThyssenKrupp Materials). Moreover, with a 4% stake in Ebay, the Elliott fund won a battle in early March 2019 to force it to undertake a strategic review of its portfolio of assets, and appoint two new directors. It is currently engaged in a dispute with the French media group Vivendi over control of Telecom Italia (the biggest Italian telecommunication company), having won the battle for board representation in the shareholders' meeting of May 2018 (see the Case study at the end of this chapter for more details). Thus, companies around the world are being forced to be prepared to face activist shareholders, and new factors – such as the increasing emphasis on environmental, social, and governance (ESG) issues, discussed in the previous section – are more likely to shape the demands of activist shareholders in the coming years.

Three examples of investor activism:

- DuPont is an American conglomerate, operating primarily in the chemical sector (being the 4th largest chemical company by market capitalization in 2014),[41] which invented some of the world's most important consumer and industrial products, such as the polymers neoprene, nylon, Teflon, Kevlar, products for the refrigerant industry, and synthetic pigments and paints. In August 2013, Trian Fund Management, an activist hedge fund run by Nelson Peltz, saw an opportunity to enhance DuPont's operating performance and long-term shareholder value, so it acquired a significant stake in the company (about 2.7%). The main strategies of the fund involved the spin-off of the businesses with the highest growth rates (nutrition, health, agriculture, and industrial biosciences) from the ones with higher cash flows, but more volatility. Therefore, the fund's strategy was contrary to DuPont's plan to spin off the performance chemicals business only.[42]
- In spring 2015, Peltz launched a proxy fight to get a seat in DuPont's board of directors, in order to make the changes he believed necessary. Even though both the principal proxy advisers recommended a positive vote, company CEO Ellen Kullman was opposed to the fund's plan, and offered Trian Fund Management one seat on the board in order to resolve the proxy fight – so long as Peltz was not be the nominee. Kullman claimed that sharing research functions across the divisions of DuPont was beneficial for the company, and DuPont reelected the same board of directors, and continued to pursue its own strategy.
- PayPal and eBay were born separately – eBay in 1995 and PayPal in 1999 – but over the years their connection has intensified: most auctions on eBay offer PayPal as a payment method, and about 25% of their transactions were effectively settled with PayPal. In 2002, few months after the tech bubble, and shortly after PayPal's IPO, eBay announced the $1.5 billion acquisition of the company. PayPal grew during the following years; in 2015, PayPal revenues exceeded eBay's sales ($2.11 bn vs. $2.07 bn). The different perspectives and dynamics of the two businesses interested Carl Icahn, who decided to buy a 2% stake in eBay in 2014. He argued that a fast-growing payments company, facing many new competitors, needed a separate management team. Even though eBay decided at first to keep the companies together, in 2015 it reversed course, and agreed to a spin-off, creating two more flexible and focused entities. PayPal followed much of Icahn's guidance, included the election of a director he nominated, and the spin-off was completed in 2017.[43]
- PepsiCo is a well-known American multinational company in the fields of food and beverages. Apart from Pepsi, its largest brands include Mountain Dew, Gatorade, Lay's, and Doritos. In 2013, PepsiCo shareholder Trian Fund Management owned a 1% stake,[44] and publicly demanded a separation of the company's beverage and food businesses. The rationale was that the snacks business was much more profitable, and a separation could lead to significant cost-cutting and a better competitive position for the two distinct units. PepsiCo decided not to follow Trian's recommendations, and achieved cost cutbacks and distribution improvements through different measures. Shareholders benefited from the new policies, because they received more cash in the following years through dividends and share buybacks.[45] Despite the fact that the activist shareholder's goal was not achieved, his pressure toward improvements in the company's cost structure led to significant results in terms of stakeholders' value.

6.5 Some final implications and suggestions

Our analysis has aimed to show the "state of the art" around the debate on the various variables that characterize the corporate governance structure of companies, by examining the role of both ownership and the board of directors in different contexts. At the same time, we have highlighted some "limitations" to the traditional approach to the issue, including:

[41] *CIS Chemical Business Magazine*, 36, September 8-14, 2014.

[42] "DuPont wins board proxy fight against activist investor Peltz (2015)," *Reuters*, May 13.

[43] "Ebay announces date of PayPal spinoff (2015)," Fortune, June 26.

[44] Picker, L. (2016), "Billionaire Investor Nelson Peltz sells stake in PepsiCo," *The New York Times*, May 13.

[45] www.fortune.com, February 11, 2016.

- the tendency to "surrender" to the passive role of ownership in contexts where it is particularly fragmented, and therefore unable or unwilling to affect business decisions (as in the case of the large corporations of the Anglo-Saxon world);
- the tendency of (listed) companies to apply the rules of the Governance Codes in an "adaptive" sense, favoring an attitude of compliance instead of searching for quality governance;
- partly as an indirect consequence of the previous points, a tendency to consider corporate governance as an issue relevant only for listed companies.

These three limitations may have the effect of damaging the quality of strategic decisions, which would be taken without benefiting from the correct dialectic that should always exist between ownership, governance bodies, and the top executives of the company. In other words, the real risks are:

1. in fragmented ownership contexts, a dominant influence by the board of directors on the main corporate strategic choices, if not a real "excessive power"; and
2. in concentrated ownership contexts, a dominant influence by the owners on business strategies, often with a limited or only "formal" role for the governance and executive bodies.

In order to prevent this from happening, and to follow the guiding principle of corporate governance (the checks-and-balances principle already discussed in Chapter 3), all the players involved (ownership, governance and management of the company) must always and systematically make their contributions to every choice relevant to the company. This can be achieved in the following ways: first, by strengthening the role of ownership where it is very fragmented; and in the opposite situation, strengthening the role of the board where the owners dominate it.

6.5.1 Strengthening the role of ownership (where it is weak)

As we have stated throughout, the fragmented ownership of large corporations in the Anglo-Saxon capitalism model has traditionally favored a "passive" attitude by investors, who are motivated essentially by financial objectives, and a short-term view of their investment. However, factors such as the evolution of the debate on corporate governance, the overall increase of shares in the hands of professional investors, and the benefits of a strong ownership (such as, for example, the family one) especially during financial crises, have shifted the attitude of corporate owners from being typically passive (exit), to being progressively more "active" (the so-called shareholder activism) and in dialogue with the management (voice). This new attitude forces institutional investors to orient their behavior more and more toward strategic decisions which effectively create value for the shareholders.

Some recent cases well represent this trend. A first example is the spin-off of PayPal from eBay, strongly suggested by Carl Icahn, owner of the Icahn Enterprises fund,

immediately after taking a stake of 2% in eBay in 2014. Although this proposal was initially opposed by eBay's management and board, due to the significant synergies achieved in the past between the two businesses, in September 2014 eBay CEO John Donahoe himself changed his position and accepted Icahn's arguments about the online payments business having better prospects than the traditional one of web auctions. Not only that: in January 2015 eBay decided to appoint an Icahn representative to the board, and to accommodate many of the other strategic ideas that Icahn had provided to the management after becoming a shareholder. A second case is that of PepsiCo, which since 2013 has been subject to persistent pressure from Nelson Peltz, an "activist" of the Trian Partners fund, who argued for the need to separate the soft drink business from the snack business. Although the proposal was ultimately rejected by the board of PepsiCo, the initiative was the stimulus for the launch of an important cost-cutting plan that the company and its shareholders are still benefiting from.

6.5.2 Strengthening the role of governance bodies (when the ownership is strong)

Our evolutionary analysis of the composition, structure, and functioning of the board of directors has shown a substantial homogeneity in the behavior of listed companies with respect to the "measurable" indicators of quality in corporate governance. In some countries, this appears to be motivated by the strong concentration of ownership, which makes the governance bodies structurally weaker than the family owners and shareholders, who often have a strong tradition and expertise in the business(s) of the company. For this reason, it seems necessary to go "beyond compliance," i.e., beyond formal requests for compliance with the Governance Code, which does not measure the actual "quality" and "effectiveness" of the boards. To do this, a greater awareness of the importance of strong and competent governance bodies is required. Moreover, the owners of companies should also pay more attention toward assuring a high quality of the boards of their companies. This could be done, for example, through:

a) a real boost toward the independence and competence of the board of directors, favoring directors with (personal) independence of judgment – and who are put in a position to exercise it – as well as directors with skills that are consistent with the strategic needs of the company;
b) the search to ensure quality information and debate on the BoD, so that advisers – especially independent advisers – can fully contribute to major strategic decisions (and not just formally ratify decisions taken elsewhere);
c) continuous training of directors, especially in the case of new appointments (with appropriate induction activities, especially about the industry), as well as through a number of ad hoc (at least once a year) and extensive (one or two days) meetings of the board of directors, to be held outside the company with the aim of discussing and sharing a common vision on long-term strategies.

6.5.3 Beyond compliance: The importance of governance in private companies

Although the issue of corporate governance was born in the context of listed companies with fragmented shareholding, the considerations above explain why this can and should be of growing interest for unlisted ("private") companies. Nowadays there seems to be a greater awareness among entrepreneurs that the ability to move effectively in ever-changing markets will depend more and more on the quality of governance. Clearly, strong resistance is perfectly understandable, due to the higher costs of a good system of governance and the complex process of transition from a "family" to a "professional" model of governance. In this regard, and in order to facilitate and support this cultural transition, there is a growing diffusion of Governance Codes for unlisted companies, very similar to those now very well known for listed companies. Among these, the first voluntary code was the Buysse Code in Belgium (first edition in 2005, now in its third edition in 2016), which includes recommendations for private companies not only in terms of the board of directors, but also on the quality of entrepreneurial action, corporate social responsibility, and specific provisions for family-owned companies.

Based on the experience of other European countries, and in light of clear scientific evidence from the AUB Observatory on Italian family firms, the first Code of Corporate Governance, called "Principles for Unlisted Family-Controlled Companies,"[46] was published in Italy in 2017. This Code aims to go beyond previous family governance models, in order to enhance efficient and effective mechanisms, and proposes 13 principles that can be applied to all unlisted family companies with revenues higher than €10 million, plus 6 other principles for larger and more complex family companies.

[46] Marchetti, P., Corbetta, G., Minichilli, A., & Passador, M.L. (2017), *Corporate Governance Principles for Unlisted Family-Controlled Companies. Code of Corporate Governance*, available at SSRN: https://ssrn.com/abstract=3045884 or http://dx.doi.org/10.2139/ssrn.3045884.

Case study **TIM. Ownership, governance and strategy**

by A. Minichilli & F. Quarato,[47] May 2019

The setting

On March 29, 2019, there is a Telecom Italia (now TIM) General Shareholders' Meeting. The meeting has been called by Vivendi – the French controlling shareholder of the company – to vote for the dismissal of five TIM directors (including the Chairman) who had been nominated by Elliott, the activist investment fund that since 2018 is campaigning for profound changes within the company.

The French group is indeed concerned about the bad performance of TIM since Elliott took control of the board of directors in May 2018: Telecom's stock market has lost about 41% in one year. The current market value is around € 0.50 per share, significantly lower than the € 0.85 of May 2018.[48] Vivendi's concern is tangible, since it paid nearly € 4 billion in 2015 to become the top shareholder of TIM with 23.9% of voting rights, and it now sees more than 50% of its investment going up in smoke. Indeed, the value of Telecom Italia is now at its lowest in the last five years – while in its pitch for the activist campaign, Elliott had promised to double the stock price in two years.

The fight between Vivendi and Elliott, however, is not new. In September 2017, for instance, Vivendi appointed Mr. Amos Genish as CEO of TIM, who was fired in November 2018, after only one year. By contrast, the new CEO (Mr. Luigi Gubitosi), nominated on November 18, has been elected primarily with Elliott's votes, without the support of Vivendi. After this episode, relations between Vivendi and Elliott have become more and more troubled. This fight should have ended at the March 29, 2019 Shareholders' Meeting, where the vote to dismiss Elliott directors was expected. Surprisingly, Vivendi and Elliott found a temporary agreement to continue with the current governance and the current CEO.

The situation is even more complicated by the presence of other relevant actors, namely, the Italian Government. Among shareholders of TIM there is indeed the "Cassa Depositi e Prestiti" (CDP, a public sector financial institution, controlled by the Italian Ministry of Economy and Finance), that in May 2018 put almost €600 million on the table to hold 5% of TIM, and supports Elliott's campaign. Despite CDP was losing more than a third of its investment, the new "Tononi-Palermo course" (appointed as Chairman and CEO at CDP in July 2018) decided to increase CDP's stake in TIM to 8.7%, in order to push for a merger with Open Fiber (a company which provides an ultra-broadband optical fiber network across Italy, and whose shareholdings are equally split between Enel, a state-owned company, and CDP). The future of the network is probably one of the most important strategic issues for TIM, and many opinion-makers are wondering whether the current governance will be able to identify and carry on a coherent strategy not only with respect to the network, but in general with respect to all the strategic issues that over these years have been raised by all the various players.

Vivendi wanted – at least initially – to create a European media champion, competing with Netflix and other Over-The-Top (OTT) players; Elliott wanted to separate the company's assets (network,

[47] © Bocconi University. This case has been prepared for educational purposes only. It is not written to present good or bad management practices. It has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of TIM or any of its employees.

[48] In May 2018 Elliott – the largest activist fund in the world – started its campaign with a complete shake-up of the board of TIM. With less than 10% of shares, Elliott was able to appoint 10 (out of 15) independent Directors (while the other 5 board members were appointed by Vivendi). It was one of the largest campaigns, and for sure the most visible, in the history of Italian market.

Brazilian activities, etc.) to create value; the Italian government wanted to support the development of national strategic infrastructure in a sector of primary interest for the country.
The question naturally arises: what will be the future of TIM? What about the stability and the cohesion of the shareholding structure? What about minority investors? Will the current CEO be able to find a strategy that make all the actors happy? Despite all the compromises, profound differences seem to remain between the French group, Elliott and the international investors, and CDP, over the strategic outlook for TIM.

Background information

What happened on September 19, 2014 and after, in the ownership structure
On September 19, 2014, the French media group Vivendi finalized an agreement to sell its Brazilian broadband business GVT to Spain's Telefónica for cash and shares worth around €7.2 billion. The deal was subject to regulatory approval in Brazil and was completed at the end of July 2015. Telefónica planned to fold GVT into its Vivo-branded Brazilian mobile phone business to create the country's biggest telecom group, Telefónica Brasil. Under the deal, Vivendi got not only a 7.4% stake in Telefónica Brasil and €4.66 billion in cash, but also opted to take its remaining stake in Telecom Italia (8.3% of Telecom Italia's voting share capital, or 5.7% of its total share capital), off Telefónica's hands. In this way, Vivendi, headed by Chairman Vincent Bolloré, became the largest shareholder in Telecom Italia (TI).
For Vivendi, the GVT sale was the latest move after a tumultuous two-year overhaul during which it has sold three telecom businesses and its video games arm, in order to reduce its debt and focus more on media and content, as part of a strategy championed by Bolloré. Part of Vivendi's hunt for content will center on Italy, given its new stake in Telecom Italia following the GVT deal.
From the initial stake of 8.3% acquired in July 2015, Vivendi has more than tripled its holding in less than a year. Between the end of 2015 and the beginning of 2016, the French media conglomerate has increased its stake in Telecom Italia to 24.9%. The French company's holding is now just under the 25% threshold that triggers a mandatory takeover offer under Italian market rules.
At the end of 2015, the French media company Vivendi won a battle to gain greater influence, securing board representation on Telecom Italia and stopping the conversion of savings shares, proposed by Telecom Italia's former management that would have diluted its stake in TI. In particular, almost 53% of Telecom Italia shareholders approved Vivendi's request to increase the number of the company's board members from 13 to 17, and to appoint four directors representing the French company. The other 13 board members had been designated by the previous main shareholder of Telecom Italia, Telco S.p.A., and by institutional investors, during the previous Shareholders' Meeting of April 16, 2014.

What happened in March 2016

At the beginning of March 2016, Telecom Italia announced that negotiations were underway on an agreement for CEO Marco Patuano to leave the company. According to media reports, Mr. Patuano clashed with Telecom's new shareholder Vivendi on strategy, including over whether to sell the company's unit in Brazil. On March 21, 2016, Telecom Italia's Chief Executive Marco Patuano resigned. The Chairman, Giuseppe Recchi, assumed Patuano's duties until March 30, when Flavio Cattaneo – already a Telecom Italia board member – was appointed as the new CEO of Telecom Italia.

April 2016: What has (not) happened from the strategic point of view

Analysts have suggested for several months that a partnership between Vivendi, which owns French pay-TV operator Canal Plus, and Mediaset, which owns pay-TV Mediaset Premium, could

make sense. Indeed, Vivendi and Mediaset signed an agreement on April 8, 2016, formalizing a strategic alliance between the two European groups.
Mediaset Premium has been assessed at around €800 million, including its 11% stake in Telefonica. At the end of the transaction. Vivendi was to have completely acquired Mediaset Premium (raising its stake up to 100%). The agreement aimed at combining the two national leaders to pursue development opportunities within the new scenario of the media industry, with a plan to create a potentially pan-European content platform large enough to compete with Murdoch's pan-European paybox Sky, and with Netflix in Southern Europe.
Despite its "binding agreement" to take full control of Mediaset Premium, after a few months Vivendi disclaimed this agreement. Indeed, the Vivendi CEO expressed his concerns over Mediaset's pay TV growth projections, both its subscriber numbers and its forecasts for average revenue per user. He said: "If you tell me that you are selling me a Ferrari but it turns out to be a Fiat Punto, there is a problem." Consequently, Vivendi asked to change some aspects of the deal, leading to the collapse of the agreement and a lawsuit launched by Mediaset against the French media company.

Summer 2016: The dispute with Mediaset

On July 26, 2016, Vivendi made a new offer in light of what it described as "significant differences in the analysis of the results" on the pay-TV business. Vivendi said that it no longer wanted the whole pay-TV unit but only a 20% stake, showing its interest in purchasing 15% of Mediaset via a convertible bond loan over three years. The battle between the two companies has escalated since last December 2016, when Vivendi scaled up its stake in Mediaset to 20% in a series of hostile stock purchases. The Paris-based company said that Vivendi's stake in Mediaset "is in line with the group's intention to develop its activities in southern Europe and its strategic ambitions as a major international, European-based media and content group." At the beginning of 2017, after months of public fighting, Vivendi boosted its Mediaset holding to 28.8% of shares and 29.9% of votes, just below the 30% vote threshold that would trigger a mandatory tender offer under Italian law. This move made Vivendi the second biggest shareholder in Mediaset after the Berlusconi family. Mediaset said that Vivendi's move confirmed its intention to shift from a friendly agreement to a hostile takeover. As a reaction, the Berlusconi family raised its share of Mediaset to close to 40%, and asked Italian market regulator Consob to intervene in the dispute.

April 2017: The AgCom verdict

On April 18, 2017, the AgCom (Italian telecommunication authority) ruled on the legality of Vivendi's equity position in both Telecom Italia and Mediaset. The Authority established that Vivendi has a dominant influence over Telecom Italia, which in turn has a share of over 40% in the communications sector. Indeed, in accordance with the Gasparri law, a player with a market share of more than 40% cannot have revenues of more than 10% of the entire communications system (or SIC, the Integrated Communications System). Therefore, TIM cannot have a link (via Vivendi) with Mediaset, which has 13% of SIC. Therefore, Vivendi should reduce its stake in Mediaset below 10% by April 18, 2018. One option proposed by Vivendi was the establishment of a trust to which it would assign the portion of its shares of Mediaset exceeding 10%. At this point, its voting rights are frozen.

May 2017: Vivendi gains the majority in TIM

On May 4, 2017, for the first time, the board of directors has been appointed by Vivendi (the outgoing board was appointed in 2014 by Telco – the former controlling shareholder of Telecom – with some slight changes at the end of 2015). To this end, Vivendi (the major shareholder, with 23.94% of the voting capital) has filed a slate (i.e., a list of candidates for board of directors' positions) of 10 candidates, while a group of asset management companies and international investors has filed

another slate of five candidates. Flavio Cattaneo, who was confirmed as CEO of TIM, resigned a few months later, and the board of directors of TIM proceeded to co-opt Amos Genish as new CEO on September 28, 2017.

Beginning of 2018: Elliott enters TIM

At the beginning of 2018, Elliott Advisors announced that it had taken a stake in TIM, and called for six board members to be replaced in a bid to improve TIM's strategy, value, and governance. In reaction, eight directors of TIM announced their resignations on March 22, 2018. The resignation of the majority of the board, including TIM Chairman and Vivendi CEO Arnaud de Puyfontaine, automatically meant that the entire board must be re-elected. A shareholders' meeting was called for May 4, 2018 to elect the new board. Arnaud de Puyfontaine, Chairman of TIM, said the May 4th meeting "will allow TIM shareholders to decide quickly on a new full board (...) rather than voting on piecemeal changes to the board as called for by Elliott."

April 2018: Elliott challenges Vivendi as most influential shareholder

On April 5, 2018, Vivendi presented a new slate of 10 candidates in view of the election of a new board, in which it proposed three new board members (Michele Valensise, Giuseppina Capaldo, and Stephane Roussel), to replace Giuseppe Recchi, Hervè Philippe, and Felicite Herzog. On April 9, 2018, in anticipation of the shareholders' meeting, the Elliott fund announced that it had increased its stake in TIM to 9% of shares, compared to the 5.75% so far declared. Moreover, through purchase and sale options equal to 4.93%, Elliott could raise its potential share holdings to 13.73%. The day afterward, Elliott presented another slate of 10 candidates for the TIM board.
The May 4, 2018 shareholders' meeting of TIM, recorded the participation of 67.15% of the company's ordinary share capital, in appointing the new board of directors (see **Table 6.1**). The winning list of candidates was that of Elliott (with 49.84% of votes). Thus, ten independent directors were elected. The other five directors came from the list submitted by Vivendi (which obtained 47.18% of votes). During a long line of interventions during the TIM Shareholders' Meeting, even the small shareholders of Telecom Italia took the floor during the meeting, most in favor of Elliott.
They expressed themselves in favor of Amos Genish for CEO "as a guarantee of continuity" and for his high skills. The major shareholders, Vivendi and Elliott, did not speak at the meeting. Even the CDP did not participate in the debate during the assembly, leaving disappointed those who expected to officially discover the intentions of the CDP and the reasons for its investment.

The new incoming CEO and the shareholders' meeting of March 29, 2019

On November 13, 2018, the TIM Board of Directors revoked all powers conferred to the CEO Amos Genish, effective immediately. On November 13, Luigi Gubitosi was elected as new CEO of TIM, with the vote of nine directors out of 15. All Vivendi directors voted against him. After this episode, relations between Vivendi and Elliott became more and more troubled, as the French conglomerate accused the American fund of pursuing financial and non-strategic purposes, with the aim of achieving short-term high returns. On March 29, 2019, the General Shareholders' Meeting took place. Vivendi was seeking to replace TIM Chairman Fulvio Conti and four other Elliott-appointed directors, citing their "substantial lack of independence."
Then, surprisingly, Vivendi offered to withdraw its motion for board member replacements. "We have decided not to pursue today our proposal to revoke and replace five board members," said Caroline Le Masne De Chermont, Vivendi's head of legal affairs.
The request to withdraw its proposal won support from 95% of shareholders, and Vivendi declared that, more than any other shareholder, it was interested in re-establishing a joint and balanced governance, supportive of management in defining and implementing the best strategies in order to create value for all the shareholders, the company, and the employees.

Table 6.1 The composition of the board of directors in charge since May 4, 2018

Name	Personal and professional profile
Fulvio Conti, Non-executive Chairman (Elliott)	Born in Rome on October 28, 1947. A graduate of La Sapienza University of Rome with a degree in Economics, he is currently sole Director of FAS Partners S.r.l., a financial strategic investor and advisor. He is a promoter and board director of the Fondo Efficienza Energetica SGR S.p.A., and serves as Chairman of SGI (Società Gasdotti Italiani). He has been Chairman of Innova Italy.1, a SPAC-listed company until its merger with Fine Foods & Pharmaceuticals N.T.M, where he is now member of the Board of Directors. He sits on the boards of directors of the Italian Technology Institute, AON Plc UK and USA, Unidad Editorial Spain, and RBC PJSC Russia. In 2007, he was awarded with the Doctor Honoris Causa degree in Electrical Engineering, from Genoa University. In 2009 he was appointed "Cavaliere del Lavoro" of the Italian Republic and "Officier de la Légion d'Honneur" of the French Republic.
Luigi Gubitosi, CEO and General Manager of Telecom Italia (Elliott)	Born in Naples on May 22, 1961, Luigi Gubitosi studied at the London School of Economics and obtained a Law degree at Naples University and a Master in Business Administration at I.N.S.E.A.D. Fontainbleau (France). He has been Vice Chairman of Confindustria Servizi Innovativi e Tecnologici (CSIT) and of Asstel, and a member of the Tax and Corporate Governance Committee of Confindustria. He has been member of the Organizing Committee for the Turin 2006 Chess Olympiade and member of the Board of Directors of Cometa (Pension Fund of metal workers), F2i Sgr e Maire Tecnimont. From November 2011 to July 2012, he was Country Manager and Head of Corporate and Investment Banking of Bank of America Merrill Lynch Italy. From July 2012 to August 2015, he has been General Manager of RAI. He has been Chairman of the European Advocacy Committee of the CFA Institute and Independent Director of TIM S.p.A. from May to November 2018. In November 2018 he has been appointed Chief Executive Officer and General Manager of Telecom Italia.
Alfredo Altavilla, Independent Director (Elliott)	Born in Taranto, Italy. He holds a degree in Economics from Università Cattolica, Milan where he began his career as an assistant. He was Chief Operating Officer Europe, Africa and Middle East (EMEA) from November 12, 2012 to August 2018. He has also been a member of the Group Executive Council (GEC) and Head of Business Development since 2011. In 1990, he joined Fiat Auto. In 1995, he was appointed head of Fiat Auto's Beijing office and in 1999 head of Asian Operations. He has been involved in Business Development since 2001, becoming responsible for coordination of the alliance with General Motors in 2002 and, in 2004, being assigned responsibility for management of all alliances. In September 2004, Mr. Altavilla was appointed Chairman of FGP (Fiat/GM Powertrain JV) and Senior Vice President of Business Development of Fiat Auto. In July 2005, he became CEO of Türk Otomobil Fabrikasil A.S. (TOFAS) – a 50-50 joint venture between Fiat Auto and Koç Holding listed on the Istanbul stock exchange – while retaining his role as head of Business Development. In November 2006, he was named Chief Executive Officer of FPT – Fiat Powertrain Technologies. In July 2009, he became a member of the Board of Directors of Chrysler Group LLC and in October 2009, he was appointed Executive Vice President of Business Development for Fiat Group. From November 2010 to November 2012, he was President and Chief Executive Officer of Iveco. He was also a member of the Fiat Industrial Executive Council (FIEC) from January 2011 to November 2012. He is Board Member of Actuant Corp., Tim S.p.A., and Conceria Pasubio S.p.A. He is Vice Chairman of Recordati S.p.A..

Paola Bonomo, Independent Director (Elliott)	Paola holds a master degree in Business Administration from Bocconi University in Milan and an MBA from the Stanford Graduate School of Business. She started her career at McKinsey & Company, where she was an advisor to top management teams at leading international companies on strategic positioning, growth, new markets, alliances, and acquisitions. She then worked in leadership roles such as Senior Director, European Operations at eBay International; Head of Online Services, Commercial Operations at Vodafone Italia; and Regional Director, Southern Europe at Facebook. Paola serves on the Boards of Directors at AXA Assicurazioni S.p.A., Piquadro S.p.A., Sisal Group S.p.A., Stefanel S.p.A., and FAAC S.p.A.. She is also the President of Stanford Club Italia, the local Stanford University alumni chapter.
Giuseppina Capaldo, Independent Director (Vivendi)	Ms. Capaldo has a degree in Economics and a degree in Law from "La Sapienza" University of Rome, has been a licensed certified public accountant since 1992, and is listed in the Register of Independent Auditors (since 1999). In addition, Ms. Capaldo has been qualified to practice law in Italy since 2003. Ms. Capaldo is Full Professor of Private Law at "La Sapienza" University of Rome and she has been Deputy Rector for Resource Planning and Assets (since 2014). She currently serves as Independent Director of Salini Impregilo (2012 – present); Ferrari N.V. (2015 – present) and TIM S.p.A. (2018 - present). She served as Independent Director of the Board of Exor S.p.A. from 2012 to 2015; Credito Fondiario S.p.A. (2014-2017); Banca Monte dei Paschi S.p.A. (December 2017 - April 2018). She was a member of the Board of Directors of Ariscom S.p.A. from 2012-2015 and A.D.I.R.- Assicurazioni di Roma (2006-2010). She collaborated with the Macchi di Cellere Gangemi law firm in the Banking and Finance, Corporate and M&A sectors (2004-2007).
Maria Elena Cappello, Independent Director (Elliott)	Born in Milano on July 24, 1968, she graduated in Engineering from the University of Pavia. In 1995, she completed an Executive Master's Degree in Strategic Marketing and Sales Techniques at Babson College, MA (USA) and in 1998 she obtained an Executive Master's Degree in Marketing Management from SDA Bocconi in Milan. In 1991, she joined Italtel S.p.A. as System Consultant in the Business Unit Switching OSS and in 1994 moved to Emc Italia S.p.A., where she was later appointed Manager of the Public Administration Division and Telecom Division. In 1998, she joined Compaq Computers (later Hewlett Packard in Munich, Germany, where she became Executive Director. From 2015 to 2018, she has been independent Director of Seat Pagine Gialle S.p.A. and Italia online S.p.A. She is a member of the Board of Directors of Fondazione ENI Enrico Mattei. Moreover, she is a member of Fortune World's Most Powerful Women, of Women Corporate Directors, and of the World Economic Forum (Climate Change Chapter.)
Massimo Ferrari, Independent Director (Elliott)	Born in Rome on August 31, 1961, he holds a Degree in Economics and Business Administration from the LUISS Guido Carli University of Rome. He is currently General Manager Corporate & Finance Group CFO of Salini Impregilo S.p.A. and a member of the Board of Directors of Lane Industries Inc. He is also a Board Member of Tim S.p.A., Equita Group S.p.A., and Cairo Communication. He has a role as Professor at Luiss Guido Carli University in Rome. He spent more than 20 years in the Asset Management industry as portfolio manager, head of investments and CEO in various companies (Fondinvest, Gestifondi, Romagest, Capitalia Asset Management, Fineco Asset Management). He has also served as Head of the Issuer Division of Consob (Italian Market Authority). Past appointments saw him a Board Member of Borsa Italiana S.p.A. (Italian Stock Exchange), and a member of Assogestioni, Assosim, and Assoreti.

Amos Genish, Non-executive Director (Vivendi)	Born in Hedera, Israel, in 1960. He holds a B.A. in Economics and Accounting from Tel Aviv University. Until the end of 2016, Amos Genish was CEO of Telefonica Brasil/Vivo (over €20 bn market cap at the time). During his tenure, Telefonica Brasil/Vivo has outperformed the Brazilian telecom market in revenue and EBITDA growth, as well as in total shareholder returns. Amos joined Telefónica at the beginning of 2015, when it acquired GVT, an innovative and fast-growing telecom and Pay TV operator, of which he was CEO. Amos co-founded GVT. CEO since 1999, he led the successful bid for the "mirror" license of region 2 in Brazil. In 2007, Amos led GVT's IPO in the Brazilian stock exchange. In 2009, he led the company's sale to Vivendi (from 2011 to 2013, Amos was part of Vivendi's Management Board). In 2014, he led the negotiations of GVT's sale to Telefónica (€7.45 billions deal). In 2016, Amos was ranked as Latin America's best CEO in the Technology, Media and Telecommunications industry by Institutional Investor.
Paola Giannotti de Ponti, Independent Director (Elliott)	She was born in Alexandria on July 13, 1962. She has a degree cum laude in Political Economics from the Bocconi University of Milan. She attended some semesters at the University of Cologne, Germany, and New York University. She is a Board member of Terna S.p.A., Ubi Banca S.p.A., ICF Group S.p.A., EPS Equita PEP SPAC 2 S.p.A., and TIM S.p.A. In TIM and Ubi Banca she is Chairman of the Risk Committees. She has held various managerial roles throughout her thirty years of international experience in the financial sector, in the Corporate and Investment Banking area, working in corporate finance as well as in the capital-markets, extraordinary-operations, and project-financing sectors. She has been Director on the Board of Ansaldo STS S.p.A. and Dresdner Kleinwort Wasserstein SGR. In 2002, she was recognized with the Bellisario Foundation Award as Manager of the Year. From 2000 to 2012, she was a member of the Council for the United States and Italy under the honorary Chairmanship of David Rockefeller.
Marella Moretti, Independent Director (Vivendi)	Marella Moretti was born in Turin, Italy, on November 4, 1965. She graduated in "Amministrazione Aziendale" at the University of Turin, where she specialized in Finance. She started her career in 1988 as International Corporate Finance Analyst at Fiat S.p.A. in Italy. From 1991 to 1996, she worked as head of Financial Planning and Control at Fiat France, in Paris. Ms. Moretti then went on to hold several successive positions at Fiat France: Head of Corporate Finance (1996-1998); Deputy Chief Financial Officer (1998- 1999); and Chief Financial Officer (2000-2005). From 2011 to 2014, she also served as an independent member of the Supervisory Board and of the Audit Committee of Unibail-Rodamco, Europe's leading commercial property company, listed on the Paris Stock Exchange. She is a member of MEDEF Europe commission (French employers' confederation), of the NGO Care France, and of the Women Corporate Directors organization (international chapter). Since 2017, she has been a Director of Telecom Italia S.p.A.
Lucia Morselli, Independent Director (Elliott)	Born in Modena, Ms. Morselli graduated with the highest honors in Mathematics at the University of Pisa. She completed a PhD in Mathematical Physics at the University of Rome and she hold two masters degrees, the first one in Business Administration at the University of Turin, and the second one In European Public Administration at the University of Milan. She started her career at Olivetti S.p.A. as collaborator of the CFO in 1982; from 1985 to 1990, she has been Senior Manager of the Strategic and Manufacturing Service at Accenture; from 1990 to 1995, she has been CFO of the Aircraft Division Department at Finmeccanica S.p.A.

	She is CEO of Acciaitalia S.p.A., and a member of World Economic Forum (Climate Change Chapter), Head of the Department of Economics at Unilink Campus University (Rome,) and a member of the Advisory Board of Veneranda Fabbrica del Duomo di Milano. In 2003, she founded the consultancy firm Franco Tatò & Partner.
Dante Roscini, Independent director (Elliott)	Dante Roscini was born in Perugia in 1958; he was educated in Switzerland and France where he received a baccalaureate in mathematics and physics. He then studied Nuclear Engineering at the University of Rome La Sapienza, from which he graduated with honors, and subsequently received a Master in Business Administration from Harvard. Before his MBA, he worked for five years as an engineer and a project manager at Nucleare Italiana Reattori Avanzati (Ansaldo Group) in Genoa, and Westinghouse Electric Corporation in Pittsburgh. Since 2008 Dante has been a member of the Faculty of Harvard Business School in the Business, Government and the International Economy Department. In 2011, Harvard awarded him the L.E. Simmons Fellowship. Before his academic career, for twenty years he held senior positions at three leading US investment banks. In such roles, he assisted companies and governments in numerous countries and sectors in planning and executing financial transactions such as capital increases, privatizations, initial public offerings, global equity and fixed income offerings, and mergers and acquisitions.
Arnaud Roy de Puyfontaine, Director (Vivendi)	Born in Paris, France, on April 26, 1964. He graduated from the ESCP (1988), the Multimedia Institute (1992), and Harvard Business School (2000). In 1989, he started his career as a consultant at Arthur Andersen and then worked as a project manager at Rhône-Poulenc Pharma in Indonesia. He held several positions during the years. In 1999, he was appointed Chairman and Chief Executive Officer of Emap France. In 2006, he was appointed Chairman and Chief Executive Officer of Editions Mondadori. In 2009, he joined the U.S. Hearst media group as Chief Executive Officer of its UK subsidiary, Hearst UK. Since 2014, he has been CEO and Chairman of the Management Board of Vivendi group.
Rocco Sabelli, Independent Director (Elliott)	Born in Agnone on August 12, 1964, he graduated in Chemical Engineering. From 1981 to 1983, he served as Assistant to the Production Manager in an agri-food company. From 1983 to 1985, he joined GEPI (now Invitalia) as Junior Analyst (company check-ups, Business Planning, Dealing) where he dealt with Mergers and Acquisitions in industrial and employment crisis areas (sale of assets or company branch/badwill, for new business initiatives). From 1985 to 1992, he held various positions within the Eni Group. From 2003 to 2006, he was appointed as Chief Executive Officer of Piaggio S.p.A. From 2006 to 2008, he took over Data Service (about 18% together with Tamburi Investment Partner and, afterwards, Intesa San Paolo), becoming Chairman of the Company (now BE S.p.A.), one of the major Italian players of the technological and operational outsourcing market (Banks, insurance companies, service companies, public and private) listed on the Milan Stock Exchange; his shareholdings were transferred in 2013. From 2008 to 2012, he took part in the privatisation process of Alitalia (extraordinary administration). Subsequently, he was appointed Chief Executive Officer and General Manager for the implementation of the Industrial Plan. From 2012, he served as Operating Partner of various private equity funds (Clessidra, NUO Capital and 4R).

Michele Valensise, Independent Director (Vivendi)	Born in Polistena, Italy, on April 3, 1952, Ambassador Michele Valensise holds a degree in Law at Università "La Sapienza" di Roma. He joined the diplomatic service in 1975. After various assignments at the Ministry of Foreign Affairs and abroad (Brazil, Germany, Lebanon, European Union), he was appointed Head of the Press Service, Spokesman, and Chief of Staff of the Minister of Foreign Affairs. He was assigned as Italian Ambassador to Sarajevo, Brasilia and Berlin. From 2012 to 2016, he was Secretary-General of the Italian Ministry of Foreign Affairs. Currently he is Vice Chairman of Astaldi S.p.A., a leading company in the infrastructure sector. Since 2017, he has been Chairman of the German-Italian Center for European Excellence, maintaining a close relationship with Germany. He is an editorialist of the Italian newspaper La Stampa.

Source: gruppotim.it/en/press/press-releases.html

Part Two:

Adopting and Adapting Corporate Governance around the World

7 Germany, One of the Homes to Corporate Governance

7.1 At the very origins of the model

Germany's institutional network has always been a fundamental ingredient of its corporate governance. The economic and financial history of the country helps to explain its trajectory over the last 150 years. Germany's economy, today the largest in Europe and the fourth one in the world, was not one of the richest in Europe until the second half of 19th century. The industrialization process started in the late 1830s but the acceleration did not occur until 1860-70. The State's role was a very important aspect of the process, serving as a sort of institutional guidance, even though Germany as a united country did not yet exist. Germany was unified only in 1871. However, some aspects of the Reich's future policy already existed in previous decades: a mixture of fiscal and tariff policy. The former aimed to increase the budgets of those states, which had been included, since 1834, in the area of the Zollverein, and the latter was to permit infant industries to develop. Another important instrument to accelerate industrialization of the country, and to contribute to sorting out of the firms and entrepreneurs, have been the banks. In the early 1850s, four banks were founded with the aim of providing more solidity to a financial and banking sector, which was still based on small private banks. Their names became famous over the next century and two of them are still some of the biggest protagonists of the German and the global banking system: Deutsche Bank, Commerzbank, Dresdner Bank, and Diskonto Bank. They are well known among economic historian and economists as the "Four Ds."[1]

The literature is full of details on the German banking model that emerged in the 1850s. It differed from both that of the City merchant banks, and from the French model of the Credit Mobilier. Its main feature was a very original and precocious nation-wide network structure and the wide range of service that permitted the banking system to support both small firms and shops, as well as big companies. By contrast, the other two main European models were very elitist and restrictive in choosing which customers and/or businesses deserved their financial support.[2]

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[1] Kocka, J. (2008), "Entrepreneurs and Management in German Industrialization," in P. Mathias & M.M. Postan (eds.), *The Cambridge Economic History of Europe*, vol. 7, part 1, Cambridge, Cambridge University Press.

[2] Pohl, M. (1994), *Handbook on the History of European Banks*, Aldershot, Elgar.

The economic development of the country was intertwined with the Second Industrial Revolution and with the emergence of new capital-intensive industrial sectors. The acceleration of the process benefited from reinforcement by the State after the completion of the unification process, and by the policies implemented by the ruling classes. The so-called "marriage" between rye and iron – names for the great agricultural estates of the Prussian region, and the coal and metallurgical interests of the Ruhr – was cemented by the military technocracy. As the country developed, these sectors became more important and influential, and the nation's industrial firms became bigger. The result was a higher concentration of economic and financial interests, which were supported by the State. On the other hand, the business, administrative, and legal culture of the country converged on supporting the big firms, and creating the best conditions for stability of the industrial sectors.[3]

The first steps in this direction were taken just before reunification, with the passage of the first German corporate law in 1870. This law was an instrument for unifying the different corporate legal systems in the German states at the time. Among the most important aspects of the law was the prohibition of dividend distribution by the *Aktien Gesellschaften*, the public stock companies, when this would weaken the solidity of the company. The same law mandated the creation of the two-tier system of governance, based on an *Aufsichtsrat* (supervisory board) and a *Vorstand* (executive board). This decision was influenced by many foreign experiences, in particular that of the Dutch and the French.[4]

The German victory over France in 1871 gave a huge impulse to the economy. There was an impressive boom of new joint stock companies, which rose from 200 in 1870, to more than 1,000 in 1873-75. Ten years later, in 1886-87 they had doubled to 2,143; in 1893 they were 3,124, and in the early twentieth century reached more than 5,400 before declining during the first wave of mergers and acquisitions (1902-03), and the international financial crisis of 1907. However, at the beginning of World War I, they had again risen to more than 5,500.[5]

The corporate law adopted many aspects of the previous state legislation concerning the protection of minority shareholders. However, from the 1880s on, pressure by many big firms to modify this aspect of the law became stronger. Yet, despite changes in corporate law in 1886 and in 1897, minority shareholders not only kept their rights but even increased them. In particular, they could now bring an action against persons legally responsible for the company based on having only 10% of the shares instead of 20%. There were many other laws concerning corporation

[3] Pierenkemper, T. & Tilly, R.H. (2004), *The German Economy During the Nineteenth Century*, New York, Berghahn.

[4] Muchlinski, P. (2002), "The Development of German Corporate Law Until 1990: An Historical Reappraisal," *German Law Journal*, 14(2), 339-379; Von Rosen, R. (2007), "Corporate Governance in Germany," *Journal of Financial Regulation and Compliance*, 15(1), 30-41.

[5] Fohlin, C. (2005), "The History of Corporate Ownership and Control in Germany," in R.K. Morck (ed.), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, Chicago, University of Chicago Press.

and their shareholders, such as the 1894 *Börsengesetz*, a new federal law about the Stock Exchange.[6]

The reduction of the power of the minority shareholders occurred primarily through the increase of companies' capital. This operation implied the immediate availability of financial resources that small shareholders did not always have. Thus, the bigger the companies became, the smaller was the presence of small shareholders. The most relevant and obvious point was the increasing role of the banks among the shareholders. This was true only in certain particular sectors. The coal, iron, steel, heavy mechanical, electromechanical, and transportation sectors were the most involved in this process, while the light manufacturing sectors were still under the control of small and medium-sized firms, the German *Mittelstand*. Their financial partners were local banks, not the big four. Nevertheless, in 1904, less than 1% of stock companies (*Aktien Gesellschaft*, or AG) held nearly a quarter of the corporate capital stock. Fewer than 10% (400 of 4,740) owned nearly two-thirds of the capital invested in joint stock companies. However, the capital of the stock companies in 1913 represented only 17.7% of the total industrial stock capital. In 1900, there were 719 listed companies on the Berlin stock exchange, just about 10% fewer than in London, where there were 783; but that was much more than in Paris (429) and in New York (129).[7]

After World War I, the very confused situation of the country led to a couple of years of high risk of a revolution, and constant social and political destabilization. This pushed forward the tripartite arrangement, which came from the war experience, an agreement between the State, representatives of the industrialists, and the labor unions. This was later ratified by the Parliament and permitted the creation of workers councils at companies, which were established by the new constitution of the Weimar Republic, and gave employees the right to nominate one or two members to the supervisory boards.[8]

The Nazi regime abolished this practice. The entire economy was based on the *Führerprinzip* that represented the Nazi concept of personal leadership. In the companies the result was the reinforcement of the power of the *Vorstand*, although from a legal and formal point of view, the supervisory board, the *Aufsichtsrat*, continued to exist.[9]

This ownership structure was guaranteed not only by the strength of the blockholders, but also by law. Unequal voting rights had been banned in 1884, but were re-legalized in 1923. Five years later the Ministry of the Economy estimated that 48% of the stock companies issued multiple voting rights. The reform of the joint

[6] Muchlinski (2002).

[7] Hannah, L. (2007), "The 'Divorce' of ownership from control from 1900 onwards: Re-calibrating imagined global trends," *Business History*, 49(4), 404-438.

[8] Peukert, D.J.K. (1989), *The Weimar Republic: The Crisis of Classical Modernity*, New York, Hill and Wang (pp. 103-110).

[9] Fohlin (2005).

stock corporation law reintroduced a partial ban on this kind of shares, but permitted it in family-owned companies.[10]

7.2 Germany between Ordo-liberalism and Mitbestimmung

After World War II, the workers councils were re-established, thanks to an agreement between the German unions and the British military authorities controlling the North-Western part of the country, and was later spread to the *Länder* of Schleswig-Holstein, Lower Saxony, North Rhine-Westphalia, and Hamburg. Slowly over the 1950s, first in the coal and iron industry, this model of industrial relations came into effect, but it was not clear which kind of companies had to follow this rule, which other kind of companies were just suggested or were free to adopt or to reject it.

Germany was on its way to a very important transformation of its business and institutional culture, according to the ideas of ordo-liberalism, which appeared for the first time in the 1930s at the Freiburg School of Law. The founders of the theory were the economist Walter Eucken (1891-1950) and two jurists, Franz Böhm (1895-1977) and Hans Großmann-Doerth (1894-1944). Their proposal did not find the political traction at that time and their ideas were immediately annihilated by the Nazi regime. They reappeared in the new democratic framework after 1945 thanks to the new general political and economic conditions, but also because of the full support given by Ludwig Erhard, the Minister of Economy in the Adenauer government. The choice of liberalism in economics was accompanied by the introduction of strong political-institutional supervision. The State acted as a sort of referee, the only party authorized to put all the economic and social actors in the same competitive position.[11] For instance, Germany was quite receptive to accepting American proposals to dismantle its cartels and to introduce rules permitting wider competition.[12]

The chief result of this cultural approach was the progressive establishment of the *Soziale Marktwirtschaft*, a system permitting the cohabitation, and even the merger, of the principles of economic liberalism with the ideas of social equality.[13] The cultural and theoretical framework, and the economic and social policies, that accompanied this phase of German economic and business development were a fundamental ingredient of the *Wirtschaftswunder*, the economic miracle of the 1950s-60s.

[10] Callaghan, H. (2018), *Contestants, Profiteers, and the Political Dynamics of Marketization: How Shareholders Gained Control Rights in Britain, Germany, and France*, Oxford, Oxford University Press (pp. 69-70).

[11] Hien, J. & Joerges, C. (eds.) (2018), *Ordoliberalism, Law and the Rule of Economics*, Oxford, Hart Publishing.

[12] Wubs, B. & Segreto, L. (2014), "Resistance of the Defeated: German and Italian Big Business and the American Antitrust Policy, 1945-1957," *Enterprise and Society*, 15(2), 307-336.

[13] Thalemann, G. (2011), *Die Soziale Marktwirtschaft der Bundesrepublik Deutschland – ein realisiertes Konzept? Analyse von Genesis, theoretischem Gehalt und praktischer Verwirklichung*, Hamburg, Disserta Verlag.

The highly concentrated nature of the Western German economy was not under scrutiny in this period. The characteristics of the previous decades did not change. The family of the founder usually controlled the main companies, together with some of the most important banks and some other company, usually a partner in the value chain. Thereafter the system kept, and even reinforced, some of the long-term aspects of the German ownership structure.

However, the government and the parliament approved a new corporate law in 1965. Its main aim was to encourage the firms to access the stock market instead of relying on the traditional relations with their banks, or using their own financial resources to develop their business. The law modified the previous situation by again giving more power and influence to the supervisory board.[14]

The most important reform concerning corporate governance came in the 1970s. The economic, social, and political situation of the country was very solid. A social democratic-liberal coalition had been ruling the country since 1969 (until 1974 with Willy Brandt as Chancellor, then Helmut Schmidt), giving stability to the political system; the German economy was still growing, not as fast as in the 1960s, but faster than any other country in Western Europe. In 1976, the Parliament passed the *Mitbestimmungsgesetz*, the Co-determination Act. The rule was now more precise, because now in all the AG, the *Kommanditgesellschaft auf Aktien* (limited joint-stock partnerships), *Gesellschaft mit beschrankten Haftung*, GmbH (Limited Liability Company), and *Genossenschaft* (cooperative society), between 30% and 50% of the seats of the supervisory board were to be allocated to representatives of the unions. The law is compulsory for all GmbHs with more than 500 employees and for all the stock corporations (AGs). All stock corporations must have a supervisory board, but GmbHs are not required to have one as long as they have less than 500 employees.

However, the act specified many further aspects, because the text also included the rules established in the early 1950s for the coal and iron sector. The picture – still valid today – is quite articulated. In companies with more than 2,000 employees, the supervisory board is equally split between shareholders and employee representatives. The number of seats is between 12 and 16, and the board's members are all non-executive. The chairman has two votes. The powers are shared, but the shareholders can exercise a veto, outvoting the labor representatives. Today about 700 companies belong to this category, including some of the largest German firms such as Deutsche Bank, Volkswagen, Siemens, and even Bosch, which is privately-owned by the Bosch Foundation.

In the mining and steel industry, the law is applied to companies with more than 1,000 employees. The supervisory board (with up to 21 members) has a perfect balance between shareholders and employee representative. The last seat is for a neutral member who has the deciding vote in case of ties. The so-called neutral member is

[14] Nörr, K.W. (2007), *Die Republik der Wirtschaft. Recht, Wirtschaft und Staat in der Geschichte Westdeutschlands. Teil 1 Von der Besatzungszeit bis zur Großen Koalition. Teil 2. Von der sozialliberalen Koalition bis zur Wiedervereinigung*, Tübingen, Mohr (pp. 257-258).

nominated by (the remainder of) the supervisory board. About 30 firms, including ThyssenKrupp and Salzgitter, belong to this category.

In companies having between 501 and 2,000 employees, including the public stock companies, the private limited liability companies, and others, the shareholders' representative occupy two-third of the seats and the employee representative one third. Between 6 and 21 non-executives, compose the supervisory board. Today this category includes about 1,500 firms, including Amprion and Vossloh. Finally, in the smaller companies, media firms, and charity organizations, shareholders nominate all members of the supervisory board, but this kind of company is not required by law to have this panel. In case of the election of the supervisory board, the members are usually between 6 and 20, and they are all non-executive. More than two million firms are included in this segment. Among them, one can find Vonovia, Deutsche Wohnen, Axel Springer, and Kloekner & Co.[15]

7.3 Toward the Code of Corporate Governance

In the 1990s, when Western countries started the debate about corporate governance, Germany remained quite at ease, because many of the aspects on which the international discussion was focused were already part of the German laws and its business and economic culture. However, the debate did have some impact.

In 1994, the Bundestag approved the *Wertpapierhandelgesetz*, the securities trading law, which increased transparency for companies' communications and introduced the *Bundesaufsichtamt für den Wertpapierhande* (Bawe), the Federal Supervisory Authority (in 2002 its name was changed into *Bundesanstalt für Finanzdeisnstleistungsaufsicht* or BAFI). In 1996 another law, the Revised Restructuring Act, modified many of the rules concerning mergers, break-ups, spin-offs, asset transfers, and eliminating taxes on capital gains coming from the re-evaluation of the assets of former GDR companies; shareholders can appeal, but not block the process.

In 1999, the German Bundestag passed the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*, simply known as KonTraG, the Law on Control and Transparency in Business. The KonTraG mainly specifies and expands the provisions of the German Commercial Code and the Stock Corporation Act. KonTraG extended the liability of the management boards, supervisory boards, and auditors in the German companies. The core of the act is a regulation that pushes corporate management to implement and operate a company-wide early risk-identification system. Moreover, the law requires the publication of the reports on risk and the company's risk structure in the management report of the company financial statements.

[15] Niedenhoff, H.-U. (2005), *Mitbestimmung in der Bundesrepublik Deutschland*, Köln, Deutscher Instituts-Verlag; McGaughey, E. (2016), "The Codetermination Bargains: The History of German Corporate and Labour Law," *Columbia Journal of European Law*, 23(1).

The *Vorstand* is requested to "take appropriate measures, in particular to set up a monitoring system so that developments that jeopardize the continued existence of the company are quickly recognized." Such "existence-threatening developments" usually result from the combined effects of specific risks, which oblige companies to carry out regular risk analysis and risk aggregation. There are also new rules concerning the duties of the auditors. They are now required to review the books in accordance with the new obligations by listed companies, in particular with regard to the existence and operation of a risk management system and related internal audit activities. All these aspects must become part of their report.

All the new aspects of the law deal with the need to increase transparency and to add internal controls to the normal state controls over the firm's activities. The other important issue is the introduction of more formal contacts between the supervisory board and the auditors. The *Aufsichtsrat* is now the representative of the company. Finally, the law introduced improved conditions for the shareholders through the elimination of the multiple and unequal voting rights, and the facilitation of the claims against members of the *Vorstand* and the *Aufsichtsrat*, as well as establishing some minor rules concerning proxy votes by the banking institutes. Additionally, the law requires the supervisory board to appoint the auditors, to receive the audit reports, and to include the auditors in the board's balance-sheet meeting. All members of the supervisory board or the audit committee must be provided with the audit reports.

The KonTraG does not exclusively concern public limited companies, but also covers the limited partnerships (KGaA) and many limited liability companies (GmbH), in particular if there is a codetermined or optional supervisory board. By contrast, the so-called small AGs are largely exempted from compliance with the KonTraG provisions. The KonTraG was the German response to the initiative of European Commission, which, in 1995, commissioned a comparative study dealing, *inter alia*, with shareholders' representation at annual meetings in the EU member states. The aim was to simplify the operating regulations for stock companies in the EU.[16]

The issue of the proxy votes needs more discussion. This system has always been one of the more important instruments adopted by the banking system to influence the strategies of the big firms. In the early 1990s, the use of proxy votes was still very common, and probably reached its peak, as the **Table 7.1** shows. The law also has been important because the text finally abolished unequal voting rights and voting caps. It also put a limit to proxy voting by banks, as well as on the voting of cross-shareholding stakes on supervisory boards.

Moreover, that law and another one, passed in 1999, re-defined the rules concerning bids. In particular, following the European directives it now became possible to launch a hostile takeover. The same law – known as the Takeover Act – included the adoption of the one-share-one-vote principle.[17]

[16] Warncke, M. (2005), *Prüfungsausschuss und Corporate Governance Einrichtung, Organisation und Überwachungsaufgabe*, Berlin, Eric Schmidt Verlag (pp. 46-49).

[17] Callaghan (2018, p. 72).

Table 7.1 Attending votes and proxy votes in early 1990s

	% votes attending annual general meeting (1992)	% of these cast by all banks	% of these cast by "big three" (Commerz, Deutsche Bank, Dresdner Bank)
BASF	50.4	94.7	40.4
Linde	60.0	99.1	57.9
Siemens	52.7	95.5	34.6
Volkswagen	38.3	44.1	15.1
Commerz Bank	48.2	97.6	48.3
Bayer	50.4	94.7	40.4

Source: Colli, A., *Corporate governance e assetti proprietari. Genesi, dinamiche e comparazioni internazionali*, Venice, Marsilio, 2006.

According to research on those years, nearly 75% of all listed companies in Germany had a majority owner; 23.1% had blockholder controlling 90% or more of official capital. Thereafter in these companies, the influence of the minority shareholders was extremely limited. For instance, they could not start suits for damages against the *Vorstand* or the supervisory board. Moreover, if the controlling shareholder was another company holding more than 95% of the shares, it could buy the minorities' shares, according to the law. A total of 18.4% of all listed companies in Germany were controlled by a shareholder holding 75% of the capital. In 30.5% of the listed companies, there is a block of 50% or more of the total capital. In 1991, only a quarter of the firms listed were not majority-controlled.[18] Another study, published a few years later by Baums and Fraune, affirmed that in 1995, there were only 24 public companies where the majority was widely held. The Anglo-Saxon world was still very far from Western Germany.[19]

In the following years, when the first codes of corporate governance were starting to be implemented in many countries, the German government and the business community decided to set up a special commission. Due to well-publicized failures in erstwhile blue-chip companies like Coop, Balsam, BVV, and Philipp Holzmann, all of which occurred in a series during the mid-1990s, the German Government realized the practical importance of good corporate governance. The Chancellor proposed a special body to study and assess the whole issue. The German Federal Minister of Justice introduced the *Regierungskommission Deutscher Corporate Governance*, better known as Kodex, in September 2001. Its members were appointed by the ministry. They were selected among the managing and supervisory board repre-

[18] Jenkinson, T. & Ljungqvist, A. (1997), *Hostile Stakes and the Role of Banks in German Corporate Governance*, London, Centre for Economic Policy Research (data are from September 1991).

[19] Baums, T. & Fraune, C. (1994), *Institutionelle Anleger und Publikumsgesellschaft: Eine empirische Untersuchung*, Osnabrück, Inst. für Handels- und Wirtschaftsrecht.

sentatives of German listed companies and their stakeholders, i.e. institutional and retail investors, academics (from the faculties of economics and law), auditors, and trade union federations. Its first president was Gerhard Cromme, who at that moment was the chairman of the Thyssen-Krupp *Aufsichtsrat*.[20]

The work of the Cromme Commission, whose aim was to develop official standards, ended in 2002 with the publication of the Kodex, the first German code of corporate governance. The code confirmed the two-tier system, although it affirms that deviations had to be disclosed. The chapter concerning shareholders reaffirmed the principle of one share – one vote, although, again, there can be exceptions. To protect minority shareholders the code introduced the pre-emptive rights, i.e., the rights of the existing shareholders to acquire new shares in case of an increase of capital. Apart from confirming the norms about the function and the duties of the two bodies that govern the firm (supervisory board and executive board), the code added some measures about the disclosure of conflicts of interest among their members, and introduced the obligation to set up certain committees inside the supervisory board (remuneration, nomination, etc.).

In evaluating the code, we can affirm that the rules introduced are of varying natures. There are legal rules, which are mandatory (for instance, the principle of one share-one vote). There are also recommendations, with which there is no legal obligation to comply (for example, the gender proportions and the number of independent members of supervisory board). Moreover, there are also mere suggestions, such as the introduction of all elements of transparency and comprehensibility of the financial statements, in order to strengthen the confidence of international and national investors, clients, employees, and the public in the management and supervision of German listed companies. The code has been updated twelve times since 2002. The last version was released in 2019. Thanks to this new code, a gender quota has been introduced for supervisory boards, forcing listed companies to have women occupy at least 30% of non-executive positions.[21]

7.4 The difficulties despite the long tradition: Scandals, institutional investors, and German corporate governance

Despite its very long tradition of the two-tier system and its historical experience with many aspects of "corporate governance before corporate governance," German business has been far from perfectly complying with the rules. The functioning of the *Aufsichtsrat*, and particularly the relations between representatives of the shareholders and the employees, can be considered positive. To some extent, the quality of industrial relations in Germany is a result of the co-participation culture and philos-

[20] https://www.dcgk.de/en/commission.html.

[21] For the different versions of the code, including the latest edition, see https://www.dcgk.de/en/code/archive.html.

ophy.[22] Certainly this situation mitigated the difficulties which arose with the financial and economic crisis, when job cuts that could have destabilized German society were transformed into generalized salary cuts.[23] A study published by *The Economist* in 2009 affirmed that 83% of German managers surveyed in 1995 considered that the companies they worked for "belonged to stakeholders rather than shareholders. Some 60% said that saving jobs was more important than paying dividends."[24] In this respect, all the conditions existed for increasing frictions between management, the supervisory boards, and the shareholders.

In the following years, many scandals damaged the image and the reputation of many German companies. A series of Siemens scandals between 2007 and 2105, all of them based on bribes paid to get lucrative contracts in Greece, Italy, China, and Kazakhstan, provoked deep changes in the management. The Greek case, in particular, became so notorious that today it has its own entry in Wikipedia.[25]

Siemens' first reaction was to claim innocence and to blame events on a small "criminal gang." The reality was very different. Bribes had become the accepted business norm over many decades. When calculating the cost of a project, Siemens employees included *nützliche Aufwendungen*, a common tax term which in English is literally translated as "useful expenditures." Everybody in the company knew that this expression meant "bribes."[26]

Apart from the legal consequences for the persons involved and for the image of the company, there were some other consequences provoked by the intervention of the U.S. Securities and Exchange Commission, which fined Siemens. Between 2006 and 2008, the German firm agreed to pay $350 million in penalties to settle the SEC's charges, and a $450 million fine to the U.S. Department of Justice to settle criminal charges. Siemens will also pay a fine of approximately $569 million to the Office of the Prosecutor General in Munich, to whom the company previously paid an approximately $285 million fine in October 2007.[27] "Today we are, in essence, closing one of the unhappiest chapters in our 160-year history," affirmed the chairman of Siemens in December 2008, commenting on the end of these procedures.[28]

[22] Weiss, M. & Schmidt, M. (2008), *Labour Law and Industrial Relations in Germany*, Austin, Wolters Kluver; Muresan, S.S. (2014), *Social Market Economy: The Case of Germany*, Cham, Springer.

[23] Souder, E. (2003), "Commerzbank May Cut Salaries Instead of Jobs," *Wall Street Journal*, February 11; Dettmer, M. (2009) "A Share of Future Profits: German Employees Exchange Wage Cuts," *Der Spiegel*, August 4.

[24] "Boards behaving badly (2009)," *The Economist*, August 6.

[25] https://en.wikipedia.org/wiki/Siemens_Greek_bribery_scandal.

[26] Theconversation.com/lessons-from-the-massive-siemens-corruption-scandal-one-decade-later-108694.

[27] https://www.sec.gov/news/press/2008/2008-294.htm; Razzano, F.C. & Nelson, T. P. (2008), "The Expanding Criminalization of Transnational Bribery: Global Prosecution Necessitates Global Compliance," *The International Lawyer*, 42(4), 1259-1286; Wrage, A. & Richardson, A. (2009), "Siemens Ag – Violations of the Foreign Corrupt Practices Act," *International Legal Materials*, 48(2), 232-249.

[28] Schäfer, D. (2008), "Siemens to pay €1bn fines to close bribery scandal," *Financial Times*, December 15.

This scandal provoked a huge reaction among Siemens' small shareholders. The leaders of the company tried to calm down the critics with an extra dividend.[29] Additionally, the company tried to dispel this negative atmosphere by nominating Gerhard Cromme, the former chairman of the Kodex Commission, as the head of Siemens, while he remained the chairman of the ThyssenKrupp group.[30] Siemens accused its former top managers of having shown an incapacity or unwillingness to stop illegal practices, and asked them to pay damages relating to the bribery scandal.[31] Some years later, there also was the conviction for another corruption scandal in China, involving Siemens Medical Solutions Group, Siemens PTD, and Siemens Transportation System, but since the persons involved were the same or others of minor importance, the consequences in Munich were not so important.[32]

Volkswagen put the quality and the performance of German corporate governance model at risk at least a couple of times. The first time was in 2012, when Ursula Piëch, the wife of Ferdinand Piëch (then the chairman of the company), who was described by the *Financial Times* as a "Kindergarten teacher with additional qualifications in business and law (not currently actively working)," was nominated for the Supervisory board of the company. The paper added, quite sarcastically, that despite her education and experience, as "a member of VW's 20-person supervisory board she will have a say in every important strategic decision."[33]

She resigned on April 25, 2015, the same day as her husband, Ferdinand Piëch, was defeated after tense discussions among the members of the supervisory board, despite his being the representative of the two families – Piëch and Porsche – which controlled the Volkswagen group with 30.8% of the shares and 52.2% of the voting rights, respectively. The showdown occurred at the end of a long confrontation between the family controlling the company and the CEO Martin Winterkorn about the strategy and the performance of Volkswagen in the USA. The supervisory board approved the report of the CEO by a large majority, provoking the resignation of the members of the family.[34]

However, Winterkorn did not survive as a CEO, because of a second scandal of the company, the so-called diesel scandal, that was first discovered in the USA in the second half of 2015, and later in Europe. About 10.7 million cars were equipped with software that cheated emissions tests; they emitted up to 40 times the permitted level of nitrogen oxide. Despite all their declarations of innocence, the CEO and many

[29] Gow, D. (2007), "Siemens profits placate 10,000 investors angry at bribe scandal," *The Guardian*, January 26.

[30] Rogowski, W. (2009), "The Siemens Corruption Outburst and the CEOs Who Combat It: A Corporate Governance Case Study," *Emerging Markets: A Review of Business and Legal Issues*, 1(1), 4-57.

[31] Schäfer, D. (2009), "Siemens ultimatum in bribery scandal," *Financial Times*, September 23.

[32] "China court gives verdict in Siemens bribery case (2011)," *People's Daily Online*, June 22. Retrieved from http://en.people.cn/90001/90776/90882/7417043.html.

[33] Bryant, C. (2012), "The first lady of Volkswagen prepares to take the wheel," *Financial Times*, March 16.

[34] Bryant, C. (2015), "VW chairman Ferdinand Piëch resigns after failing to oust chief," *Financial Times*, February 25.

other top managers were accused of misconduct and charged with responsibility for this crime. The reputation of not only Volkswagen, but of the entire German manufacturing industry was at risk. Even Chancellor Angela Merkel was suspected to have had some knowledge and to have hidden it. The cost of the scandal for the company was very dear: Porsche, which controls Volkswagen, paid €535 million for "negligent violations of supervisory duties." This fine came one year after one of €1 billion by the public prosecutors in Braunschweig.[35] In the end, the diesel-scandal cost the company about €25 billion.

All these scandals contributed to a negative image of German corporate governance. The most important German newspaper, *Handelsblatt*, was very severe. Using the example of Deutsche Bank, which was not involved in the scandal, but did not perform well, the newspaper wrote: "investors blamed the bank's non-executive board chairman, Paul Achleitner, for poor management (...) slow decision-making and flip-flopping on strategy." This and many other examples speak to the fact that "a lack of expertise and tunnel vision are often the cause for mismanagement and weak oversight." Many other cases have shown "the need for industry expertise and experience as well as diversity on Germany's supervisory boards." Moreover, "a problem is the lack of international and ethnic variety because German language skills are often a prerequisite." The gender quota is also something that could help to improve checks and balances between management and non-executives. However, continued the article, "at Deutsche Bank, women have occupied more than 30% of non-executive seats for years, but this hasn't kept the bank from running into trouble repeatedly. An international board with non-executive directors from the US, Britain and Switzerland hasn't prevented it, either."[36]

However, the situation seems to be improving. The old German joke – "What's the difference between a doghouse and the supervisory board? The doghouse is for the dog; the supervisory board is for the cat" ("for the cat," *für die Kätze* in German, is slang for something like "trash") – is no longer completely true. A study has shown that in 2003 the average supervisory-board member at a public company sat on 1.9 boards; that figure decreased to 1.6 in 2014.[37] This probably means that a new generation of supervisory board has members emerged, which is more active, and more committed to its important job.

These criticisms are possible – and to some extent necessary – because some of the pillars of German corporate culture are changing. The role of the banking system is no longer the same, and the rules governing the mechanism of the proxy vote have been improved and based on more transparency. Thus, banks must inform customers whose shares they administer that they may choose to have their voting rights exercised by the bank or by a shareholder association. In addition, a bank must inform its

[35] Chazan, G. (2017), "VW emissions scandal not German government's fault, says Merkel," *Financial Times*, March 8; Mcgee, P. (2019), "Porsche fined €535m by German prosecutors over diesel scandal," *Financial Times*, May 7.

[36] Fockenbrock, D. (2018), "The flaws of Germany's corporate board system," *Handelsblatt*, May 28.

[37] "Diversifying the board (2014)," *The Economist*, June 25.

customers when it holds 5% or more of the voting rights if the company is listed, or if the bank was a member of the company's most recent underwriting syndicate. Finally, the bank must also advise customers in the case that one of its managers or employees is a member of the management or supervisory board of the respective stock corporation. However, there are clear signals that banks have reduced their links with the industrial companies. As noticed by *The Economist*, a cut in taxes on sales of shares, introduced in 2001, let banks and insurance companies "start disentangling themselves from companies."[38]

The proxy vote system is still very relevant; however, the banks are not the only one to intercept the majority of them. Other institutions such as the *Deutsche Schutzvereinigung für Wertpapierbesitz e.V.* (an independent body for shareholders associations) are able to organize the voting representation for private investors at hundreds of general shareholders meetings in Germany. In general, there is more participation at these meetings. A report published in 2017 stated that in 2016 there was a significant increase in the average voter turnout: "Voter turnout in the DAX-30, Germany's main index, increased by 9% from 54.9% to 59.9%, while the quorum in the MDAX rose from 66.9% to 71.1% (+6.3%)". These results had been reached in 1998 and in the 21st century only in 2012.[39]

The presence of institutional investors, both German and foreign, contributed very much to modifying the ownership structure of many big German firms, including those belonging to the DAX-30, the German blue chips. In 2019, investment companies manage more than €3 trillion. This represents virtually 70% of German gross domestic product. Around €1,500 billion of this is attributed to institutional investors. There are estimations affirming that about 50 million Germans have handed over the management of their assets to institutional investors. Insurance and pension funds are largely dominating the field among the German institutional investors, and most of them are considering sustainability as a criterion for their investments.[40] The OECD recognized already in 2008 that even in Germany, institutional investors could have a very positive impact in improving corporate governance. Maybe it took more time, but today it seems finally to be true.[41]

These aspects also explain the new versions of the Code introduced in 2017, and especially the one adopted in May 2019. The need to align the new version to the EU recommendations is the official explanation. However, the many scandals, the unfortunate conclusions of certain initiatives (the failed mergers between Bayer and Monsanto or between Siemens and Alsthom), and the asymmetric advantages of the co-determination process (social cohesion without better income distribution) are

[38] *Ibidem*.

[39] https://www.dsw-info.de/en/services/general-meetings/proxy-voting-abroad.

[40] https://www.bvi.de/en/capital-investment/institutional-investors; https://www.investmenteurope.net/investmenteurope/news/3706222/65-german-institutional-investors-invest-sustainably-%E2%80%93-union-investment.

[41] OECD (2011), "Germany," in *The Role of Institutional Investors in Promoting Good Corporate Governance* (pp. 111-129), Paris, OECD Publishing.

generating deep reconsideration of the pillars of the German corporate governance model. As we have seen in Chapter 1, these problems and reconsiderations emerge at the same moment when in the USA there are proposals suggesting that corporate America should look a bit more like Germany, precisely mentioning the co-determination model. However, the room for shareholders' activism, encouraged already by the code of 2002, is an opportunity that is generating many positive fallouts thanks to a social system ready to englobe them.[42]

Case study Siemens

History and main scandal

Siemens AG is the largest industrial manufacturing company in Europe (Siemens and its subsidiaries employ approximately 385,000 people worldwide and reported global revenue of around €87 billion in 2019 according to the earnings release). The Group, whose structure is currently under review to focus on its core business (i.e. industrial automation), includes an holding company with three main divisions – Gas & Power (which, however, will be spun-off in the near future), Smart Infrastructure and Digital Industries – and three main subsidiaries – Siemens Mobility (retail business), Siemens Gaemesa (renewable energy business) and Siemens Healthineers (medical health-care division).

1989 and 1998 were characterized by two main organizational restructuring: first, the eight former business units were rearranged into 15 new, leaner units, two operating groups with their own legal form, and two independent divisions; then, the "Ten-Point Program" – governed by the motto "Buy, cooperate, sell or close" – led to further drastic changes within the portfolio keeping only those activities where Siemens was first or second in the global market. In 2006, Siemens fell into one of the most dangerous phases in its entire history: the compliance crisis.

In November 2006, the Security and Exchange Commission and the Munich public prosecutor's office revealed that Siemens engaged in massive bribing to secure huge public works in the USA, Germany, South America, Middle East and Africa. The investigation found questionable payments to government officials for $1.4 billion from 1999 to 2006. Siemens was fined for $1.6 billion. In the fourth quarter of fiscal 2008, the company accrued a provision of approximately €1 billion in connection with the discussion with the Munich public prosecutor's office and the SEC. The cash outflows related to the fines took place during the first quarter of fiscal 2009 and amounted to €1.008 billion. But, after World War II, Siemens found itself with most facilities destroyed, several material assets and trademarks confiscated and with weakened business prospects in the already operated markets. Thus, the company began to focus on developing markets and by the mid-1950s, Siemens was handling projects in South America, the Middle East and Africa. Business development in these areas was facilitated by the fact that until 1999 no German law prohibited overseas bribery and bribe payments could be, instead, tax deducted under the reference "useful expenditure" (while in 1977, the Foreign Corrupt Practices Act was passed in the US and it prohibited companies from influencing foreign officers with personal payments or rewards).

[42] Pearlstein, S. (2019), "Save capitalism by freeing companies to try new models: Politicians should make it easier to nominate board directors," *Financial Times*, January 20; Toplensky, R. (2019), "EU blocks planned Siemens-Alstom rail deal in landmark decision," *Financial Times*, February 6; "German governance must be fit for purpose (2019)," *Financial Times*, May 12.

When in 1999 German law implemented OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Siemens issued internal documents to address the compliance matters within the organization. In 2001, the German conglomerated released its Business Conduct Guidelines and in 2002 its Code of Ethics and Financial Matters. At the time, however, off-book accounts were still active and non-mandatory recommendations were largely ineffective as Siemens fell under investigation for bribery in Italy and Nigeria. Even if in 2004, the CFO delivered a speech to the Siemens ZV and high-level business managers named "Tone from the Top." He established that consulting agreements should have been reviewed and signed by the chairmen of divisional boards and in 2005, after that a benchmarking analysis with General Electric's compliance guidelines showed serious deficiencies, Siemens redistributed new Business Conduct Guidelines, the efforts were not enough to halt existing bribing practices.

In order to hide bribery payments, the company used several tools such as off-book accounts in Austria, Switzerland, Lichtenstein and Arab Emirates and entered business-consulting agreements with no basis. Corrupt payments were made using profit reserves accumulated as liabilities and post-it notes were used to affix approval signatures.

As of the time of the scandal, Siemens had a two-tier board, composed of a supervisory board, made up of 20 members, of which 10 were elected by the shareholders and 10 were elected by workers' representatives; and a managing board, made up of 11 members. According to Siemens' existing bylaws, a corporate governance committee, named "Siemens ZV," was created as a subset of nine members of the managing board with the task of coaching and overseeing both a geographic region and an operating group.

Indeed, being a company incorporated in Germany, Siemens AG had to be compliant to the German Stock Corporation Act, disciplining the legal relationship between the company and its shareholders, and the German Codetermination Act, and safeguarding the right of the workers to participate in the management of the company where they work. Furthermore, the company had to follow the recommendations of the German Corporate Governance Code. Being its securities listed on the New York Stock Exchange, Siemens also voluntarily complied with many of the US requirements for domestic issuers, with the well-disclosed exceptions of the typical German two-tier board structure and the lack of stringent observance of some of the independence requirements of certain board members.

Bribe payment arose as a consolidated practice within Siemens' business model since the mid-1950s and, even if the company tried to address the issue in order to be compliant with the related legal requirements passed in the 1970-80s, several lacks and deficiencies still prevented the German conglomerate from definitely eradicate the problem.

When, in 2001, Siemens established a compliance function, further enhanced in 2004 with the introduction of an official corporate compliance office, many of the compliance officers still had other full-time responsibilities besides compliance, and they received minimal training or direction to carry out their tasks.

Mandatory and non-mandatory recommendations and guidelines related to bribe payments were largely ineffective as they substantially lacked practical implementation.

Senior management provided little corresponding guidance on how to conduct business lawfully in countries where Siemens had been historically paying bribes, while keeping employees under tremendous pressure to meet their sales goals.

Even when public prosecutor offices began to investigate over Siemens' corrupting business practices, the subject of compliance was never faced with particular effort and the topic was actually taken out of the Siemens ZV meeting agenda. Finally, reports to the audit committee by the chief compliance officer often conveyed incomplete information as result of the fact that management often provided inaccurate information in responses to the audit committee inquiries.

As a consequence, corporate books shooting business results were systematically falsified to hide bribery payments and internal controls were systematically circumvented.

After the scandal, Johannes Feldmayer, a former Siemens management board member was arrested. Following the scandal, Siemens experienced five main leadership changes: the CEO Klaus Kleinfeld

resigned and, for the first time in Siemens' history, an external CEO (Peter Löscher) was appointed. The chairman of the supervisory board (Heinrich Von Pierer) resigned and Gerhard Cromme replaced him. In the meantime, Peter Solmssen was appointed as general counsel, namely a figure responsible of legal and compliance issues in the executive/managing board. A new compliance organization lead by chief compliance officer (Andreas Pohlmann), who reports to both the CEO and the general counsel and a new corporate finance audit unit led by chief audit officer (Hans Winters) were introduced.

As of 2008, pursuant to the German Codetermination Act, the Siemens AG Supervisory Board (which serves for a 5-year period) consists of 20 members, half of which represent the company's shareholders, and half representing the company's employees. The board has six standing committees, two of which were introduced following the 2006 corruption scandal. These are the compliance committee, which monitors the company's adherence to statutory provisions, official regulations and internal company policies, and the nominating and remuneration committee, which recommends suitable nominees for election to the supervisory board at the annual shareholders' meeting. A third one, the ownership rights committee, replaced the finance and investment committee.

As previously anticipated, also the managing board composition experienced a few changes. The most important ones were the introduction of an officer responsible for compliance in the board, which establishes clear accountability and a strong governance, and the institution of a compliance organization. As shown in Siemens' organizational chart, the chief compliance officer, head of Siemens' compliance organization, reports at the same time to the general counsel and to the President and CEO Peter Löscher. This procedure ensures a clear and strong communication with respect to compliance matters is in place with top management positions to ensure that bribery does not take place again.

Under CEO Peter Löscher new management, the company experienced the biggest restructuring in nearly two decades, switching from eight units to three sectors – infrastructure and industry, energy and healthcare technology – aligned with global growth trends. The aim of such organizational change was to achieve clearer accountability, a reduction in corporate complexity and the creation of more synergies.

Then, in 2013, the company experienced a change of CEO. Former CEO Löscher was fired overnight. Since this seems quite strange, we asked ourselves where this decision came from and we found out that at the time a new phenomenon was developing in Germany: shareholder activism.

Shareholder activism in Germany

Shareholder activists are institutional investors who target companies where wrong governance led to substantial operating underperformance compared to their industry's peers. They believe that those companies could generate higher value if properly managed. Therefore, they identify value that can be unlocked through proper investments in the business, operational improvements and changes to the organization or corporate structure. Activism becomes a tool in value-based investing, continuously researching higher efficiency and improvement. This reflects in a positive externality for the entire society, demonstrating how finance can have an impact on the real economy.

Shareholder activism developed as a way to realign the interests of people investing and those of institutional investors investing on their behalf, filing the governance vacuum as institutional investors here care about results. In the past, instead, when few institutional investors invested on behalf of people and can diversify their investment, they have different interest from the people on behalf of they were investing. Indeed, the latter wanted to maximize their absolute returns, while institutional investors did not care about a company's results and, therefore, how it was managed: if a company is mismanaged they don't include it in their portfolio as trying to fix it would mean costs and benefiting competitors as well. They were rationally apathetic entities (agency capitalism era). To be noted that the misalignment of interest finds its roots even earlier, in the era of managerial

capitalism when companies were managed by strong managers and owned by multiple (and weak) owners. The agency problem.

In the USA, Bebchuk, Brav and Jiang found out and proved that operating performances and share prices of American companies targeted by shareholder activism in 2007 increased in the long run and were higher compared to the average of peers which were not subject to shareholder activism. This is also confirmed by empirical evidence for what concerns Italy, the German system known as Deutschland AG, namely an intricate web of cross-shareholdings between banks, insurers and big industrial companies was in part designed to protect Germany's corporate jewels from predators. This gave a perception that the big corporate decisions were taken behind closed doors by a small group of insiders. When, however, a wave of corporate restructuring and a new governance code led companies adapting to international norms, an increasing number of foreign and domestic activists have been shaking up German boardrooms over the last years.

Some new conditions inherent to the German corporate landscape played into the hands of activists and made it easier for them to gain direct influence on the decision-making of many German companies. The importance of conglomerates, as these are perceived negatively as they have long-established business strategies and they are unwilling to reform them. Then it comes the role of ESG factors, related to the room of improvement in such areas for German companies. The public perception of activists changed from predatory to beneficial favorable. Finally, the legal framework contributed as the German scenario can benefit activists as minority shareholders. Indeed, holding one single share entitles the owner to attend, speak and vote at general meetings, file countermotions before and at a general meeting and file proposals regarding the election of supervisory board members or auditors; scandals, poor management, and lack of transparency need to be fought. Many directors have been serving for a long period, often without significant improvement of the company's performance. On top of this, many scandals regarding the compensation of executives, a lack of transparency in the decision-making process, a passive leadership and, of course, an inexperienced management in regard to activism and thus no defense mechanisms leave many room for activists in Germany companies.

Looking back at Siemens' situation, the official reason provided by the company to justify the removal of Löscher is that he failed to meet the profitability targets. Even if this is indisputable, it necessary to underline that these were actually really ambitious. However, the CEO himself set them, together with the CFO. And here the main point came: Löscher successor was actually the former CFO Joe Kaeser. As a consequence, it appears clear that the choice made back in 2007 to appoint an external CEO was necessary, but it was never actually digested. Siemens was just waiting the first useful opportunity to change this: Löscher failing to meet the targets was actually the perfect situation to appoint as CEO a person that has sort of "grown up" within the company (he has spent three decades at the company). We actually found out many articles supporting this "infamous plot" against Löscher and stressing how Kaeser was a "chief executive in waiting" due to the network and power base developed over the years spent at Siemens. Nonetheless, being a conglomerate and given that both performances were not exactly excellent and the company came from a quite recent corporate governance scandal, Siemens represented a potential ideal target for active investors. Moreover, after the CEO change, investors lost trust in the supervisory board, as it seems no long-term plan was in place. However, the firm has been able to look critically in the mirror. As a consequence, Siemens' corporate structure was remodeled. From the conglomerate model, it changed for a holding company, which owns various businesses partly or wholly before active investors could enter it and push for similar changes (renewable energy, healthcare and rail units have been already spun-off into separately listed companies and the same will be for the gas and power unit next year). This move was widely welcomed by analysts and investors and involves the company is now concentrating on its core industrial business, while granting non-core units more autonomy. Indeed, as the company's CEO said: "synergies do not create growth, focus does." On top of this, some changes in the supervisory board were made: Jim Hagemann Snabe succeeded Gerhard Cromme as chairman and shareholders actually elected seven new members as their representatives.

A very push factor was the disruptive technological transformation that took place in many areas of manufacturing and energy. Advances in the internet, artificial intelligence, and electrification are affecting how products are designed, made and used.

Conclusion

In conclusion, Siemens represents a positive example when dealing with how to handle scandals. Indeed, the company was able to avoid the disastrous consequences that a scandal such the 2006 one could have on a company and recovered quite quickly. Then, the poorly executed CEO changes show how the German culture had (and has) a strong influence on Siemens' corporate decision. However, this is not completely bad, as it could seem, as the new (internal) CEO was able to improve Siemens performances and, consequently, to avoid the company being subject to activist shareholders actions.

8 France, Corporate Governance, the Resilience of the Past, and Market Pressure

8.1 Is corporate governance a State affair? From Colbert to the privatization process of the 1980s

Some of the most relevant French attitudes toward corporate governance can be detected through some episodes of the international company Compagnie Internationale des Wagons Lits (CIWL), better known for some of its trains, in particular, the *Orient Express*. The firm was established in 1876 in Brussels. The subscribers to CIWL's capital were Belgian, French, and British bankers and rentiers. CIWL's shares were listed on the Brussels stock exchange from the early 1880s on, but the internationalization of the shareholdings increased after its listing on the Paris stock exchange in 1882. In 1891, an extraordinary shareholders' meeting was called to vote an increase of capital. British citizens and bankers represented by the founder of the company, the Belgian engineer George Nagelmackers, held more than 50% of the admitted shares. However, French citizens and German bankers (such as Edouard and Alfred von Oppenheim of the Köln bank and Sal. Oppenheim Jr. & Co.) also attended the meeting.[1]

Nevertheless, French public opinion, under the influence of *revanchism*, was not satisfied with the national composition of the board of directors. A campaign started in the early 1890s, when a magazine suggested that the presence of only one French member out of the nine on the board of directors, plus three "commissaires" (the auditors), was not enough, compared to the large presence of Belgian and German members. The French Ministry of Public Works intervened as well, and in summer of 1892, Félix Faure, then a deputy in the French national parliament, became vice-president of CIWL, a position he kept for three years before he was elected president of France in 1895. *Le Journal des Transports* commented that the new vice-president of the company "would defend, in the board of directors, the French interests that had been sacrificed" up to then. This new situation was the precondition for establishing a better balance of national representative on the board of directors. In 1899, the chairman of the company was a Belgian, Octave Neef-Orban, who was a cousin of Nagelmackers, a deputy from Liège and a member of several other

[1] Centre des Archives Economiques et Financières, Archives Economie Finances, Savigny-sous-le-Temple, France, box B0031177.

boards of directors of industrial and financial firms. The nine members of the CIWL board were then three Frenchmen, two Germans, one Austro-Hungarian, and one Italian: "All nationalities are represented," wrote *Le Journal* in 1894. "No one has preponderance."[2]

The French government was not a shareholder of the company at that time, but its successful intervention in the governance of the firm established a precedent for the expression of the French attitude that has reappeared throughout the twentieth century and into the twentyfirst, up to today. This behavior has its roots in French economic history prior to the industrialization of the country. The State has always not only played an important role in the French economy, but also a very active role in promoting economic development. During the seventeenth and eighteenth centuries, the State's initiative took the form of establishing firms such as the Porcelains de Sèvres, Manufacture des Gobelins, and the la Manufacture des Glaces, which later became Saint Gobain Company. The period of royal manufactures lasted until the second part of eighteenth century. Altogether, more than twenty companies were established. The literature considers most of them as the first example of state-owned companies, and their directors as the first managers of modern times.[3] The man who symbolizes this culture is certainly Jean-Baptiste Colbert (1619-1683), the *Contrôleur général des finances* (Minister of Finance) under King Louis XVI. Colbertism became – and is still today –synonymous with State intervention.[4]

In the early 1970s, there were four kinds of companies among the top 200 French firms: family-controlled firms (about 50% of the total); those under foreign control (about 28%); and the rest a mixture of state (4%) and technocratic firms (17%).[5] However, there was some confusion about the relationship between ownership and management. What had already been established in the Anglo-Saxon countries in the 1920-30s, and was to some extent a basic factor in Germany, was still far from a clear objective and practice in France.

For instance, at Michelin a process of separation had already started; the same thing was true for Peugeot, although the family was still present on the board, was holding some operational positions, and was even considering coming back to the helm of the company. There was also another big company where the family largely dominated the ownership structure – L'Oréal. Even in this case an external manager who enjoyed the confidence of the owners ran the company.[6] In the State-owned or State-controlled companies (for instance, the Societé Nationale Chemin de Fer

[2] *Le Journal des Transports*, 6 August 1892 and 5 May 1894.

[3] Coleman, D.C. (1961), "Economic problems and policies," in F.L. Carsten (ed.), *The New Cambridge Modern History, Volume 5: The Ascendancy of France, 1648-88*, Cambridge, Cambridge University Press, 24-40.

[4] Barbiche, B. (1999), *Les institutions de la monarchie française à l'époque moderne*, Paris, PUF.

[5] Morin, F. (1974), *La structure financière du capitalisme français*, Paris, Calman-Lévy.

[6] Daumas, J.-C. (2003), "À propos du capitalisme familial," in J.-C. Daumas, *Le capitalisme familial, logiques et trajectoires: actes de la journée d'études de Besançon du 17 janvier 2002*, Besançon, PUFC (pp. 7-36).

(SNCF), the French railways company, nationalized in the 1930s; or Picheney, the largest chemical firm in France) there was a combination of different choices and values. In the former case, the SNCF board was highly politicized, and its business logic and aims were mixed together with social objectives. In the latter, the composition of Picheney's board, originally based on technocrats (the *Politechniciens*, the engineers educated in the prestigious *Ecôle Politechnique*), had progressively changed in order to include lawyers and representative of the ministries.[7] All these elements contributed to reinforcing the ownership structure. However, the government's veto power over transactions with foreign currencies *de facto* represented a powerful instrument for blocking any foreign takeover bid. These prerogatives were more important than those assigned in 1967 to the newly created *Commission des Operations de Bourse*, the French securities market regulator.[8]

The configuration of French capitalism changed during the 1980s. The election of the socialist candidate François Mitterrand to the presidency – and the consequent victory of the left coalition between socialists, communists, and left-wing radicals – implied a wide series of nationalizations of the most important industrial and financial companies. The list included Thomson, Saint-Gobain, Rhône-Poulenc, Pechiney-Ugine-Kuhlmann, Usinor, Sacilor, Suez, and Compagnie générale d'électricité. The list was longer for the financial companies. Here we cite just the most important ones: Crédit commercial de France; Crédit industriel et commercial, Crédit du Nord, Banque de l'Indochine et de Suez, Banque industrielle et mobilière privée, Banque de Paris et des Pays-Bas, and some of the oldest and most famous private banks such as Banque Hervet, Rothschild, Banque Worms, Odier Bungener Courvoisier, Banque Laydernier, and Banque Tarneaud. Moreover, the state also acquired the shares of three other very important banks – Banque nationale de Paris, Crédit lyonnais, and Société générale.

In 1986, the elections of the Assemblée National, the French Parliament, gave the majority to the center-right parties. France entered into the period of the so-called cohabitation: a socialist president and a center-right government. The new prime minister, Jacques Chirac, privatized many, but not all the companies that had been nationalized in 1982: Saint-Gobain, Paribas, Crédit commercial de France, Compagnie générale d'électricité, Société générale, Suez, and many others.[9] The privatization program continued after 1988, when Mitterrand won a second seven-year mandate as president. His new governments (with prime ministers such as Rocard and Jospin), took a spectacular U-turn, and privatized other companies either totally or partially, like Renault, Crédit Lyonnais, and Air France. In the early

[7] Daumas, J.C. (2005), "La gouvernance des entreprises à la française: le modèle et l'histoire," *Comptabilité – Contrôle – Audit*, 11(3), 167-178.

[8] Callaghan, H. (2018), *Contestants, Profiteers, and the Political Dynamics of Marketization. How Shareholders Gained Control Rights in Britain, Germany, and France*, Oxford, Oxford University Press (pp. 96-98).

[9] Chabanas, N. & Vergeau, E. (1996), "Nationalisations et privatisations depuis 50 ans," *INSEE Première*, 440.

1990s, the political and cultural climate was very much different. The discussions about corporate governance that started in those years in many Western countries had an influence on these events. In fact, since the approval of the corporate law in 1967, the French firms had a choice between the one-tier and two-tier systems, but there was never a discussion about this topic, and *de facto* all French companies were using the one-tier system.

8.2 The evolution of the ownership structure, the PDG, and the "new" corporate governance

Effective corporate governance was guaranteed by the ownership structure. In contrast with the situation in the 1970s, in the late 1980s the cross-shareholding system, together with interlocking became the most popular instrument for keeping control of companies. This trend changed over the following decade. "It can thus be seen," wrote François Morin, "that on average the interlocking stakes, held by the network 'hard cores' through small groups of companies, directly accounted for no more than 20.5% of the capital of the companies in 1997, whereas the average had exceeded 30% at the start of the 1990s." In the meantime, the growing presence of foreign investors contributed to accelerating the reflections on the subject. In fact, "the share of foreign ownership is impressive: between 1985 and 1997, foreign owners have increased their share of stock exchange capitalization from 10 to 35%."[10]

This process had to have consequences, especially because the discussions about a renewal of corporate governance in United Kingdom and in the United States, which appeared in the first reports published in those countries, pushed certain sectors of the French economic and institutional establishment to deal with the problem.

The issue emerged for the first time in the monthly bulletin of the French *Commission des operations de Bourse* in 1994. After the first discussions in 1994-95 among the members of the Commission, two French entrepreneurial associations – *l'Association française des entreprises privées* (AFEP) et le *Conseil national du patronat français* (CNPF) – asked Marc Viénot, chairman of Société générale, to set up a working group to examine to what extent the French practice of corporate governance needed change. In particular, the group was to investigate the composition, powers, and functioning of the board of directors, and to compare these aspects with the practices abroad and the discussions taking place within the most advanced economies. The so-called *Comité Viénot* published its report in July 1995; it was 20 pages, compared to the 91 of the Cadbury Report and the 59 of the Greenbury report. Otherwise, what was surprising was that the French document, despite its brevity,

[10] Morin, F. (2000), "A transformation in the French model of shareholding and management," *Economy and Society*, 29(1), 36-53 (for the quotations see pp. 38 and 41).

dealt with broader issues: representation of the employees, the shareholders' employees, and the minority shareholders in companies with a block-holder, and without a controlling shareholder.[11]

The document highlighted the most relevant tasks of the board of directors, but its main point was a proud defense of the role of the Président-Directeur Général, known in France as PDG. This function combines the functions of the chairman of the board of directors and the CEO. The PDG is a sort of "king," who has total control of the firm from the institutional and the managerial point of view. This function has existed since 1940, when it was introduced in a new law concerning the functioning of stock companies. The document indirectly criticized the Cadbury report on corporate governance, affirming that "the dissociation of functions [was] not a panacea." The responsibility for mistakes depends on the person, not on the function. The Viénot Report confirmed that the 1940 law unifying the two roles, was a response to many mistakes and dysfunctions of the past.[12]

During those years, France provided a fresh example that scandals were not necessarily due to corruption, nor they were linked with the centralization of powers in the PDG. The bankruptcy of State-owned Crédit Lyonnais was due to incompetence of its president, Jean-Yves Haberer, a technocrat and former general director of the Treasury. His decisions to invest in Metro Goldwin Mayer – supporting an Italian businessman who did not have any idea of how the sector worked, apart from the pleasure of taking part of parties surrounded by movie stars and by many would-be starlets –, in Bernard Tapie's group, and the very risky Paris real estate sector, can only be qualified as big mistakes. Its price tag came to about 190 billion French francs (1994), or about €29 billion– resisted for a long time as the biggest financial loss in France.[13]

The Viénot report had the effect of opening the floodgates. One year later, in 1996, there was another commission, which produced the Marini report (1996), that focused on the modernization of company law. In 1999, Viénot chaired another commission to answer some questions from the Ministry of Justice, which had proposed separating the office of chairman of the board of directors from the office of chief executive officer. The new report approved this proposal, and it added some recommendations about the disclosures of the compensation and options granted to corporate officers of listed companies.[14]

[11] The report can be downloaded from htpps://ecgi.globaldownload/file/fid/9211.

[12] Tunc, A. (1996), "Le Rapport Viénot sur le conseil d'administration des sociétés cotées," *Revue internationale de droit comparé*, 48(3), 647-655 (for the quotation see p. 653).

[13] Maclean, M. (2002), *Economic Management and French Business: From de Gaulle to Chirac*, New York, Palgrave (pp. 180-181).

[14] Association Française Mouvement des Entreprises Privées des Entreprises de France (1999), *Rapport du Comité sur le Gouvernement d'entreprise presidé par M. Marc Vienot*; Bien F., Délga J, Ged A. (2008), *The French National System of Corporate Governance*, in Naciri A. (ed.), *Corporate Governance Around the World*, London, Routledge (pp. 139-140).

The consequences of the Enron scandal in the USA – including the role of the audit company Arthur Andersen, which led to the passage of the Public Company Accounting Reform and Investor Protection Act of 2002, better known as Sarbanes-Oxley Act – provoked a new debate in France about how to improve corporate governance. Now, the question concerned whether or not to reinforce financial reporting and internal controls As in the case of the first report, the chairman of the commission was the new Number One of Société générale, Daniel Bouton, who replaced Viénot in 1997. The Bouton report, published in 2002, reaffirmed the "superiority" of French corporate governance over the Anglo-Saxon system. One magazine stressed that French "diversity" and better methods would allow it to avoid scandals like Enron.[15] However, apart from its certain tone, the Bouton report was the first complete program for better corporate governance in France. Its focus on transparency, ethics, and recommendations for the financial code was accompanied by many suggestions for internal control procedures, i.e., the role of auditors.[16] The recommendations of the Bouton report were all accepted by the government, which introduced them in the company law reform. Ironically, Bouton had to resign from his position at Societé générale in April 2009 because of the fallout from the Kerviel affair, the escapade of a young trader whose series of unauthorized operations led to €4.9 billion in losses for the bank.[17]

During the following years, there were several amendments of the code. The first ones occurred in 2010, when the gender issue was finally introduced. These established an obligation to have a minimum of 20% women on the board in the next three years, and at least 40% in the next six years. In 2013, the MEDEF/AFEP code was amended again. The most relevant addition was the establishment of the *Haut Comité de gouvernement d'entreprise* (the High Committee on corporate governance). It is formed by seven experts or representative of investors (in 2019 the number was increased to nine, and the Committee was chaired by a woman, Patricia Barbizet, chairperson of Temaris & Associés), and has the mission of supervising the implementation of the code and updating its text and practices. Moreover, the new 2013 code introduced the following: an advisory vote on executive compensation; the reinforcement of the "comply or explain" principle; the restriction on the number of offices for executive directors; a deeper transparency of multi-year variable compensation, following the same principles as annual variable remuneration; and the reinforcement of recommendations relating to performance requirements for stock options and performance shares.

Still another revision of the code appeared in 2016. It resulted from a very innovative system: public consultation through a website instead of again setting up a new commission. Professor Bernard Fages (Université de Paris-Sorbonne), the specialist invited by AFEP and MEDEF to organize the project, published the results in November 2016. In 2018, the code incorporated the new recommendations. The most important recommendations specified the mission of the board of directors, which must particularly focus on promoting long-term corporate value creation by considering the social and environmental ramifications of its activities. They reinforce, in particular, the requirements of non-discrimination and diversity; more strictly regulate the clauses related to the departure of managers, and favour a direct dialogue by the shareholders with the board of directors.[18]

[15] "Le rapport Bouton ou l'anti-Enron à la française (2002)," *L'Expansion*, September 23.

[16] Knapp, M.C. (2010), *Contemporary Auditing: Real Issues and Cases*, New York, South-Western (pp. 504-505).

[17] http://evene.lefigaro.fr/celebre/biographie/daniel-bouton-18934.php.

8.3 Protecting minority shareholders, or favoring long-term investors? The French dilemma

In 2014, the French parliament passed the so-called *Loi-Florange,* a law that includes several aspects concerning the life of a firm. The general purpose of the act was to reconcile the "real economy" with the evolution of the markets. Of course, the text is full of social aspects, starting with the need to avoid as much as possible the shutdown of a firm and the loss of jobs, by looking for a new entrepreneur who could take over a company in crisis. However, there were also some articles introduced to avoid the hostile takeovers. According to the law, a takeover bid's validity is confirmed only if the offer wins over the majority of the shares and the voting rights, without counting the shares and the voting rights already in possession of the takeover company.

In the meantime, the law codified a measure that was proposed about ten years before by Claude Bébéar, the founder and chairman of AXA, the biggest insurance group in France and the second largest in Europe. In a book published in 2003, *Ils vont tuer le capitalisme* ("They will kill capitalism"), he affirmed that shareholders have forgotten that they have duties as well as rights. His proposal was far from being easy to implement. On the one hand, Mr. Bébéar proposed that voting by shareholders should be compulsory. On the other, he prescribed the end of the principle of equal treatment of shareholders. He proposed a system that rewards investors for holding shares over time. Thus, an investor keeping a share for, say, two years, will have more voting rights than one who bought it yesterday. In addition, the dividend received would also increase with the length of the investment. For instance, after a decade, it might even be 50% higher than on a newly purchased share.[19] The Florange law, which came into force in 2015, introduced automatic double voting rights for shares that had been held by a shareholder for more than two years in registered form (*actions au nominatif*). Prior to the new law, companies were free to offer this privilege according to their bylaws. Now, for the listed companies, the double voting right is automatic unless differently established in the bylaws of the company. It is

[18] https://www.afep.com/publications/le-code-afep-medef-revise-de-2018.

[19] "Killing capitalism? (2005)," *The Economist*, 1 May; Bébéar, C. (2003), *Ils vont tuer le capitalisme*, Paris, Plon.

possible to opt out, but to do so, it is necessary to get the approval of the shareholders' meeting, with a majority of at least 66% of those with voting rights.[20]

After the law came into force, 26 companies among the CAC-40, the French blue chips, adopted this measure; the number increased one year later to 32. Many commentators stressed that the French State was the biggest beneficiary of this regulation, because it could reduce its shares without reducing its voting rights. The best example is Renault. Thanks to this law, the State increased its shares to 20%, and then. 15 months later, sold 4.5% of them to institutional investors for about €1.21 billion. The remaining 15.01% permits the State to *de facto* control the company.[21] Others have simply suggested, "France has become a European champion of non-compliance with the equal treatment of investments in shares and the voting rights." The issue became a sort of litmus test between two opposite visions: on the one hand, the democratic principle of one share-one vote as a symbol of preserving the rights of minority shareholders; on the other hand, the advantage for long-term investors coming from the adoption of the double voting rights.[22]

Two recent scientific, non-journalistic studies offer very similar results. One shows that most one-share/one-vote companies reverted to the pre-reform arrangements. The exceptions were firms with a stake held by the French state. Companies that kept the same structure have a significantly higher market-to-book ratio than those that the new regime by default.[23] The second study affirms, on the one hand, that firms that adopted double voting rights – particularly those with a large blockholder – experienced a negative reaction from their foreign institutional shareholders and an increase in the cost of capital relative to other firms. On the other hand, the market has reacted positively to successful opt-out votes. The study concludes that criticism about the reinforcement of insiders' entrenchment, are well grounded.[24]

This analysis is consistent with the situation highlighted by **Table 8.1**, which confirms that the *Loi Florange* reinforced the ownership structure for the controlling shareholders.

[20] Stothard, M. (2015), "French companies fight back against Florange double-vote law," *Financial Times*, 16 April; "Short-term or short-changed? (2015)," *The Economist*, May 2; Davidoff Solomon, S. (2015), "France Answers Hostile Bids with the Two-Vote Share," *The New York Times*, May 19.

[21] Campbell, P., Massoudi, A., Agnew, H., & Keohane, D. (2017), "French government to sell down stake in car maker Renault," *Financial Times*, November 2.

[22] Thomson, A. (2016), "Some French equities are more equal than others," *Financial Times*, November 1; Ponkratova, N. (2015), *Multiple voting rights – illusion of reward of long-term shareholders*, November 10, retrieved from http://www.proxinvest.fr/?p=3200&lang=en

[23] Becht, M., Kamisarenka, Y., & Pajuste, A. (2018), *Loyalty Shares with Tenure Voting – A Coasian Bargain? Evidence from the Loi Florange Experiment*, ECGI Working Paper Series in Law, Working Paper N° 398/2018.

[24] Bourveau, T., Brochet. F., & Garel, A. (2019), *The Effect of Tenure-Based Voting Rights on Stock Market Attractiveness: Evidence from the Florange Act*, retrieved from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3324237.

Table 8.1 The double voting rights and their impact on the ownership structure of some top French listed companies in 2019

Company	% of shares with double voting rights	% of shares held by largest owner	Ownership structure
Bouygues	48	21.4	family company
LVHM	43	47.3	controlling shareholder
Lafarge	43	9.3	main shareholder
Kering	42	48.0	controlling shareholder
Michelin	32	n.a.	widely held
Safran	23	17.2	main shareholder
Saint Gobain	21	n.a.	widely held
Accor	21	13.0	main shareholder

Source: Companies' websites.

8.4 The resistance: Old habits die-hard

Despite all the changes in corporate governance since the *Rapport Viénot*, and regardless of the increasing role of institutional investors, especially from abroad, some aspects have shown stronger resistance than others. The centralization of power in the PDG did not really change very much. Despite the suggestions from the early versions of the code, very few changes have been introduced. Thomson Reuters' data of late October 2017 (based on a survey covering 6,500 companies) shows that over the last 15 years, France has gone in the opposite direction from countries like the USA, Germany, Japan, and the United Kingdom. In the USA about 60% of the firms still have one person holding the two top positions, while in the UK, Japan, and Germany it's just 20%. In France, the percentage is still 75%,[25] although in cases where a company established the division between the two positions, usually it also eliminated the position of vice-president or deputy-CEO, which had been introduced by the first reforms of corporate governance.[26]

However, the most important aspect concerns the role of the State as a shareholder. From this point of view, France is still the country of the "religious wars." On the one hand, there are "purists" like the *Institut Montaigne*, an independent think-

[25] Thomas, L. (2017), "Corporate France swims against tide on chairman independence," *Reuters*, October 30, retrieved from https://www.reuters.com/article/us-france-business-governance/corporate-france-swims-against-tide-on-chairman-independence-idUSKBN1CZ1QN.

[26] This is the case, for instance, of Societé Générale. See its press release *Société Générale: Change in Corporate Governance*, dated 15 January 2015.

tank founded in 2000 by Claude Bébéar and directed by Laurent Bigorgne (a former member of the *Institut d'Etudes Politiques* in Paris, and an intellectual very close to President Macron). The Institute is suggesting that the State should not be a shareholder, which it considers a sort of "oxymoron," and should find the best way to sell all the shares it still owns.[27] On the other hand, looking at the concrete behavior of the French government, regardless of political differences, over the past ten years of the economic and financial crisis, its interventionism has never diminished. To some extent, it has even grown. The sectors most affected by government initiative are very mature, but according to a certain vision of French industrial development, they are still considered strategic for several different reasons.

The first example goes back to 2010, and it has to do with the decision of Renault, in which the State has about 15% of the shares, to invest in a new factory in Turkey. Turkey, during those years, was one of the most dynamic among the emerging economies. Many investors also moved to Turkey in light of its geo-economic position: not far from many other emerging economies (the former Soviet Asian republics and the Middle East) and with a relatively good industrial culture and tradition, not to mention, of course, of a very low cost of labor. In 2010, the government (at that time a center-right government, with Sarkozy as a president) vetoed the board of directors' decision to move the production of its *Clio* model to Turkey. The Ministry of Industry affirmed that the auto industry should contribute to the French balance of trade, thus echoing the mercantilist theories of the eighteenth century. The European Commission reacted with strong requests of explanations for the veto. Even the moderate newspaper, *Le Figaro*, which traditionally supports the center-right parties and the government, criticized the return of Colbertism.[28] It took some time, but finally a compromise was reached. The French factory at Flins would continue to produce a portion of the small car (about 30%) without losing all its workers, while the new plant in Bursa (Turkey) could develop according to the initial plans. Over the next years, the Turkish factory (where the models *Fluence* and the *Mégane* were already built) became a plant equivalent in size to Volkswagen's (VW's) Wolfsburg (Germany) facility.[29]

The second example is even more relevant, because it represented a new State intervention. In 2013, the market received many signals about financial difficulties at Groupe PSA, the second French automaker owner of Peugeot and Citroën brands. The Peugeot family controlled the company, thanks to the double voting right. In fact, the share distribution gave the Peugeot family about 30.3%, just a bit less than the 30.6% owned by foreign institutional investors, while the French institutional investors owned 23.66%, and some important French and English banks between 1.3

[27] Institut Montaigne (2017), *The State, an impossible shareholder?*.

[28] François, I. (2010), "Renault, la tension monte entre l'état actionnaire et la direction," *Les Echos*, January 15-16; "Kroes wants Paris to explain veto on Turkey's plan (2010)," *Financial Times*, January 15; De Kedrel, Y. (2010), "Colbert est bien vivant, mais son 'roi est nu'!," *Le Figaro*, January 19.

[29] Amiot, M., & Pascal Ambrosi, P. (2013), "La Renault Clio de plus en plus 'made in Turkey'," *Les Echos*, March 13; https://ihsmarkit.com/country-industry-forecasting.html?ID=106594671.

and 2.7% each. However, in terms of voting rights, the family had 45.1% against 24% for the foreign investors and 18.5% for the French institutional investors. The consolidation of the group and the necessary injection of fresh capital, as well as the need to increase the globalization process to access the most promising markets in Asia, seemed a step too far for the family at that moment.

The solution reached was a brilliant *coup de théâtre*. A new industrial shareholder entered the company, the Chinese automaker Dongfeng, which was the second in the Chinese ranking in 2013. Peugeot and Dongfeng had their first joint venture in 1992. To avoid any risk of losing control of the company to a very dynamic foreign firm, the French State also invested in the company with the same number of shares as Dongfeng, in order to recapitalize PSA. The new governance of the company was completely different, because the three main shareholders – the family, the Chinese company, and the French State – held the same number of shares, 14% each. Over the following years, the situation changed. On December 31, 2017, the French State, the Peugeot family, and Dongfeng each owned 12.23% of the company, while the voting rights were distributed according to this proportion: the Chinese firm 19.94%, the family 17.63%, and the French State 9.97%.[30] The option for a two-tier system was almost a necessity considering this very complex balance.

A similar example is linked with another mature sector – shipbuilding –with even greater strategic importance. A few months after Macron's election as French president, in 2017, the government temporarily stopped a preliminary deal between the Italian state owned shipbuilding firm Fincantieri and the French company STX France, based in Saint-Nazaire, where Fincantieri planned to buy 55% of STX's shares. The reasons were connected with the French company's military production. After very long negotiations, which included setting up a very complex governance structure, in February 2018 the project got the green light from the French Government. Fincantieri could run the civilian business. Over the following months, however, France and Italy moved closer toward a military shipbuilding alliance. In October 2018, the French state-controlled shipyards Naval Group and Fincantieri announced a 50-50 joint venture to bid for Franco-Italian warship projects and export to the world market. From the French point of view, the agreement represents an updated version of the strategy of creating a "European champion," which was already proposed in the 1980s for many other sectors.[31]

However, in a very recent case, the French government blocked a deal, as it did in 2010 with Renault's program for Turkey. A mega-merger (between Nissan and FCA), valued at €33 billion, which could lead to the creation of the second largest, or the

[30] Feuerstein, I. & Amiot, M. (2014), "PSA: l'entrée au capital de l'Etat et de Dongfeng se concrétise," *Les Echos*, January 19; https://www.groupe-psa.com/en/finance/peugeot-sa-share/#ownership-structure.

[31] https://www.dw.com/en/macron-gentiloni-agree-italys-fincantieri-can-run-french-shipyard/a-40715760; https://www.reuters.com/article/stx-ma-fincantieri/italian-shipbuilder-fincantieri-takes-control-of-stx-france-idUSL8N1PS65H; Bauer, A. (2019), "Naval Group et Fincantieri concrétisent leur alliance franco-italienne," *Les Echos*, June 15.

even the biggest carmaker in the world, was blocked by the French government, although the management agreed with the project proposed by FCA. The French government postponed the final vote many times because it wanted to have the approval of its Japanese partner Nissan, which was not so enthusiastic about the project. This pushed the chairman of FCA, John Elkann, to cancel the offer because of "lack of political conditions in France." The reasons lie in the complex consequences of the Ghosn affair from November 2018, in which the leader of the Renault-Nissan group was arrested in Japan because of a series of accusations concerning his salary and private expenses for millions of dollars. This situation re-raised the serious frictions between the new CEO of the company, Mr. Senard, who took the position in January 2019, and the biggest shareholder of the company. This was a kind of repetition of the story of nine years ago, but with a more important objective than one plant in Turkey and the risk of losing 2,300 jobs in France.[32] Later the same year it was announced that PSA and FCA would merge. This time the French government did not block it and allowed the two partners to define the details of the deal, which will be most probably finalized in 2021.[33]

For a final example, it could be useful to recall an old expression: he who lives by the sword will perish by the sword. The case concerns the group Air France-KLM, formed in 2007 by the two companies. The company's governance has always been very complicated because of the presence of the French and the Dutch states. The AF-KLM group owns 100% of Air France and 49% of KLM, while the remaining 51% of KLM belongs to a Dutch Foundation (44.4%), the Dutch State (5.9%), and other shareholders (0.7%). Among the shareholders of the group, at the end of 2018 there was the French government (14.3%); two airline partners (China Eastern Airlines and Delta Airlines) with 8.76% each; and the employees and some institutional investors (all together about 19%). The other shares are publicly held.

In February 2019, the Dutch government announced that it had bought 12.68% of the shares of the group for about €668 million in the capital market. The Dutch finance minister, Wopke Hoekstra, said that since "in recent years it has become apparent that important decisions about KLM's strategy were increasingly taken at the level of the Air France-KLM holding company," his government wanted to be able to influence the future development of Air France-KLM with the aim of ensuring the Dutch public interest. The French response was very embarrassed, and actually a non-response. The French Ministry of Finance affirmed the Dutch decision was "an unfriendly, surprising move that is extremely detrimental to Air France-KLM financially (...). Investors are completely confused about the move." He concluded, with a sort of self-absolution and a ridiculous attempt to present its position as the best

[32] Campbell, P., Massoudi, A., & Keohane, D. (2019), "Fiat Chrysler proposes €33bn merger with Renault," *Financial Times*, May 27; Campbell, P. & Keohane, D. (2019), "Renault chairman attacks French state for scuppering FCA deal," *Financial Times*, June 12.

[33] Keohane, D., Massoudi, A., Fontanella-Khan, J., & Campbel, P. (2019), "Fiat Chrysler and Peugeot parent PSA in merger talks," *Financial Times*, October 29; Espinoza, J. & Campbell, P. (2020), "EU launches in-depth antitrust probe into $50bn Fiat Chrysler-PSA deal," *Financial Times*, June 17.

defense of the Dutch interest: "The Dutch authorities have already lost €70 million on their investment. It's their problem..." This reaction was due less to the surprise of having an old partner among the new shareholders, than to the severe criticism launched by the Dutch against the French management of the company. The *Financial Times* made the best comment: "The Hague's stake in Air France-KLM proves we live in interventionist times." If even one of the most liberal government moved into that direction, many aspects of the corporate governance, especially for international companies, must be deeply revised.[34]

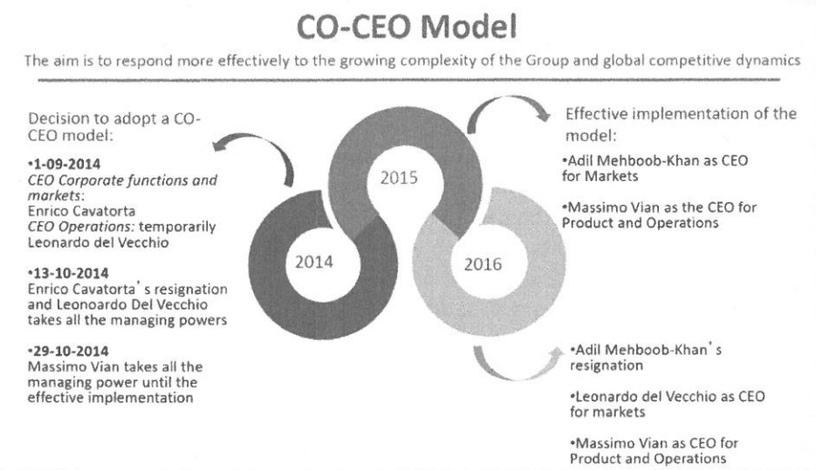
[34] Treviduc, B. (2019), "Air France-KLM: La Haye monte à 14%, Le Maire dénonce une opération 'inimicale'," *Les Echos*, February 28; Khan, M., Keohane, D., & Spero, J. (2019), "Netherlands wants Air France-KLM to 'perform better'," *Financial Times*, February 27; "Dutch dirigisme gives France a corporate shock (2019)," *Financial Times*, March 1.

Case study EssilorLuxottica

Before the merger

The Luxottica Group S.p.A., an Italian company established in 1961 by Leonardo Del Vecchio, nearby Belluno, an industrious province in the Italian North-East, has been for years a leader in the design, manufacture and distribution of fashion, luxury, sports and performance eyewear. Among the brands controlled by the group one can mention Ray-Ban, Oakley, Vogue Eyewear, Persol, Oliver Peoples, and Alain Mikl. It also works under license for prestigious fashion groups like Giorgio Armani, Burberry, Bulgari, Chanel, Dolce&Gabbana, Ferrari, Michael Kors, Prada, Ralph Lauren, Tiffany & Co., Valentino, and Versace. The group implemented its business strategies through the presence of subsidiary companies in various countries in which it operated. Its global wholesale organization covered more than 150 countries and was complemented by an extensive retail network of approximately 8,000 stores mostly located in North America, Latin America and Asia. Luxottica was listed on the New York Stock Exchange ("NYSE") and on the Telematic Stock Exchange organized and managed by Borsa Italiana ("MTA").
Company's most important shareholder is Delfin S.à r.l, a holding firm based in Luxemburg, which holds 62.45% of the issued share capital. The chairman, Leonardo Del Vecchio, controls Delfin S.à r.l. through the CDV HOLDINGS LLC. Another relevant shareholder is Giorgio Armani, who holds 4.64% of the issued share capital. More than a half, 2.947%, is held in the form of ADRs at Deutsche Bank. They can be included in Deutsche Bank's shareholding, together with 5.644% controlled by Deutsche Bank Trust Company Americas. Moreover, Luxottica Group S.p.A. holds treasury shares corresponding to 1.34% of the issued share capital. Company's share capital is made up exclusively of ordinary, fully paid-up voting shares. Apart from being the founder, Mr. Del Vecchio has always been Luxottica's chairman and its controlling shareholder.

Figure 8.1 Remodelling the CO-CEO relationship



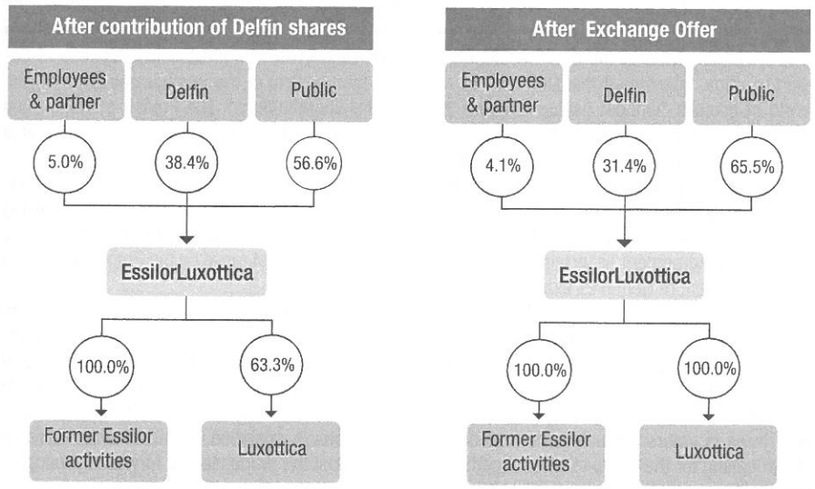
Source: Own elaboration.

Essilor stands out as the world leader in corrective and ophthalmic lenses (about 40% market share), with a budget of €200 million allocated to R&D. Since 1975, ESSILOR has recorded an average annual increase of 11% in turnover and 13% in profit, reaching a turnover of over €7 billion and a capitalization close to €25 billion in 2017. In terms of governance, Essilor is a public company with dual governance with a chairman and an operational CEO and a share of 8.2% of employees (including the Valoptec association).

The merger

On January 16, 2017, Essilor and Delfin announced the strategic combination of Essilor and Luxottica. The merger will result in the following changes in the ownership structure: 1) Essilor, renamed EssilorLuxottica, will become the new Holding Company; 2) the contribution from Delfin to Essilor of its holding equal to 62.45% of current Luxottica share capital (the "Holding"); 3) subsequent mandatory public exchange offer by EssilorLuxottica of all outstanding Luxottica shares; 4) Delfin would own a shareholding comprised between 31 and 38% of the share capital of EssilorLuxottica and would be its largest shareholder.
As regards to the governance of EssilorLuxottica, for the three-year period following the transfer, Luxottica's executive chairman, Leonardo Del Vecchio, would serve as executive chairman and CEO of EssilorLuxottica. Essilor's chairman and CEO, Hubert Sagnières, would serve as Executive vice chairman and deputy CEO of EssilorLuxottica, with equal powers to those of the executive chairman and CEO. As regards to Luxottica, Leonardo Del Vecchio would act as director with executive powers of Luxottica for as long as he is EssilorLuxottica executive chairman.

Figure 8.2 EssilorLuxottica ownership structure



Source: https://www.essilorluxottica.com/it/governance/introduzione.

Situation at the moment of the "Italian" delisting

In October 2018 the merger agreement was finalized, with the contribution of all Essilor shares and Delfin's stake in Luxottica (63.3%). Subsequently, between the end of October and mid-December 2018, there were public offers on Luxottica shares, definitively delisted in March 2019 (with EssilorLuxottica's listing on the CAC40). Here there had been a certain coldness between the two "souls" of the group already: while Del Vecchio has always talked about the goal of achieving a double quotation, bringing the stock back to Milan, the French partners have never followed this desire and so far EssilorLuxottica is listed only at Euronext in Paris.

Multiple governance issues

Among the announcements made at the end of 2018 was also the one that the EssiLux appointments and remuneration committee was to receive (by the end of January 2019) the mandate to start the search for a CEO who should lead the group from the approval of the 2020 budget. At the meeting last November, Olivier Pecoux (president of the nomination committee) explained that this was not an issue "on the agenda." A few days earlier, however, Del Vecchio had said that he saw Francesco Milleri – CEO of Luxottica – as a potential successor and that he intended to propose him as such in EssilorLuxottica. "I know very well that there is a commission that deals with these things. If I decided I wanted to do it, I would turn to the commission and the board of directors according to the contract that we have and that I intend to respect until the end," he had specified. In the months that followed, the willingness of an entrepreneur to hand over part of his powers to Milleri had been revealed.

New tensions

The clutches between the two "coalitions" are deflagrated in an open clash on March 2019. In an interview with Le Figaro, Del Vecchio openly accused the French partner of not respecting the agreements and of having appointed four top managers without his consent and without having brought the decision to the board of directors. Hubert Sagnieres, Vice President Executive of EssilorLuxottica, interpreted that Del Vecchio wanted to take control of the number one group in the world of glasses "without having to pay a premium for shareholders." The French manager also added that he did not want to be "diverted by governance issues that often reflect only personal ambitions," among other things criticizing the issue of Milleri's potential appointment as CEO.
The funds also teamed up to ask to integrate the board of directors with two independent directors, with the support of Valoptec, the association of employees and managers Essilor. In the following days, Delfin filed a request for arbitration with International Trade "to have violations of the 2017 combination agreement ascertained," which was followed by the last move by the French that led to the appointment of Gentin as external mediator.
The agreement came three days before the meeting scheduled for May 16, 2019: the board of directors supported and unanimously approved it. The group, in this way, will be "immediately operational in a more efficient and effective way." Equal power governance, which was envisaged at the time of the merger, will remain in place until the shareholders' meeting in spring 2021 called to approve the FY 2020 budget. The representatives of the Essilor employees – who are on the board with three directors (including the president of the Valoptec association, Juliette Favre) – are no longer calling for the board to be enlarged: they voted against the proposals put forward by Valoptec itself and by some funds in support of the French.

What does the agreement provide for?

Milleri (VP & CEO of Luxottica Group) and Vacherot (CEO of Essilor International) are responsible for implementing the strategy and integration processes of the "new" EssilorLuxottica within the next 12-24 months. Vacherot also joins the board of directors in place of Bernard Hours, who recently resigned, and will sit on the strategy committee. The representative of Valoptec will also join the strategy committee and the integration committee between the two companies as a new member. Milleri and Vacherot have approved the appointment of executives with strategic responsibilities for the group's central functions, but the search for a new CEO continues. Both have informed the board of directors that they will not be candidates for this position.

Concluding remarks

The Executive President Luxottica (Del Vecchio) has the same decision-making and operational powers as the Executive Vice President (Hubert Sagnieres) of Essilor, and both hold their positions as President Luxottica and CEO Essilor, while two figures are entrusted with the tasks of strategic managers for the integration of the group. The board of the resulting company is made up of thirteen directors, but only six are independent (despite the AFEP-Medef Code recommends that at least 50% of them in listed companies be independent), and three are employee representatives. There is an audit and risk committee, a strategy committee, a nominating and compensation committee and a CSR committee.
The merger, to date, can be considered successful. The company's profitability has increased significantly; synergies appear to be working, as revenue growth of more than 40% was associated with a 29.6% increase in costs: primarily, there was a 49.7% decrease in administrative costs during 2018. EssilorLuxottica's Earnings Quality shows a drastic decrease at the time (9 April 2019) when the first post-merger consolidated financial statements were published. The deterioration is mainly due to the recognition of a significant Goodwill (Other Non-Current Assets) and the increase in real estate and other tangible assets, also due to the integration between the two companies. It shows the excellent result in terms of operating margin.
The board of directors currently consists of 16 members, half of whom are appointed by Essilor (including the executive deputy chairman of EssilorLuxottica) and half by Delfin (including the executive chairman of EssilorLuxottica). They were appointed for the "initial period" (i.e., from the completion of the contribution until the date of the shareholders' meeting called for the approval of the financial statements as of 31 December 2020 of EssilorLuxottica).
After the initial period, the members of the board of directors of EssilorLuxottica will remain in office for three years. Any proposal for the appointment of new members of the board must be submitted to the shareholders' meeting by the board of directors on the recommendation of the appointments and remuneration committee of EssilorLuxottica or of any member of EssilorLuxottica pursuant to applicable law, without any indication of the origin of the candidates from Luxottica or Essilor.

9 Italy, Corporate Governance, and the Many Paradoxes of an Advanced Economy

9.1 The historical background

The attempt to compare different models of corporate governance has frequently led to placing the Italian case among the countries belonging to so-called "Latin capitalism." There are numerous similarities between Italy, France, Greece, Spain, Portugal, and Turkey. However, time has progressively shown that they are more superficial than structural, although some of the economic and historical literature still insists on the long-term distinctiveness of the evolution of societies and economies that grew – but also declined – around the Mediterranean basin.[1]

Italy is part of the G8; its per capita GDP puts the country in approximately the thirtieth position in the world; it is number eight in the world ranking for exports; and it has one of the highest savings ratios among the advanced economies. However, the Italian capital market looks like that of an emerging economy. In June 2020, listed companies were 457. Among the "Latin" countries, only Portugal has much fewer (41), while Spain has 2,870 (but just a few years ago it had more than 3,000), France has 1,015 (down from 1,587 in 2002), Turkey 233 (the peak was 438 in 2015), and even Greece, definitely a poorer economy, in 2017 had 196, just 20% less than Italy. Even a country that entered the market economy just 30 years ago, Poland, has nearly the same number of listed companies as Italy (445 in April 2020). Before considering the characteristics of the system of corporate governance adopted in this country, we have to understand this paradoxical situation and its consequences for business culture and the Italian capital market.

The late industrialization and modernization of the country are certainly the starting point of the story. However, the aims of this chapter do not include presenting a long-term view of the factors that explain today's specificities. Nevertheless, we have to consider some of the aspects that influenced Italian economic and financial development over the long term.

Italy represents one of the best examples of the Gerschenkronian model of industrialization.[2] During the last decades of the nineteenth century, the State played

[1] Sapelli, G. (2005), *Southern Europe Since 1945: Tradition and Modernity in Portugal, Spain, Italy, Greece, and Turkey*, London, Routledge.

[2] Gerschenkron, A. (1962), *Economic Backwardness in Historical Perspective: A Book of Essays*, Cambridge, Belknap Press of Harvard University Press.

a crucial role in the industrialization process by offering an industrial and a trade policy for the sectors depending on foreign sources for their raw materials, and by protecting the domestic market from the foreign competitors with tariffs. The universal or mixed banks are the second important factor considered by Gerschenkron. The model of these banks was similar to that one adopted in Germany around the mid-nineteenth century. Actually, those German bankers were among the founders of the two biggest Italian banks, Banca Commerciale (today Banca IntesaSanPaolo) and Credito italiano (today Unicredit). The predominant business culture in the country – another ingredient of the model described by Alexander Gerschenkron – at that time was protectionism and nationalism. In the meantime, Italian bourgeoisie were never attracted by risky investments, such as industrial ones, despite the huge financial resources they had at disposal. Their preferred investments were always very prudent: a mixture of real estate and state bonds, especially but not exclusively issued by the Italian Treasury, but also by other European States.[3]

The Italian commercial code opened the door to stock companies, but their number did not grow very significantly in the 1880s. The Italian stock exchanges (in the late nineteenth century they were in the most important cities – Turin, Milan, Florence, Rome, and Naples) were quite peaceful places with a few tens of listed companies, most of them banks and insurance companies, until the early twentieth century.[4] The first speculative boom occurred in 1906-07, immediately followed by a crisis. The number of Italian listed companies, which at the peak of the bubble numbered more than 170, slowly decreased to some 100-120. Before the mid-1980s, the number of the Italian listed companies never again reached the same pre-crisis level.[5]

The economic literature has discussed the role of the banking system in the industrialization process. The prevailing opinion, based on archival researches, underscores the decisive role of the universal banks for Italian economic development.[6] However, there is a minority view, largely based on economic models and on the technological paradigm, instead of the theory of stages of economic development. This interpretation suggests that the banks' role has been overestimated because many other financial institutions, even at the local level, contributed to providing the financial means necessary for the day-by-day firms' activities.[7] However, both interpretations agree on the fact that the universal banks in Italy did play the same role as in Germany, where they pushed the companies they helped grow to go into the capital market, because they did not want to be their main creditors forever. In Italy, they did not succeed, because the business culture of the entrepreneurs was very conservative: they did not want to enter the stock market because they feared losing control of the company they and their family created. This cultural limitation influenced – and is still influencing today – Italian capitalism. However, apart from such cultural resistance, the failure of the German model of integration with the stock exchange in Italy has been explained with the predominance of a bank-oriented system that emerged after the 1907 crisis and that characterized a long part of the twentieth century.[8]

[3] Ciocca, P. (2007), *Ricchi per sempre? Una storia economica d'Italia (1796-2005)*, Turin, Bollati Boringhieri.

[4] Baia Curioni, S. (1998), *Regolazione e competizione. Storia del mercato azionario in Italia (1808-1938)*, Bologna, il Mulino; Siciliano, G. (2001), *Cento anni di borsa in Italia: mercato, imprese e rendimenti azionari nel ventesimo secolo*, Bologna, il Mulino; Volpi, A. (2002), *Breve storia del mercato finanziario italiano: dal 1861 a oggi*, Rome, Carocci; Piluso, G. (2011), "Il ruolo dello Stato imprenditore e regolatore," in *Dall'Unità ai giorni nostri: 150 anni di borsa in Italia*, Consob (pp. 111-135).

[5] Baia Curioni, S. (2000), *Modernizzazione e mercato: la Borsa di Milano nella "nuova economia" dell'età giolittiana (1888-1914)*, Milan, EGEA.

[6] Confalonieri, A. (1976), *Banca e industria in Italia 1894-1906*, 3 voll., Banca Commerciale Italiana.

[7] Fenoaltea, S. (1983), "Italy," in P. O'Brien, *Railways and Economic Development in Western Europe, 1830-1914*, London, MacMillan; Rinaldi, A. & Spadavecchia, A. (2019), "The banking-industry relationship in Italy: large national banks and small local banks compared (1913-1936)," *Business History*, 1, 1-20.

[8] Nardozzi, G. & Piluso, G. (2010), *Il sistema finanziario e la borsa*, Rome-Bari, Laterza.

9.2 The Italian mixed economy

Another reason the Italian capital market never grew very large was because of the level of income, which has remained relatively low compared to the most advanced European countries. In the 1920s, the banking system tried to revitalize the capital market. It did not succeed in an operation that was decisive for its very survival, i.e., re-igniting the stock exchange. A kind of "mission impossible" in a country with still a too low per capita income level. In fact, in those years, the balance sheets of the largest banks grew in size with an increase in shares that, in many cases, were just the forced transformation of a firm's debt. Nobody was interested in buying these shares. When the 1929 crisis arrived, the Italian banks went *de facto* into bankruptcy. They were rescued by the State, which from the 1930s on, became the new major protagonist of the Italian mixed capitalism. The State was not only making the decisions on economic policy because it was the biggest shareholder of the Italian business system, but the State holding company IRI (*Istituto per la Ricostruzione Industriale*, Institute for industrial reconstruction) controlled a large portion of the industrial base and all the most important banks.[9]

The State holdings and the sectoral sub-holdings played a fundamental role in the Italian "economic miracle" of the 1950s-60s. Other state-controlled holdings (in the oil, mining, and industrial sectors) were set up until the late 1940s and the 1950s, contributing to the Italian economic boom. The private sector of Italian capitalism was not defeated. The system worked quite well for the next 60 years: a non-competitive arrangement that permeated both private initiative and State interests to attain their strategic objectives. The big private groups developed a consensual command

[9] Castronovo, V. (2012), *Storia dell'IRI. 1. Dalle origini al dopoguerra, 1933-1948*, Rome-Bari, Laterza; Conte, L. & Piluso, G. (2012), "Il finanziamento dell'Iri e i rapporti con il sistema bancario (1948-1972)," in F. Amatori (ed.), *Storia dell'IRI, Il "miracolo" economico e il ruolo dell'IRI, 1948-1972*, Laterza (pp. 463-522).

strategy that was celebrated in the common shareholdings of certain financial firms (Bastogi) and/or merchant banks (Mediobanca) that were considered the "salotto buono" (VIP Lounge) of Italian capitalism.[10]

This business culture did not change despite the huge transformation of the Italian economy after World War II. The governments of the new Italian Republic accompanied this trend with a fiscal policy that incentivized the firms' system of choosing their alternatives according to a clear priority structure. In first place was bank credit, a choice that became easier because of the establishment of new special financial institutions; in second place, the issuance of corporate bonds; and just as a last resort, the issuance of shares, the least convenient instrument in terms of costs and fiscal privileges.[11]

On the other hand, the Italian economic system was unreceptive when rules were proposed to favor competition. In the 1950s and 1960s, Italy was particularly strong in rejecting the U.S. proposal to introduce anti-trust laws as an instrument to fight against monopolistic or oligopolistic conditions. From this point of view, there was an effective convergence of the State and the private firms' interests: both could be criticized for profiting from such positions in several sectors.[12] In 1964, a special parliamentary commission issued a report, approved only by the government's parties, affirming that there were no obstacles to competition in Italy.[13] According to Baumol, Italy appeared to be a perfect example of the bad use – or no use at all – of the incentives produced by rules, both formal and informal, which could lead entrepreneurs and managers towards innovation and risk-taking. As Di Martino and Vasta suggest, the consequence was companies choosing rent seeking, which played a "destructive" role in the economy, typical of a "predatory and immature" economy.[14]

The ineffectiveness of the Italian stock exchange in that period was not only due to the economic system being bank-oriented, but also because the micro-regulation was very weak and inefficient. The choices made by the lawmakers and the business

[10] Segreto, L. (1997), "Models of Control in Italian Capitalism from the Mixed Bank to Mediobanca, 1894-1993," *Business and Economic History*, 37 (pp. 649-661); Piluso, G. (2005), *Mediobanca. Tra regole e mercato*, Milan, EGEA; Piluso, G. (2011), "Financial intermediaries: their evolution and relations with firms," *Review of Economic Conditions in Italy*, 64(2-3), 333-379.

[11] Ciocca, P. (1991), *Banca, finanza, mercato. Bilancio di un decennio e nuove prospettive*, Turin, Bollati Boringhieri; Barbiellini Amidei, F. & Impenna, C. (1999), "Il mercato azionario e il finanziamento delle imprese negli anni cinquanta," in F. Cotula (ed.), *Stabilità e sviluppo negli anni cinquanta, vol. 3: Politica bancaria e struttura del sistema finanziario*, Bari, Laterza; Piluso, G. (2012), "Corporate Governance in Italy. Groups, Families and Financial Institutions in a European Mirror, 1896-2000," in H. Bonin & L. Segreto (eds.), *European Business: Corporate and Social Values*, Brussels, Peter Lang.

[12] Segreto, L. & Wubs, B. (2014), "Resistance of the Defeated: German and Italian Big Business and the American Antitrust Policy, 1945-1957," *Enterprise & Society*, 15(2), 307-336.

[13] Granata, M. (2008), *Cultura del mercato. La commissione parlamentare d'inchiesta sulla concorrenza (1961-1965)*, Soveria Mannelli, Rubbettino.

[14] Baumol, W.J. (1990), "Entrepreneurship, productive, unproductive, and destructive," *Journal of Political Economy*, 98(5), 893-921; for an application of this approach to Italy see Di Martino, P. & Vasta, M. (2018), "Reassessing the Italian 'Economic Miracle': Law, Firms Governance and Management 1950-1973," *Business History Review*, 92, 281-306.

and financial community favored rules oriented toward macroeconomic stability. When the nationalization of the electricity industry took place in the early 1960s, it could have produced a positive shock, considering the numbers of listed electric companies and their financial size. The Italian government and the Bank of Italy preferred to nationalize the plants and the infrastructure, *de facto* transforming all the companies into financial firms. Most of them merged with industrial groups that were seeking lucrative financial assets, thus annihilating the purpose behind the governmental decision, i.e., to relaunch the stock exchange.[15]

9.3 The reforms, finally

During the 1960s, the center-left government presented a reform for the stock exchange. The acceleration of the discussions in the early 1970s was linked to the attempt by the banker Michele Sindona to take over Bastogi, one of the most powerful Italian financial holdings.[16] Instead of approving the law, after a discussion in the Parliament, the government introduced the most important novelties with a decree-law, a procedure that gave less time for discussion (the parliament had just two months before the lapsing of the act). Thus, in 1974 the law established the *Commissione Nazionale per le Società e la Borsa Italiana* (abridged as Consob), the Italian Commission for stock companies and the stock exchange. Criticism and praise characterized the debate after Consob came to life. Was the glass half-full or half-empty? Italy was coming very late to establishing a set of rules concerning stock companies and the stock exchange. Undoubtedly, the reform of 1974 did not introduce tools of so-called internal oversight for significant minorities and for institutional investors. However, one cannot forget that, despite the active presence of mutual funds (established in Luxemburg by the Italian banks), they were not yet legal in Italy (the law was passed in 1983). On the other hand, in the 1970s, foreign exchange regulations still represented an important barrier to entry from abroad, and therefore "Italy lacked then the pressure represented by market depth, and by efficient brokers and investors."[17]

However, regardless of the limitations and despite the political influence of certain nominees for the leadership of the independent authority, Consob represented

[15] Piluso, G. (2014), "Maturity Mismatch and Allocative Efficiency. Long-Term Financing and Investment Banking in Italy, 1936-1975," in C. Brambilla & H. Bonin (eds.), *Investment Banking History: National and Comparative Issues (19th-21st Centuries)*, Brussels, Peter Lang (pp. 291-315); Piluso, G. (2016), "Le dinamiche evolutive della finanza italiana in prospettiva storica," in G. Morbidelli (ed.), *Il modello italiano di intermediazione finanziaria: specificità, eredità e futuro*, Fondazione Cesifin (pp. 133-159).

[16] Sindona was an unscrupulous Italian banker connected with some the American Mafia, accused both in Italy and in the USA of bankruptcy, and nevertheless able to keep the political support among some prominent leaders of the Christian Democratic Party that dominated the governments until the early 1990s (Magnani, M. (2016), *Sindona. Biografia degli anni Settanta finanziaria*, Turin, Einaudi).

[17] Marchetti, M. (2011), "La regolamentazione delle società quotate," in *Dall'Unità ai giorni nostri: 150 anni di borsa in Italia*, Rome-Milan, Consob, p. 61.

an important step toward international standards, and opened the door to further changes. In the 1980s, and even more so in the 1990s, the acceleration of the transformation of the financial market and the globalization process required many interventions. Finally, the introduction of the antitrust legislation in 1990 (Italy was one of the last OECD countries to approve such a law) paved the way to more advanced reforms. In 1991, there was a law establishing the Società di intermediazione mobiliare (SIM, securities brokerage companies); a few months later, there was another law covering insider trading, while in 1992 another legislative intervention introduced the norms defining when a takeover bid is obligatory. Many of these interventions became not only possible but compulsory because of the strong initiative of the European Commission, the real *deus ex machina* of many reforms made in Italy in that period. Europe was the "external constraint," to quote Guido Carli, who was governor of the Bank of Italy (1960-75), president of the Italian industrialists (1976-80), and minister of the Treasury (1989-92), in the years of maximum reform efforts.[18]

The end of the IRI experience, with the transformation of the SOEs into stock companies and the privatization process, started in 1993-94, and opened a new era. In particular, the arrival of foreign investors among the shareholders of the big privatized Italian banks prepared a different institutional framework for Italian corporate governance. By the way, the privatized banks could own industrial shares, but only up to 15% of their capital.[19] However, the reforms did not stop. In 1997 a special commission headed by Mario Draghi, then the General Director of Italian Treasury, reorganized and reunified into one single document the long series of economic and financial reforms approved in those years and in the previous decades. In February 1998, this document became the *Testo Unico della Finanza*, simply known as TUF or *Legge Draghi* (Draghi Law), the unified text on finance. The aim of the reform was to reinforce protection for investors and minority shareholders. The law's elements concern the regulation of listed companies: shareholders' agreements, internal controls, minority shareholders' rights, and public bids. Among the most important aspects of the unification of all the laws concerning the financial and capital markets were the new powers given to the Consob, and the more precise sanctions for misconduct like insider trading.[20]

Stock market capitalization boomed in the second part of the 1990s, as one can observe from Figure 9.1; it reached almost 50% of GDP, not far from other advanced economies of that years. About 40% of trading activities were coming from abroad. However, as we have already seen in the first section, the number of listed companies did not really change very much. In the boom years (1996-2001), the number of new listed companies (100) was almost equivalent to that of the de-listed companies (95).[21]

[18] *Ibidem*, pp. 63-67; Carli, G. (1993), *Cinquant'anni di politica italiana*, in collaborazione con Paolo Peluffo, Bari, Laterza (p. 267).

[19] Macchiati, A. (1996), *Privatizzazioni tra economia e politica*, Rome, Donzelli.

[20] Consob (2020), *Testo unico della finanza, Decreto legislativo 24 febbraio 1998, n. 58. Aggiornato con le modifiche apportate dal D.L. n. 23 dell'8.4.2020, in vigore dal 9.4.2020, a cura della Divisione Tutela del Consumatore Ufficio Relazioni con il Pubblico*, Roma.

[21] Consob, *Relazioni annuali, 1996-2001.*

Figure 9.1 Market capitalization of listed companies (% of GDP), 1998-2018

Source: CEIC data.

The discussion about the TUF could not avoid considering the impact of the European discussions about corporate governance. In particular, the Cadbury Report and the first Viénot Report were part of the discussion within the special commission headed by Draghi. However, the text approved was very different from the British and the French codes simply because it was not supposed to produce an Italian code. Rather, it was supposed to issue a draft for a law to be followed by all listed companies. In the meantime, no mention was made about any topics concerning the board of directors, its functions, and its duties.[22]

These elements, to the contrary, can be found in the *Codice Preda* (Stefano Preda, chairman of Borsa Italiana between 1997 and 2000, the founder and the chairman of the committee charged by the Italian stock exchange to prepare a text on corporate governance). The *Codice di Autodisciplina*, the Code of Self-discipline, issued in 1999, can be considered the real Italian version of the codes of governance enacted in the same years abroad.[23] The principles established by the Code affirms that Corporate Governance is "the set of rules according to which firms are managed and controlled, is the result of norms, traditions and patterns of behavior developed by each

[22] Melis, A. (2000), "Corporate Governance in Italy," *Corporate Governance. An International Review*, 8(4), 347-355.

[23] Melis, A. & Zattoni, A. (2017), *A Primer on Corporate Governance: Italy*, New York, Business Expert Press.

economic and legal system. (...) The main aim of a good corporate governance system is creating shareholder value." If these last two words represent evidence that the Italian code absorbed the mainstream of Anglo-Saxon financial capitalist thought, another word – traditions – testifies that the text was also influenced by Italian juridical and economic history.

The Code includes, among other things, the following topics: the role of the board of directors; the composition of the board of directors; the presence of independent directors; the processing of confidential information; the procedures for appointing directors and their remuneration criteria; the internal control committee; and the relations with institutional investors and other shareholders.[24] The code was modified for the first time in 2002. However, the scandals of 2003-04 involving two big food companies, Cirio (owned by Sergio Cragnotti) and Parmalat (owned by the Tanzi family),[25] forced another reformulation in 2006. Over the following years, other versions amended the text in 2010, 2011, 2014, and 2015. The latest version was introduced in 2018.[26]

The reforms of the company law of 2003 introduced several models of corporate governance. The text provided for the possibility of choosing between three different models of administration and control. Alongside the "traditional" model, characterized by the presence of the administrative body (sole director or board of directors), and the board of statutory auditors, the law introduced two alternative models. They are commonly referred to as the "dualistic" model and the "monistic" model. While the reform of company law has been limited to a few changes in the traditional system, the two alternative models are a new concept. In particular, the "dualistic" model is characterized by the simultaneous presence of a supervisory board and a management board, accompanied by a significant reduction in the powers of the ordinary shareholders' meeting. In particular, the latter loses the power to approve financial statements and appoint directors, leaving that to the supervisory board.[27] The

[24] Comitato per la Corporate Governance (1999), *Codice di Autodisciplina*, Borsa Italiana, Milan.

[25] Sapelli, G. (2004), *Giochi proibiti. Enron e Parmalat capitalismi a confronto*, Milan, Bruno Mondadori; Mazzoni, M. (2005), "La parabola di Sergio Cragnotti. Tra sogni imprenditoriali e acrobazie finanziarie," in Associazione di storia e studi sull'impresa, *Annali di storia dell'impresa, Voll. 15-16*, Venice, Marsilio.

[26] Melis, A. & Gaia, S. (2011), "Corporate governance in Italy: Normative developments vs. actual practices," in C.A. Mallin, *Handbook on International Corporate Governance*, Cheltenham, Edward Elgar.

[27] With regard to the dualistic model, the company's by-laws may provide that a management board and a supervisory board exercise the administration and control. In the presence of such a model, the ordinary shareholders' meeting: 1) appoints and removes the supervisory board; 2) determines the remuneration due to them; 3) decides on the responsibility of the members of this body; 4) decides on the distribution of profits; 5) appoints the auditor. The Supervisory Board, on the other hand, consists of no less than three persons, who remain in office for three fiscal years. The President is elected by the assembly, and his powers are determined by the statute. In this model, the Supervisory Board: 1) appoints and removes the members of the Management Board and determines their remuneration; 2) approves the financial statements for the year and the consolidated financial statements; 3) monitors compliance with the law and the articles of association; 4) promotes an action of responsibility towards the members of the Management Board; 5) reports to the shareholders' meeting at least once a year on the activities carried out. Although it has many similarities with the German model, of which it reproduces the double level (supervisory board and management board), it should be noted to avoid misunderstandings, that the Italian dualistic system has a substantial difference with respect to the model by which it was inspired. While in Germany the system of codetermination (*Mitbestimmung*) is required by law, in Italy there is no provision for the presence of workers on the supervisory board. This leads to a concentration of power in the hands of the supervisory board, which, moreover, only represents one category of stakeholders, the shareholder (Corsetti, B., Sannasardo, C., & Sforza Portolano Cavallo, G. (2019), *Corporate governance and directors' duties in Italy: overview*, Thomson Reuters, available at https://uk.practicallaw.thomsonreuters.com/7-502-0235).

so-called "one-tier" model, on the other hand, is based on the sole board of directors with an internal management control committee, along the lines of the Anglo-Saxon board model.[28] The majority of the listed companies adopted the one-tier system, mostly because of the complexity of the dual system.[29] Important exceptions have been two of the biggest Italian private financial institutions, the biggest Italian bank, Banca IntesaSanPaolo, and the most important and most famous merchant bank, Mediobanca; this is due to their very complex ownership structures, including the presence of some foundations in the case of the former. However, also in their case, the system was abandoned after some years. Unicredit, the second largest Italian bank, never adopted the two-tier system, but opted for the one-tier system with the audit board.[30]

All the reforms and the different version of the *Codice di Autodisciplina* did not change some deep features of the Italian economic system. The most recent analysis, issued in 2019 and based on the Consob report, confirms certain historical trends of Italian listed companies. The ownership structure remains very concentrated: 52% of the listed companies in 2017 were directly controlled by the majority of the shareholders' meeting that approves the report and nominates the board, while 9% were controlled by a coalition among shareholders, a number that is decreasing. Those widely held were only 7%. The average level of shares controlled by the first share-

[28] With regard to the one-tier model, the Articles of Association may provide that the administration and control are exercised respectively by the Board of Directors and by a committee established within it. The management of the company is the exclusive responsibility of the board of directors, and at least one third of the members of the board must meet the requirements of independence. In this model, the role of the management control committee is of fundamental importance. It is composed of directors who meet the requirements of integrity and professionalism established by the articles of association, and the requirements of independence, who are not members of the executive committee, and to whom no particular powers are attributed. The Internal Control Committee elects the Chairman among its members by an absolute majority; supervises the adequacy of the company's organizational structure, the internal control system, and the administrative and accounting system; carries out the additional tasks assigned to it by the Board of Directors, with particular regard to the persons in charge of accounting control.

[29] Abatecola, G. & Poggesi, S. (2010), "Le difficoltà del cambiamento dei sistemi di governance delle società italiane quotate," in F. Fortuna (ed.), *La corporate governance nell'esperienza internazionale: aspetti comparativi e profili evolutivi*, Bologna, il Mulino (pp. 10-50).

[30] Benewitz, S. (2008), "Mediobanca abbandona il sistema duale," *la Repubblica*, 31 July; Greco, A. (2016), "Intesa Sanpaolo abbandona il duale per guardare all'Europa," *la Repubblica*, 27 April.

holder has remained between 47% and 49% since 1998. In the majority of the cases, the controlling shareholder is a family. In 2017, 18.6% of listed companies (44.7% of the market capitalization) belonged to pyramidal or mixed structures (they had been 44% in 1998), while the level of separation between ownership and control is decreasing. "Loyalty shares" (equivalent to the French double voting rights shares), introduced in 2014-15, existed only in about 15% to 20% of the total. The members of the boards were primarily Italians; their average age is below 57 years. The family is represented in 16% of the cases. Board members who are college graduates comprise about 88% of cases (the post-graduate 23%), and they are managers in 70% of cases. The system is very much "Italian:" foreign citizens represent just 7% of the total number of boards' members. There is a decreasing number of board members with seats on other listed companies, but among women, the trend is going into the contrary direction. This permits us to say a few words on the gender issue. The rules say that the women must be at least 30% of the members of a board of directors: this gender requirement is practically observed by all the listed companies. However, the women are basically elected as independent directors. Women CEOs – or chairpersons – are still marginal among listed companies.[31]

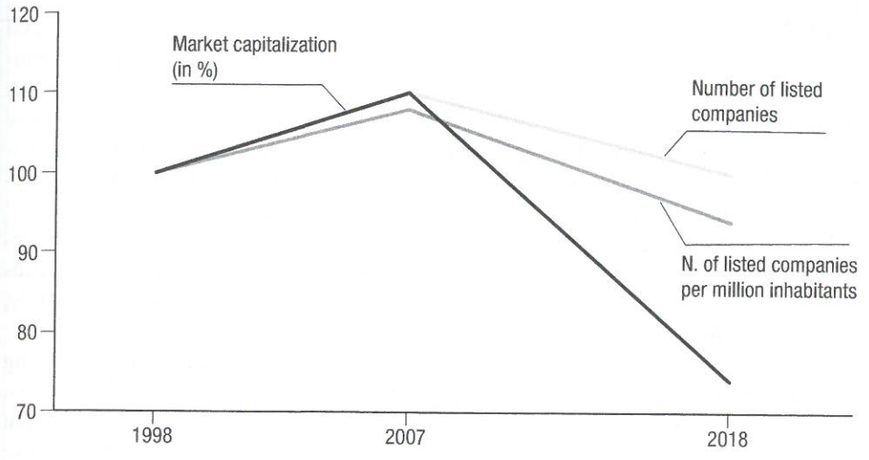
There are other aspects that permit us to affirm that the Italian stock exchange still has to progress. After the relative boom of the late 1990s and early 2000s, the trend continued until 2007. The crisis stopped it, but the capitalization/GDP ratio remained higher than in the mid-1990s. In decade 2007-2017, the representativeness of the Italian economy in the listed companies, measured by the number of companies per million of inhabitants, sharply shrunk. The stability of the number of listed companies does not help. These elements are visible in **Figure 9.2**.

Despite the improvements, many aspects are still very critical. The evaluation offered in March 2019 by the Assonime, the Italian Association of stock companies, was very negative. "The underdevelopment of the Italian capital market affects investment choices of the international institutional investors (especially of those who prefer a passive strategy). The weight of Italian listed companies in the international stock exchange indexes heavily underestimates the importance of the Italian economy and of the Italian stock exchange as well. This reflects the low propensity to be listed, as well as the historical resistance to spread the ownership structure by the listed companies. The floating shares are not only below the level of that in countries where widely held shareholding prevails (USA, UK, Switzerland, The Netherlands) but also below that of countries where family control prevails (France, Spain, Germany, Sweden, and Finland)."[32] The paradoxes of the Italian economy are not easy to resolve.

[31] Linciano, N. (2019), *L'evoluzione della corporate governance in Italia. Le evidenze del rapporto Consob*, Rapporto sulla corporate governance delle società quotate italiane, Rome, 18 March.

[32] Belcredi, M. & Bianchi, M. (2019), *Una corporate governance orientata alla creazione di valore e alla crescita: il ruolo dell'autodisciplina*, Rome, Comitato per la Corporate Governance e Assonime, March 18.

Figure 9.2 The evolution of the Italian stock market, 1998-2018



Source: Belcredi, M. & Bianchi, M. (2019), *Una corporate governance orientata alla creazione di valore e alla crescita: il ruolo dell'autodisciplina*, Rome, Comitato per la Corporate Governance e Assonime, March 18.

In January 2020, the new Code has been published. It aims to stimulate listed companies to adopt strategies increasingly oriented towards the sustainability of the business activity. The primary task of the management body is to pursue the sustainable success of the company, defined as the objective of creating long-term value for the benefit of shareholders taking into account the interests of the stakeholders relevant to its business. The management body is responsible for integrating sustainability objectives into the business plan, the internal control and risk management system and the remuneration policies.

The new Code recommends listed companies to develop dialogue with the market by adopting engagement policies complementary to those of institutional investors and asset managers. A key liaison role is attributed to the chairman of the board, to whom the Code entrusts the task of submitting to the approval of the board itself, in agreement with the CEO, a policy for managing the dialogue with the majority of the shareholders. The aim is to ensure an adequate disclosure to the board on the development and significant contents of the dialogue that took place with all the shareholders.

Moreover, in order to facilitate access to the listing of medium-small and high-concentration companies, the application of the new Code is based on principles of flexibility and proportionality. Some recommendations are therefore addressed only to large companies (companies with a capitalization exceeding €1 billion for three consecutive calendar years) while specific simplifications are envisaged for

companies with a concentrated ownership (companies in which one or more shareholders have, directly or indirectly, of the majority of the votes that can be exercised in the ordinary meeting).

Another relevant aspect of the new Code is its more streamlined structure, based on principles that define the objectives of good corporate governance, and recommendations subject to the "comply or explain" rule, while the comments have been eliminated. To facilitate its application, the *Comitato per la Corporate Governance* (the Committee for Corporate Governance) of the Italian Association of Stock Companies will reinforce the contacts with the member companies to start the development of a regular system of Q&A, to be updated periodically.

The Committee has also developed a neutral approach to best practices with respect to governance models to make the Code directly usable in all types of corporate model (traditional, monistic, dualistic), also by foreign companies listed in Italy, an element of strong originality.

Lastly, the occasion for the review was also taken to strengthen some existing recommendations (assessment of independence, quality of information to directors, role of the board chairman). The new code explicitly recommends best practices that were merely desired in previous editions of the Code (plan of succession of executive directors, equal treatment and opportunities between genders in the company organization). Thus, it aligns domestic self-discipline with some international best practices (possibility to qualify the board chairman as independent, recognition of the role of the board secretary, attention to foreign experiences in defining remuneration policies).[33]

[33] http://www.assonime.it/assonime/area-stampa/Pagine/Pubblicato-il-nuovo-Codice-di-Corporate-Governance.aspx.

Case study Mariella Burani Fashion Group

An overview of the group

Mariella Burani Fashion Group S.r.l. (later on "MBFG") was a clothing company, founded in 1960 by Mariella Burani and his husband Walter Burani. Just in the 1970s, after the spread of "prét à porter" in Italy, the company begun to export its products and to expand their range by producing women clothes, accessories, and opening its first boutiques in Italy. Between 1980 and 2000 the group started operating with a licensing system in order to foster growth. In July 2000, the group was listed in Borsa Italiana Stock Exchange in the STAR segment. In the same period, the company made several acquisitions, most of them concerned among small-medium manufacturing companies such as Coccinelle, Baldanini and Braccialini, all operating in the leather goods sector. The diversification strategy was even more evident in 2006, when MBFG acquired and made agreements with businesses in the jewelry market. In less than 25 years, the group passed from being considered as "small-medium" to being considered a large group.

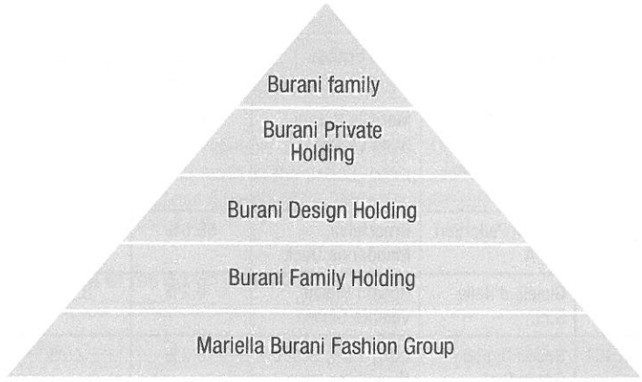
The governance structure of the group

The controlling family of the Mariella Burani Fashion Group was composed by Mariella, Walter, and their sons Giovanni and Andrea. They held the ownership of a complex group, made of several companies.

1. Burani Private Holding (hereafter BPH) was a financial holding not listed in the Stock Exchange owned at 79,3% by Walter Burani and for the remaining percentage by financial investors. The Board of Directors was composed by:
   - Walter Burani – President
   - Giovanni Burani – Chief Executive Officer
   - Andrea Burani – Director
   - Giuseppe Gullo – Director
   - Enrico Palandri – Director.

   The auditing firm of BPH and all its subsidiaries was Mazars & Guerard S.p.A.

Figure 9.3 The structure of the group



2. Burani Design Holding (hereafter BDH) was established in March 1990 with the aim of achieving a leadership position in the accessible luxury sector, owning and acquiring companies in the following industries:
   - fashion – with Mariella Burani Fashion Group
   - beachwear and underwear – with Arcte S.p.A.
   - wellness and skincare – with 50% of shares of Eurocosmesi S.r.l.
   - fine food – by establishing BDH Food Design S.r.l., focusing on the sale of drinks, instant food products and shops such as cafes and chocolatiers.

   The company was listed in the London Stock Exchange in the Alternative Investment Market (AIM). It was owned at 53% by BPH, and its headquarters were based in Amsterdam. The Board of Directors was composed by:
   - Giovanni Burani – President
   - Giuseppe Gullo – Vice-president and CFO
   - Kevin Campere Tempestini – CEO
   - Simon Erroll Prior-Palmer – non-executive and independent director
   - Davide Enderlin Jr. – non-executive and independent director
   - Dick Haarsma – non-executive and independent director
   - Dirk Peter Stolp – non executive director.

3. Mariella Burani Family Holding (hereafter MBFH) was established in 2004 with the aim of controlling and holding participations of its subsidiaries, and of buying and selling real-estate properties and industrial buildings. This holding was totally owned by BDH.

4. Mariella Burani Fashion Group was the operative company, listed at the Borsa Italiana Stock Exchange in the MTA Star segment. The main divisions of the group are listed in **Table 9.1.** The Board of Directors was composed by:
   - Water Burani – President and CEO
   - Giovanni Burani – CEO
   - Andrea Burani – CEO
   - Giuseppe Reno Zoboli – Independent Director
   - Daniele Monarca – Independent Director.

Table 9.1 Revenues of the companies and the different brands of the group (2006-2008)

Division	Companies	Main brands	% of revenues 2008	% of revenues 2007	% of revenues 2006
Apparel	Mariella Burani Retail S.r.l. Junior Fashion Group S.r.l	Mariella Burani, René Lezard	28.9%	38.6%	50.81%
Leather goods	Antichi Pellettieri S.p.A.	Braccialini, Mandarina Duck	56.6%	45.4%	42.61%
Jewellery	Gioielli d'Italia S.r.l.	Rosato Gioielli, Valente Gioielli	6.2%	8.48%	0.7311%
Digital and ICT services	Sedoc Digital Group S.r.l.	Longwave, Sedoc. IT	8.2%	7.5%	5.838%

Source: Own elaborations based on data from Aida.

The listing processes on the stock exchange

In July 2000, during a period of rapid growth, the management of Mariella Burani Fashion Group (MBFG) decided to list the group on the Italian stock exchange. The reasons for the operation were the necessity of equity capital in order to finance growth operations. After just 5 years from the listing of MBFG, the management decided to list two subsidiaries (Green Vision Ambiente and Bioera) in the Expandi market. In 2006, also Antichi Pellettieri S.p.A was listed in the Expandi market and just one year later, Burani Design Holding (BDH) was listed in the Alternative Investment Market (AIM) in the London Stock Exchange. With BDH the IPOs happened in seven years amounted to five. In the end, the gains of the listing processes amounted to €370 million. Thanks also to this success, Giovanni Burani was awarded as "financial manager of the year" in 2008 by Borsa Italiana Stock Exchange for his "strategic use of financial leverage."

The tender offer

During the second half of 2008 the management of MBFH decided to make a tender offer to increase its ownership in MBFG. Walter Burani, who held the 61.24% of MBFG's share capital through BDH, indirectly controlled this company. The operation was approved by the Italian Consob (Italian authority responsible for regulating the Italian security market) and was preceded by intra-group operations. The most important one concerned the acquisition by BDH of the majority of stake in MBFH from the Burani family. Walter Burani offered €17.5 per share and succeeded in increasing its stake to 79.175%. The price was not determined by an independent advisor, but was calculated internally by MBFH, using management's estimates on profitability and financial perspectives. As a result, the debt of MBFH increased by €47.242 million.

Other fraudulent transactions

Many false acquisitions were made with the support of Mr. Giacinto Giuliani, whose companies helped the Burani family to make fraudulent transactions in London, in order to acquire brands and trademarks from the group. Mariella Burani UK (also known as MB UK) was sold to Giacinto Giuliani in 2004. The company was indebted with Bipielle Bank Suisse for €10.8 million. At the end of 2008, the debt was extinguished by a fund in the same bank, owned by the Burani family. In early 2009, Mr. Giuliani exchanged e-mails with Giovanni Burani, in order to ask BDH a loan of €10.845 million. On April 13, 2009, Mariella Burani UK was liquidated, however the loan took place without guarantees, and the money was available on MB UK's bank account on April 29, 2009.
Concerning the sale of trademarks such as Amuleti Profumi, the acquirers never paid the full amount established for the transaction: out of €11 million, they just paid €3.4 million. Further transactions were made with those companies, such as the €2 million bank account transfer from the group to London based company Watford Solutions owned by Mr. Giuliani without a specific reason. The concerns of the Consob reflect the destination of that money, amounting to approximately €22 million in total, still unknown.

The collapse of the group

The group's indebtedness grew considerably during the years 2006-2008. The reason lays mainly in the large amount of acquisitions made in the period, considered by the management as necessary in order to enhance growth and diversification. **Table 9.2** highlights the amounts of consolidate debts of the group from 2006 to 2008.

Table 9.2 Net debt of the group (2006-2008)

Net Debt (mln €)	2008	2007	2006
MBPH	1,004.40 €	777.90 €	644.42 €

Source: Own elaborations based on data from Aida.

The collapse publicly started in 2009. However, the covenants on the group's debt were not respected as early as late 2008, and it has been the first public signal of a great financial difficulty. In the first semester of 2009, MBFG's consolidated net loss amounted to €142 million. In May 2009, the Italian merchant bank Mediobanca tried to solve the financial situation of the group by implementing a resignation plan for €60 million together with the restructuring of MBFG's non-consolidated debt amounting to €404 million in 2009 and an increase of capital for €50 million. All the family efforts to save the group were vain. The selling of the Multi-Brand Retail division to a private-equity fund in 2007, even if successful, was not sufficient to cover the debt. Mazars, MBFG's advisory company, refused to certify the half-year financial statement for 2009. Another evidence of the difficulties of the group was the resignation of Giovanni and Andrea Burani as CEOs. Ettore Burani and Gabriele Fontanesi were nominated as new CEOs. In the end of 2009, the situation was critical: no one believed that the Burani had the €50 million necessary to save MBFG's situation and Mediobanca abandoned his role as advisor. In the early months of 2010, Burani Private holding was liquidated because its share-capital was below the legal requirements.

The end of Mariella Burani's dream

From the end of 2008, the Italian authorities started to investigate on the operations of MBFG. They subsequently found out that Mr. Walter and Giovanni Burani, together with Mr. Gullo, Mr. Giuliani and Mr. Bardini, provided misleading and false information concerning MBFG's economic and financial situation during the period 2007-2009. They were accused of manipulating the financial statements of MBFG, and particularly the subsidiary Antichi Pellettieri S.p.A.
Mr. Walter and Mr. Giovanni Burani were also accused of providing false and overestimated data (through MBFH) on the balance-sheets of the group contained in the tender-offer document, especially regarding the determination and the adequacy of the price of 17.5 € per share. Furthermore, they were accused of manipulating the prospective documents and budgets concerning the future evolution of revenues. Doing so, they have manipulated the price of MBFG's shares in the market, convincing its stakeholders of a better economic and financial situation of MBFG and Antichi Pellettieri S.p.A.
The Declaration of failure of Burani Design Holding on February 2010 by Milan's tribunal caused the cascade failure of all its subsidiaries. The only suitable asset available to sell was the indirect participation hold in MBFG, which in that period was experiencing a decrease in terms of company value. The evolutions of enterprise value, equity and consolidated debt of MBFG during the period from 2006 to 2008 are shown in **Table 9.3**.

Table 9.3 Main financial figures of the group (2006-2008)

MBFG (mln €)	2008	2007	2006
Enterprise Value	1,016.1 €	1,159.6 €	1,160.9 €
Equity	54.1 €	173.6 €	134.8 €
Consolidated Debt	713.8 €	591.2 €	524.1 €

Source: Own elaborations based on data from Aida.

The Milan's Tribunal convicted Walter and Giovanni Burani for fraudulent bankruptcy and obstacle to the activities of the Italian Authorities to 6 years in prison. Furthermore, they were condemned to pay a sanction of €1.4 million each. The sanctions were also charged to Giuseppe Gullo, Giacinto Giuliani, Daniele Bardini and to the subsidiaries benefitting from the fraudulent transactions.

10 Japan, Corporate Governance, and the Culture of Harmony

10.1 Corporate governance between history and culture: From the zaibatsu to the keiretsu

Corporate governance is strictly connected with business culture. The absence – or the weakness – of the latter creates problems for the good practices of the former. On the other hand, a strong business culture has the power to influence the model, the shape, and the functioning of corporate governance. In the case of Japan, we are dealing with a country that not only has a strong business culture, but a very deep and articulated social culture that influences all aspects of society, including the business world. As has been recently said, when we deal with Japanese business law and corporate governance, we should remember that "Japanese law seems an 'exotic' variation of Roman-Germanic models," affected by United States legal models transplanted after World War II." However, at the same time, the system includes "original features related to the history, evolution, and economic and social legacy of both Buddhist and Confucian philosophies."[1]

Japan only became a modern society during the second half of the nineteenth century, after a very short and dramatic transition period from the habits, behavior, and economic model of the Middle Ages. Modernization was very rapid. From the economic point of view, the country went from an underdeveloped non-industrial economy, to a very advanced and modern one, in about three decades. The symbol of this very rapid transformation could be represented by the Russian-Japanese war in 1904-05, where Japan showed technological superiority over what was then the biggest army of the world. The ingredients of its economic and technological success were a mixture of State intervention and private initiative. The most relevant protagonists of the first Japanese economic boom were the *zaibatsu* ("group"). Their indirect influence spread over the entire period of their existence. To some extent, according to the literature, they can be considered the most influential factor shaping Japanese business culture and ultimately Japan's model of corporate governance. From an organizational point of view, the *zaibatsu* were industrial and financial groups containing all the elements necessary to guarantee the protection of the ownership structure and good corporate governance.

[1] Passador, M.L. (2016), "Corporate Governance Models: The Japanese Experience in Context," *DePaul Business and Commercial Law Journal*, 15(1), 25-53.

Each *zaibatsu* was controlled by a limited partnership holding company, which usually had the name of the family of the founder. Its commercial activities were all concentrated in a special firm called a *sōgō shōsha* (a general trading company), which were particularly active in the cotton industry. The *zaibatsu* had also a bank, which worked in the capital market, but only offered credit and financial assistance to the companies belonging to the holding. Finally, the *zaibatsu* controlled a series of publicly listed industrial firms, run by professional management, which in some case had also their subsidiaries, controlling large part of the market.[2] The importance of the *zaibatsu* grew over time. In the interwar period, they represented a sort of state within the state. The top 10 *zaibatsu* controlled 35% of the Japanese economy. However, in certain sectors their importance was even greater. In finance their share was 53%, and in heavy industry 49%. However, in manufacturing, they only controlled 17%, and in other sectors 16%, two relatively small percentages, but still decisive because in those branches the competitors were smaller companies.[3] However, from the corporate governance point of view, in the 1930s there were different patterns. Besides the *zaibatsu*, there were broadly held joint-stock companies and state-owned enterprises.[4]

The close connections between the *zaibatsu*, the political and military elites in the 1930s, and the collective responsibility for the economic and military aggression against several Asian countries before and during World War II produced a deep change in the Japanese economy after 1945. In fact, the original plan of the American occupation, headed by General McArthur, was for the dissolution of the economic instruments of Japanese aggression and the introduction of a real industrial democracy. Some *zaibatsu* were eliminated, thanks to the anti-monopoly law established in 1947, while some other were reorganized. The old families controlling the *zaibatsu* were expropriated and the top executives were purged. The project was supposed to Americanize the Japanese economy and reform the capital market to enlarge the number of publicly held companies. In this context, the limit on a bank's shareholding was put at 5%. The idea was to reduce as much as possible the formal and informal links existing among the industrial and financial groups.

The Korean War dramatically modified the situation. The U.S. troops needed a complex logistical structure that the islands under American administration were not suited to provide. Japan offered the necessary support. The *quid pro quo* situation implied a reconsideration of the role the Japanese business community could play in the economic Cold War. This opened the door to a new organization, the *keiretsu* (literally group or system). To provide a very simplified description of the post-1950 Japanese economy, we can say that there are two different types of *keiretsu*: horizontally diversified business groups, and vertical manufacturing networks, which also

[2] Shiba, T. & Shimotani, M. (1995), *Beyond the Firm: Business Groups in International and Historical Perspective*, Oxford, Oxford University Press; Morikawa, H. (2002), *Zaibatsu: The Rise and Fall of Family Enterprise Groups in Japan*, Tokyo, University of Tokyo Press.

[3] Yasuoka, S. (1976), *Nihon no Zaibatsu*, Tokyo, Nikkei (pp. 34-35).

[4] Yao, Y. (1999), "Historical Dynamics of the Development of the Corporate Governance in Japan," *Journal of Politics and Law*, 2(4), 167-174 (pp. 169-170).

include a vertical distribution. Actually, the complexity of the variations of this paradigm, which has many exceptions, goes well beyond these two typologies. However, for the purposes of this chapter, it is not necessary to elaborate on this description.

The first kind of *keiretsu* was set up around banks, with cross-shareholding as the instrument for controlling the whole structure. According to the law, bank shareholding must be lower than 5% (according to the 1947 anti-monopoly law), while no limit exists for the shareholding in companies (according to Anti-Monopoly Law Reform of 1977). This type of *keiretsu* reached its peak in the late 1980s, when cross shareholdings were the most representative forms of ownership structure. The vertical manufacturing networks (the second type of *keiretsu*) link together the suppliers, manufacturers, and distributors of one industry. Cross shareholdings are not necessary because of the strength of the other factors. However, the vertical structure provides a very solid and strict hierarchy to this kind of *keiretsu*. But when we consider the corporate governance issue, "in both variants, public shareholders only have access to minority interests, rendering them essentially irrelevant to corporate governance."[5]

In general, we can affirm that in both kinds of *keiretsu* there is an efficient level of coordination without centralized control, as in the time of the *zaibatsu*. The ethical ties among the different components of the *keiretsu* are very strong. This permitted Japan to avoid practically all hostile takeovers after World War II. From a strictly statistical point of view, only three occurred between 1950 and 2005. However, despite their very limited formal powers, the presidents' councils – the regular meetings among the presidents of the different firms of the *keiretsu* – contribute to defining the group's strategies, and coordinating and mediating, when necessary, conflicts that could emerge inside a group.[6]

Apart from the introduction of boards of directors in the Nippon firms, the American dream of Americanizing Japan and having the Japanese fall in love with the American business model did not last very long. By the end of the 1960s, the widely-held firm had practically disappeared, and the *keiretsu* occupied all the available space. This was also the period of the best performance of the Japanese economy, which grew between the late 1950s and the mid-1970s by an average of 9% per year. In the second half of the 1970s until the late 1980s, GDP growth was by average below 5%, but nonetheless two to three points higher than in America or the Western Europe. The perfect integration of the moral suasion and industrial policy of the MITI (the Japanese Ministry of International Trade and Industry), the *keiretsu*, and the main industrial associations led the country to pose the first economic challenge to the USA. The two countries faced growing frictions because of the competitiveness of Japanese goods (partly due to the monetary exchange rate) and the determination of the Japanese multinationals to enter the American domestic market via direct in-

[5] Morck, R.K. & Nakamura, M. (2005), "A frog in a well knows nothing of the ocean: A history of corporate ownership," in R.K. Morck (ed.), *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, Chicago, University of Chicago Press (pp. 423-442).

[6] Yonekura, S. (1985), "The emergence of the prototype of enterprise group capitalism: The case of Mitsui," *Hitotsubashi Journal of Commerce and Management*, 20(1), 63-104.

vestments. During that period, the trade war reached its peak. However, Japan's political subordination to the USA never permitted economic issues to destabilize the long-term relationship between the two countries.[7]

10.2 The lost decade and the need for economic reforms

In the 1990s Japan fell into the so-called lost decade. The speculative real estate and stock bubble of the late 1980s provoked a recession from which it hardly recovered over the following decade. The keiretsu had to restructure their organizations. The globalization process offered new opportunities for the vertical integrated groups to supply parts and components (the best example is Toyota, which reorganized its whole supply chain, by integrating it at the global level).[8]

Although the Japanese population was quite accustomed to political scandals, at least since the 1970s,[9] the situation was different with the companies. Yet, since the 1990s, shareholders who had already been damaged by the collapse of the bubble, became familiar with unprecedented scandals in Japanese business.

The banking system, which in the late 1980s was the most solid and dynamic in the world, was the first to show its hidden weaknesses. In 1996, the New York branch of Daiwa Bank admitted to $1 billion in trading losses, and was fined $340 million by the American judicial authorities.[10] Other scandals were damaging the image and the reputation of some very famous Japanese corporations, putting more pressure on the quality of corporate governance. In the year 2000, the Japanese police launched a criminal investigation into an outbreak of food poisoning attributed to Snow Brand Milk Products Co. goods; they were accused of professional negligence resulting in bodily injury as well as violations of the Food Hygiene Law. About 14,000 people had fallen ill after drinking Snow Brand's low-fat and calcium-enriched milk. The scandal had a very strong impact on public opinion. While the managers of the company tried to minimize their responsibility, suggesting that it was just a technical mistake which occurred at the rank and file workers' level, the government intervened and affirmed that "top executives of Snow Brand were 'naturally' responsible for the food-poisoning scandal." Prime Minister Yoshiro Mori affirmed categorically: "Also the executives are getting slack on the job. I think the executives should teach all their employees to make products carefully."[11] In the same year another

[7] Dore, R. (1987), *Taking Japan Seriously: A Confucian Perspective on Leading Economic Issues*, London, Athlone Press; Tsuru, S. (1993), *Japan's Capitalism: Creative Defeat and Beyond*, Cambridge, Cambridge University Press.

[8] Aoki, K. & Lennerfors, T.T. (2013), "The new, improved keiretsu," *Harvard Business Review*, 91(9), 109-113.

[9] Carlson, M.M. & Reed, S. (2018), *Political Corruption and Scandals in Japan*, Ithaca-London, Cornell University Press.

[10] Truell, P. (1996), "Daiwa Bank admits guilt in cover-up," *The New York Times*, 29 February; Misawa, M. (2006), *Current Business and Legal Issues in Japan's Banking and Finance Industry*, Hoboken, World Scientific Publishing (pp. 330-331).

[11] "Snow Brand faces criminal probe over tainted milk (2000)," *The Japanese Times*, 13 July.

scandal occurred. The carmaker Mitsubishi had to recall nearly 600,000 cars and trucks. The company said it had resolved the problems, claiming that there had been poor maintenance by the trucks' owners. In reality, they were hiding consumer complaints of vehicle defects. However, less than two years later a Mitsubishi bus hit and killed a 29-year-old person. The police investigation discovered that "company representatives were fanning out across Japan, replacing parts and begging vehicle owners not to go public with their experiences."[12]

In addition, an important pillar of Japanese corporate governance – the Shūshin koyō, or job-for-life system – that characterized Japanese economic development by giving an employee-oriented aspect to industrial relations, came under discussion. Despite the fact that the Shūshin koyō only covered Japanese 20% of the entire Japanese working population, its symbolic importance went far beyond the numbers.[13]

The ownership structure of the listed companies also came under scrutiny. The predominance of the traditional actors (banks, industrial companies, insurance firms) meant that Japan was not attracting the foreign investors that in the late 1990s-early 2000s were much needed in order to revive the Japanese economy, especially the big firms. Of course, for the "seduction offensive" to succeed, it had to include a rise in the dividends paid by the Japanese firms. Since the early 2000s, many Japanese listed companies announced buybacks before the end of financial year. Investors welcomed this strategy, which was aimed mainly at increasing profits per share. As the **Table 10.1** shows, the comparison with the USA and Germany permits us to appreciate the results of this strategy.

This trend continued in the following years. At the end of 2012, the breakdown of shareholdings in the Japanese markets was as follows: individuals/others – 26.2%; overseas corporations, etc. – 24.3%; business corporations – 23.3%; and trust banks – 15.7%. The percentage held by domestic institutional investors (trust banks and insurance companies) was 20.9%. That percentage increases to 45.2% when foreign institutional investors are included. Almost one-half of Japan's listed companies had the participation of institutional investors. This element is particularly important when considering that the number of listed companies, which in 1990 numbered 1,627, increased to more than 2,055 in 2000. In 2012 they were 2,294, and just one year later 3,408, i.e., 50% more. In June 2020 they were 3,816. This was the effect of the integration, in 2013, of the Tokyo Stock Exchange and the Osaka Securities Exchange.[14] **Figure 10.1** describes quite well the long-term evolution of the ownership structure among Japanese listed companies.

[12] Faiola, A. (2004), "Safety scandal shames Mitsubishi," *Washington Post*, 6 July; "Scandal-wracked Mitsubishi Motors struggling to survive (2004)," *The Japanese Times*, 21 August.

[13] Wolff, L. (2008), "The death of lifelong employment in Japan," in L. Nottage, L. Wolff, & K. Anderson, *Corporate Governance in the 21st Century: Japan's Gradual Transformation*, Cheltenham, Edward Elgar (pp. 53-54).

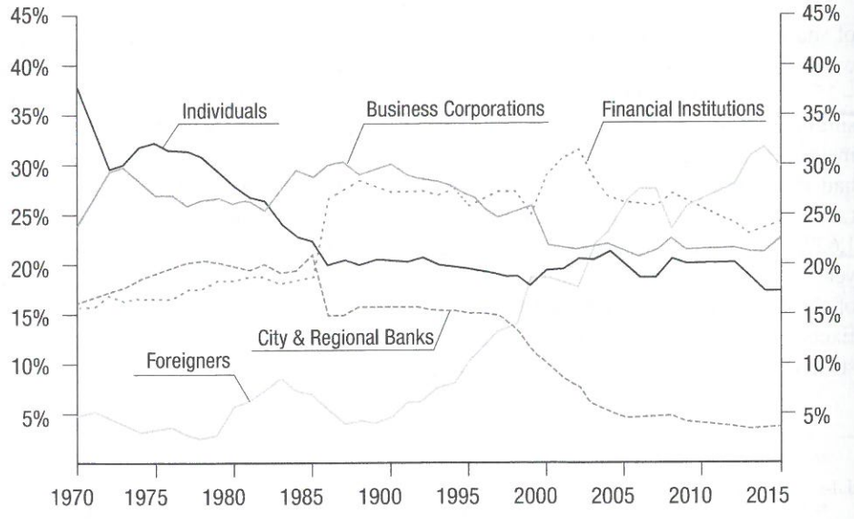
[14] Ueda, R. (2015), *How is Corporate Governance in Japan Changing? Developments in Listed Companies and Roles of Institutional Investors*, OECD Corporate Governance Working Papers No. 17 (pp. 10 and 13); https://www.theglobaleconomy.com/Japan/Listed_companies.

Table 10.1 Ownership of listed companies in Japan, United States, and Germany

	Japan		United States		Germany	
	1990	2004	1990	2003	1990	2004
Banks	20.9	16.2		8.0	9.4	6.6
Nonfinancial firms	30.1	21.9			41.4	42.9
Government	0.3	0.2	0.0		6.0	6.6
Insurance firms	15.9	7.6	1.9		3.2	4.3
Pension funds	0.9	4.0	24.4	21.0		
Investment firms	7.0	6.1	15.8	24.4	3.3	4.1
Individuals	20.4	20.3	51.0	37.0	18.3	14.5
Foreign	4.7	23.7	6.9	10.0	18.6	21.0

Source: Vogel, S.K. (2007), *Japan Remodeled. How Government and Industry are Reforming Japanese Capitalism*, Ithaca-London, Cornell University Press (p. 135).

Figure 10.1 Distribution percentage of market value owned by type of shareholder



Source: Ovsiannikov, K. (2017), "Corporate governance reforms in Japan: Instilling the new regime," Cogent Business & *Management*, 4(1), 1300993. doi:10.1080/23311975.2017.1300993. © 2017 The Author(s). This open access article is distributed under a Creative Commons Attribution (CC-BY) 4.0 license.

Table 10.2 Number of members on boards of directors in the 1990s

U.S.			U.K.			Japan		
Ford	15	(10)	Glaxo	16	(7)	Toyota	60	(1)
IBM	14	(11)	Hanson	19	(8)	Hitachi	36	(3)
Exxon	12	(9)	Guinness	10	(6)	Matsushita	37	(6)
Mobil	16	(10)	British Airways	10	(6)	Nissan	49	(5)
Philip Morris	16	(4)	Allied Domecq	12	(4)	Toshiba	40	(3)
RJR Nabisco	9	(6)	Grand Metropolitan	14	(1)	Honda	37	(3)
Texaco	13	(11)	BTR	10	(4)	Sony	41	(6)
Johnson & Johnson	14	(12)	Associated British Foods	7	(1)	NEC	42	(5)
GAP	11	(8)	British Steel	8	(0)	Fujitsu	36	(7)
						Mitsubishi Electric	37	(3)
						Mitsubishi Motors	43	(4)
						Mitsubishi Heavy Industries	43	(3)
						Nippon Steel	53	(1)
						Mazda	45	(8)
						Nippon Oil	22	(0)

Figures in parentheses: U.S.: Outside directors; U.K.: Non-executive (outside) directors; Japan: Outside directors (including cross directorships).

Source: Authors' elaboration from Milhaupt, C.J. (2006), "A lost decade for Japanese corporate governance reform? What's changed, what hasn't, and why," in M. Blomstrom & S. La Croix (eds.), *Institutional Change in Japan: Why it Happens, Why it Doesn't*, London, Routledge.

Another element that had to change was the excessive number of board members. The tradition of enlarging this body was connected, on the one hand, with the need for forming consensus on the most important decisions; and on the other hand, the keiretsu structure pushed hard for that approach. However, as **Table 10.2** shows, in most cases, the magnitude of the board was unrelated to the size of the companies' business, and very different from the equivalent British or U.S. corporations.

10.3 From the new Commercial Law to the first Code of Corporate Governance

Many elements were pushing towards revisiting corporate governance rules in Japan. The first step arrived in 2002 with the approval of the new Commercial Law. Before that revision, some minor, but not less important changes had already been introduced: lifting the ban on treasury stock; creating new stock acquisition rights; expanding the authority of statutory auditors, authorizing limitations on managers' liability, and creating an option to form committees of the board of directors in lieu of the statutory auditor system.[15] The revision of the Commercial Law made it possible to establish holding companies. Despite the strong links with America and U.S. business and financial models, the new code also allowed companies to organize separate boards of directors for the executive and supervisory functions of strategic management.

The discussion about a real convergence with the American model, or choosing an alternative one, took place during the following ten years, while the economic situation had not changed very much from the previous decade. Actually, the lost decade had already become the lost decades, because the GDP was not showing any real increase, despite the huge injections of financial resources into the economy by different governments. According to the literature, the Code seemed to encourage a convergence between the old Japanese corporate governance model and the American model, but the text also contained many echoes of the OECD Principles. The still-powerful admiration for the U.S. business model within Japanese society, and among at least a portion of the business community, was behind the attempts to stress the convergences.[16] For instance, the system of "companies with three committees" – a nominating committee, an audit committee, and a remuneration committee – was introduced in 2003 with the purpose of reducing the differences between Japan and the Western countries. However, only a few listed companies (Sony, Hitachi, Toshiba, and Nomura) decided to adopt it.[17] To what extent these reforms will modify the virtual absence of market for corporate control, which has characterized Japanese capitalism for many decades, despite the great importance and centrality of the financial market in the country's economy, only time will tell.

The criticism of the weapon replaced the weapon of criticism. The reforms were going in the right direction, but the choices made by the listed companies to attract institutional investors – as we have seen above – were doing more to change Japanese corporate governance. However, some formal changes were also necessary, because – apart from the small and big reforms of the late 1990s and early 2000s – there was not yet an official document called the Code of Corporate Governance.

[15] Milhaupt, C.J. (2006), "A lost decade for Japanese corporate governance reform? What's changed, what hasn't, and why," in M. Blomstrom & S. La Croix (eds.), *Institutional Change in Japan: Why it Happens, Why it Doesn't*, London, Routledge.

[16] Ovsiannikov, K. (2017), "Corporate governance reforms in Japan: Instilling the new regime," *Cogent Business & Management*, 4(1).

[17] Ueda (2015, p. 19).

The time for reforms arrived with the new Prime Minister Shinzo Abe. He was elected with a complex program of economic reforms – the so-called Japan Revitalization Strategy based on three prongs or "arrows" – that were to finally permit the country to escape the stagnation of the previous twenty years. He clearly stated that corporate governance reform was an instrument of industrial policy – a way of boosting economic growth without further inflating Japan's public debt. Thus, in response to a request from Abe, Japan's Financial Services Agency and the Tokyo Stock Exchange (TSE) jointly launched a panel in the fall of 2014 to discuss the establishment of Japan's Corporate Governance Code. The panel announced its final draft of the Code in December 2014; it was finalized in the spring of 2015.

The official presentation of the Japanese code affirms that corporate governance is "a structure for transparent, fair, timely, and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders and also customers, employees, and local communities." The subtitle of the document underscores its mission statement: "seeking sustainable corporate growth and increased corporate value over the mid- to long-term."[18]

Five general principles, each of which has several specific sub-principles, establish the guidelines:1) shareholder rights and equal treatment of shareholders; 2) proper cooperation with stakeholders; 3) proper disclosure and transparency; 4) responsibilities of the board; and 5) shareholder engagement. The Code is most likely to require companies to appoint at least two independent outside directors, or else explain their reasons for not complying with the rule. In fact, in 2013, nearly 600 of the 1,400 or so largest listed Japanese firms still had no outside directors, and foreigners held only 274 of some 40,000 directorships. The situation changed a lot with the new code. According to the report published by Bain & Co. in July 2014, approximately 65% of TSE-listed companies had outside directors. The situation improved, but it remains quite far from the U.S. standards. On companies listed on the S&P 500, for example, outside directors hold an average of 84% of board seats, compared with only 23% of Nikkei 225-listed companies.[19] By July 2015, nearly 90% of Japanese listed companies had outside directors. As of December 2015, all Nikkei 225-listed companies had at least one outside director.[20] However, despite their limited number, they have created an Association of Foreign Board Directors of listed Japanese corporations, which held its inaugural meeting on April 2016 in Hong Kong.[21]

[18] JPX Tokyo Stock Exchange (2018), *Japan's Corporate Governance Code: Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term (revised version)*, June 1.

[19] The report of Bain & Co., *Corporate Governance in Japan: Board Membership and Beyond*, can be downloaded from https://www.bain.com/insights/corporate-governance-in-japan-board-membership-and-beyond.

[20] The definition of outside director concerns a director of any stock company "who is neither an executive director nor an executive officer, nor an employee, including a manager, of such Stock Company or any of its subsidiaries, and who has neither ever served in the past as an executive director nor executive officer, nor as an employee, including a manager, of such Stock Company or any of its subsidiaries" (Ueda 2015, p. 19).

[21] https://innovategovernance.com/2016/07/26/inauguration.

The Code, according to the general economic policy of the government, seeks "growth-oriented governance" by promoting timely and decisive decision-making based upon a transparent and fair process which fulfills the companies' accountability and responsibilities to shareholders and stakeholders. The Code does not place excessive emphasis on avoiding and limiting risk, or the prevention of corporate scandals. Rather, its primary purpose is to stimulate healthy corporate entrepreneurship, support sustainable corporate growth, and increase corporate value over the mid- to long-term. The gender issue was also addressed in the Code. Before 2014 only 20.4% of the NIKKEI 225 companies had have appointed a female director, i.e., 51. However, 46 of these 51 female directors (90.2%) were outside directors. Moreover, of the five women legally appointed as internal directors, four were either from outside the company, or members of the founder's family. The situation has improved in the last few years, but still the figures are not good. In 2019, about 57% of Japanese companies had no female board representation. In the Topix 100 – the Tokyo stock Price InDeX – only crept above 10% for the first time. However, this data remains below 30% ratio among the TSE350 companies and 27% of S&P 500board members.[22]

While there are still very few "companies with three committees" (less than 2% of the listed companies in 2016), over 90% of listed companies use the system called "companies with a board of company auditors." This is not a novelty of the Code: it existed already in Japan's traditional systems. In these companies, there is no obligation to have external directors on the board of directors, but at least 50% of the board must be comprised of external auditors who sit on a board of company auditors with supervisory functions. The system of "company auditors" (kansayaku) is a traditional system of corporate governance unique to Japan. Company auditors are responsible for auditing and supervising the executive functions of the board of directors. It has been noted that this model permits companies to take decisions quickly, enabling "outside directors to concentrate on fulfilling their originally expected roles." Thus, "the newly introduced option eliminates the burden of employing outside statutory auditors and two committees, in exchange for requiring outside directors." In the meantime, the reform permitted a sharp reduction in the number of board members, who are now no more than fifteen. The Code permits duality, i.e., to nominate a CEO and a chairman from among the members of the board. Usually the latter is the founder of the company or a descendant of the founder. [23]

The Economist welcomed the Code as a "revolution."[24] And probably, as with any other revolution, this one "devours its children." The Nissan case, started in November 2018 with the arrest of the CEO Carlos Ghosn, who was accused of financial misconduct and misappropriation, is a clue that Japan still has many steps to go. In March 2019, a special committee of the firm presented a report on Carlos Ghosn's managerial style. "He set his own pay, kept board meetings, on average, to

[22] Lewis, L. & Inagaki, K. (2020), "Japan's all-male boards face gender reckoning," *Financial Times*, June 2.

[23] Ueda (2015, p. 49); Passador (2016, pp. 42-43).

[24] "A revolution in the making (2014)," *The Economist*, May 3.

no longer than 20 minutes, and discouraged debate," wrote *The Economist*. In summarizing the key issues of the Code, the magazine reported that "it recommended changing Nissan's board structure and introducing a majority of outside directors."[25] In particular, according to people familiar with the issue, Ghosn proposed creating a Dutch-based foundation that would have consolidated his control over both the Renault-Nissan-Mitsubishi Alliance and over his own compensation.[26] Ghosn was known in Japan as the "*keiretsu* killer" for "severing the tangle of cross-shareholdings that had almost brought the Japanese firm to its knees."[27] In the end, what he did was probably acceptable in the very dramatic circumstances when he intervened to rescue the company. Despite transforming him in a manga comics' hero in 2001 as the savior of Nissan,[28] the country probably never appreciated his managerial style. His decision to escape the Japanese justice the last day of the year of 2019 reinforced negative appreciation of Ghosn among the Japanese media.[29]

[25] "Japan toys with shareholder capitalism just as the West balks (2019)," *The Economist*, March 28.

[26] Lewis, L., Inagaki, K., & Keohane, D. (2019), "Ghosn tried to set up foundation to run Nissan-Renault," *Financial Times*, May 24.

[27] "Carlos Ghosn's arrest shows the merits of a carmakers' merger (2018)," *Financial Times*, December 1.

[28] Zaun, T. (2001), "Staff Nissan's Carlos Ghosn Becomes Unlikely Star of Japanese Comic," *The Wall Street Journal*, December 27.

[29] Sugiyama, S. (2020), "Once a hero in Japan, Carlos Ghosn's news conference unlikely to restore his image," *The Japan Times*, January 9.

Case study **Nomura, tradition vs. rules**

Nomura was founded in 1925 when Nomura Securities Co., Ltd. (NSC) was established in Osaka. The company was a spin-off from the Securities Dept. of Osaka Nomura Bank Co., Ltd. (now Resona Bank). The core business of the firm was the bond market. It was named after its founder Tokushichi Nomura II, a Japanese businessman and investor born in 1878, who made his personal fortune in 1915 by investing in Fukushima Boseki, a textile company believed to be close to bankruptcy. Nomura established Osaka Nomura Bank in 1918, based on the zaibatsu model with a capital of ¥10 million. Like most Japanese conglomerates, or zaibatsu, its origins were in Osaka. At the end of World War II, Nomura was in the top 10 of Japanese zaibatsu and controlled 26 companies in the financial sector, 50 in heavy industry, 27 in light industry, and 62 in many other sectors. NSC acquired the stock trading authority in 1938, and went public in 1961, when the old zaibatsu, now a keiretsu, became the head of a large financial and services group based in Tokyo. In the following decades, Nomura became one of the most dynamic Japanese groups and is currently the largest financial services group headquartered in Japan, with more than 26,000 employees of about 90 nationalities in over 30 countries.

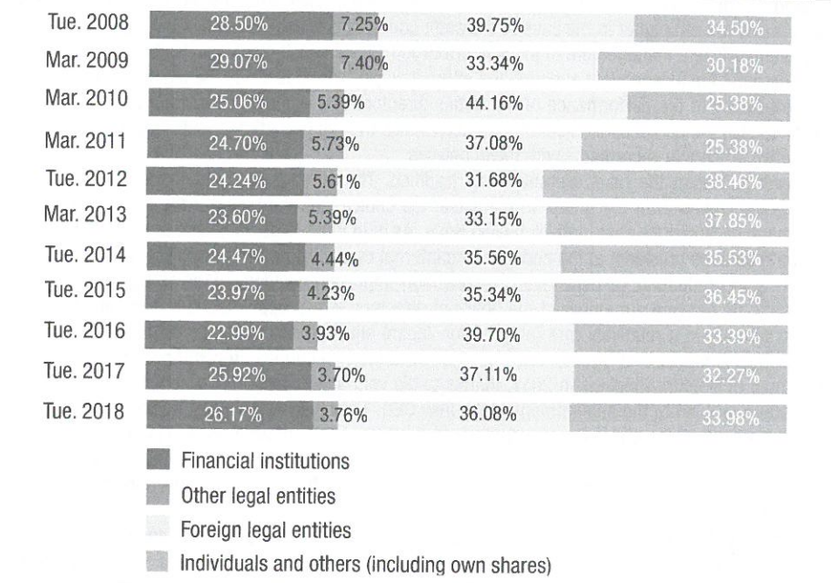
International development has always been one of the main aspects of Nomura's strategy. However, the acquisition of Lehman Brothers' Asian and the European operations in 2008 was an important step in the group's internationalization process. The subsidiaries were renamed Nomura Europe Holding plc and Nomura Asia Holding N.V. This acquisition transformed Nomura into the world's largest independent investment banks assets under management of $225 billion. "My vision – the group's CEO, Kenichi Watanabe, confessed to the press in 2009 – is to create a global investment bank based in Asia that ranks among the top five investment banks in the world." On the staff side, now increased by more than a thousand employees, Nomura's CEO denied that the integration of the two groups would create tensions between Nomura's highly paid and less paid Lehman staff. The group moved the global investment banking headquarters from Tokyo to London. It was a clear sign that Nomura was adopting a strategy more focused on global markets than Japan.

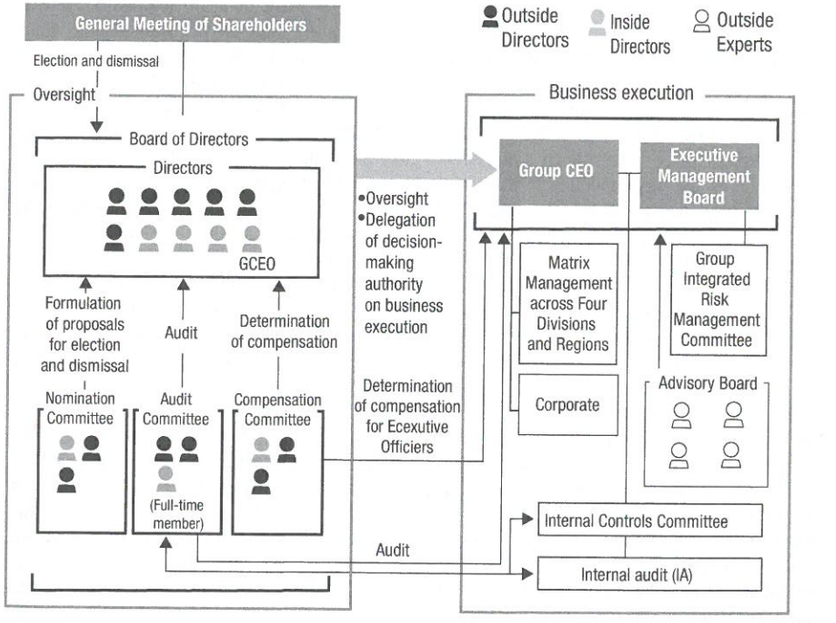
Like many other Japanese listed companies, since the early years of this century, Nomura has welcomed many international financial investors among its shareholders. **Figure 10.2** shows the evolution of the equity structure immediately before and after the acquisition of the Lehman Brothers business. As in other cases, overall, foreign financial investors had a relative majority of the shares. However, the Nomura group was – and is – controlled by two Japanese financial institutions, which own the largest number of shares, Japan Trustee Services Bank, Ltd. (part of Sumitomo Mitsui Banking Corporation), more than 10%, and Master Trust Bank, Ltd. (part of Sumitomo Mitsui Banking Corporation, Ltd., controlled by Mitsubishi UFG Trust and Banking Corporation), with about half of the share of the former. It is worth noting the growing presence of foreign investors around the years of the acquisition of Lehman Brothers' assets in Europe and in Asia: the market welcomed the transaction very favorably. However, the share price continued to fall due to the financial crisis: from a level of ¥2,360 in January 2007, it fell to ¥591 in May 2009.

After a miscalculated attempt to turn itself into a global player – wrote the Financial Times in 2012 – the Japanese bank faced a difficult withdrawal. In 2012, Kenichi Watanabe resigned on charges of insider trading together with the chief operating officer, Takumi Shibata, and some other top managers in the sales division. The accusation was quite serious: they provided confidential information in view of the placements managed by Nomura. The decision was not entirely surprising. Watanabe was already under fire for other reasons, including accumulated losses in foreign markets, the area where Nomura had been leading its strategy since 2008. However, the image and the reputation of the group were under serious attack, especially now that the internationalization strategy was so relevant.

Officially, the task of selecting the new CEO was a duty of the nomination committee, according to the Code of corporate governance, visible in **Figure 10.3**, which also highlights the other most relevant functions of the internal committees and bodies such as the audit committee. The reality was different.

Figure 10.2 Component shareholders relationship





Source: Nomura Annual Reports, authors' elaboration.

According to the regulations, the appointment committee evaluate proposals for the election and dismissal of directors to be submitted to the general assembly on the basis of their personality, their intuition, their values and their knowledge and experience in their area of specialization. This level of formality is even higher in the case of the audit committee. In fact, it verifies the legitimate, adequate and efficient management of the Nomura Group's business. It exercises its statutory authority and instructs the independent auditors and internal organizations to verify the legitimacy, adequacy and efficiency of the performance of the duties directors and managers and to draw up audit reports. Lastly, the compensation committee determines the remuneration of individual directors and executive officers in accordance with these policies.

However, in Japan the rules are subject to tradition. The person who actually chooses the new CEO is the chairman of the group. In this case, the choice was the result of the initiative and full command by Nomura's chairman, Nobuyuki Koga. As with most large Japanese groups, Koga (born in 1952) became president at the end of a long internal career. After joining Nomura in 1974, immediately after graduating, he held several increasingly important positions in the group until 2003. In that year, he became a member of the board of directors, which appointed him managing director and chairman, in a relatively rare (at least for Japan) situation of duality. In 2008, he added two other important positions, director and chairman of Nomura Securities. Reconfirmed as director and chairman of Nomura Holdings in 2011, thanks to his very solid position he was able to control the procedure that led to the appointment of the new CEO. The choice fell on Koji Nagai. Born in 1953, he joined the bank in 1981. Nagai held several positions in the group prior to his appointment as CEO of Nomura Securities Co., Ltd. in 2011. He was in a very good position – with very high visibility – to become CEO of the group in August 2012. It would be difficult to present his appointment as a surprise.

President and CEO seemed the "perfect couple": same trajectory, long experience in the group, and most likely, same vision. According to Nomura's statutes, on the one hand, Koga, the president, must manage affairs of the board of directors and provide guidance and direction to the other board members. In particular, in the very delicate phase for the group, he stepped forward to loosen Nomura's ties with the Japanese Financial Agency, and to loosen the more costly sanctions, which could range from imposing compliance with the law to the damaging suspension of some operations for weeks. On the other hand, the CEO Nagai should establish strategic processes, oversee progress towards achieving business objectives. He should also instruct other top managers to act appropriately to keep corporate bullying in the right direction.

In subsequent years, governance management paid particular attention to three aspects. The first concerns the independence of internal audit, as the CEO can appoint the main members of the internal control committees, which can contribute to potential opportunistic behavior as this committee, indirectly influenced by the CEO's decision appoints the members of the internal audit department. The second one is based on effective management, as Nomura has the necessary control system, but may not function as effectively as it seems. Scandals such as insider trading are the best example. The last point concerns the diversity of directors, which has improved since 2009 after the global financial crisis, but seems to be getting worse. One of the most visible changes is the growing ratio of foreign directors since 2012, when Nagai became the new CEO, while the ratio of non-Japanese directors remained stable for a few more years before decreasing from 2017.

One can note that, in 2015, Nomura approved a resolution to amend the internal control system. An external director from outside the Nomura Group was appointed in Nomura Asset Management Co., Ltd. In addition, the Corporate Governance Guidelines of Nomura Holdings, the Founding Principles of Nomura and the Day of Corporate Ethics were established and the meetings of the board of directors began to be evaluated. The following year, Nomura established the office of non-executive directors and the internal control committee as an organization to support the performance of directors' duties ensuring full information to external directors and so on, and resolved to change the internal control system.

Figure 10.3 Composition of the committees

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Organizational structure	Company with Committees (renamed afetr the enforcement of the Companies Act)						Company with Three Board Committees (renamed after the revision of the Companies Act)			
Number of Directors	12	12	14	**11**	11	11	12	12	10	10
Number of Outside Directors	6	**7**	8	7	6	6	7	6	6	6
Ratio of Outside Directors	50%	**58%**	57%	64%	55%	55%	58%	55%	60%	60%
Ratio of non-Japanese Directors	0%	17%	**29%**	27%	27%	27%	25%	27%	10%	20%
Ratio of female Directors	0%	8%	7%	**9%**	9%	9%	8%	9%	10%	20%
		2010 Indepentent Outside Directors accounted for a majority of the Board of Directors								
		2010 Improve the Diversification of the Members of the Board of Directors								
				2012 Appointed Outside Directors for Nomura Securities with non concurrent posts at Nomura Holdings						
					2013 Announced Indepentent Criteria for Outside Directors					
							2015 Several Policies Changes			

Source: Nomura Annual Reports, authors' elaboration.

The reforms, particularly tweaking to how top executives are selected, are also likely to weaken the influence of management over who eventually succeeds Nagai, the bank's longest-serving CEO in three decades. By stripping Chairman Nobuyuki Koga of his role as head of the key nomination committee in favor of an outside director, Nomura has decided to break with the traditional way Japanese financial companies choose their leaders when the time comes for Nagai to step down.

This reform is like a bomb because it transforms the structural aspects of the appointment process. "It is possible for the company to choose a candidate who is open to a wider range of strategic moves than a protégé of Nagai who can somehow fall back on the views of the former CEO" – said a source familiar with the issue. These events occurred at the same time as other Japanese companies, the most important of which is Nissan, were facing different problems that had many aspects directly related to the quality of corporate governance.

As in 2012, the reality was quite different. In 2019, CEO Koji Nagai was reconfirmed at an annual shareholder meeting along with nine other candidates proposed by the company. The vote was held nearly a week after Nomura announced several moves to appease investors following the leak and recent losses, including changes in governance and a $1.4 billion share buyback. In fact, employees leaked market-sensitive information and prompted institutional shareholder services to recommend a vote against Nagai's re-appointment. At the company's annual general meeting in June 2019, he received only 61.7% of investors' support to continue as CEO. This percentage was significantly lower than the 94% received the previous year. However, the net loss of ¥100.4 billion, down from the previous year's profit of ¥219.3 billion was the most significant criticism against him.

Just two months before he was re-elected, Nagai indicated in an interview that he could resign before the three-year review was completed, provided everything went smoothly. In fact, this happened much sooner than expected. In December 2019, Nagai announced his decision to resign from office. In April 2020, Kentaro Okuda, previously deputy president and co-chief operation officer, became the new CEO of Nomura Holdings after an internal career very similar to that of his predecessor and without any real use of the new procedures implemented by the controversial reforms.

11 Corporate Governance in Emerging Countries. Between Market, State, and Family: The Cases of Brazil, Argentina, India, and China

11.1 The emerging economies and the capital markets

The globalization process introduced new opportunities for investors. The relatively low levels of return in advanced economies in the 1990s were mostly due to the low interest rates in the USA and Western Europe. The difficulties of the Japanese economy – which was just starting its (first) "lost decade" – also reduced alternative opportunities. Investing in "emerging economies" – a term introduced by World Bank economist Antoine Van Agtmael, to differentiate among developing countries (some definitively more advanced than others) – was still too risky. However, despite the debt crisis of 1992, the second one after that of 1982, analysts suggested investing in these countries.[1]

The first effects of the reforms demanded by the IMF for many of its rescue plans – the so-called Washington consensus – were still timid, but quite promising. Actually, investments in emerging economies were mainly in State bonds. The Emerging Markets Bond Index (EMBI), which was introduced in 1992 and covered only Brady bonds (named after the U.S. Treasury Secretary), the financial instruments issued after the international agreement on the sovereign debt of some developing countries. The rise of the Asian Tigers offered the first concrete opportunities for redirecting the flow of investments, both FDI and financial investments. However, the 1997-98 Asian crisis showed that the stability of these economies was still at risk, as **Figure 11.1** shows.[2]

Only in the early twentyfirst century did emerging markets become a credible alternative for investors. The rapidly changing world economic situation and Goldman Sachs' need to offer long-term prospects to its big investors led the firm to create a special research team. The decision also had a political and a psychological background. The team, headed by James O'Neill, started its activities some months after the terrorist attack of 9/11. That dramatic event launched a wide debate about the pros and cons of globalization. Goldman Sachs' aim was to identify the long-term dynamics in a world that appeared very confused, dynamics which might be of interest to the bank and its most important clients.

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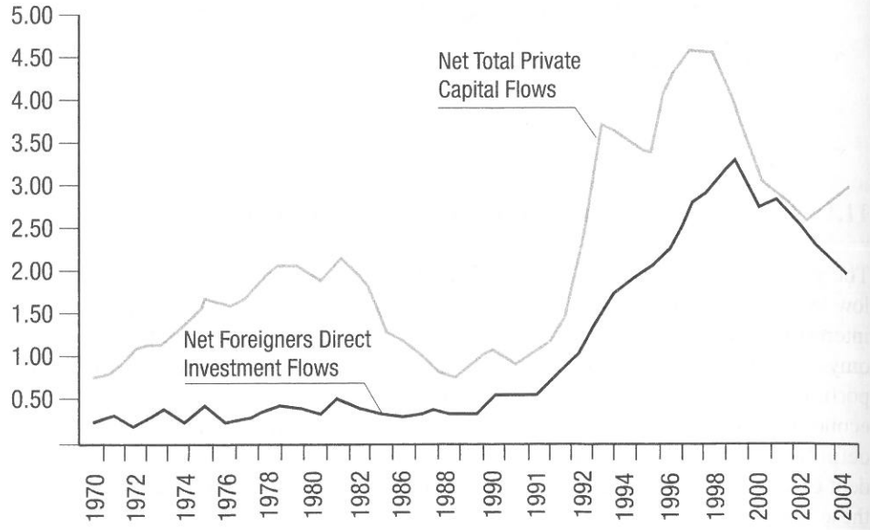
[1] Van Agtmael, A. (2007), *The Emerging Markets Century: How a New Breed of World-Class Companies is Overtaking the World*, New York, Free Press.

[2] Knoop, T.A. (2013), *Global Finance in Emerging Market Economies*, New York, Routledge.

Figure 11.1 Capital inflows to developing countries as percentage of total GDP (low and middle income)



Source: World Bank, Foreign direct investment, net inflows (BoP, current US$); author's elaboration.

The results were condensed in the report *Dreaming with BRIC: The Path to 2050.* The report set out the case for changing the image of a process entirely centered on the USA, with the intent of showing that "globalization could be good for all the world," as O'Neill later put it in his book about the BRIC countries (BRIC being an acronym for Brazil, Russia, India, and China), published in 2003. He coined the term in 2001 in an economics paper entitled "Building Better Global Economic BRICs."[3] In the following years, it became part of economists' and journalists' jargon, and marked the start of an investment boom in the four markets. The fact that the word sounded like bricks, perfectly conveyed the idea that in the future, the world economy would grow thanks to the dynamism of these countries. In 2006, Goldman Sachs launched a special BRIC fund to funnel investments into these countries. The fund grew in the following years despite the crisis, but faced some difficulties in the following decade; it was closed in 2015 because of losses of around 20%.[4]

[3] O'Neill, J. (2001), *Building Better Global Economic BRICs*, Goldman Sachs Global Economics Paper No. 66, November 30; O'Neill, J. (2011), *The Growth Map. Economic Opportunities in the BRICs and Beyond*, London, Portfolio Penguin.

[4] McLannahan, B. (2015), "Goldman fund walks away from the BRICS era," *Financial Times*, November 9.

These four countries had both many things in common and many differences, but the former prevailed. Apart from the USA, the BRICs are the only countries in the world to have GDPs of over $600 billion, more than 100 million inhabitants, and a surface area of over 2 million square km. In the years O'Neill was preparing the report, their economic growth rates ranged from 4% for Brazil to 11% for China, which they were generally able to maintain (only Brazil had some difficulty) until the end of 2008, when the crisis exploded. Starting with 2010, the BRICs began to meet annually. This was an evident political reaction to the ineffective decisions taken at the London G20 meeting in April 2009, which attempted to deal with the crisis. For purely political reasons – to avoid the accusation of neo-colonialism towards Africa – South Africa was invited to join the group in 2011 to represent this continent, and the BRICs became the BRICS.

This general introduction was necessary to understand how corporate governance also reached the emerging economies.[5] The timing was a decisive factor, because the macroeconomic trends that we have seen were strictly interlaced with the elaboration of the first codes of corporate governance, and even more with the OECD discussion about this issue, which resulted in the report on the Principles of Corporate Governance, issued in 1999. We will consider the BRIC countries as separate examples of the development and the difficulties in implementing corporate governance in economic systems very different from the advanced economies.

We will first consider two South American countries, Brazil and Argentina, the former a member of the BRIC group, that during the decade of reforms (2003-2012), used corporate governance to modernize its business world. The latter is a special case because of the very risky strategies it adopted while implementing the code of corporate governance. In addition, we will take into account the cases of the two largest countries in Asia, India and China, which have two very different economies.

India is a country of many contradictions. It is the place where the national parliament could discuss an Indian contribution to the Greek bailout in 2012, while still receiving a sort of indemnification from Great Britain more than 50 years after independence. Still, India is the place where most high-tech companies have research centers – most of them concentrated in Bangalore – and where many banks and airline companies outsource their back offices. In addition, it is a country where, on the one hand, almost one third of the population is still below the poverty line, while on the other hand, the number of companies listed on the stock exchange is one of the biggest in the world. India is a country with a deep British legacy, but also one where corporate governance had to fight – and compromise – with the power of family businesses.

China is the country that, according to a visionary Chinese writer, accomplished in forty years what took Western countries four centuries.[6] It is the country where the

[5] Sabri, B. & Nguyen, D.K. (2014), *Corporate Governance in Emerging Markets. Theories, Practices and Cases*, Berlin, Springer.

[6] Yu, H. (2012), *China in Ten Words*, London, Duckworth Overlook.

Communist party and/or the State are controlling the economy as in no other country in the world. China is the second biggest economy after the United States in terms of nominal GDP, but its citizens do not perceive any advantage from this condition. However, in China, as we will see, corporate governance is also an instrument for modernizing the biggest companies, especially the SOEs, focusing them on respect for the market's rules, but still keeping them under the strict control of the political power.

11.2 Brazil, corporate governance, and the need for stability

11.2.1 The privatization process of the 1990s

The Brazilian economy entered a phase of stabilization around the mid-1990s after many years of severe difficulties and a high level of inflation. The severe recommendations of the IMF and the World Bank to all developing economies – referred to as the Washington consensus – had a positive influence on the attitude toward structural problems. The results arrived slowly, mostly in the following decade, but the beginning of the reforms in that period was of a crucial importance.

During the 1990s Brazil, like many other emerging economies, started a broad process of privatizations of its SOEs. In some cases, the process led to complete privatization, while in others, the State kept a substantial part of the shares. Despite the success of the process, the stock exchange did not flourish. Some big companies preferred to cross-list in the U.S. capital market through the American Depository Receipt (ADR) programs that permit shares of foreign companies to be traded on the New York Stock Exchange. The clearest evidence of the failure of the project to revitalize the Brazilian stock exchange, the Bolsa de Valores de São Paulo, simply known as Bovespa, was the drop in the number of listed companies from 550 in 1996, to 468 in 2001.[7]

However, Brazil was quite precocious on corporate governance. In 1995, it created the Brazilian Institute of Corporate Governance, which in 1999 published the first Brazilian code of corporate governance, with the official name of *Código Brasileiro de Governança Corporativa*.[8] These initial steps were much appreciated with the improvement of the economic situation in the early 2000s, when the GDP growth was around 5%, particularly after the election of Lula as president in 2003. This was visible in the number of IPOs and thanks to the introduction of the code of corporate governance. In 2000, in response to concern about weak protection for minority shareholders (including extensive use of non-voting shares, few independent directors, and low levels of disclosure), the São Paulo Stock Exchange created three high-governance markets (Novo Mercado, Level I, and Level II).[9]

[7] Clemente, A., Taffare, M., &. Espejo, R.A. (2013), "The Brazilian stock market: Dimension, structure, and main features," in C.H. Quah (ed.), *Business Dynamics in the 21st Century*, Rijeka, InTech; Nyasha, S. & Odhiambo, N.M. (2013), "The Brazilian stock market development: A critical analysis of progress and prospects during the past 50 years," *Risk Governance and Control: Financial Markets & Institutions*, 3(3), 7-15.

[8] https://www.csiaorg.com/csia-affiliate-member/15/brazilian-institute-of-corporate-governance.php.

This new structure created better conditions for improve the number of listed companies. Although the companies listed in Bovespa kept on falling after 2001 (their descent reached the lowest point in 2006 with 394 companies), the firms listed in Novo Mercado increased rapidly from 5 in 2002, to 133 in 2010. This trend also contributed to a surge in IPOs, which had been nearly non-existent until 2004, remaining in the single digits until skyrocketing in 2006 (26) and 2007 (62). In addition, trading volumes increased rapidly from $11 billion U.S. in 2001, to $22 billion one year later, and then $460 billion in 2005, $1,284 billion in 2007, and $1,522 billion in 2010. The same trend was visible for pension fund assets, which in the first decade of 21st century grew from $72 billion in 2001 to $324 billion in 2010.[10]

11.2.2 The new rules concerning corporate governance

The new rules concerning listed companies included the maintenance of a free-float of at least 25% of the capital; public offerings having to use mechanisms to favor capital dispersion; an improvement in quarterly reports, including the disclosure of consolidated financial statements, and special audit revision. Moreover, the need for disclosures was strongly reinforced: companies had to offer monthly disclosure of trades involving equities issued by the company on the part of the controlling shareholders, as well as an annual calendar of corporate events, and disclosure of the annual balance sheet according to standards of the International Financial Reporting Standards.

The Brazilian code adopted the one-tier system. The board of directors of these companies had a two-year mandate. They had to have at least five members, of which at least 20% had to be independent. According to Brazilian Corporate Law, up to one-third of the members of the board of directors could also have management positions. The directors are elected by the shareholders at a general shareholders' meeting. A cumulative voting is applicable if requested by 5% of the common shareholders. This is a type of voting system "imported from the USA" that helps strengthen the ability of minority shareholders to elect a director. This method allows shareholders to cast all of their votes for a single nominee for the board of directors when the company has multiple openings on its board. being. Moreover, provided certain statutory thresholds are met, the Brazilian Corporate Law grants common shareholders and/or preferred shareholders the right to elect a director.

Another series of rules was established to protect the minority shareholder. If the majority shareholders sell their stake, the same conditions granted to them must be extended to common shareholders, while preferred shareholders must get, at least,

[9] Chavez, G.A. & Silva, A. (2009), "Brazil's experiment with corporate governance," *Journal of Applied Corporate Finance*, 21(1), 33-44.

[10] http://www.b3.com.br/en_us, *Corporate Governance Level 1 Listing Regulation*.

100% of the value/conditions. Voting rights should be granted to preferred shareholders in circumstances such as incorporation, spin-off and merger, and approval of contracts between the company and other firms of the same holding group, when they are deliberated on at a general meeting. The audit function belongs to a special fiscal committee, which can be established according to the company statutes, or can be requested by the shareholders.[11]

The ownership structure varies from concentrated control to a mixed pattern characteristic of a substantial minority of companies with shared control via shareholders' agreements, and a few companies with diffuse control. However, as in most other South American countries, there is very high concentration of ownership. Families of the founders of the firm usually control between 75% and 80% of the shares. At the Bovespa, about 40% of the listed companies belong to this category, while those controlled by the State, traditionally the other big shareholder, despite privatizations, are still about 10% of the total, somewhat less than those controlled by foreign investors. Institutional investors, in general, do not make an effective contribution to improving corporate governance for their investees, and the largest ones face serious internal conflict of interest issues.[12]

In bull market conditions, the adoption of corporate governance rules was also a prerequisite for getting credit from the banking system, as the example of Banco del Desenvolvimento Economico e Social showed.[13] Recent statistics suggest a reversal of this trend, with the increase in companies with concentrated control. Companies that once embraced premium-trading lists that required better corporate governance practices resisted the tightening of this self-regulation, and some successfully and lawfully did not comply with new compensation disclosure regulation. Many companies have gone back to being private. Actually, the number of listed companies, after the short boom years before the crisis, has declined. In 2005, they were only 342, while two years later they were 395, a level from which they didn't stop dropping until 2017, when they were down to 335.[14]

The "scandals of the presidents" (Lula, Roussef, and Temer), all accused of receiving bribes from big State companies, contributed to creating negative institutional circumstances in the second part of this decade, while the economy has stagnated since 2011-12. However, the stock exchange index has been growing since 2016. This performance does not eliminate the worries about the real conditions of the country. In fact, despite the records set by the Bovespa, the gap with other emerging capital markets has increased. Investors are asking for deep reforms and the new president,

[11] BM&F Bovespa, Corporate Governance Guidelines.

[12] Ararat, M., Alexandru, P.B., & Yurtoglu, B. (2008), *Novo Mercado and Its Followers: Case Studies in Corporate Governance Reform*, Global Corporate Governance Forum Focus, 5.

[13] "BNDES tendrà criterios corporativa na conceiçao de governança corporativa na conceiçao de credito (2016)," *O globo*, June 23-25.

[14] https://www.theglobaleconomy.com/Brazil/Listed_companies.

the right-wing populist Bolsonaro, was welcomed by them after his victory. However, in capital markets, the honeymoon is very short.[15]

11.3 Argentina, corporate governance and the dream of common law

11.3.1 The impossible bid of the 1990s: From civil law to common law

The second South American case is Argentina, where the introduction of corporate governance implied a forced transition from civil code rules to the common law. This was a rather extreme attempt to link the reorganization and modernization of the capital markets with the adoption of the general legal framework of the Anglo-Saxon countries, and particularly the United States, considering the links between the Americans and South America.

In 1991, Argentina was a country in deep recession and devastated by inflation. This situation was the result of the long period of political instability and social distress that characterized the country from the 1950s. Such chronic instability is the most relevant cause of general underdevelopment and inefficiency in a country's economic sector. Between 1991 and 2000, Argentina experienced a strong regulatory effort aimed at improving its capital markets and attracting foreign investments. Privatizations were used to induce foreign investors to come to Argentina, but also to reduce public debt. In fact, government participation in the ownership structure had increased sharply during the previous decades as result of numerous nationalizations. The State became the main – and often lonely – shareholder in many strategic sectors such as telecommunications, airlines, oil, electricity, gas, and the water supply. In 1991, the State owned six of the top ten Argentinian corporations.[16]

The role of the capital markets declined between the 1960s and the early 1990s. From the early 1960s on the stock market went through a heavy involution. The best evidence is the dramatic decrease in the number of listed firms: 550 in 1960, 278 in 1980, and only 170 in 1991. The first comprehensive corporate law framework was introduced in Argentina in 1972 with Ley 19550. It quite faithfully followed the equivalent laws in European Latin countries such as Spain and Italy. However, there was still no specific regulation for listed companies. and firms were subjected only to provisions of general corporate law. Similarly, the Comisión Nacional de Valores (CNV), the body charged with controlling the financial and capital market, remained completely inactive until 1991. Regulations for listed companies were non-existent.

Because of a highly concentrated ownership structure and of the deficiencies in corporate law, until 1991 boards of directors were merely bodies to screen owners'

[15] Wheatly, J. (2019), "Brazil's soaraway stock market masks deeper troubles," *Financial Times*, January 15.

[16] Pou, P. (2000), "Argentina's structural reforms of the 1990s," *Finance and Development*, 37(1). When he wrote this article, Pedro Pou was the governor of the Bank of Argentina.

decisions. In most cases, the controlling shareholder himself was the president of the board of directors or the CEO. When this was not the case, directors and managers were appointed based on loyalty and fiduciary claims or personal interests, rarely on the grounds of their competence and experience. As to protections for minorities' interests, the most important were the right to appoint one third of directors through cumulative votes, like in Brazil (see above) and to call shareholder meetings. Nevertheless, company by-laws gave companies the power to ignore these rights, also making also these forms of protection virtually non-existent.

In 1991, Carlos Saul Menem became president of Argentina. His election represented the beginning of a decade in which the national economic system changed in many ways. Menem came to power in a country literally devastated by hyperinflation, foreign capital outflows, and domestic currency devaluation. In the face of this situation one achievement was indispensable. To limit inflation the new government introduced the so-called *ley de convertibilitad* that linked the value of the peso to the U.S. dollar in a one-to-one ratio. The effects of the reform are well known: a strong appreciation of the local currency, the worsening of the balance of payments, and the enormous increase of foreign debt.[17]

The other important reform concerned the rules of ownership and capital structure, probably the most relevant and effective change characterizing the decade. The government launched a wide program of privatizations through IPOs in the gas, oil, electric, telephonic, water distribution, airlines, and highway sectors. The aim was to remove the State as a shareholder and favor the arrival of foreign investors.

Many authors described the 1990s reform wave as a forced shift towards "common law practices." All efforts were directed to the creation of efficient capital markets. The hope was that market forces alone would automatically create the basis for a healthy, competitive, and efficient economic environment. The prerequisites for the creation of a highly efficient capital market were historically non-existent in Argentina. The government should have given priority to other elements on which economic sectors are based in Civil Law countries. In particular, it would have been necessary to reform the corporate legal system and put in place specific and adequate provisions for listed companies.[18]

In 2001, structural problems had been rooted in Argentina economy for many years, and it was clear that they would eventually have led to a collapse. Quite surprisingly though, market forces seemed to have become aware of them only in the second half of 2001, having ignored them during the previous decade.[19]

A new important category of shareholders entered the Argentinian capital market during the 1990s: institutional investors. In many other emerging economies, pen-

[17] Cohen, M. (2012), *Argentina's Economic Growth and Recovery: The Economy in a Time of Default*, London, Routledge.

[18] Apreda, R. (1999), *Corporate Governance in Argentina: New Developments through 1991-2000*, CEMA Working Paper No. 154.

[19] Manzetti, L. (2009), *Neoliberalism, Accountability, and Reform Failures in Emerging Markets. Eastern Europe, Russia, Argentina, and Chile in a Comparative Perspective*, University Park, Pennsylvania State University.

sion and mutual funds played an important role in improving corporate governance standards. They normally take relevant, long-term positions in companies' ownership, playing a proactive role in governance as minority shareholders and bringing important competences and experiences into the firms. Unfortunately, this was not the case for Argentina. It is true that a large number of these institutions entered the marketplace during the decade, but the role they played in improving corporate governance standards was quite limited. Altogether, the reforms undertaken during the 1990s were not followed by real improvements in corporate governance standards.

11.3.2 The 2001 default and its consequences for corporate governance

The effect of the sudden loss of confidence from investors and international institutions resulted in a severe hit to Argentinian economy, leading to the default and deep recession. The 2001-02 financial crisis played a role in the rupture of the regulatory efforts of the policy makers Empirical evidence shows an abandonment of the attempts to liberalize the capital markets and other Common Law practices introduced during the 1990s, with a marked return toward a Civil Law model starting from early 2000s. The first point is demonstrated by the entire new set of regulation introduced into the Argentinian corporate legal system starting in 2003. The focus was no longer on liberalizing capital markets, but on reforming the corporate legal system and the public sector, in an effort to put in place adequate mechanisms for guaranteeing investor protection and transparency in companies' actions.

The new reforms started in 2003 with the "transparency decree" that launched the beginning of incisive "hard law" reforms of the corporate legal system. In 2007, a Corporate Governance Code was introduced, putting in place for the first time in Argentina so-called "soft law" mechanisms alongside the hard law ones. This new piece of law had the great merit of providing for the first time a complete regulatory framework addressed exclusively to listed companies, and of officially introducing the concept of corporate governance in Argentina. The model was quite similar to the most advanced Anglo-Saxon codes. In particular, it made explicit reference to the Corporate Governance code adopted by the SEC in 2003. On the one hand, this solution ensured the high-quality contents of the Code and alignment with international best practices. On the other hand, some criticisms have been raised over the unsuitability of the U.S. provisions to the Argentinian economic context and its companies' characteristics. An escape clause was possible: the principle of "Comply or Explain," which says compliance with the recommendations is not mandatory. Nevertheless, each firm is required to provide a yearly Codigo de Gobierno (Governance Code) report, which states its degree of compliance with each of the recommendations in the Code and provides exhaustive explanations for its compliance or lack thereof.[20]

[20] De Michele, L. (1999), *Corporate Governance: An Introduction to the Argentinean Case*, OECD Development Center.

There were specific rules concerning the board of directors, expressly requiring it to keep relevant powers in terms of strategic planning and investment decisions (not only the simple administration of the company). This rule was set in order to avoid the common practice of keeping all relevant strategic decisions in the hands of the shareholders meeting (usually dominated by a single majority stakeholder), and making the board purely an instrument of the owner's will. Directors' duties were substantially increased with respect of what was required by general corporate law. In particular, the law imposed on them loyalty, confidentiality, and disclosures, for the purpose of increasing transparency in their conduct and enhancing investors' protection. The figure of the independent director was for the first time introduced into the Argentinian legal framework, along with clear criteria in order to determine independence. However, there was no clear requirement as to their number. Internal and external audit committees were also introduced as in the majority of the codes.

New rights in terms of representation, legal protection against directors, and access to information were introduced on behalf of minority shareholders. New regulations allowed minorities to appoint one third of the board of directors via cumulative voting and no possibility to invalidate this right. For the first time minority shareholders were granted representation on the board.

Shareholders holding at least 5% of shares had the right to call a general meeting and undertake corporate action against directors. Moreover, all shareholders had the right to take derivative actions against the board (when it fails in implementing general meeting decisions within three months of the meeting) and to take actions against individual directors in cases of breach of fiduciary duties.

In general, the spirit of the reforms was to introduce more regulations. As a result, the following years were characterized by a huge burst of regulatory activity, which totally changed the entire corporate legal framework of Argentina. On one side, the CNV and Buenos Aires Stock Exchange (BCBA) issued a large quantity of regulations for listed companies, in which transparency provisions were integrated and amplified.

However, despite the quality of the new practices, some aspects of the Argentinian capital market did not change. The decline of the listed companies, which started in the mid-1970s when 321 companies were on the BCBA, did not stop. In 1989, they were 183, in 2001 they were down to 122, and in 2005 they reached the lowest point of the decade (100). In 2008 they increased just a bit to 108, but in 2017 they were below the symbolic bar of 100, down to 96, and in 2019 they were even fewer, 91. Even less changed was the shape of the ownership structure of the listed companies. The high level of concentration remained with the largest shareholders holding an average about 75% of the companies' shares.[21]

In December 2018, the *Comision Nacional de Valores* prepared a draft of a new text for corporate governance, asking those interested to react within 15 days. The new reform aims at updating the Argentinian code according to the principles of the

[21] https://www.theglobaleconomy.com/Argentina/Listed_companies/.

OECD and the G20, after the recent revisions, and to the best international practices.[22] The text has not yet been officially introduced six month after its presentation.

11.4 India: Corporate governance, and the contradictions of the world's biggest political democracy

11.4.1 The British legacy

India is the largest democracy in the world with its 1.2 billion inhabitants. The country's economic profile has been very different from the other emerging economies for a long time. Since its independence in 1947, economic development was quite slow until the 1990s. The economic model established since then is based on a mixed economy. The largest part of the new ruling class had been educated in India before 1947 under the British educational system or even in the United Kingdom. In refusing to adopt the British economic model – but not the capitalist model per se – India was open to other economic and institutional influences. Indeed, a dynamic minority, especially of the top bureaucracy, had some of its education in the Soviet Union. For these reasons, the Soviet economic model was attractive to some of the political elites, particularly within the Congress Party, the leader of the independence process and the ruling party for 45 years after independence.[23]

The approval of the Industrial Policy Resolution in 1948 and the establishment of the National Development Council and Planning Commission in 1950 set up the institutional framework for a dual structure in the economy. On the one hand, there was private initiative that was never criticized; on the other hand, there was a strong presence of the State, which established the general framework of economic development through the main parameters of a five year plan. The first plan was approved in 1950.[24]

The Indian economic model was based on a clear division of interest between the private sectors and the public one. Practically no competition existed between them. However, the control of the system remained in public hands, because any private initiative was submitted to the approval by the State authorities. Industrial sectors were divided between strategic sectors (mainly State monopolies), a sort of mixed sector (where there was cooperation between public and private initiative), and light manufacturing sectors (completely in private hands). The licensing policies were only partially revised in the 1970s. The institutional framework – India is a confederation with many prerogatives still in the hands of the State or regional governments – add-

[22] https://www.cnv.gov.ar/SitioWeb/Prensa/Post/1298/1298-consulta-publica-reforma-del-codigo-de-gobierno-societario.

[23] Guha, R. (2008), *India After Gandhi: The History of the World's Largest Democracy*, London, Macmillan.

[24] Panagariya, A. (2008), *India: The Emerging Giant*, Oxford, Oxford University Press.

ed complexity to a situation which was already quite complicated. In fact, licenses were issued by State governments, not by the national government.[25]

The Indian economic model remained based on domestic market for many decades, quite the opposite of most of the developing economies, which adopted an export-led model. It is not surprising that the Indian share of world exports fell from 2.5% (1938) to 0.9% (1968), before growing again to 1.6% (1988). The economy was largely dependent on political initiative. Bureaucracy played a crucial role in all activities. Corrupt practices to get permissions, licenses, and even unimportant documents became the main aspect of an economy that was still struggling to get out of underdevelopment.[26]

The opening up of the economy in the early 1990s, implied a series of reforms that included the elimination of quantitative import licensing, the reduction in import tariff levels, the adoption of a flexible exchange rate regime, and a legal framework to permit an increase of FDI and regular portfolio equity flows. Some other interventions involved the financial sector. In this case, the reforms liberalized the interest rate controls and the constraints over bank credit allocation. In the capital market a law eliminated government control over the issuance of capital. The approval of a new law in 1993 permitted the development in the capital market of mutual funds and the private mutual funds.[27]

However, the most important reform to improve the institutional framework of the financial and banking system was the establishment by the Indian parliament of the Securities and Exchange Board of India (SEBI), an independent regulator for the securities market. In addition, the insurance companies were affected by a series of economic reforms. New private companies could now enter the sector, including those whose capital was up to 26% in foreign hands.

The British legacy has always been very strong. The legal framework has always been based on the common law system. Quite soon for a developing economy, in 1956, India adopted a quite advanced Companies Act, together with a series of other legal provisions, that permitted the functioning of joint-stock companies as well as a precocious system of protections of investors' rights. These characteristics, which were not so effective in a country that from many points of view had rejected modern development, acquired a new sense and momentum, thanks to the long series of reforms introduced in the 1990s.

[25] Kaoila, U. (ed.) (2008), *India's Economic Development Since 1947*, New Delhi, Academic Foundation (pp. 25-45).

[26] Corbridge, S., Harriss, J., & Craig, J. (2012), *India Today: Economy, Politics and Society*, Cambridge, Cambridge University Press.

[27] Nagarai, R. (1996), "India's capital market growth: Trends, explanations and evidence," *Economic and Political Weekly*, 31(35/37), 2553-2563.

11.4.2 The economic reforms of the 1990s and the introduction of the code of corporate governance

In the 1990s India, like many other countries in the world, started the discussion about the code of corporate governance. An important event that contributed to the development of the debate was the 1992 opening of the National Stock Exchange of India Limited (NSE), the leading stock exchange of India, in Mumbai; it was the successor to the Bombay Stock Exchange, which was founded in 1875. The NSE started trading in 1994.[28] The discussions about the code took place for many years. The Confederation of Indian Industry played a very relevant role in this context. In 1996, the Confederation took the initiative of establishing a committee to study how to implement corporate governance in Indian listed companies. The top leaders of the Indian business community were directly engaged at several stages. The committee was chaired by Rahul Bajaj, an Indian billionaire businessman, who had also been a politician and an important philanthropist. He was the chairman of the Indian conglomerate called the Bajaj Group and a member of parliament. The committee's work was concluded with the proposal for a Code for Desirable Corporate Governance, which was finally published in 1998.

The code concerned only listed companies. It contained some recommendations. The text made a controversial choice about which bodies should govern the company. The text was more of an indirect criticism of the two-tier system than an explicit choice for the one-tier model. In fact, it read: "There is no need to adopt the German system of two-tier boards to ensure desirable corporate governance. A single board, if it performs well, can maximize long-term shareholder value just as well as a two- or multi-tiered board. Equally, there is nothing to suggest that a two-tier board, per se, is the panacea to all corporate problems." The second most important recommendation was about the presence of independent members in the board. "Any listed companies with a turnover of Rs.100 crores and above should have professionally competent, independent, non-executive directors, who should constitute at least 30% of the board, if the chairman of the company is a non-executive director – or at least 50% of the board if the chairman and managing director is the same person."

The text contained a timid warning against multi-board membership. The recommendation said that no single person should hold directorships in more than 10 listed companies. Non-executive directors were fundamentally important, because they were supposed to play a "material role" in corporate decision-making, but also pursue another priority, i.e., maximizing shareholder value. Their presence on the board had to be very active, not passive. They were asked to become active participants on boards, not passive advisors, as well as to take clearly defined responsibilities within the board such as on the audit committee. The Code's final recommendation was trivial but representative of a certain "naïveté" of the Indian business community.

[28] IBP, Inc. (2014), *India Stock Market Laws and Regulations Handbook, Volume 1, Strategic Information and Basic Regulations*, International Business Publications.

The code said that independent members of the board were supposed "to know how to read a balance sheet, profit and loss account, cash flow statements and financial ratios and have some knowledge of various company laws." The audit committee was also included in the code, but its real importance was compromised by the fact that the regulatory body did not endorse it. Moreover, its functions were not described clearly in the rules listing.[29]

In 1999, a new committee was formed, chaired by Kumar Mangalam Birla (an entrepreneur, owner and chairman of the Aditya Birla Group), and including members from various walks of public and professional life (captains of industry, academicians, public accountants, and people from financial press and industry forums). The committee proposed new formulations of the code, whose name was changed to the National Code on Corporate Governance. The SEBI approved the text in 2000. Thus, the code was introduced into the rules of the Indian stock exchange. The new mandatory recommendations included designating the optimal combination of executive and non-executive directors; establishing a remuneration committee, and defining the norms for the audit committee – three independent directors with one having financial and accounting knowledge. The board's functioning was also addressed by the reforms. The code stated that it should have at least four meetings a year, with a maximum gap of four months between meetings. Moreover, the chairman of a listed company could not be a board member of more than five committees across all companies.[30]

In 2003, a new committee (chaired by Nagavara Murthy, the famous IT industrialist and co-founder of Infosys) was set up to continue and enlarge the discussions. Its main aim was to evaluate the effectiveness of the existing code of corporate governance, since the country was frequently experiencing financial scandals. Its works were closely connected, although independent, with parliamentary discussions about the revision of the 1956 company law. The revision of the code contained many suggestions. The most relevant were about strengthening the responsibilities of audit committees; and improving the quality of financial disclosures, including those about related party transactions and proceeds from initial public offerings. Moreover, corporate executive boards were now required to assess and disclose business risks in their annual reports. Other changes concerned the board's responsibilities to adopt formal codes of conduct; the position of nominee directors; and stockholder approval and improved disclosures relating to compensation paid to non-executive directors.[31]

In 2007, the Ministry of Corporate Affairs proposed a draft of new Companies Bill. Discussion lasted many years. The Indian national parliament only approved the law in 2013. The Ministry of Corporate Affairs decided that the core principles

[29] https://www.scribd.com/document/29103687/cii-code.

[30] https://archive.india.gov.in/business/corporate_governance/kumarmangalam.php; Reed, A.M. (2002), "Corporate governance reforms," *India Journal of Business Ethics*, 37(3), 249-268.

[31] https://archive.india.gov.in/business/corporate_governance/narayana_murthy.php. For a general overview see Priyanka, K.S. (2015), *Corporate Governance Practices in India. A Synthesis of Theories, Practices, and Cases*, London, Palgrave Macmillan; Rajesh, C. (2005), *Corporate Governance in India: Evolution and Challenges*, January 17, available at SSRN: http://dx.doi.org/10.2139/ssrn.649857.

of corporate governance ought to be included in the bill. Its aim is to improve corporate governance by vesting greater powers in shareholders. To achieve a more favorable evaluation by the business community and the financial markets, these measures were balanced by greater emphasis on self-regulation, minimization of regulatory approvals, and increased and more transparent disclosures.[32]

The latest version of the code permits us to affirm that the Indian situation may be thought of as a combination of two conflicting models (Anglo-Saxon and German). Though the basic corporate legal structure is Anglo-Saxon, share ownership is far less dispersed, and financial institutions play a much bigger role in financing corporate activity, like in Germany. Share ownership and board representation by financial institutions give these bodies the ability to serve as important monitors of management activities. Their powers, however, are significantly more limited than those in typical bank-based systems, and universal banking is not widespread. Nevertheless, in general, financial institutions have failed to fulfill even their limited role in corporate governance.[33]

Despite the important, although maybe just formal, presence of some of the most important Indian entrepreneurs on all these committees, the real level of adoption of the code, even just from a cultural point of view, was quite low. Evidence of the ambiguous attitude of some of the most important businessmen and industrialists, can be found in their statements after the code was introduced, and, even more so after they took part in the activities of the committees involved in preparing the codes or evaluating them. For instance, in discussing the most controversial points of corporate governance, Narayana Murthy affirmed that "Corporate Governance is about owners and the managers operating as trustees on behalf of every shareholder – large or small." However, in 2019, he clarified his ideas with these words: "Good governance is about representing shareholders faithfully, doing everything possible to increase shareholder value legally and ethically, and enhancing the reputation of the corporation. It is about ensuring that every law of the land is fully complied with."[34] Murthy is considered, despite his sometimes naïve statements, "an iconic visionary," the "father of corporate governance in India." On the webpage of the Tata Group only a few years ago, one could read that corporate governance is "a set of principles and practices that together embody the idea that it is eminently possible for businesses to be very profitable and yet be powerful change agents and forces for good in society." This approach – mixing corporate governance and CRS – has become one of the main features of the Indian business community and particularly of the main industrial groups.[35]

[32] https://indiacode.nic.in/handle/123456789/2114?view_type=browse&sam_handle=123456789/1362.

[33] Krishna, A., Goyal, K.A., & Joshi, V. (2012), "Indian banking industry: Challenges and opportunities," *Global Business and Management Research: An International Journal*, 3(1), 18-28.

[34] Rakshid, A. (2019), "Narayana Murthy's take on good governance and what it takes to be a CEO," *Business Standard*, April 7.

[35] Arvind Babu, A. & Rentala, S. (2018), "Role of leadership and corporate governance: The case of

However, many aspects of corporate governance in India remain weak, not because of the imprecision of the text but because of other aspects that endanger the effectiveness of the code. Probably the most important one is the court system. In 2008, the World Bank Doing Business publication ranked India virtually the worst in the world, in this area (177th out of 178), on the basis of tracking the efficiency of the judicial system in resolving a commercial dispute, following the step-by-step evolution of a commercial sale dispute before local courts.[36] Reforms approved by Narendra Modi's government, despite many difficulties in implementation, have permitted the country to significantly improve its position according to all the criteria established by the World Bank. Since 2017, India has been among the top 100 countries in the general ranking. In particular, the introduction of the National Judicial Data Grid made it possible to generate case management reports on local courts, thereby making it easier to enforce contracts.[37]

11.4.3 Between the largest stock exchange and the power of family capitalism

Many Indian companies operate in a family-dominated culture. This is not surprising. In most Asian countries, including the most advanced like South Korea, Singapore, and, in general, all the so-called Asian Tigers, families have a predominant role in the shareholders' structure of the listed companies. A table published a few years ago by the Financial Times (**Table 11.1**) verifies this assertion.

Pyramiding and family control of businesses in Asian countries, particularly in East Asia, are prevalent in India as well.[38] This situation was detected already in the early 2000s, when discussion about the best code of corporate governance was very hot. Actually, in 2002, the average shareholding of promoters (according to Indian Company Act, the promoter is someone whose name is there in the prospectus of the company, identified in the AR of the company, or who has dominance over the directors of a company or who can guide them to act) in all Indian companies was as high as 48.1%. This is a result of the ineffectiveness of the legal system in protecting property rights.[39]

This situation fostered many negative effects. During the 1990s, Indian business groups evidently funneled considerable funds to the top of the ownership pyramid, thereby depriving minority shareholders at lower levels of the pyramid of their rightful gains.

Tata Group and Infosys," *FIIB Business Review*, 7(4), 252-272.

[36] Rajesh, C., Megginson, W., & Yadav, P.K. (2008), "Corporate governance in India," *Journal of Applied Corporate Finance*, 20(1), 59-72.

[37] https://www.worldbank.org/en/news/press-release/2017/10/31/doing-business-2018-fact-sheet-india; Vaishnav, M. (2016), "Modinomics at Two. The Indian Economy Under the BJP," *Foreign Affairs*, March 8.

[38] Carney M., Gedajlovic, E, & Yang, X. (2009), "Varieties of Asian capitalism: Toward an institutional theory of Asian enterprise," *Asia Pacific Journal of Management*, 26(3), 361-380.

[39] Rajesh, Megginson, & Yadav (2008).

Table 11.1 Family-owned listed companies as a percentage of total in 2015

Listed companies	Country	Market capitalization
67	India	47
66	Philippines	83
66	Thailand	48
63	Singapore	54
62	Hong Kong	26
62	Malesia	39
61	Indonesia	49
58	South Korea	52
35	Taiwan	49
13	China	11

Source: authors' elaboration based on https://asia.nikkei.com/Business/list.

This was permitted by bad practices in the nomination of the directors and in the functioning of the board itself. For instance, there has been an implicit assumption among boards – without any real evidence for it – that senior managers know their job and have the best interests of companies they manage at heart.

One of the consequences has been the low level of discussions and decision-making processes on the boards. This has sometimes resulted in boards refraining from asking the difficult questions to senior managers when the company has been performing well, or until there is a crisis. The selection of independent directors who are known to promoter directors has further compounded the problem. There is still incomplete adoption of a formal and transparent process for director appointments. Conflict of interest is inherent in the management structure. The code underlines the importance of independent directors but does not offer a framework to permit their role to be decisive. Appointing independent directors should be carried out through nomination committees (comprised of independent directors), in order to align the needs of the company with the skills required in the boardroom.

The revision of the Company law mentioned in the previous section took place under the pressure of public opinion. The big scandal of a few years before, known as the Satyam case, was still very hot among the business community and in Indian public opinion. This company, which was number 185 in the ranking of the Fortune 500 companies in 2008-09, was considered one of the best performing of the country. Among its clients there were very big names like General Electric, Nestlé, and British Petroleum. Satyam did a variety of IT jobs, which range from project-based programming to running business-critical systems such as those offered by SAP and Oracle. The scandal emerged in early 2009, when the chairman of the company,

Byrraju Ramalinga Raju, resigned. He confessed that he had manipulated the accounts of Rs 14,162 crore in several forms. Investigations and the ensuing legal process confirmed the crime. On April 10, 2015, Byrraju Ramalinga Raju was convicted, with 10 other members of the board of directors.[40]

The effects of the scandal were terrible. Vinnie Mirchandani, an expert on outsourcing and a negotiator for large-scale outsourcing contracts, affirmed: "It's like a terrorist attack. It sends shockwaves that have a significant effect on Satyam customers." Not to speak of the company's reputation, which is probably the most difficult thing to re-establish after such a shock. "There are only two things a service firm has, its people and reputation," said an analyst. "People can be replaced but reputation is far more difficult to re-establish."[41] The case had a global echo, because the big independent auditor PricewaterhouseCoopers (PwC) was involved. The Indian branch of the U.S. firm was fined $6 million by the Security Exchange Commission for not following the auditor's code of conduct and auditing standards. In 2018, the SEBI banned PwC for two years from offering its services to Indian listed companies. The Indian financial watchdog accused the audit firm of being complicit with Byrraju Ramalinga Raju and his partners.[42]

During the same period, in 2011, the India-OECD Corporate Governance Policy Dialogue was launched. Its aim is to support policy makers "by assessing key market practices and policy trends that may be detrimental to sound corporate governance." It also offers recommendations and policy options based on comparative analysis. Its program facilitates closer engagement in the regular work of the OECD Corporate Governance Committee and continued involvement in the Asian Roundtable on Corporate Governance. The Principles of OECD have been reinforced and are still being implemented. Regular meetings between OECD representatives and members of the SEBI guarantee that India is on the right track.[43]

The effects are quite visible in the most recent reforms of certain aspects of corporate governance. Many of the disclosure and governance requirements are now mandatory, and the government has started to suspend companies and disqualify directors of the companies that have not complied with governance and reporting requirements. Listed companies in India are mandatorily required to also comply with the Securities and Exchange Board of India (Listing Obligations & Disclosure Requirements) Regulations, 2015 ("SEBI Regulations") and the listing agreement with the Stock Exchange on which the company may be listed. There are also many additional provisions that affect governance, like the whistle blower policy, corporate social responsibility and related party transactions.

[40] Mandal, S.K. (2010), *Ethics in Business and Corporate Governance*, New Delhi, Tata McGraw Hill Education; Cristopher, E. (2017), "The dark side of leadership in the transformation of Asia and the need for reform in public and private sectors: the cases of China and India," in N. Muenjohn & A. Mcmurray (eds.), *The Palgrave Handbook of Leadership in Transforming Asia*, London, Palgrave Macmillan.

[41] Howlett, D. (2009), "Satyam scandal: the fallout," *The Guardian*, January 15.

[42] "Tip of the iceberg? PwC has a long history of controversies in India (2018)," *Economic Times*, January 11.

[43] https://www.oecd.org/india/oecd-indiaworkoncorporategovernance.htm.

The SEBI Regulations restrict directors from serving on more than ten company boards, and broadly require every publicly listed company to meet a series of requirements. It is now compulsory to have at least one female director in the board, while no less than 50% of its members must comprise non-executive directors. Specific committees have been set up: audit committee, the stakeholders' relationship committee, the risk management committee and the related party transactions policy. Moreover, there must be two independent directors if the paid-up capital is more than INR 100 million or if there is turnover of more than INR 1 billion, and such directors are not entitled to any stock options. Finally, the independent directors must hold at least one meeting within the financial year, without the presence of non-independent directors and members.[44]

SEBI has also framed regulations for the issuance of shares, foreign investment, the buy-back of securities and the prevention of insider trading. One should not forget that India has the largest stock market in the world. According to World Bank data, in 1983, its listed companies were 1,153; in 1992, when the SEBI began, they were 2,781. In 1996, they reached their peak with 5,999 companies. In the following years, they decreased to a low of 4,725 in 2003, but from that year onward, they grew steadily. In 2017, they were 5,615. On Wall Street in the same year, there were just 4,336 listed companies (the peak had been reached in 1996 with 8,090 companies). There are very strong reasons for good corporate governance in this country.

11.5 China, corporate governance, the power of the State, and the ineluctable strength of the market

11.5.1 The economic reforms

Corporate governance, gōngsī zhìlǐ (公司治理) in Chinese, has been one of the most interesting aspects of this country's transformation over the last 40 years. One must immediately add that it has been one of the last aspects of the complex economic and social reforms, started a couple of years after the death of Mao Zedong in 1976, to be implemented.

The reforms launched in 1978 changed the Chinese economy in many respects. From agriculture to industry and banking, all sectors have been thoroughly modified: the foundations were first laid in the primary agricultural sector, with new land management and the creation of township and village enterprises; the closure of the communal/collective farms (abolished in 1983); and the partial liberalization of prices of agricultural products to create internal demand in rural areas. Immediately after this came changes to the banking system via the creation of four State banks: the

[44] https://practiceguides.chambers.com/practice-guides/corporate-governance-2019/india.

Bank of China, the People's Bank of China for Industry and Commerce, the China Construction Bank, and the Agricultural Bank of China.[45]

Seduced by experiments in Singapore by the Prime Minister Lee, in 1979 Deng Xiaoping, the architect of the Chinese economic reforms, proposed the introduction of a law to attract foreign investments in designated special economic zones (SEZ).[46] In the meantime he started a more subtle form of transfer of ideas via cultural contacts with Western economists and some in the Eastern European bloc who had already introduced some very timid economic reforms.[47] One year later, in 1980, China joined the World Bank, and state-owned companies were allowed to keep a share of their profits to finance investments and give out productivity prizes/bonuses. The Bank of China became the central bank in fact and in law, but with a politically-privileged position, since it has the administrative level of a ministry, and thereafter is part of the State Council, the official name of the Chinese government.

By 1985, the number of SEZ rose to 14, and internal migrants moved in the tens of millions to these areas along the Chinese coast – the Eastern provinces for the Chinese – where foreign companies paid much higher wages. In 1986, China applied to become part of GATT, the first step on the way to its subsequent entry into the WTO. In the meantime, in 1981, trading in treasury bonds was resumed. In 1984, stocks and enterprise bonds emerged in Shanghai and a few other cities. However, trading activities were not yet formalized.[48]

All these changes had various consequences, not all of them positive. Concerns in the Chinese Communist Party (CCP), and in society in general, became more acute among those who worried about the changes in course, and those who wanted change to accelerate. These tensions culminated dramatically in the government repression of the Tiananmen Square protests in June 1989, when between two and three thousand protesters were killed and about 30,000 arrested. Deng ordered the shift to repression out of concern for social stability. The prime minister, the reformist Zhao Ziyang (supporter of Chinese general secretary of the CCP, Hu Yaobang, who was disgraced in 1987, then died suddenly in April 1987, to be replaced by the mayor of Shanghai, the more conservative Jiang Zemin) was discharged and replaced by the vice-premier Li Peng. In 1993 Jiang became president of the People's Republic of China and remained in office for ten years, so that he was actually in power for a total of 14 years (or 16, since he continued to serve as chairman of the party's powerful Central Military Commission for two more years).[49]

[45] Walter, C. & Howie, T.J.T. (2012), *Red Capitalism. The Fragile Financial Foundation of China's Extraordinary*, Hoboken, John Wiley & Sons.

[46] Vogel, E.F. (2011), *Deng Xiaoping and the Transformation of China*, London, Belknap Press of Harvard University Press.

[47] Gewitz, J. (2017), *Unlikely Partners. Chinese Reformers, Western Economists, and the Making of Global China*, Cambridge, Harvard University Press.

[48] Coase, R. & Wang, N. (2012), *How China Became Capitalist*, London, Palgrave Macmillan.

[49] Li, C. (2008), *China's Changing Political Landscape. Prospects for Democracy*, Washington, Brookings Institution Press.

The collapse of the USSR and the transition in Eastern Europe dealt a hard blow to the conservative wing of the CCP, which remained hostile to the economic changes that had been taking in place in China for almost fifteen years. But after just over two years of stagnation, Deng was finally able to relaunch his reforms in 1992 during his southern tour of China, and in the following autumn, the CCP Congress defined the aim of the path outlined by Deng as the "socialist market economy." In the same year, the Congress of the CCP confirmed that vision, affirming that a market economy was compatible with socialism, and that private ownership in the industrial sector was again permitted.[50]

11.5.2 The Chinese stock market and the introduction of corporate governance

Chinese "shareholding experiment" started from the countryside where the State policy allowed rural enterprises to sell shares in late 1979. The real period was picked up with the flooding of creations of new corporate forms over 1984 to 1986, the issuance of shares by urban enterprises and the creation of the first securities companies. The first IPO was carried by a Shanghai-based firm in 1984 while over-the-counter trading followed in the Shanghai in the mid-1980s. The first securities exchange opened in Shenyang in 1986.[51]

Two of the most symbolic instruments of the capitalist system – the stock exchange and the capital market – were opened again after more than forty years. On November 26, 1990, Shanghai Stock Exchange (SSE) came into existence, and on December 19 of the same year, it started formal operations. This was followed one year later by a second exchange in Shenzhen, the city on the mainland opposite to Hong Kong, which at that time was still under British rule. The China Securities Regulatory Commission (CSRC) started operations in Shanghai the same year. This institution is formally the equivalent of the U.S. Securities and Exchange Commission, but with a very important difference: it is not independent like the American model, since it is directly controlled by the executive power, the State Council.[52]

Over the following years other more important events occurred. In December 1993, the first Company Law passed in the National People's Congress. It became effective in July 1994. One month later, the State Council issued "Special Regulations" raising governance standards of overseas offerings, followed by "Mandatory Obligations." In December 1998, the first Securities Law was passed in National People's Congress. It became effective in July 1999. In March 1999, the China Securities Regulatory Commission issued new "Opinions on Further Improving the Standard Oper-

[50] Shambaugh, D.L. (2008), *China's Communist Party: Atrophy and Adaptation*, Berkeley, University of California Press.

[51] Allen, J. & Li, R. (eds.) (2018), *Awakening Governance: The Evolution of Corporate Governance in China*, ACGA China CG Report 2018 (p. 23).

[52] Suliman, M.O. (ed.) (1998), *China's Transition to a Socialist Market Economy*, Westport, Quorum Books.

ation and Deepening Reform for Listing Overseas," a solution that was increasingly considered by large SOEs. In September 1999, there was the first IPO of a commercial bank, the Shanghai Pudong Development Bank since 1987.[53]

A major challenge of the first half of this period was the reform of "non-tradeable state shares" (known as G share), the large blocks shares owned by the State and they couldn't be liquidated through stock exchange. Another highly debatable local solution implemented was the "IPO moratorium," a complete prohibition of new stock issuance to calm the market and stop liquidity rushing out of existing stocks and into new issues. The policy was first carried out in the middle of 1990s with great success and did not achieve the desired bounce in the second moratorium in 1995 and between 2001 and 2004. Nevertheless, the moratorium from May 2005 to January 2006, prior to the G share reform, was followed by a severe fluctuation.[54]

However, many SOEs, particularly the oil companies (Sinopec and China National Petro-Chemical Company), started a parallel strategy, with listings in Hong Kong (thanks to the formula "one country, two systems" that governed the new relationship between mainland China and the former British colony after 1997), and even in New York. To pursue that purpose, they set up some special companies with some of their most valuable assets, strictly controlled by the mother company, and these "appendix-companies" were listed abroad.[55] Moreover, the development of the stock market initiated something of a bubble effect. In early 2000, the market capitalization of Petrochina was bigger than that of Exxon, but this was just because of the limited number of shares available on the market (about 2% of the total).[56]

The State-owned enterprises (SOEs) underwent a deeper reform. In 1993, the government started a radical restructuring policy that reduced the number of jobs in these companies. The result was that by the year 2000, the employees of the SOEs sank from 76 to 50 million. At the same time, business legislation introduced different forms of ownership. Thus, the SOE became public limited companies, or limited liability companies. The following years saw the first privatizations of the smaller SOEs, sold firstly to employees and managers, but also to foreign investors. In 1997, the year of Deng's death, the CCP Congress established that State intervention in the economy should be progressively limited exclusively to certain strategic sectors (defense, communications, electricity, oil, aviation and railways). However, this decision did not have immediate effects. It was but part of a long-term vision.[57]

[53] Chan, K.C., Hung-gay, F., & Liu, W.Q. (2007), *China's Capital Markets: Challenges from WTO Membership*, Cheltenham, Elgar; Zhang, F. (2018), *The Institutional Evolution of China: Government vs Market*, Cheltenham, Elgar.

[54] Allen & Li (2018, p. 24).

[55] Liu, L. (ed.) (2014), *International Cross-Listing of Chinese Firms*, Hershey, IGI Global.

[56] Greenlees, D. & Laguenov, D. (2007), "PetroChina shares triple value in record IPO," *The New York Times*, November 5.

[57] Liao, C. (2009), *The Governance Structures of Chinese Firms: Innovation, Competitiveness, and Growth in a Dual Economy*, Berlin, Springer (pp. 41-44).

The reforms of the 1992-2002 period opened the door toward market values, although with Chinese characteristics. The new generation of leaders who rose to power in 2003, President Hu Jintao and Premier Wen Jiabao, completed reform of the SOEs, concentrating on the 196 most important companies with the aim of creating around 30 internationally important groups. For this purpose, state-owned companies were placed under the control of a new organization, the State-Owned Asset Supervision and Administration Commission (SASAC). When the SASAC was set up, information about the number of SOEs was very limited. A census was necessary. The results were available in 2006. The total number of SOEs was 119,254, with 37.75 million employees and $39 trillion in assets. However, the central government directly controlled only 22,589 firms, with about 17 million people and $14.8 trillion in assets. Local governments owned the other 96,672 firms, where they had almost 20.8 million employees and assets of $16.65 trillion. The SASAC progressively reduced the number of companies under supervision. In 2017, there were 116, while in 2019 there were only 96. The establishment of the SASAC was a direct consequence of another important reform that changed the ministerial bureaucracy. In the late 1990s, the old Soviet structure of public administration came to an end. Instead of a series of ministries, each charged with supervising the activity in tens of industrial sectors (ministry of chemical industry, ministry of coal industry, ministry of machine building and electronics industry, and so on), there was now only a Ministry of Industry and Information Technology for all the industrial sectors.[58]

More important for the issue of corporate governance was the Fourth Plenum of the Chinese Communist Party's 15th Central Committee held in September 1999. This meeting adopted a decision that identifies corporate governance as "the core of the modern enterprise system."[59] This was a declaration that couldn't be made even in many Western countries during those years. However, at that point it was a declaration without any specific consequences. Many steps still had to be taken.

In December 2001, after 15 years of difficult negotiations, long enough to "transform the hairs from black to white," as the Chinese prime minister Zhu Rongji put it, China entered the World Trade Organization.[60] The next step, a sort of corollary to all the previous reforms, came one year later, in 2002, again at the Congress of the Chinese Communist Party (CCP). The amendments to the party statutes changed one important article, which had been unaltered since the Party's foundation in 1921. It stated that the CCP no longer represented "the vanguard of the working class," but

[58] Naughton, B. (2015), "The Transformation of the State Sector: SASAC, the Market Economy, and the New National Champions," in B. Naughton & K.S. Tsai (eds.), *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, New York, Cambridge University Press, 46-71.

[59] Feinerman, J.V. (2008), "New hopes for corporate governance in China?," in D.C. Clark (ed.), *China's Legal System: New Developments, New Challenges*, Cambridge, Cambridge University Press (p. 39).

[60] Lardy, N.R. (2002), *Integrating China into the Global Economy*, Washington, Brookings Institution.

the "vanguard of Chinese society." Thanks to this new definition, the new Chinese private entrepreneurs could become members of the party.[61]

In 2001, China's Securities Regulatory Commission published some initial rules concerning corporate governance. The privatizations of the 1990s focused attention on the rules governing enterprise operations. The rise of the stock exchanges and the increasing number of small savers interested in stock investments required some intervention. Unlike in Russia, which was forced to take action as an IMF conditionality, this move was part of a seduction strategy adopted by the Chinese government within the new positive atmosphere after China's entrance into the WTO. China's commitments under the principles of the WTO added some urgency to tackling corporate governance issues in a comprehensive and systematic manner.[62]

The model of corporate governance adopted some of the recommendations included in the OECD's Principles, but with a strong Chinese accent. A two-tier system was introduced, in which the supervisory board nominates the board of directors as well as the CEO and the general manager. However, the document affirmed that "the board of supervisors plays a key role in setting and monitoring policies and procedures. The board of supervisors in China is different from that of other countries due to the lack of an audit committee. Consequently, the board of supervisors and the board of directors have similar authority levels." In addition, to further underline its differences with the Western style of the two-tier system, the supervisory board is "comprised of shareholders' representatives and a reasonable number of employee representatives." However, the State and the Party, directly in the case of the SOEs, and with a Chinese version of moral suasion elsewhere, has a direct influence in the formulation of the list of the members of the board of supervisors. Since they are politically nominated, sometimes its members have less experience and know-how than the members of the board, and even less than that of the managers. Moreover, "PRC listed companies do appoint company secretaries," a senior management position within the company, and he (very rarely she) is appointed by the board of directors. "Any board of directors and senior executives within the company are eligible for the position of company secretary." This figure is the "unofficial" representative of the Chinese Communist Party, usually nicknamed "the boss" (the function exists in all Chinese public organizations like the schools, the universities, museums, and so on).[63]

According to these rules, at least one third of the members of the board should be independent. It was also suggested that one of them should be an accounting professional. Independent members of the board of directors could be co-opted or can be nominated by the supervisory board. Moreover, as in the Russian Code of Corporate

[61] Zou, K. (2006), "The Party and the Law," in K.E. Brødsgaard & Y. Zeng (eds.), *The Chinese Communist Party in Reform*, London, Routledge.

[62] Liu, S. (2006), "Corporate Governance and Development: The Case of China," *Managerial and Decision Economics*, 26, 445-449.

[63] China Securities Regulatory Commission (2001), *Information Disclosure and Corporate Governance in China*.

Governance, any shareholder with at least 5% of the shares has the power to nominate board members.

The reforms of the SOEs, announced in 2013 by the Chinese government and met with skepticism among Western economies, made some important new steps in 2017. The government declared that all major Chinese enterprises owned by the central government would be turned into limited liability companies or joint-stock firms by the end of that year, as part of overhauling their unwieldy structures. The aim was to create "bigger and stronger" conglomerates capable of competing on the global stage. Restructuring state-owned enterprises (SOEs) will separate government administration from day-to-day management of business operations, a new step toward greater efficiency.[64]

Until early 2019, Chinese legislation did not allow foreign direct investment (FDI) in Chinese companies that operate in key industries, e.g., Internet, education, and telecommunications. Many private listed companies retain founder involvement. Due to the nature of the contractual relationships and the associated risks, the reputation and equity commitment held by the founder is often key to as IPO's success. Founders typically use three primary tools to maintain a tight grip on the control of the listed SPV (Special Purpose Vehicle): 1) a dual share class structure granting them superior voting power; 2) incorporation in a management-friendly jurisdiction; and 3) dominating the board, often via the key role of chairman while retaining executive powers.[65] More recently, another kind of response emerged. Variable Interest Entity (VIE) as a main challenge arose in recent years of corporate governance reform originated with the listing of Sina.com, an online news provider and owner of the micro-blogging site, Weibo. Because of the Company Law restriction and profitability requirement of stock market, domestic operational entities are not allowed to be controlled by listed companies abroad. VIE is used by Chinese Internet companies to list abroad. Through VIE, offshore company abroad can establish a wholly foreign-owned enterprise (WFOE) instead of direct acquisition of domestic operating entity. The wholly foreign-owned enterprise could provide monopolistic consulting and management services. The domestic operating entity will repay WFOE all its net income as service fees.[66]

In March 2019, the ban on FDI was lifted in the framework of an economic-diplomatic offensive around the U.S.-China trade war talks. However, there is still a restricted area, a "black list" of 48 sectors, which will not be open to foreign investment or, in some cases, not open without conditions or special permission. For example, there is a complete ban on investing in fishing, gene research, religious education, news media, and television broadcasting. Partial investment is permitted in

[64] https://www.reuters.com/article/us-china-economy-soe-reforms/chinas-state-firms-to-shed-old-corporate-governance-structures-by-end-2017-idUSKBN1AB07F.

[65] msci.com (2017), *Corporate Governance in China*.

[66] Allen & Li (2018, pp. 26-27 and 45).

oil and gas exploitation, nuclear power, airlines, airport operation, and public health, among other sectors.[67]

Despite many reforms and many efforts to implement them, the quality of Chinese corporate governance is still relatively poor, according to the most important watchdog on this issue in Asia, as we will see later. China is not getting worse, but it seems unable to improve. Since the trend has been relatively stable over the last ten years, the problems are deeply rooted. In addition, most probably, as we will see, their origin does not lie in the companies nor in the management.

In June 2018, the CSRC published a draft of its newly revised Code of Corporate Governance for Listed Companies for consultation, which took the "OECD/G20 Principles of Corporate Governance" (the 2015 version) as reference and emphasized the rode of institutional investors and duties and responsibilities of the board of directors. In September 2018, the China Securities Regulatory Commission issued the revised "Code of Corporate Governance for Listed Companies."[68] It was the first revision after the first code in 2002. Among the most relevant changes, the New Code includes "requiring companies to establish Party organizations (representative units of the Communist Party intended to play a political role in the company and ensure implementation of state objectives and policies) and incorporating Party-building work into the articles of association of state-controlled firms." Analysts have interpreted this change as a return to strict Party control connected to the development of the anticorruption campaign launched in 2013 by President Xi Jinping. Companies are explicitly requested to fight for green development and to target poverty alleviation. Companies are encouraged to develop concepts of "innovation, coordination, green development, openness, sharing" and social responsibilities. From the point of view of the shareholders, the new elements consist in "encouraging cash dividend distribution; promoting board diversity; strengthening audit committee functions; and restricting powers of controlling shareholders."[69] These aspects seem to confirm that the dominant philosophy in China now is that "corporate governance requires a firmer guiding hand from above, namely that of the CPC, to avoid the excesses of the past."[70]

11.5.3 The anti-corruption campaign and corporate governance

When the Shanghai stock exchange began to fall – and then to plummet – in July and August 2015, the effects on the other stock exchanges were immediate. Besides demonstrating increasingly deep-seated world integration – at least at the financial level – this development highlighted the weakness of a stock exchange system buoyed up by a chronic insufficiency of supply, in comparison with the demand for

[67] https://www.bbc.com/news/business-47550559, China foreign investment: How doing business will change.

[68] Allen & Li (2018, p. 30).

[69] https://www.glasslewis.com/regime-change-begins-at-home-chinas-new-governance-code.

[70] Riding, S. & Thompson, J. (2019), "Chinese governance raises red flags," *Financial Times*, June 1.

shares and corporate bonds. At first the Chinese government preferred to let the market forces act, but it was then compelled to intervene decisively in support of the stock exchange buying up shares worth $200 billion. The question can evidently not be limited just to the stock exchange. A famous Chinese economist, David Daukoi Lee, told the Financial Times: "The stock market sell-off is not the problem. Yes, the Shanghai Composite Stock Index has dropped almost 40 per cent since its June peak, but the Chinese economy has rarely been upset by fluctuations of its financial markets. The problem – not a huge one, but a problem nonetheless – is the Chinese economy itself. It requires corrective action from Chinese authorities – not surgery, but acupuncture."[71] However, the crisis did not discourage companies from entering the capital markets. The cumulative number of listed companies in Shanghai and Shenzhen grew from 323 in 1995 to 1,530 in 2007, and to 3,485 in 2017, according to the World Bank.

The issue involves not only the reforms now in effect but even the credibility of a power that once seemed unassailable. At the same time, the intense battle against corruption, which was launched several years ago, is perhaps achieving some results at the political level, but has somewhat slowed private enterprise. Chinese companies have been affected by the initiative. Anti-corruption campaign is also part of SOEs' reform, most of which starts from the monopolized industry like energy and enterprises who have large scales of overseas investment. At that moment, supervision loopholes are commonly observed among SOEs. Executives ignore the managerial operation and maximize their own fortunes by insider trading, outsourcing to bribers, employing relatives or cronies and privatizing corporate assets. Therefore, some SOEs are stuck in poor corporate governance and worsening operating performance.[72]

The effects were immediate, because the Chinese government wanted to show that the country was entering a new season. In 2013, when the Plenum of the Central Committee of the CCP established new rules for the SOEs, in order to increase their use of market criteria, efficiency, and effectiveness, the number one of SASAC, Jiang Jiemin, was removed. The accusations against him concerned the period when he was the chairman of China National Petroleum Corporation (2004-08). He was expelled from the CCP and sentenced to 16 years in prison.[73]

Insider trading is considered the most dangerous but also the most common result of a situation where SOEs are still over-dominating the market. Because so many Chinese enterprises are state-owned, with non-tradable shares, insiders at many of these companies have made fortunes on stock offerings. Finally, China continues to suffer from immature capital markets, characterized by the Chinese banks' prefer-

[71] Li, D. (2015), "China's problem is the economy itself, not the market sell-off," *Financial Times*, August 31.

[72] http://finance.ifeng.com/business/special/zhen xiang55.

[73] Buckley, C. & Ansfield, J. (2013), "Senior Chinese official falls under scrutiny as some point to larger inquiry," *The New York Times*, September 1; https://www.bbc.com/news/world-asia-china-34503469.

ential treatment of state-owned enterprises, difficulties in issuing corporate bonds (many state-owned companies have been forced to issue them in foreign capital markets), and the absence of an over-the-counter securities market and corporate debt market. The China Securities Regulatory Commission investigated 71 cases of market manipulation in 2015, a nearly fourfold increase over 2014. In the first half of 2016, it issued 109 sanctions in 88 general enforcement cases, many concerning insider trading and manipulation – an 85% year-on-year rise. The fees totaled ¥2.55 billion ($377 million), almost 20 times the level reached during the first six months of 2015.[74]

All these bad practices of corporate governance and firm management very much concerned the government. Although they are considered the biggest market manipulators, the Chinese government and the authorities, the so-called "national team," in are very worried about the social impact of bad behavior of the listed companies and of their management.[75] In China a huge middle class has invested an important share of their savings in the stock exchange which gobbled up a huge chunk of the market" when stocks crashed in July 2015. Risks for minority investors generally are increasing. The issue not only concerns the quality of the stock exchange, the transparency of the operations, and the bad practices of corporate governance. The most delicate point is the trade-off between the CCP and the middle class, and the need to keep the reciprocal political and social trust in a society that is still undergoing deep changes.

Part of the deal has to do with the trend in the stock exchange and the evolution of shareholders' rights. Despite many efforts in this decade, China has not been able to modify its relative ranking within the Asian capital markets in the quality of corporate governance, according to the most important watchdog for Asian capital markets, Asian Corporate Governance Association. In 2010 China was ninth and it remained in the same position until 2016. Unfortunately, over the next two years it fell to the 10th position. This step back is probably linked with the increasing presence of the CCP. In fact, the report for 2018 affirms that the "reinforcement of Party Committees raises numerous questions." The only positive point detected was an initial and very timid shareholders' initiative without transforming it in real activism: "Retail investors still dominate share trading, show no inclination towards activism; but some quasi-class actions have occurred since 2015."[76]

However, some recent novelties are partially changing the situation. At the end of April 2020, the Central Commission for Comprehensively Deepening Reform passed a plan on "Reforming the ChiNext market – a trial of registration system overall implementation." The registration system of ChiNext market came into effect. Information disclosure is now the core of registration system. The trial of registration system provides new opportunities and challenges for corporate governance. On the one hand, the quality of information disclosure would be improved with the providing

[74] http://www.jy857e.com/html/20161127/409117.html.
[75] https://www.economist.com/comment/2813493.
[76] https://www.acga-asia.org/cgwatch.php.

of more transparency, understandability and comprehensiveness. While the range of information disclosure are widely expended. On the other hand, as value discovery and information perception are carried by the market, every published information is likely to be reflected in the stock price fluctuation. Any tiny unfavorable information related to financial or operational situation of the enterprises may plunge dramatically the price. As a result, the corporate governance will be probably strengthened. Investors should be more professional and sensitive in case of any gossip and misbehaviors. In addition, they will be requested to increase effective company engagement and build rational investment philosophy under current mechanism: the broadening of daily price limit to 20%, the cancelation of issue price restriction, which is 23 times the price earnings ratio and simplified delisting system, etc.

Secondly, the overall corporate governance situation would be improved. The pressure and burden faced by the supervisory institution could be lower. With the implementation of registration system, the "corporate shell," including M&A for the purpose of backdoor listings may not exist anymore. The junk stocks and mismanaged enterprises may never be reversed and eliminated by the market. Another possible positive consequence arose would be return of Interest and technological companies adopting VIE. It would be more convenient for these non-profitable companies to raise funds.

The differences between registered system and approval system are obvious. Except for the role of CSRS-supervisory institution is different, fundamentals of law and ideology behind diverge as well. Under registration system, market autonomy is followed and the efficiency and freedom of the market are emphasized. The right to issue shares is owned by the enterprise instead of being empowered by the State. Under approval system, the government substantively manages and judges stock listing. The macro-control of the government and justice, rules and regulations of the market are pursed. As far as fundamentals of law, registration system has higher level of requirements for the issuer and financial institutions: the degree of honesty and trustworthy and the ability of self-discipline. Furthermore, registration system has emphasis more on the ex-post control and compensation including the reorganization of civil and criminal liability.[77]

[77] Allen & Li, (2018, p. 159).

Case study Tata

History

Tata Group is an Indian multinational conglomerate holding company headquartered in Mumbai, Maharashtra, India. It was founded by Jamsetji Tata in 1868. It currently comprises 96 operating companies which together employed some 330,000 people and had revenues of US$110.7 billion in FY2018, the equivalent of about 4% of India's GDP. The Group has operations in more than 54 countries and its companies export products and services to 120 nations.
The company gained international recognition after purchasing several global companies. Tata Group is now one of India's largest conglomerates. We can consider this conglomerate as a business group; this means that a holding company, often unlisted, holds equity stakes in several independently listed affiliates.
For instance, each affiliated has a separate board of directors, is answerable to its own shareholders, raises capital from investors on its own, independently develops and executes strategies and creates its own incentives for managers. Business group can be considered as a federation of companies.
The advantages of being a group
Here is a list of avantages related to their nature of business groups:

- high level of involvement between ownership and management;
- investment committee, which usually reviews and approves all major investment decisions of the group and its affiliates;
- cross-business innovation.

In 1998, the Tata Group announced the creation of a group executive office that would strengthen its relationship with its affiliates and review strategy issues. The group center adds value to a company by guiding activities along 2 dimensions: strategy and identity. For instance, every major Tata company has a business review committee – made up of that affiliate's top leaders and key members of the group center – that works with it to redraw its horizons. Furthermore, the group center can help find cross-business opportunities by identifying potential synergies that typically would not be apparent to individual affiliates and by setting up initiatives that foster the exchange of capabilities and ideas. The Tata Group Innovation Forum sponsors five innovation clusters in the areas of engineering, information technology, nanotechnology, plastics and composites, and water. Moreover, the group center plays a role in defining the identity of the company, because the affiliates are autonomous and have different aspirations, the center's first challenge is to manage the presence of multiple identities.
The group center's identity work has three objectives:

- refresh identity
- multiply goodwill
- safeguard values

In the late 1990s, the Tata group received a proposal from an affiliate that wished to produce movies. Senior executives were concerned that movie production, then tainted by the financial ties some producers had to organized crime, was incompatible with the group's purpose of "improving the quality of life of local communities." Ultimately, the group executive office decided to turn down the proposal. To strengthen the group identity, some initiatives has been taken among the years such as: The Tata Code of Conduct, the Brand Equity and Brand Promotion Agreement, the Tata Business Excellence Model, and the makeover of Tata Administrative Services.

Ownership structure and the role of Mistry

Tata group has a unique ownership structure: the main holding company Tata Sons Limited is majority-owned by charitable trusts. Indeed, 66% of the equity share capital of Tata Sons is held by philanthropic trusts, which support education, health, livelihood generation, and art and culture. Tata Sons Limited is the principal holding company, and so the core owner of the Tata Group.
As explained earlier, group companies are independently managed and are under guidance and supervision of their own Board of Director. But there are significant cross shareholdings and a member of the founding family (Mr. Ratan Tata) chairs the Trusts, holding companies and major subsidiaries. The governance structure is characterized by managerial distance between trusts and Group companies. The trusts' governance role is limited to nominating two members to the Selection Committee which recommends the Chairman of the company's Board of Directors.
Tata Sons, the main holding company of Tata group (29%) can be considered as the ultimate owner of the group.
The composition of TATA group is comparable with other companies, with 8 directors and 10 executives. Only one female director is on the board, while Ratan Tata, a family member, is Chairman Emeritus overlooking the the Board. Natarajan Chandrasekaran is both the Chairman and CEO of the company, resulting the CEO duality.
From 1990 to 2009, Mistry served as the director of Tata Elxsi Limited and Tata Power until 2006. On September 1, 2006, he joined the board of Tata Sons, after his father's retirement from Tata Group. Mistry's father Shapoorji Pallonji is the second largest stakeholder in the Tata Group with 18.5% of shares in Tata Sons making them the largest individual shareholder in the holding company of the Tata Empire.
In 2010, Mistry was tasked to find the successor for the position of Chairman held by Ratan Tata as he decided to retire a year later. Ironically, the choice was a big surprise as Cyrus Mistry, being part of the selection committee, was appointed as the successor to Ratan Tata. It was announced as an anonymous and favourite choice by Ratan Tata. It was announced that Mistry would takeover as the Chairman a year later, thus completing the entire transition process.
The transition phase started from Ratan Tata to Cyrus Mistry in November 2011, with Mistry being appointed as the deputy chairman of the Tata Group. Slowly one after another Tata companies appointed Mistry as their chairman in 2012 prior to his appointment as the group chairman. It started on November 8, 2012, with the appointment as the chairman of Tata Power; then on November 20 he took charge as the chairman to Tata Global Beverages. Later, he became the chairman of Tata Teleservices, Tata Industries, Tata Sons, Tata Steel, Tata Chemicals, Tata Consultancy Services and Tata Motors. Finally, on December 28, Cyrus Mistry was appointed as the sixth chairman of India's oldest business empire the Tata Group at the age of 44, after a long stint with Tata's since the 1990s.
After 45 months as a chairperson, Mistry was sacked from his position without explanation at the time, and in very public and noisy way (it could have been done more conveniently 5 months later at shareholders meeting). The decision was made in short meeting by family Tata, that later explained that the reasons were repeated departures from culture and ethos of the group.
Afterwards, it was acknowledged that the true reasons were style of functions, poor governance and conflict of interests: (1) doing business with his company and (2) misleading the election committee.
Mistry also brought his people what started a conflict between old and new gourd. Tata Group have tradition of elevating senior group executives to Tata Group board (Japanese style).
To sum up, Tata Trusts and Ratan Tata were not happy with Mistry's approach to fees and commissions for directors on the boards of the group of companies, as well as departure from the long-running tradition of elevating senior group executives to the Tata Sons board. The break up was when Mistry decided to acquire Welspun Renewables Energy company at ,95 billion for which questions remained over the extent to which the boards of Tata Power and Tata Sons were kept in the loop and supportive.

The friction with the family started way back in 2014 with Mistry's solo decision-making style, ignoring the Tata Sons board. Several of Mistry's business decisions, such as the sale of Indian hotels in overseas and the move to shut down the UK steel operations, did not go well with Ratan Tata. The move to shut down the UK steel business was highly criticized in Britain and was seen as a set back to Ratan Tata. These were considered as Ratan Tata's legacy which he undertook during his stint as group chairman. Tata's wanted to turn around the loss-making business than selling it, but Mistry had different plans altogether.

During Mistry's tenure as an executive chairman, dividend income (apart from TCS) declined continuously, but staff costs doubled. All this would have resulted in losses but survived due to TCS dividend; thus there was an increasing dependence of Tata Sons on TCS. Mistry did not show concern on these issues, which the board did not like.

In his 45 months' tenure, the total assets of the Tata's empire grew by 33% to 6,065.89 billion Rupee from 4,576.70 billion Rupee in the FY 2013. In the last 4 FYs under Mistry between FY 2013 and FY 2016, Tata Motors saw its sales turnover increase by 44.6% to 2,800.97 billion Rupee from 1,936.98 billion Rupee. Tata Capital Housing put up a good show with the sales turnover notch up by 224 per cent to 12,550 million Rupee from just 3,870 million Rupee in the FY 2013 before Mistry took over.

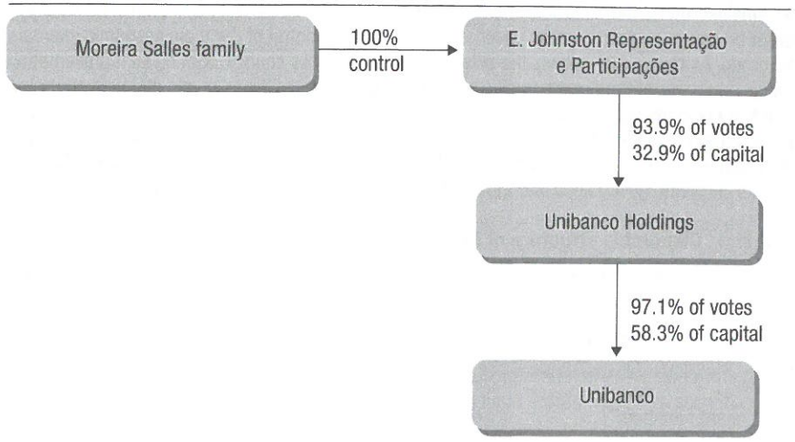
Case study Banco Itaú Unibanco

Banco Itaú Unibanco S.A. (commonly referred to as Itaú) is a Brazilian listed bank based in Sao Paulo, Brazil. The bank is the result of the merger, which occurred on November 4, 2008 between Banco Itaú and Unibanco, the two largest Brazilian banks, to form Banco Itaú Unibanco S.A. It became the largest financial conglomerate in the Southern Hemisphere.

The history of the bank is quite complex. In one case, we have to go back to the 1920s. João Moreira Salles founded the Casa Bancária Moreira Salles (Moreira Salles Bank House) in 1926 in the town of Poços de Caldas, about 80 km (50 mi) northwest of Pouso Alegre. His son Walter became his partner at the age of 21. In 1940, Banco Moreira Salles merged with three regional banks. It was renamed União de Bancos Brasileiros (Unibanco). Walter Moreira Salles had also an important political career. He served as Brazilian ambassador to USA in the 1950s. He was also secretary of Treasury in the government and played a crucial role in many other moments of Brazilian financial history, especially when foreign debt had to be renegotiated. As a banker, he implemented a series of successful acquisitions and put an emphasis on human resources, helping to make Unibanco one of Brazil's top three banking institutions by the end of the twentieth century. Unibanco grew to become the third largest non-governmental bank in the country, largely thanks to the 1995 acquisition of Banco Nacional, which went bankrupt along with other major financial houses during the period of national banking activity. In the early 2000s, the bank had a very solid reputation for being a strong player in insurance, credit card and consumer finance. Its client profile was considered to be of a high standard, while its initiative was prone to high exposure to speculation. Despite its listing at Bovspa, the Moreira Salles family retained control of most of Unibanco's shares through a series of holdings companies that gave the family the majority of the voting rights (**Figure 11.2**).

The other must be found in December 1943 when Alfredo Egydio de Souza Aranha and his partner Aloysio Ramalho Foz founded Banco Central de Crédito in São Paulo. Alfredo Aranha was elected president of the bank. In 1952, following requests from the Brazilian central bank Banco Central de Crédito changed its name to Banco Federal de Crédito, to avoid any confusion with the Brazilian central bank. The development of the bank, under the dynamic and strategic control of Souza Aranha, accelerated from 1961, when the bank acquired Banco Paulista de Comércio S.A. The most important moment was the merger with Banco Itaú in 1964. Banco Itaú S.A. was founded in the city of Itaú de Minas, in the state of Minas Gerais. The new bank was named Banco Federal Itaú SA.

Figure 11.2 Ownership structure of Unibanco (early 2000s)



In 1966, this institution became the first bank in Brazil to establish an investment bank called Banco Federal Itaú de Investimentos. This operation attracted the interest of Banco Sul Americano do Brasil S.A. In the same year, this bank merged with Banco Federal Itaú and the new entity was named Banco Federal Itaú Sul Americano SA. In the following years the consolidation process continued. In 1969 Itaú Sul Americano carried out another merger, this time with Banco do América S.A. Thanks to this financial operation Itaú América S.A. became the seventh Brazilian bank of the time with more than 270 branches. Subsequently, the bank moved into a multi-state dimension, having acquired Banco Aliança S.A., one of the most important banks in the Northeast of the country, in 1970.

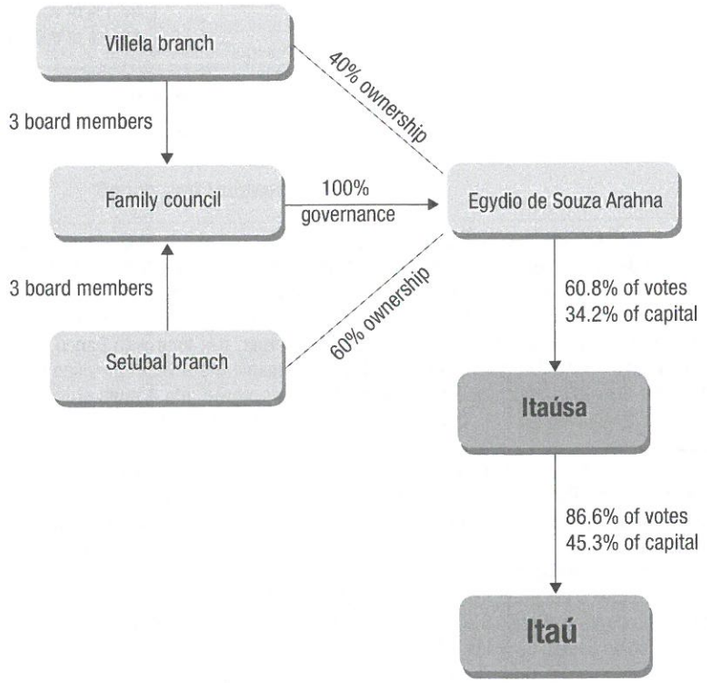
In 1980 the bank opened its first branches outside the country, in New York and Buenos Aires. In 1989 it founded Itaúsa Portugal, which in 1994 was the originator of Banco Itaú Europa S.A. In the 1990s the bank participated in the process of stabilising the Argentine economy Banco Itaú S.A. de Buenos Aires was renamed Banco Itaú Argentina S.A. In the same decade, the bank acquired Argentine banks and participated in the process of privatisation of state-owned banks in Brazil. In 1996 it acquired Banco del Buen Ayre S.A., and subsequently Banco Banerj S.A. (1997), Bemge – Banco do Estado de Minas Gerais S.A. (1998), Banestado – Banco do Estado do Paraná S.A. (2000) and BEG – Banco do Estado de Goiás S.A. (2001).

In 2000 the bank formed a strategic alliance with AOL Latin America Inc and AOL Brasil. In 2002, Itaú acquired 95,75% of Banco BBA-Creditanstalt S.A., creating Banco Itaú-BBA S.A., the largest retail bank in the country. An important alliance with the Italian Fiat Group led to the acquisition of Banco Fiat S.A., the largest financial institution of car manufacturers.

During that decade an important reorganization took place, approved by Banco Central do Brasil. All the financial companies controlled by the bank were placed under the control of Banco Itaú Holding Financeira S.A. Banco Itaú S.A. also became a subsidiary of the new holding company. Itaú also began to control important companies operating in the life insurance sector, private pension funds and the management of funds belonging to AGF Brasil Seguros. In 2004 a special institute was created to offer special services to low-income customers. In the meantime, the bank opened its first branch in Tokyo, Japan. Here, in 2006, the bank acquired a Santander Banespa and its 13.5 million customers were able to start doing their financial transactions online.

In those years, the bank was listed on Wall Street and Bovespa, the Brazilian stock exchange. The bank remained under the control of the Aranha family. However, the development of the family in different branches involved specific governance to maintain control of the main economic interests of the group. As **Figure 11.3** shows, the establishment of a family council, with equal representation of the two branches of the Aranha family, made it possible to avoid disputes and maintain control of the holding company named after its founder – Egydio da Souza Aranha. This entity has a relative majority but a majority control of the voting rights of the group holding Itaúsa, which controls Itaú bank almost with a totalitarian situation for voting rights. However, Itaú also had a very positive image for its corporate governance and the protection of minority shareholders' rights.

Figure 11.3 Ownership structure of Itaú Bank in 2005



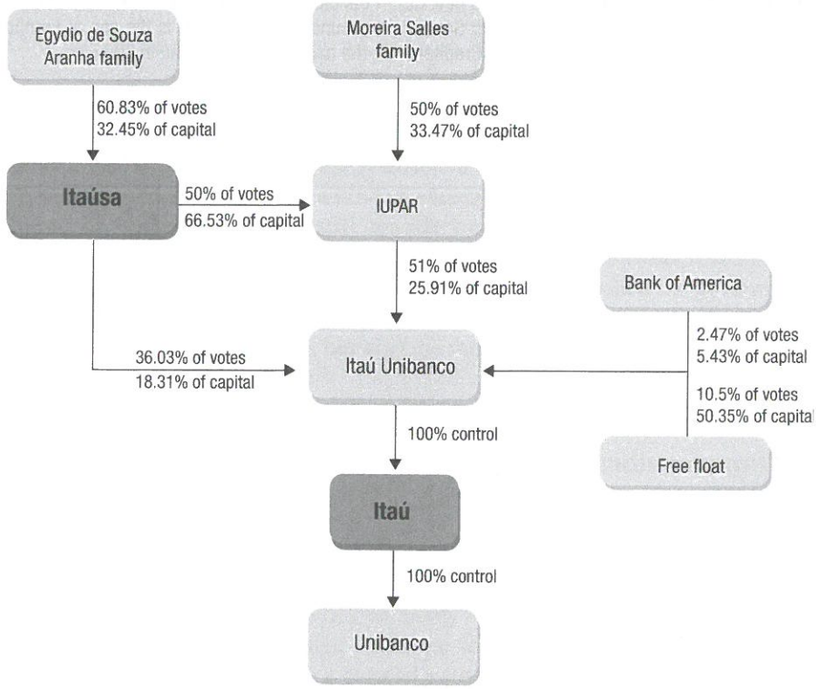
The merger of the two entities in 2008 was a very important example of a successful operation but also an original solution to the governance problem, as in both cases the shareholder was a family. Hoverer, there were factors that favoured the integration process: a previous partnership, similarities in visions and corporate culture, not to mention the possibility of compensating for the weaknesses and the catalytic drive of the international financial crisis. Moreover, the merger would not only create the largest bank in Brazil, but could also lead to an increase in total assets and financial strength, a more diversified portfolio of products and services. Moreover, the merger could also have some important opportunities at international level, strengthening some strategic agreements and partnerships, extending the continental expansion with the addition of new services. The establishment of a new large bank would therefore make a definitive contribution to making Brazil the most important financial centre in South America.

On the other hand, there were also some weaknesses (e.g. over-reliance on retail banking) and some threats related to the general impact of the economic slowdown and confidence in the asset management system. Barriers could arise during negotiations on the exchange of shares and the mutual influence of the two block holders on the combined, not to mention the effects of the merger on the new management structure.

The financial aspects of the merger established that Unibanco was valued at $14 billion (43% premium); Unibanco shares were exchanged for an equivalent number of shares in Banco Itaú Holding Financera. In addition, the agreement provided for the name of Itaú Holding Financiera to be changed to Itaú Unibanco.

The new ownership structure is a masterpiece of balance and control, but even more of a sharp Machiavelli mentality, as **Figure 11.4** shows quite well. According to the agreement, the new luar entity will hold 51% of the votes of Itaú Unibanco, while each family will hold 50% of the voting shares. In addition, no family can sell its shares without losing control of its holdings. The two families will appoint the members of the board of directors of Iupar. Itaúsa must vote according to Iupar at the shareholders' meeting of Itaú Unibanco. Until 2015, Pedro Moreira Salles will be the president of Unibanco, while the managing director will be Roberto Egydio Setúbal.

Figure 11.4 Ownership structure of Unibanco in 2015



The decision-making process was based on a consensual procedure involving a preliminary meeting between the officials of Iupar, Itaú Unibanco and Itaú. Any vote cast outside this order was to be considered invalid, and any administrator/officer voting against the orders had to be removed – two rules that are not in accordance with the Brazilian corporate governance code. The agreement between the two main shareholders also provided for a very precise procedure to be followed in the event of a dispute: 60 days to resolve the dispute without external intervention; a mediation procedure that should not last more than 120 days. If no agreement was reached, the next steps were the arbitration court and finally the legal proceedings.

The Board has fourteen directors elected on an annual basis, eleven external directors (78.6%) and three independent directors (21.4%). It is clear that the two families are taking advantage of this situation because six directors are family members. No woman is among the members of the board of directors, while the Brazilian code requires a percentage of female directors.

The shares of the post-merger bank were of two types: ordinary shares (49% of the total, of which 87% were controlled by the two families; all shares with voting rights); preference shares (51% of the total, with priority in the payment of dividends and in the event of liquidation, but without voting rights). As in the case of female members, the Brazilian corporate governance code, which requires the application of the principle of one share – one vote, is not respected.

In the following years the situation changed under many perspectives. In 2010, the most important shareholder, apart from the two stockholders – the Bank of America – left. One year later, the Abrasca Code of Corporate governance was introduced, allowing listed companies to opt for it instead of using the Brazilian Code. These changes also introduced a new directors' compensation policy. In 2012, the group also introduced the rule requiring at least 30% independent members of the board of directors. Following the introduction of electronic voting in 2015, the most significant change was the appointment, in 2017, of a new CEO – Candido Botelho Bracher – who is not a family. Bracher, who has worked closely with Setubal for around fourteen years, is the son of Fernão Bracher, former chairman of Banco BBA-Creditanstalt, the bank acquired by Itaú in 2002.

12 Between the State and the Market: Corporate Governance in Former Centrally Planned Economies. The Cases of Russia and Poland

Russia and Poland represent two good examples of the transition from a Soviet-styled planned economy to a market economy. The sizes of the two economies are not comparable. However, the procedures of the transition have been very similar: fast, severe, and with many compromises in Russia; more determined in Poland. Thirty years after the beginning of the transition, the two economies have a different profile. Russia is still struggling with many aspects of its legacy. It is facing the consequences of the sanctions introduced by the Western countries in 2014, following its support for the rebels in the eastern regions of Ukraine. Since the early 2000s, Poland has become one of the fastest growing economies in Europe. However, regardless of the success and/or the completion of those transitions, the business culture that has developed in both countries from the early 1990s on is still at a very low level.

One should never forget when we analyze the implementation of its corporate governance rules, that their introduction in Russia was part of a deal with the Western economic institutions in exchange of economic and financial support during the 1990s. However, its implementation still suffers from the excessive concentration of ownership. In Poland, despite a slightly different situation, the introduction of corporate governance has been seen as a kind of mandatory passage that a large part of the business elites considered – and still considers – a constraint on a real free market economy. The fear of State control, inherited from Soviet times, is responsible for this attitude. Moreover, the weakness of the capital market pushed the government to transform pension funds, born after the pension reform of the late 1990s, into really big players of the stock exchange, but also the most interested actors in the effectiveness of the corporate governance.

12.1 Russia, corporate governance and the never-ending transition to a market economy

12.1.1 The difficult transition from a Soviet economy to a market economy

The transition from a state-controlled economy – the largest one in the world – to a market-oriented system was a huge challenge for the new Russian government after 1990. Paradoxically there was a parallel with the early days of the Soviet Union. Marx and the other most important representatives of his thought never explained in

detail how a socialist economy should be organized. The transition from the Soviet system to the market economy was also, to some extent, a "première." Yeltsin, the first president of the Russian Federation, faced some extremely difficult challenges. Four of them were absolute priorities. The first was starting the construction of a democratic State through free elections and the adoption of a new constitution. The second was the creation of a market, which required fiscal and monetary stabilization to prevent rising prices from causing inflation. Third, the main consequence of adopting the market economy was an enormous privatization program. And finally, Russia needed the institution of a new legal system, which would necessarily entail long time scale needed to adopt laws, create courts, and train thousands of lawyers.[1]

Yeltsin announced his economic reforms in October 1991. The greatest and most rapid transformation of a centralized economy into a market economy took just three years. The Russian government chose a very similar policy to the shock therapy adopted by Poland's Deputy Prime Minister and Finance Minister Leszek Balcerowicz in Warsaw's first non-communist government following the free elections of June 1989. In Poland, the timeliness of policy decisions made it possible to rapidly halt hyperinflation, quickly put many goods back in shops, and cut absenteeism in factories by 50%. On the other hand, many state-owned companies were forced to close, and unemployment climbed from the official figure of 0.3% in January 1990 to 6.5% by the end of the same year. Over the next two years, GDP fell by 9.78% and 7.02%. In Russia, the Gaidar government (an ineffective combination of economists with the reforming zeal of "Young Turks," "mediocre politicians from Yeltsin's hometown," and "competent ex-ministers of the USSR") attempted to emulate the Polish success story.[2]

The privatization policy was launched at the beginning of 1992, when about 150 million Russians received a voucher with the nominal value of RUB 10,000 ($25, soon devalued to just $2) to participate in the auctions for all types of privatization. Since the vouchers could be sold, they often ended up in the hands of extremely powerful Russians (foreign investors were excluded from this stage of the process). This prepared the way for the new centers of power, bringing the State no advantages at all. For example, car manufacturer Avtovaz (which managed the Togliatti grad car factory built with Fiat) was privatized for just $45 million. Fiat had previously made an offer of $2 billion for the company, but was excluded because – it was said – the government did not want Russian property to come under foreign ownership. In this case, as with the collective farms, the workers had precedence and were authorized to buy 51% of shares. The State continued to hold substantial shares in many companies, ready to cede them to selected investors, all of whom were Russian.[3]

[1] Medvedev, Z. (2000), *Post-Soviet Russia: A Journey through the Yeltsin Era*, New York, Columbia University Press.

[2] Kotkin, S. (2001), *Armageddon Averted: The Soviet Collapse, 1970-2000*, Oxford, Oxford University Press.

[3] Lieberman, I.W., Stilpon, N., & Desai, M. (eds.) (1997), *Between State and Market: Mass Privatization in Transition Economies*, Washington, World Bank.

However, it cannot be denied that the privatization process was mass corporatization, most probably the biggest ever attempted. In the course of the privatization, more than 30,000 open joint stock companies were created in Russia. In the 1990s, there were more of these companies in Russia than in the rest of the countries of Eastern and Central Europe and the Confederation of the Independent States combined.[4]

At the firm level, privatization took place in a different way. Major special advantages went to insider employees and managers, due to their widespread participation in the process (at the very outset of the privatization process, 50-60% of shares were transferred to insiders for vouchers, or later sold for cash). The vouchers had a freely transferable nature and free circulation on the market, which made it possible for processes leading to the concentration of ownership. The sale of shares through certificate-based instruments was possible both directly and through intermediaries – certificate investment funds – set up for that purpose. During the 1990s, the process had a real mass impact, although it probably had more of a symbolic meaning than a real one. Nevertheless, some 25 million citizens became shareholders in 450 such funds; the certificate investment funds were the first collective investment institution in post-communist Russia.

The distribution of the privatization shares was correlated to\\with the type of assets which had been privatized – namely, federal, regional, or municipal. There was great geographical asymmetry in this process. This distribution reflected the locations of the biggest enterprises and industries in the country, as well as the centralized concentration of ownership control. The regions benefiting most from the largest share of the combined budget receipts from privatization were the City of Moscow, the City of St. Petersburg, the Tumen Region, the Moscow Region, the Republic of Bashkortostan, and the Kemerovo Region. Although approximately 80% of companies were privatized during this period, the most important privatizations took place in 1995 and 1998, when 29 big groups were involved.[5]

The government's financial and fiscal problems had led it to seek loans from the new private banks, known as loans for shares, i.e., credit guaranteed by government shares in the oil industry and other sectors. If the government did not repay its debt, the shares could be sold at auction, as actually happened. The problem was that the same creditor banks were authorized to run the auctions. They included Oneximbank, which benefitted the most from this operation, and whose president, Vladimir Potanin, had created the scheme. The outcome was inevitable: the State received much less than the real value of the companies put up for sale, but certain people managed to create gigantic personal fortunes. Mikhail Khodorkovsky obtained 78% of Yukos shares, worth around $5 billion, for just $310 million, while Boris Berezovsky and Roman Abramovich bought Sibneft, another giant in the same sector, worth $3 billion, for just $100 million.[6]

[4] Aslund, A. (1995), *How Russia Became a Market Economy*, Washington, Brookings Institution.

[5] Slider, D. (1994), "Privatization in Russia's regions," *Post-Soviet Affairs*, 1(10), 367-396.

[6] Guriev, S. & Rachinsy, A. (2005), "The role of oligarchs in Russian capitalism," *Journal of Eco-*

This perverse mechanism was not sufficiently contested by the Russian government, and contributed to the formation of a new oligarchy of powerful businessmen. Their origins were essentially of three kinds. There were high-level former Party officials, and there were managers of big companies with solid personal connections to political power, the former KGB and the industrial establishment. In addition, there were figures with links to the criminal activities that had sprung up in the towns and cities immediately after the end of the USSR, which involved the first private businesses as well as large-scale international trafficking in drugs, arms, and people. As one Russian oligarch explained to Anders Aslund: "There are three kinds of businessmen in Russia. One group is murderers. Another group steals from private individuals. And then you have honest businessmen like us who only steal from the State."[7]

12.1.2 The weakness of the capital market

Despite the huge privatization and all the financial operations connected with it, the capital market remained relatively informal for a long time. There was no formal stock exchange. The Moscow Interbank Currency Exchange (MICEX) and the Russian Trading System centralized all the operations in the public sphere. Both institutions were controlled indirectly by the State. The Stock Exchange was officially inaugurated less than 10 years ago, in 2012. As of early 2019, 554 companies were listed. Before that, most of the biggest Russian companies had been already listed in London or New York.[8]

In a country without a market and a business culture for a long time, all discourse about corporate governance would seem to make no sense. Paradoxically, such discussions had a very strong influence, at least in their first formulations, in permitting Russia to jump, at least from a formal point of view, into financial modernity.

The high concentration of ownership that resulted from the way the privatization took place, characterized the new Russian economy.[9] However, the privatization process was not generalized. The State remained a very important shareholder, in many cases the most important one, in many industrial sectors. Even more relevant is another aspect. **Table 12.1** shows that at the sectoral level, the Russian economy looked like a huge field perfectly divided between the State and the big oligarchs, without any actual sector – or segment of the economy – where these two main protagonists in the transition to a market economy competed with each other.

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nomic Perspectives, 19(1), 131-150; Sakwa, R. (2014), *Putin and the Oligarch: The Khodorkovsky-Yukos Affair*, New York, I.B. Tauris.

[7] Aslund, A. (2007), *Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed*, Peterson Institute of International Affairs.

[8] Kuznetsov, A., Kuznetsova, O., & Mirkin, Y. (2011), *The Russian Capital Market: The First 20 Years*, available at SSRN: https://dx.doi.org/10.2139/ssrn.1883582.

[9] Guriev, S. & Rachinsky, A. (2004), *Ownership Concentration in Russian Industry*, Working Papers w0045, Center for Economic and Financial Research (CEFIR). For a shorter version of the paper see Guriev, S. & Rachinsky, A. (2005), "The role of oligarchs in Russian capitalism," *Journal of Economic Perspective*, 19(2005).

Table 12.1 Ownership structure in different sectors (% of companies in given sectors)

	State owns more than 50%	State owns between 25 and 50%	Largest private shareholders own more than 75%	Largest private shareholders own more than 50%
Machine engineering	33	0	17	17
Oil and gas	43	14	0	29
Food	0	0	40	40
Retail trade	0	0	0	100
Constructions	0	0	50	50
Communication and IT	43	14	0	43
Transport	50	33	0	33
Coal and metallurgy	0	0	50	31
Management and financial services	0	33	0	33
Chemistry and petroleum industries	25	0	13	50
Power engineering	67	22	0	11

Source: Guriev, S. & Rachinsky, A. (2003), *Ownership Concentration in Russian Industry*, Background paper for Russia CEM 2003, CEFIR, Moscow (p. 30).

A study conducted during the early 2000s demonstrated (see **Table 12.2**) the very high level of concentration of ownership, particularly when the biggest shareholder is a private company.

In 1995, the Duma passed a law introducing joint-stock companies, and in 1996 a law explicitly protecting minority shareholders' rights was also approved. Paradoxically, this law contained many provisions that gave them more power than in many West-

Table 12.2 Average share of control for the leading controller

Largest owner %	Average control stake	Number of firms
Largest Private	79.5	289
Foreign	76.2	144
Other	72.4	586
Regional	72.2	107
Federal	71.8	210

Source: Guriev, S. & Rachinsky, A. (2003), *Ownership Concentration in Russian Industry*, Background paper for Russia CEM 2003, CEFIR, Moscow (p. 28).

ern countries. For instance, shareholders with at least 2% of the voting rights could introduce topics on the agenda of the annual shareholders' meeting. They could also nominate candidates for the board of directors. In that phase, there was actually no discussion about the choice of the Anglo-Saxon model, or the one-tier system, as more "natural" for a country willing to enter into the market economy with great fanfare.[10]

The reality of the shareholders' meeting was quite different. The presence of a blockholder diminished the effective possibility for approving any request by the small shareholders. The management was in-between these two powers, but their loyalty to the biggest shareholders was never in doubt. However, over the following years, the management of the big companies became more interested in the implementation of new rules for the governance of the privatized companies.

12.1.3 The introduction of the code of corporate governance: How to pay a "debt" to Western countries

The introduction of the first Russian Trading System was an indirect consequence of the economic difficulties of the Russian economy in 1997-98. The country was finally starting a very slow recovery after 5-6 years of GDP decline, when the Asian crisis, beginning in Thailand in 1997, also invaded the still quite fragile Russian economy. International economic organizations like the IMF and many western countries, starting with the USA, made important efforts to help the Russian government stabilize the economy. This became a kind of exchange of favors, and started the Russian discussions about corporate governance. Moscow wanted to show its new Western partners – no longer enemies – that the fundamental rules of the market, including the very hot issue of corporate governance, were taken seriously in Russia.

The discussions, which concluded in Paris in 1999 (at the OECD) with the publication of the first edition of the Principles of Corporate Governance, had an echo and an immediate reaction in Moscow. Its assessments are part of the World Bank and International Monetary Fund (IMF) program on Reports on the Observance of Standards and Codes (ROSC). Thus, the links between the main international economic institutions and Russia were established. These discussions about corporate governance in Moscow were an indirect – but very political – way to pay Russia's financial debt to the IMF and the World Bank. In 2000, The Centre for Business Ethics and Corporate Governance was established. Its dialogues with the OECD and with some of its collateral bodies permitted the real start of the discussions about corporate governance in Russia.[11]

The first result of this formal and informal cooperation was the publication of a White Paper on Russian Corporate Governance. The document was prepared by the Russian Corporate Governance Roundtable, which included the Federal Commission

[10] Black, B.S., Kraakman, R. & Tarassova, A. (1998), *Guide to the Russian Law on Joint Stock Companies*, The Hague, Kluwer Law International.

[11] http://www.ethicsrussia.org.

for the Securities Market, the Supreme Arbitration Court, and the Ministry of Economic Development and Trade. It was the first to be published among many prepared by many similar Round Tables in transitional and emerging economies. According to the General Secretary of OECD, Donald J. Johnson, the document represented "an important signal about Russia's commitment toward corporate governance reform." One year later, in October 2001, President Putin made a very emphatic speech about corporate governance: "We understand that we have to solve questions pertaining to the protection of owners' rights and the improvement of corporate governance and financial transparency in business in order to be integrated into world capital markets." In 2002 the Federal Securities Commission of the Russian Federation published the Corporate Code of Conduct.[12]

The words remained just words. The concentration of ownership set up the basis for a permanent conflict between big and small shareholders. On the other side, the conflict between management and (big) shareholders, which sometimes occurs in Western countries, never materialized. The absence of an official text reporting the rules of corporate governance also had an effect. The White Paper, as well as some manuals on corporate governance which appeared in those years, did not permit real enforcement of certain rules.

Only in 2013, one year after the opening of the Moscow stock exchange, was a real Code of Corporate Governance finally published.[13] For the entire previous period many problems had remained unsolved. For instance, the opening of Russian companies to foreign shareholders (institutional investors, firms, individuals) remained far from characterizing the supposed Russian market economy. The internationalization of the boards of directors was very limited and done for purely marketing purposes. Many Russian companies allocate the role of "honorary guests" to foreign shareholders and investors, while decision-making process and monitoring are in hands of an influential majority shareholder.[14] However, among the top 10 Russian companies investing overseas the situation is quite different: as of February 2017, foreign nationals held 30% of board seats. British and German nationals comprise two-thirds of the foreign nationals on the boards of directors. Among the 30 foreign holders of board seats, there is only one citizen of China. Women are only 5%. In the top 50 Russian companies, the proportion is similar.[15]

There are still many other aspects that prevent a better implementation of the Code of Corporate Governance. The culture of secrecy, one of the worse legacies of the So-

[12] OECD (2001), *White Paper on Russian Corporate Governance*; McCarthy, D.J. & Puffer, S.M. (2003), "The emergence of corporate governance in Russia," *Journal of World Business*, 38(4), 284-298.

[13] Mishra, N. (2015), "Corporate governance in Russia," in A. Banik, A. Das Gupta, & P.K. Bhaumik (eds.), *Corporate Governance, Responsibility and Sustainability*, London, Palgrave Macmillan (pp. 91-116).

[14] Porshakov, S., Gilbert, C., Ivakhnik, A., & Chumakova, E. (2010), *Modern Corporate Governance In Russia as Seen by Foreign Businessmen and Experts*, Findings of Survey held by National Council on Corporate Governance and Russo-British Chamber of Commerce, Moscow (p. 17).

[15] Liuhto, K. (2017), "Foreign nationals on the boards of directors of Russia's ten largest non-financial companies investing overseas," *Baltic Region*, 9(4), 33-52.

viet times, still introduces element of paranoia into a business system that should be open and transparent. It is difficult introduce the culture of disclosure in this context. Time has not improved the situation. For instance, the information offered by Gazprom about its ownership structure was much more accurate in 2007 than in 2020, despite the fact that the essence of the information is the same: the State is controlling the company. One could also cite many remaining absurdities – like the time necessary to publish the annual reports: 80 days for a foreign bank operating in Russia; up to 346 days for some Russian financial institutions; also the energy and the telecom sectors offer similar results. It is understandable where this comes from – fear of the State, fear of competitors, a poor legal and regulatory environment, and uncertain enforcement – but it is very unhelpful to the constructive conduct of business. Russian business needs an environment in which businessmen are much less afraid.[16]

12.1.4 The State and the society: Two conflicting actors for good corporate governance?

The Russian State – its bureaucracy, its inefficiency, and its culture – is responsible for many of these elements. However, it is also the only institution that can be asked to intervene to prevent the worst aspects of its own activities. The government has pledged to improve protection of private businesses from abusive prosecutorial and law enforcement services. However, the State and the government are to some extent a mirror of society. The State also has to consider its many social and political constraints as a shareholder; by mid-2015 about 55% of the Russian economy was in State hands, with 20 million workers directly employed by the government. That's equal to 28% of the workforce. These figures give the State as a shareholder a responsibility that will never be like that of big private shareholders.

Nevertheless, another sector of Russian society could modify things. The business community's calls for a bigger role for civil society appeared to be at odds with the growing restrictions Mr. Putin's administration has imposed on non-governmental organizations (NGOs). "It's not only about government, it's about civil society. We need more and more activism from civil society in order to achieve law enforcement in a proper way," affirmed Alexei Mordashov a few years ago. Mordashov is Russia's sixth-richest man, with a fortune worth $12.5 billion, according to Forbes, and the owner of Severstal, a conglomerate operating in steel, metallurgy, mining, and energy. He acknowledged that it would require the government to create an environment in which civil society could function, but he suggested that – even with goodwill from the top – successfully implementing economic reforms would be a challenge. "It requires a lot of skills not only from the prime minister or the president; it requires a lot of skills from many people," he declared in 2016 to the Financial Times.[17]

[16] McGee, R.W., Yoon, Y., & Tarangelo, T.J., "The Timeliness of Financial Reporting: An Empirical Legal Study of Russian Banks," *Hastings Business Law Journal*, 9(2), 2013, 303-325.

[17] "Russian tycoon says civil society is key to economic growth (2016)," *Financial Times*, June 20.

Russia's new Code of Corporate Governance strongly insists on the importance of nominating independent directors to corporate boards. However, the Russian Code has a completely different vision from the Western one about the concept and the intrinsic characteristics of independence, when it comes to evaluating the profile of a potential candidate to a board. In Russia, the fact that a director could have annual transactions up to 10% of company's net asset value is not considered a lack of independence. Moreover, a member of the board elected as an independent is still considered independent even if he or she has transactions with the company which make up 10% of his or her annual income. "In most cases, it is impossible to understand if they are really independent," affirmed a report of the European Bank for Reconstruction and Development on corporate governance in Russia appeared in December 2017.[18]

In January 2012 Putin launched a new privatization program to revive the economy, but without abandoning the State's role in designing the project, which was to transform the structure of the productive economy by concentrating more on high-tech sectors and creating the economic conditions to encourage foreign investments. This program was re-launched by Putin halfway through the year just after he was re-elected for the third time as president, but in June 2013, Prime Minister Medvedev reduced by about half the financial objectives that had been set for 2014-16. In the following years (data are available up to 2018) the process of privatization slowly begun again, although the new phase did not include big assets.[19]

The situation was already difficult, therefore, when the U.S. and European Union imposed sanctions on Russia for supporting pro-Russian rebels in eastern Ukraine. But the sanctions did not have all the intended effects. Despite the unstoppable fall in the price of oil, the Russian economy reacted in a way that took all observers by surprise. It contracted by 4.6% between June 2014 and June 2015 (the ruble fell by 37% against the dollar during that period) – the most dramatic contraction since the 2008-09 crisis. Real incomes dropped for the first time in 15 years since Putin first economic system showed shown signs of other positive elements according to a textbook model of economics. The substitution for imported goods with Russian products allowed 78% of the companies quoted on the Moscow Stock Exchange (Micex) to earn more than their foreign competitors during the first half of 2015 (for example, Rosneft increased its earnings by 17%, compared with a 1% rate of growth for its competitors in the petroleum goods market). On the other hand, the sanctions imposed on the oligarchs closest to Putin seem to have been much more effective, since Western companies do not want their names associated with figures belonging to the Russian president's inner circle.[20]

[18] European Bank for Reconstruction and Development (2017), *Corporate Governance in Transition Economies. Russia Country Report*, prepared by Gian Piero Cigna, Yaryna Kobel with the assistance of Nestor Advisors.

[19] "To privatize or not to privatize (2013)," *The Economist*, January 19; Malginov, G. & Radydin, A. (2018), "Russia's public sector and privatization policy in 2018," in Gaidar Institute for Economic Policy, *Russian Economy in 2018. Trends and Outlooks*, Issue 40, 379-424.

[20] "Russia's economy. Phase two. Russia's economic problems move from the acute to the chronic (2016)," *The Economist*, January 21.

Despite these unfortunate developments following the political crisis in Ukraine and the American and the EU sanctions, the corporate governance remains one of the most important policy issues. The OECD Russia Corporate Governance is still very much active. If in the past good practices were a tool to attract foreign investors, now even Russian policymakers and companies themselves have realized the importance of good corporate governance, regardless of the level of interest of foreign investors. The main concern of Russian legislators still lay on balancing the contrasting interests of various internal stakeholders with appropriate legal instruments. Protection of minority shareholders in the process of takeovers is another very important topic. The debate concerning takeover regimes is still ongoing among lawmakers. Resistances against a solution more favorable to small shareholders are still quite strong.[21]

Many things have changed since the end of the Soviet Union. In 1992, the year after the end of the USSR, the ratio between Russia's GDP and that of the USA was 1:14.3, but the gap had slightly narrowed to 1:13 in 2019. It was just 1:5.7 measured in purchasing power rather than using current dollars. These numbers are useful, but they do not tell the whole story. As already seen, modernization of the Russian economy was not yet complete, nor were privatizations. In addition, there were so many doubts about the quality of the democratic system that the term often used to describe the Russian political and economic system is "authoritarian capitalism," a concept Russia shares with China and other countries like Singapore, whose histories and development paths are quite different from its own. To what extent authoritarian capitalism has real chances of introducing working corporate governance is still a question mark. The words pronounced by Putin in October 2001, mentioned above, seem today to be coming from another planet. But maybe not so far anymore. In fact, the final rating given by the above cited report of the European Bank of Reconstruction and Developments based on international recognized best-practice benchmarks was between weak and fair.

12.2 Poland, corporate governance, the strength of the market, and the resistance of the blockholders[22]

12.2.1 Rediscovering the market

Researchers' interest in corporate governance in Poland dates back to the 1980s. At that time, with the introduction of economic reforms (1980-81), but before the beginning of the period of political transformation, the first workers' councils, were established, inclusive of employees, in the management of state-owned enterprises.[23] But the most important period of corporate governance development is the years of transition after 1989, when Poland decided to shift from a centrally planned to a market economy and the State's regulatory function was taken over by the slowly-growing private sector. At that time, the number of enterprises increased dramatically: from 255,691 entities registered in the *Rejestr Gospodarki Narodowe* (the Polish National Register) in 1992, to 567,785 in 1998.[24]

That decade was also the period of the first wave of privatizations, which is reflected in the sharp decrease in the number of state-owned companies (2,906 in 1998, compared to 7,245 in 1992), and a parallel rise in the number of all kinds of partnerships, including joint-stock companies (2,600 in 1992, and around 8,000 in the year 2000).[25] Privatization of state-owned enterprises was a very important process affecting both the size of private sector corporations and the transformation of the system of corporate governance. The privatization process was carried out with a diversity of schemes: from the ESOP (Employee Share Ownership Plan), an idea imported from the U.S., through capital privatization (applied mostly in case of the large companies), to the National Investment Funds (NIF) program launched by the government in 1995.[26] In total, during 1990-2001, privatization covered approximately 5,400 companies. However, although the privatization process gave a number of preferences to the employees of privatized enterprises, they did not lead to the formation of employee ownership as an important element of corporate governance.[27]

This important privatization process has built the foundations for the Warsaw Stock Exchange (WSE), the sector of public companies listed there, and the OTC market. Established in 1991 on a basis of a Franco-Polish intergovernmental agreement, the WSE grew slowly until the end of the 1990s. The first five public companies appeared on the stock exchange in 1991. They were the former state-owned enterprises, privatized through public offerings.[28]

[21] Guryanov, D., Morozov, D., & Shtoma, B. (2019), "Russia," in W.J.L. Calkoen, *Corporate Governance Review*, 9th ed., London, Law Business Research (pp. 344-345).

[22] Large part of this paragraph is based on the paper by Popowska, M. & Segreto, L. (2014), *Corporate Governance and Ownership Structure in the Top 30-Listed Non-Financial Companies in Poland*, in 7° International Conference, An Enterprise Odissey: Leadership, innovation and Development for Responsible Economy, Proceedings, edited by Lavorka Galetic, Mario Spremic. and Jurica Simurina, University of Zagreb, Zadar, Croatia, June 4-7, 2014, Sveucilisna. I would like to thank Magdalena Popowska for her permission to use it in this book.

[23] Niedbała, Z. (1982), "Rada pracownicza w systemie organów przedsiębiorstwa," *Ruch Prawniczy, Ekonomiczny i Socjologiczny*, XLIV(4), 85-103.

[24] Tamowicz, P., & Dzierżanowski, M., *White Paper on Corporate Governance*, Instytut Badań nad Gospodarką Rynkową, Gdańsk, 2002.

[25] Chmiel, J., Problemy statystycznego pomiaru i analiza tendencji rozwojowych sektora prywatnych przedsiębiorstw w Polsce, w latach 1990-1998, Raporty CASE, 1999.

[26] Hashi, I. (1998), "Mass privatization and corporate governance in the Czech Republic," *Economic Analysis*, 1(2), 163-187; Aggestam, M. (2004), "Corporate governance and capital groups in Poland," *Journal for East European Management Studies*, 9(4), 367-390; Grosfeld, I. & Hashi, I. (2004), *The Emergence of Large Shareholders in Mass Privatised firms: Evidence from Poland and the Czech Republic*, The William Davidson Institute, Working Paper No. 718.

[27] Kozarzewski, P. (2001), "Corporate governance restructuring in the course of privatization in Poland," in *Enterprise in Transition, Fourth International Conference on Enterprise in Transition*, Split, Hvar, 2053-2074; Kozarzewski, P. (2006), *Privatization and Corporate Governance in Poland: Problems and Trends*, CASE Network Studies and Analyses 0325, CASE-Center for Social and Economic Research.

[28] Nivet, J.-F. (2007), "Stock markets in transition: The Warsaw experiment," *Economics of Transi-*

The total capitalization of zł100 billion reached in June 1999 seemed to reflect a symbolic maturity of this capital market. In the early 2000s, the WSE grew very rapidly, showing some of the best performances of Central-Eastern European capital markets. At the end of 2001, 216 companies and 14 National Investment Funds were listed on the stock exchange; the capitalization of the public market amounted to 15% of GDP. Modernization process both from the technological point of view and from the financial instruments traded among the different financial actors was a decisive aspect in this period.[29] Both before and after the 2007 financial crisis, the WSE was considered one of the most dynamic stock markets in Europe, and it established itself as a sort of platform for the whole Central-European capital market, leaving not only Prague and Budapest far behind, but also surpassing Vienna substantially.[30]

12.2.2 The beginning of corporate governance

The development of corporate governance in transitional economies requires implementing new laws and creating institutions able to support major changes and perform assessment and decision-making functions. The timing in adopting corporate governance rules has been quite similar in most of the Central Eastern European countries. All of them eventually opted out for the Continental or German model, based on the two-tier system. Only in the Republic of Macedonia did a recent legislative intervention allow companies to choose between the Anglo-Saxon or German model of corporate governance.[31]

In Poland, one of very important steps, and the proof of the growing awareness and discussions relating to corporate governance, has undoubtedly been the establishment of the Corporate Governance Forum in 1998 by the Gdansk Institute for Market Economics. It is not surprising that this did not occur in Warsaw because

tion, 5(1), 171-183; Wheeler, F.P., Neale, B., Kowalski, T., & Letza, S.R. (2002), "The efficiency of the Warsaw Stock Exchange: The first few years 1991-1996," *The Poznań University of Economics Review*, 2(2), s. 37-58.

[29] Sopocka, A. (2005), "The efficiency of the Warsaw Stock Exchange," in G.W. Kolodko (ed.), *The Polish Miracle. Lessons from the Emerging Markets*, Aldershot, Ashgate.

[30] Cielski, J. (2012), "Buoyant growth gives city clout," *The Financial Times*, May 22.

[31] Hashi (1998); Gregorič, A., Prašnika, R.J., & Ribnikar, I. (2000), "Corporate governance in transitional economies: The Case of Slovenia," *Economic and Business Review*, 2(3), 183-207; Collin, S.-O., Cesljas, I., "Corporate governance in transitional economies: Business groups in Croatia," *Journal for East European Management Studies*, 7(2), 162-186; Drakulevski, L. (2002), "Corporate governance in the Republic of Macedonia," in *An Enterprise Odyssey: Economics and Business in the New Millennium*, International Conference, University of Zagreb, June 27-29, 1131-1139; Kuznetsov, A. & Kuznetso, O. (2002), "Corporate governance: Does the concept work in transition countries?," *Journal of East European Management Studies*, 8(3), 244-262; Postma, T. & Hermes, N. (2003), "Institutions, corporate governance and corporate governance institutions: The case of Estonia," *Journal of East European Management Studies*, 8(3), 263-292; Pučko, D. (2007), "The choice of the Corporate Governance model and its implications for the corporate social responsibility," in *Enterprise in Transition, Seventh International Conference on Enterprise in Transition*, Split, Hvar.

Gdansk was already one of the most dynamic of the country, and hosted many important foreign direct investments. However, there is also another reason. In post-communist Poland, not one entrepreneurial association had been founded. The business community – more informally organized than anywhere else – considered such associations to be indirect instruments of control that could inhibit the economic transformation of the country. Regional or local organizations, in the form of Business Clubs or Chambers of Commerce, emerged in many areas of Poland. Today, thirty years after the transition to a market economy and to democracy, there is still no national business association. However, current legal regulations do not provide business clubs, the Chambers of Commerce, and any other existing structure with the status of public legal associations.[32]

The Forum's primary role has been promoting the CG idea and other initiatives among the participants of the Polish stock market. In 2001, the Best Practices Committee was established within the WSE. It was composed of representatives of various stakeholders and aimed at civilizing corporate behavior by working on establishing best practices for relations between majority and minority stakeholders.[33] In 2002 the first version of the corporate governance code was released; it was entitled "Best Practices in Public Companies 2002," and went along with the new company law approved in 2000. Among the most relevant points included in the code was the "comply or explain" rule; the same was included in the many other codes adopted during the same years in many European countries there was the "comply or explain" rule. In 2004, the WSE Supervisory and Management Board accepted the Code.[34]

At that time, Polish companies did not enthusiastically welcome the idea of good practices or the formulation of recommendations. In previous years, conflicts among shareholders and the very low protection of minority shareholders were the main problems for WSE-listed companies. Although all market participants should benefit from raising standards, for many of them this initiative was confusing, and it was treated as a needless bureaucracy by the WSE authorities. During this period, companies had often witnessed unethical activities by shareholders, sometimes at the edge of the law, and the protection of investors had not been among their main concerns. Additionally, the implementation of better practices in the initial period meant significant costs and organizational structural changes to allow the effective reporting on compliance with best practices. Furthermore, the high concentration of ownership in the Polish capital market meant there was no guarantee that potential investors would appreciate these efforts. Formally, all companies listed on the WSE were required to issue an annual report on their compliance with the principles of

[32] Kmieciak, R. (2016), "Pozycja ustrojowa samorządu gospodarczego w Polsce," *Studia z Polityki Publicznej*, 2(10), 89-102.

[33] Koldakiewicz, I., "Building of a Corporate Governance System in Poland: Initial experiences," *Corporate Governance: An International Review*, 9(2), 228-235.

[34] Aluchna, M., & Koladkiewicz, I. (2008), "Guidelines for corporate behaviour, origin, current stage and future tendencies of Polish Corporate Governance Code," in D. Crowther, G. Aras, *Culture and Corporate Governance*, Leicester, Social Responsibility Research Network.

corporate governance, but the reliability of the data in these documents was not subject to further formal verification.[35]

Research carried out during the first years of the adoption of best practices, found several pathologies, such as the lack of independent members on the supervisory board; the reluctance of companies to create an audit committee; the implementation of rules concerning the company's information policy or the quality of reports issued by Polish companies. The turning point in this extremely "superficial approach" to the implementation of corporate governance principles, came during the years 2004-2005. This change was possible thanks to the growing popularity of the Polish Stock Exchange, and the rapid inflow of the foreign capital. Additionally, after the accession of Poland to the EU in 2004, the best practices code had to follow the recommendations of the European Commission. The supervisory board of the WSE approved the new code in late 2007. It became binding as of January 1, 2008. Among the most relevant points, the new version added some other articles to protect the rights of minority shareholders. In particular, it was established that amendments to articles of association require a 75% supermajority vote; that authorized capital increases were rarely allowed, and that in any case, existing shareholders have pre-emptive rights. Finally, yet importantly, minority shareholders may demand that their shares be bought out by a 90% majority shareholder.

The biggest challenge for public companies listed on the WSE at that time has been the number of independent directors on the board committees, and the improvement of corporate transparency. The governance of companies established after 1989 was very often criticized. The most relevant negative aspect was the composition of the boards of directors, where it was relatively easy to detect among them members who were friends and relatives of the main shareholders.[36] However, companies were learning very fast, and the new code, "Best Practices for Companies listed on Warsaw Stock Exchange," from 2007 on addressed other issues, such as company communication with investors, corporate disclosure, and the decision-making process.

New versions of the "Code of Best Practices for WSE Listed Companies," (the slightly different name given to the document) released in 2012 and in 2016, may have had a positive influence on the market valuation of companies, thus reducing the cost of capital. Compared to the 2007 regulation, these new codes recommended which model off investor relations to be followed, to the broadest extent possible. They specified more explicitly the remuneration aspects, mostly referring to EC recommendations. Points related to gender equality in the management and supervision body appear in these versions. Much more extended and detailed are the parts devoted to transparency about reporting on the socially responsible activity of a listed company, including on the website in English. These documents also introduced the obligation to use electronic means for better communication, including for the organization of general shareholders meetings.[37] The most important changes were introduced with the Code of 2016. This latest version of the Best Practices Code takes the legislative approach adopted in the UK Corporate Governance Code and repeated in the EU model of corporate governance rules, which consists of stating general principles followed by detailed guidelines. The absence of such general principles in the earlier Best Practices Code was heavily criticized. In particular, it was emphasized that without general principles, the Best Practices Code was essentially just a manual providing a set of technical rules.[38]

[35] World Bank (2005), *Poland – Report on the Observance of Standards and Codes (ROSC): Corporate Governance Country Assessment*, Washington.

[36] Aluchna & Koladkiewicz (2008).

12.2.3 The concentration of ownership and the role of the pension funds

A study prepared for the inaugural meeting of Polish Forum for Corporate Governance held at Polish Senate on April 5, 2001 affirmed that that the ownership and control (measured by voting power) of Polish corporations was rather concentrated, but not too distant from – and in many cases even less than– some Western European countries. Additionally, the paper noted that separation between ownership and voting control was not significant, although there were many cases, especially in small companies, of the use of dual-class shares. For public companies (210 were being reviewed), the median for the largest shareowner was 39.5% of votes, which increased to 45% where the shares of the company's founders were combined into one block. At that time, the median for the top shareholder was 43% in The Netherlands, 50% in Belgium, 51% in Italy, 52% in Austria, and 9.9% in Great Britain.[39] This process was accelerating, because the data for 2002 suggested that, for the 130 non-financial companies listed on the WSE, the largest shareholder controlled 40.6% of voting rights, up from 33.8% in 1997. In the meantime, the average percentage of floating shares (as measured by the WSE) of the 130 companies decreased from about 43% to 33% from 1997 through 2002.[40] The use of pyramidal structures to control firms was also widespread.[41]

An analysis of the ownership structure of the largest Polish listed companies, conducted in 2013 among the top 30 Polish non-financial companies listed on the stock exchange (twenty of them were included in the WIG30, the blue chips of the WSE) confirmed that picture. Among the top-30 companies six can be officially considered family controlled firms, while seven other companies have among their main shareholders or blockholders financial trusts and/or foundations that are under the direct

[37] Jerzemowska, M. & Golec, A. (2013), *Corporate Governance in Poland Strengths, Weaknesses and Challenges*, Conference on Economic Challenges in Enlarged Europe, Tallinn.

[38] Opalski, A. (ed.) (2016), *Kodeks spółek handlowych: Tom IIIA: Spółka akcyjna* (pp. 81-82).

[39] Szomburg, J., Tamowicz, P., & Dzierżanowski, M. (2001), *Corporate Governance for Poland's Growth*, Gdańsk Institute for Market Economics.

[40] World Bank (2005).

[41] Aluchna, M. (2013), "Corporate governance in founders' controlled companies," *Intellectual Economics*, 7(2), 195-205.

or indirect control of the founders and/or the entities that have the strongest influence on the company. Only two of the top-30 Polish companies listed at the WSE apparently seem without a strict connection with one single shareholder or a precise entity controlling the firm. Only one half of the top-30 companies have more than 40% of their shares dispersed among the large public or even among institutional investors, who own less than 5% of the shares.[42]

However, one of the most relevant results of that research was the discovery of the important role the pension funds are playing in the ownership structure of those companies. The reform of the pension system adopted in 1997 led to the introduction of a three-tiered pension system, melding the state-run, pay-as-you-go scheme with a compulsory private savings plan for all new entrants into the labor market, and then for all workers who were under 30 at the end of 1999.[43]

The success of this government initiative went beyond the most optimistic forecast. More than ten million Poles signed up immediately for private pensions.[44] Moreover, the pension funds became some of the most relevant investors in the WSE, contributing in a massive way to its take-off in the late 1990s and the early 2000s.[45] Actually, the law permitted them to invest up to 40% (later increased to 43%) of their portfolio in Polish equities. In 2001, they were generally accounting for about 10% of the free float of the Warsaw bourse, and one year later they were holding 28% of market capitalization, significantly less than the average among the OECD countries (46%), but definitively in the leading position among the Central-Eastern European countries.[46] In the period between 2001 and 2012 the 20 authorized Polish pension funds increased their total investments from zł18.9 billion to zł274.2 billion (from $4.7 billion to $88.4 billion), and their impact on the national GDP of these investments rose from 2.4 to 17.2%.[47]

However, the role of pension funds has not been limited to their quantitative impact. They have formed one of the most important pressure groups for introducing the Code of Best Practices at the WSE. During the first decade after its reopening, the dominance of large shareholders among listed companies on the Warsaw bourse was the result of a spate of privatization tenders in which many of Poland's biggest

[42] Popowska & Segreto (2014). The exclusion of the financial institutions was motivated with the fact that in 2013 they were all largely controlled by foreign banks.

[43] Hausner, J. (1998), *Security through Diversity: Conditions for Successful Reform of the Pension System in Poland*, Collegium Budapest Working Paper.

[44] "Patriotic pensions: The rise of pension funds helps a weak stock market (2001)," *The Economist*, August 30.

[45] Monkiewicz, J. (2005), "Pension funds and the acceleration of economic development," in G.W. Kolodko (ed.), *The Polish Miracle. Lessons from the Emerging Markets*, Aldershot, Ashgate.

[46] www.oecd.org/finance/financialmarket/33865642.pdf; for the most recent data www.oecd.org/els/public-pensions/indicators.htm; for a comparison among central European countries see Holzman, R. (2006) (ed.), *Aging Population, Pension Funds, and Financial Markets: Regional Perspectives and Global Challenges for Central, Eastern, and Southern Europe*, Washington, World Bank.

[47] OECD (2014), *Development Co-operation Report 2014 Mobilising Resources for Sustainable Development*, Paris.

companies were sold to Western multinationals. Therefore, Poland had a structure of ownership closer in its concentration to that of continental Europe than of the United States or Great Britain.[48] The absence of assertive minority investors ended with the rise of pension funds. Instead of merely acting as one of the protagonists in an increasing variegated financial market, (as the government probably believed they would when it introduced the reform of the pension system), from the very beginning, as strong minority shareholders, the pension funds managed their investments along more Anglo-Saxon lines – that is, more assertively. At that time one Polish fund manager affirmed that the proposed codes should not antagonize big investors on the Warsaw bourse. "If corporate governance in Poland is seen as a threat to strategic investors, then we're all doomed," declared Paweł Wojciechowski, head of the German Allianz pension fund in Warsaw, to *The Economist*.[49]

The presence of the biggest Polish pension funds is quite significant among the top 30 listed companies. The list of the companies where they disclosed having at least 5% of the shares is quite long. We can assume that in many other cases they have less than 5%. According to Polish company law, a shareholder has to declare to the company any ownership over 5%. The most important Polish pension funds have on average a portion of shares closer to 10%, but in six cases they have shares above that level, reaching in one case 19.74% of the company's shares. This is the pension fund named "Gold Autumn," which is the lead shareholder in the Vistula Group, a company specializing in design, production, and distribution of jewelry and clothing for women and men.[50]

Some years ago, two IMF researchers expressed concern about the high proportion of Polish pension funds' equity holdings relative to the size of the stock market. In their opinion, that situation could create liquidity constraints in a still highly concentrated market.[51] Before the financial crisis, another Polish scholar affirmed that, considering that pension funds invest in a handful of "blue chip" companies with the highest liquidity in their balance sheet, these institutional investors tend to take up a high proportion of the free float.[52] In more recent years, the situation has not changed very much. Empirical evidence confirms that their involvement as big shareholders in the top-listed companies has even increased. There are good reasons to suggest that the size of their involvement is contributing to modifying the character of the pension funds.[53] In line with their original Anglo-Saxon model, they usually tended to diversify their portfolio, and to limit their involvement in a company to a small

[48] OECD (2001), *OECD Economic Surveys: Poland 2001*.

[49] "Minority Protection (2002)," *The Economist*, May 2.

[50] Popowska & Segreto (2014).

[51] Iorgova, S. & Ong, L. (2008), *The Capital Markets of Emerging Europe: Institutions, Instruments and Investors*, International Monetary Fund WP/08/103.

[52] Zalewska, A. (2006), "Is locking funds into the local market beneficial? Evidence from the Polish pension reforms," *Emerging Markets Review*, 7, 339-360.

[53] Popowska & Segreto (2014).

number of shares, in order to keep down the level of liquidity risk.[54] However, in a report issued at the end of 2013, after the reform had been introduced, the Polish National Bank affirmed, on the one hand, that that are no signs of a risk to the stability in the capital market coming from not achieving the minimum required rate of return. On the other hand, the same institution does not seem to fear any consequences from a change in the composition of the holders of national debt, where an increase of non-residents is very likely: "The impact of these changes on financial system stability should not be significant."[55]

As in most economies of the former Soviet Bloc, the transition period and the specific procedures adopted for the privatization process of the state-owned enterprises contributed, to a large extent, to the development of a sort of "natural" culture of the blockholders, which some authors have recently even characterized as an "authoritarian culture."[56] The implementation of a new legal framework, largely based on the necessity to protect the new entrepreneurs, was a compromise between the needs of a real liberalization, and the search for stability in the new economic and business framework. The political and institutional democratic system, which is also very young, had neither the instruments nor the force to impose the best guidelines for a corporate governance culture, and even less (although certainly more important) for a business culture, which is the product of long historical processes. The result could only be a system where the new entrepreneurs – acting rapidly and sometimes very aggressively – created a new economic system, even while the State was still very relevant in some strategic sectors (energy, heavy industry, chemical products, telecommunication, etc.). New big personal fortunes flourished as well as a culture of the "first takes all," which implies a very limited respect for minority shareholders. The introduction of the Codes of Best Practices at the WSE at least had an important impact at on the disclosure of information, both in terms of the amount and the quality of available data. However, one aspect of the code – the ability for shareholders to participate in the annual shareholders' meeting via Internet, is still practically impossible. The companies assert that there are insufficient technical guarantees to make available the connection and the information securely available to them.

In addition, the political situation is responsible for some important changes in the ownership structure of some big listed companies. The nationalist and populist wind which has been blowing very strongly in Poland in recent years, has had among many consequences a subtle re-nationalization – also defined as anti-re-

[54] Clark, G. (2000), *Pension Fund Capitalism*, Oxford, Oxford University Press; Olson, R.L. (2000), *Investing in Pension Funds and Endowments: Tools and Guidelines for the New Independent Fiduciary*, New York, McGraw Hill Professional; Boeri, T. (2006), *Dealing With the New Giants: Rethinking the Role of Pension Funds*, International Center for Monetary and Banking Studies, Washington.

[55] Narodny Bank Polski (2013), *Financial Stability Report*, Warsaw.

[56] Brotio, M. (2001), "Corporate governance in transition economies," *International Journal of Governance*, 1(2).

form – of certain sectors, including banking, energy, and mining.[57] As of spring 2019, the State owns stakes of at least 27% in nine out of 20 companies on Poland's blue-chip index.[58]

Ultimately, despite some important improvements, one can conclude that the evaluation proposed some years ago by Mortimer, suggesting that to be successful, a corporate governance model had to be designed for specific circumstances still seems to be valid.[59] This opinion appears totally appropriate in today's Poland, a country that is developing more rapidly than the rest of Europe, but for many aspects with a still poor business culture.

However, some improvement seems to go in the right direction. Minority shareholders have now the right to appoint members of the supervisory board by a vote in separate groups. Shareholders representing at least one-fifth of the share capital, even if the company's statute provide for a different manner of appointing the supervisory board, can make the request. As a result, minority shareholders representing at least 20% of votes may have their representative appointed to the supervisory board. Furthermore, the majority shareholder is obliged to purchase shares of the minority shareholders under the buyout procedure. Moreover, since the Polish law does not set out any regulations that would prohibit shareholders from joining forces and gathering enough shareholder proxies to win a corporate vote, this tactics, frequently used for instance in Germany, could become an important result for the small shareholders.

The corporate market and the listed companies market will also probably be influenced by a some other reforms. Since years, it is under discussion the introduction of a simplified joint-stock company, not very much different from the French *société par actions simplifiée*. This solution could gather the needs of many start-ups firms and, according to a recent survey, "might attract more investors than the public stock market, where companies and their managers may be penalized with huge administrative fines, such as those provided for in the MAR," the Market Abuse Regulation.[60] The system introduced in Poland with the Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC ("MAR"). Since then it is considered a very binding law that risks to block the development of more fragile capital markets.

[57] Civil Development Forum – FOR (2017), *Perspectives for Poland the Polish Economy from 2015-2017 Against the Background of the Previous Years and Future Forecasts.*

[58] Shotter, J. (2019), "Polish political interference at top of business only seems to be rising," *Financial Times*, March 21.

[59] Mortimer, T. (2009), "Corporate governance in Poland," *Corporate Ownership & Control*, 7(2).

[60] Wierciński, A., Wojciechowska, A., & Wyrzykowska, A. (2019), *Poland*, in W.J.L. Calkoen, *Corporate Governance Review*, 9th ed., London, Law Business Research (p. 310).

Case study LPP

LPP company is the biggest Polish fashion company with headquarters in Gdansk, probably the most important in Central Eastern Europe. LPP includes five well-known brands: *Reserved*, *Mohito*, *House*, *Cropp*, and *Sinsay*. Each of those brands is targeting different costumers. They are designed for people in different age and having different lifestyle. *Reserved* is a brand providing clothes for women, man and children. Its collections are inspired by global trends and are characterized by classic design and original patterns. *Reserved* is a fast fashion brand. All stores are provided with new collections and models every three weeks. What is interesting, in 2014, *Reserved*, as the first Polish brand entered German market. Unlike *Reserved*, *Cropp* is designed for youth, teenagers. It was founded in 2004. *Cropp* products are perfect for people that want to manifest their uniqueness and independence through clothing. *Cropp* shops also offer products of different brands like: Converse, New Balance, Mitchell & Ness, Sharpie and Komono. *Mohito* joined LPP in the same year as *House*. It is the brand addressed to independent businesswomen. *Mohito*'s collections combine elegance and comfort. *Mohito* follows the latest trends and enables women to look great no matter what the occasion is – a business meeting, or a lunch with friends. Each season, *Mohito* is proud of having a collection signed by a star. *Sinsay* is the newest LPP brand. It was created in 2013. It is designed for young women that look for inspiration or unique party outfit. *Sinsay* is characterized by brave patterns, original designs and extraordinary prints.

The history of LPP dates back to the 1990s, when Marek Piechocki and Jerzy Lubianiec started their activities in the clothing trade. Before, entering the fashion industry, they studied at the Gdansk University of Technology and later, they engaged in importing electronic equipment from Singapore, textiles from China, Thailand, Taiwan and India. From that time, until today, it remained their companies such as Home Sales Market, and LPP Tex. Their first trading company in the fashion sector was Mistral, which can be considered the commercial predecessor of LPP. Finally, together they founded in 1995 the clothing company LPP with headquarters in Gdansk, on the Baltic Sea. Currently they have more than 1,400 shops in Europe, including Poland, Germany, the Czech Republic, Slovakia, the Baltic States, Russia, Ukraine, Belarus, Romania, Bulgaria, Hungary and Croatia. LPP is also present in the Middle East. Since 2015, it has been operating in Egypt, Qatar and Kuwait. In 2016, a showroom was opened in the United Arab Emirates. A year later, the company made its debut on the British market by opening the flagship *Reserved* store in London on Europe's largest shopping street – Oxford Street. Company's offices are also in Shanghai and in Bangladesh.

LPP entered Warsaw Stock Exchange in November 2000. A few months later, successful public placement of G series shares occurred and new investors subscribed for 300,000 shares. The financial resources from selling these shares was invested in development LPP's core brand – *Reserved*. The second crucial date was May 16, 2001, when LPP's shares made their debut on the equidistant market of the WSE. Price per share was zł48.4. In 2003, the management board of LPP decided to issue new series of shares. The issuing price was zł265 and investors subscribed 190,000 shares. As previously, the capital was used to improve and develop the network of *Reserved* shops, but also for financing the investment regarding digitalization of the company.

The two partners have different responsibilities in the governance of the company. Jerzy Lubianiec is the head of the supervisory board, while Marek Piechocki is the president of the management board responsible for all the aspects of the operation of the company, from the management of strategic investment projects in Poland and abroad to his contribution in the creation of new brands. In 2013, he was named the most effective CEO by Harvard Business Review magazine. The ownership structure of the company changed very much in the last years. It represents a good example of the strategy followed by many companies listed in the Warsaw Stock Exchange. In 2012, each of the two founders owned directly 9.55% of the shares. However, in that year the biggest shareholder was Grangeford Ltd., a company based in Cyprus, with 19.1% of the shares. The second biggest shareholder was another Cyprus company, Monistor Ltd., owner of another 10.96% of the shares of the company. Both individual biggest shareholders officially declared that they do not have a dominant position in Monistor. However, it was not a secret among Polish investors that both the Cyprus based companies where under control of the two founders of LPP.

In 2015, the shareholders' structure was relatively simplified. Only three shareholders owned more than 5% of the LPP's share – the limit required for public information. Two of them were the founders of the company – Marek Piechocki and Jerzy Lubianiec. Each of them holds 10% of shares with a slight difference in favor of Marek Piechocki's (175,498, whereas Jerzy Lubianiec had just 175,000). The third core player was Monistor Limited, with detained the 11% of the shares. The remaining shareholders owned 69% of the total, but none of them had more than 5% of the shares. However, in the last few years the company decided to modify this situation because the social media started a campaign against the Polish companies paying taxes in tax heavens. Even the *Reserved* fan page published sharp accusations. A local political activist group made to the prosecutor's office in Gdansk notice of a possible crime committed by LPP according to Art. 55 of Fiscal Penal Code, which speaks of penalties that can meet the taxpayer, "that in order to conceal the real size of economic activity uses the name, company name or another entity and thus exposes a tax on depletion." This campaign risked having a negative influence on the company' image. LPP decided in last year to "optimize taxes" and accordingly the ownership structure was reformed. In 2018, the two main shareholders, Piechocki and Lubianiec, transferred their shares in LPP to two foundations established in Malta – Semper Simul Foundation and Sky Foundation – to maintain the company as a family business. In fact, the official motivation was "to ensure long-term continuity and avoid fragmentation of the Company's capital in the future." Semper Simul Foundation had now 31.5% of the shares and Sky Foundation 28.6%. The free float was representing the remaining 39.9% of the shares. In the last couple of years, however, the two foundations sold part of their shares in the market. The new ownership structure at the end of 2019 shows a larger number of free float (69% of the capital), while Semper Simul has 17.2% and Sky Foundation 12.2% of the shares. Nevertheless, considering the different voting powers of the various categories of LPP shares, the two foundations keep the strategic control of LPP. Altogether the have 59.1% of the voting rights, more precisely Semper Simul 31.5% and Sky Foundation 28.6% of the voting rights.

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The book places ownership at the center of all relevant choices that the company makes: in particular, it addresses the "problem" of governance from the perspective of ownership, and in a broader and more articulated sense than most Anglo-Saxon studies. The authors analyze the relationship between ownership, governance, and corporate strategy, with a dual objective. On the one hand, the aim is to identify the consistency relationships between the governance structure of the company and its results, because of the centrality that it assumes with respect to many of the strategic choices that companies make. On the other hand, the objective is to consider possible variants to the "basic scheme," going to investigate the role of ownership, governance and management from a contingency perspective, i.e. in different types of enterprise: public companies, multinational enterprises, state-owned enterprises, and especially family-owned enterprises are analyzed.

The second part of the book analyzes, in a number of countries, different economic and business systems and their role in defining the type of corporate governance that has emerged. The assumption is that national business and economic cultures as well as historical, economic, juridical, and institutional dimensions play a crucial role in shaping the debate triggered by the corporate scandals and the implementation of corporate governance.

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