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AICGSPOLICY**REPORT**

CORPORATE GOVERNANCE IN FLUX: ASSESSING THE RECENT ROUND OF REFORMS IN THE UNITED STATES AND GERMANY

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AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES THE JOHNS HOPKINS UNIVERSITY

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AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES

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FOREWORD

In 2004, the American Institute for Contemporary German Studies published an analysis by Sigurt Vitols and Thomas Kenyon, exploring the respective approaches of the United States and Germany toward corporate governance. In the wake of major corporate scandals that in the United States and with signs of brewing corporate troubles in Europe, AICGS was interested in exploring how the German and American corporate governance systems, each shaped by a set of unique historical, cultural, and institutional factors, would adjust to the pressures of economic globalization. With the generous support of the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft, AICGS launched a series of studies exploring the sources of U.S.-German regulatory disputes and the prospects for greater harmonization, not only of our respective approaches to corporate governance, but to product standards and taxation as well.

As documented in our first study, *Corporate Governance in Germany and the United States: Key Challenges for the Transatlantic Business Community*, both countries have relied on national approaches and regulations that in turn reflect the influence of history, cultural attitudes, and institutions. For Germany, this means adherence to the "stakeholder" model of corporate governance; for the United States, the traditional building blocks of corporate governance have been supplemented in recent years by the passage and implementation of the Sarbanes-Oxley Act.

Neither approach has proven infallible in implementation. And the importance of corporate governance as a public policy problem is little diminished since the publication of that first study.

For these reasons, AICGS in 2005 approached the two authors with the idea of revisiting the issue of corporate governance in the transatlantic arena. How were American companies dealing with the implementation of Sarbanes-Oxley? Had the new legislation resolved the problems that had led to the high-profile corporate scandals of the late 1990s? Did Germany remain firmly wedded to the prevailing structure of corporate governance, based on a dual board system, strong employee representation, and a high concentration of share ownership? Or was a series of home-grown scandals building support for changes to this uniquely German system? What had resulted from thinking within some EU circles about a European code of conduct or set of best practices pertaining to corporate governance? What has been the outcome of recent attempts at transatlantic or international harmonization of disparate regulatory approaches? What challenges do both countries face in the future?

As this updated analysis by Vitols and Kenyon underscores, many questions about corporate governance remain open. As the authors note, "the search for a 'good system of corporate governance' is not yet finished, and is likely to be a major public policy problem for the foreseeable future." Harmonization efforts are likely to continue but, the authors advise, these efforts should take into account the cost to firms associated with implementation as well as the differences between large companies that operate internationally and those primarily active in national markets.

This study is part of an ongoing AICGS series examining the historical/cultural, institutional, political, and economic causes of regulatory disputes and the way that these factors shape our respective responses to the challenges of remaining competitive in a global market. Future studies will examine the regulation of services in Europe and the implications for the United States, and the difficulties that companies and other interest groups face in navigating the maze of national and EU-level agencies and actors that now shape German/European regulatory policies.

We are grateful to Sig Vitols and Tom Kenyon for their continued engagement in this project and for their willingness to revisit the issue of corporate governance. We are particularly thankful for the sustained support of the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft for this project and the Institute's work. I would also like to express my gratitude to Dr. John Starrels, Senior Fellow-in-Residence, who has helped immeasurably to shape and guide this series of reports, and to Ilonka Oszvald for her expert assistance in the editing and preparation of the manuscript.

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EXECUTIVE SUMMARY

Until recently the corporate governance systems in place in the United States and Germany exhibited two key characteristics: institutional stability and an inward (national) orientation. In the last decade, however, we have witnessed a dramatic shift in the stability and national orientation of both systems. First, corporate governance reform has become a public policy problem that appears to have no easy solution, and will remain on the agenda for the foreseeable future. Second, the debate on corporate governance has become international, with reference to both best practices in other countries as well as global competition between financial centers.

What explains this dramatic rise in the importance of corporate governance as a public policy problem? The main reasons for these changes include: greater concern about the access of new, highly innovative companies to stock markets; the 2000-2002 stock market crash and exposure of financial wrongdoing at U.S. and European companies, which shook investor confidence and spurred policymakers and private sector actors to reform; international attempts at coordination/harmonization, including the move to International Accounting Standards, the development of international corporate governance codes (OECD, UN, etc.), and legislation on Corporate Governance in the European Union; and the trend to socially responsible investing and corporate social responsibility.

Germany has long been known for its distinctive "stakeholder" model of corporate governance involving a dual board system, strong employee representation, and a high concentration of share ownership (including significant ownership by the large banks). Since the mid-1990s, however, a growing number of business leaders and policymakers have been increasingly unhappy with this postwar system of corporate governance. In the second half of the 1990s significant legislative measures were implemented in order to try to move Germany away from a bank-based system, and more towards a market-based system of corporate finance and corporate governance. These measures briefly appeared to have achieved some success, particularly in encouraging the development of a new stock exchange segment for high-tech startups (the *Neuer Markt*). However, the 2000-2002 stock market crash created a new crisis of confidence in Germany's corporate governance system; new measures were undertaken, and a new round of reforms started. The impact of these reforms on investor confidence and on the ability of new firms to raise equity capital remains uncertain, and the search for new solutions is likely to continue.

The basic features of the U.S. corporate governance system were put in place during the Great Depression through the Securities Act of 1933 and the Securities Exchange Act of 1934. In contrast with the German system, the U.S. system early on attempted to provide a high level of protection for small shareholders. Since the general perception up until recently has been that U.S. financial markets have functioned fairly well, the major corporate governance reform in the United States, the Sarbanes-Oxley Act (SOA), was mainly aimed at repairing the basic framework to prevent the recurrence of scandals like Enron. Much like the German situation, problems with the implementation of SOA signal that corporate governance reform in the United States has entered a period in which there are unlikely to be easy solutions to the fundamental questions and problems that have been raised. As a result, corporate governance reform will remain on the policymaking agenda for the foreseeable future.

The report makes a number of recommendations for policymakers in Germany and the United States regarding corporate governance reform (these are discussed in more detail in Chapter 5):

- Recommendation #1: Efforts to coordinate and harmonize corporate governance regulation for the largest, internationally active companies should be strengthened. However, the cost impact of regulatory compliance on companies should be taken more into account.

- Recommendation #2: Consideration should be given to strengthening the “two tier” nature of corporate governance systems in Germany and the United States in order to improve startup firms’ access to capital without undermining investor confidence.

- Recommendation #3: Attention should be partially shifted from the legal framework to the problem of “liquidity” on financial markets.

- Recommendation #4: Current discussion of corporate governance reform is too focused on shareholder rights. A better balance should be achieved between shareholder rights and shareholder responsibilities.

- Recommendation #5: Expectations of what can be achieved through corporate governance reform should become more realistic, and other alternative approaches strengthened.

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CHAPTER ONE

INTRODUCTION

Until recently the corporate governance systems in place in the United States and Germany exhibited two key characteristics: institutional stability and an inward (national) orientation. With regard to stability, the basic features of the U.S. system were established in the 1930s, through the Securities Act of 1933 and the Securities Exchange Act of 1934. Fundamental aspects of the German system also have a long history. The dual board system was introduced in the second half of the nineteenth century, concentrated ownership developed in a series of waves since the late 1800s, and employee board representation was introduced in the 1950s.

With reference to the second fundamental feature, i.e. a national orientation, institutions in both countries were established as “home grown” solutions to domestic crises or as responses to domestic pressure groups. Rather than drawing on other national experiences, the U.S. system was an internal response to the consequences of the 1929 stock market crash and the ensuing Great Depression. In Germany, the dual board system and concentrated ownership emerged as a result of financial crises, and workers’ board representation developed in the context of the social market economy after World War II. The tendency to a national orientation was supported by the imposition of protective walls around national capital markets and financial systems in the 1930s and 1940s.

In the last decade, however, we have witnessed a dramatic shift in the stability and national orientation of both systems. First, the abrupt ending of almost two decades of increasing stock market returns (i.e. of the so-called Great Bull Market of the 1980s and 1990s) has shaken the faith of investors in the functioning of equity markets. This loss of confidence has been further exacerbated by the disclosure of numerous corporate scandals in both countries. These scandals have increased the perception that both systems suffer major flaws and are in need of fundamental reform. Second, the reform debate has become “internationalized” due to the search for best practices around the world and the increasing competition between countries to attract investors and new company listings. This can be seen not only in the increasing reference to best practices in other countries and the debate on the advantages and disadvantages of different systems, but also in the activities of international organizations such as the OECD and UN.

In the United States, the Sarbanes-Oxley Act (SOA) of 2002 and the congruent adoption of corporate governance principles by the New York Stock Exchange (NYSE) and NASDAQ represented the first major corporate governance reform since the 1930s. These reforms were in part based on the experience from other countries, such as the separation of the roles of the CEO and the board chairperson. Passage of Sarbanes-Oxley had immediate international implications, as seen e.g. in the conflict with Germany over the definition of independent board members.

Furthermore, one of the main criticisms of SOA is that it discourages foreign companies from listing in the United States, and that such countries might consider other alternatives, such as the London Stock Exchange.

In Germany, major attempts to reform the corporate governance system started in earnest with the passage of the Second Law on Promoting Financial Markets of 1994 and KonTraG (Law on Transparency and Governance of Large Companies) in 1998, and have continued with other legislative measures and regulatory initiatives. These measures in large part have been explicitly based on copying the U.S. corporate governance model. Whereas the Anglo-Saxon term "corporate governance" was for the most part unknown before the passage of KonTraG, it has in the meantime become widely used in business and by political elites.

Why have the stability and national orientation of both corporate governance systems been transformed so dramatically in recent years? What are the key features of these changes? What have the successes and failures of these reforms been? What lessons can be learned, and what are the implications for policymakers? These are the major questions addressed by this report.[1]

This report argues that the trends to less stability and to the "internationalization" of the corporate governance debate will most likely continue in the foreseeable future. The analysis from other countries' positive and negative experiences is an important source of policy learning. Furthermore, there is a need for selective regulatory convergence—in some sense an embryonic international corporate governance system—for the very largest, most international companies.

At the same time, the report provides two major cautions. First, there is no "one best solution" corporate governance system. Major institutional features which differentiate the United States from Germany—different levels of ownership concentration and different systems for employee "voice" within the firm—are likely to persist for the foreseeable future. The report argues for the introduction of stronger "two tier" corporate governance systems in the two countries, which differentiate between large internationally-active companies and smaller, domestically-oriented companies.

Second, corporate governance reform, though important, cannot be expected to solve all problems. Lately there has been the tendency to blame more and more unfortunate corporate occurrences on faulty corporate governance. However, the weight of evidence is that "good corporate governance" can only have a limited positive impact on company performance. Therefore, in addition to corporate governance reform, other solutions need to be implemented, such as improving best practice in companies' internal control mechanisms, and strengthening management ethics curricula at business schools.

The report proceeds as follows. Chapter 2 examines the major causes of the trends of instability and internationalization in the two corporate governance systems. Chapters 3 and 4 examine the responses to the stock market crash and company scandals in Germany and the United States, respectively. Chapter 5 summarizes and concludes the lessons that can be drawn from these experiences, and makes a series of policy recommendations.

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CHAPTER TWO

FORCES FOR CHANGE IN CORPORATE GOVERNANCE

What explains these sudden changes in corporate governance after decades of stability? This chapter explores the main reasons for these changes, which include the following:

- Greater concern among policymakers over the functioning of financial markets, reflecting the need for high-risk equity markets to provide finance for new companies, and the growing demand for financial instruments among European pension funds;

- The 2000-2002 stock market crash and exposure of financial wrongdoing at U.S. and European companies which shook investor confidence and spurred policymakers and private sector actors to reform;

- International attempts at coordination/harmonization, including the move to International Accounting Standards, the development of international corporate governance codes (OECD, UN, etc.), and legislation on corporate governance in the European Union; and

- The trend to socially responsible investing and corporate social responsibility.

Policymakers' Concerns with Equity Financing

As competition on world markets intensifies, policymakers are becoming more concerned with the innovative capacity of their national economies and companies. Given the flood of exports from low-wage countries such as China, high-wage countries like the United States and Germany will have to compete by providing innovative, high quality products and services. Many European companies are also realizing that they must grow in order to achieve the critical mass to relocate manufacturing to low cost areas such as East Asia and Eastern Europe. These concerns were given impetus in Europe by the so-called Lisbon Agenda, which was launched in 2000 and put improving competitiveness as one of its highest priorities.

Achieving this growth requires access to finance. Bank debt becomes less available and cost-effective as companies decrease in size. It is also not a suitable form of finance for risky ventures. Equity finance, in which investors share in both upside profit potential and downside risk, is a more appropriate tool for financing start-ups and high growth companies. Unfortunately, Europe has lagged far behind the United States in venture capital and other forms of equity finance—with noticeable consequences for innovation. While the rate of biotech start-ups is comparable across the two countries, for example, financial constraints mean a much lower proportion of European companies ever grow to any significant size.[2] For this reason the development of risk finance mechanisms has been a key item on the post-2000 European policy agenda.

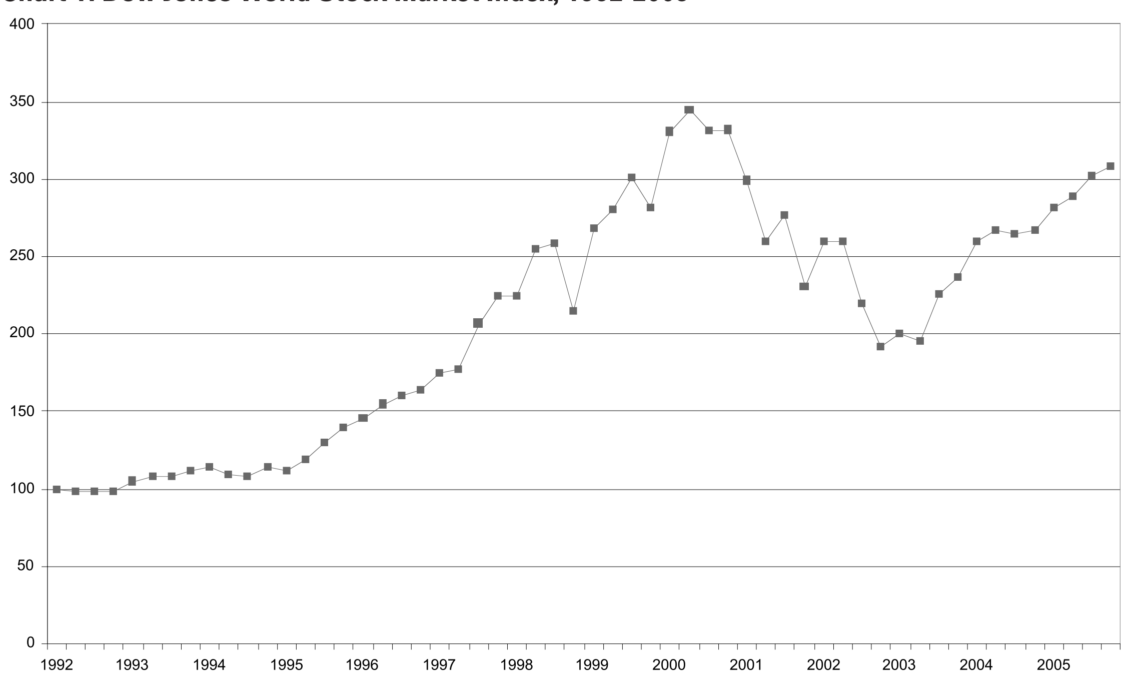
A second broad development has been policymakers' increasing concern over demographic shifts and the need for adequate pension provision. Historically, institutional investors have played a less prominent role in continental Europe relative to the United States. Germany is no exception here. However, aging populations and the partial privatization of retirement accounts–which in Germany occurred through the 2001 "Riester-Rente" reforms–have caused a structural change in financial markets in these countries. Among the implications of this shift are the need for regulatory oversight to support more rigorous risk management, greater transparency, and better governance of private pension funds. More fundamentally, there is likely to be an increased demand for financial instruments capable of meeting these institutions' investment needs, including equities.

The consequence of these developments has been increased pressure for better corporate governance. It is now widely accepted that good corporate governance is a prerequisite for equity market development.[3] Transparency is necessary to mitigate the information asymmetries between 'insider' managers and 'outsider' shareholders. Minority shareholder protections, including tender-offer rules and board representation, are necessary to manage the agency problems that follow from the separation of ownership and control. Many recent studies have shown that greater transparency and strong minority shareholder protections are associated with higher market capitalization and higher trading volumes.

The Stock Market Crash and Financial Scandals

Following the 'great bull market,' which began in 1982 and accelerated in the late 1990s, stock markets around the world experienced a serious crash between early 2000 and the beginning of 2003. The Dow Jones World Index, a broad summary index of stock markets around the world, fell from almost 350 in the first quarter of 2000 to 200 (see chart 1). The U.S. and German stock markets were badly affected. Between March 2000 and early 2003 the S&P 500 (representing the largest 500 U.S. listed companies) lost around 30 percent of its value and the DAX (largest 30 German listed companies) over 50 percent.

Chart 1: Dow Jones World Stock Market Index, 1992-2005



Source: Dow Jones Indexes (www.dowjonesindexes.com)

Perhaps more significantly for developments in corporate governance, the crash also exposed a series of instances of financial wrong-doing at large companies that further shook investor confidence. Although Enron was the most prominent of these, it was not the only one in the United States. These scandals generally involved the misreporting of companies' true financial situation to the investing public, revealing a widespread failure in one of the primary functions of the corporate governance system. More specifically, they demonstrated the vulnerability of the U.S. reporting system to abuse by corporate executives.[4] Germany also experienced a number of company scandals, though on a smaller scale. For the most part these involved more mundane transgressions such as bribe-taking and insider trading.

The search for the causes of this breakdown in trust, as well as for measures that might be taken to try to prevent its recurrence, has motivated recent corporate governance reform efforts. Aside from legal reforms the most visible consequence of these failures in both countries has been to focus attention on transparency and communication with investors. The Volkswagen and other scandals involving the misuse of works council funds may also prompt a further rethink of the German system of industrial relations and codetermination in particular (see Chapter 3).[5]

Achieving this goal of increased investor trust in equity markets through increased regulation, however, does not come without a price. In particular, the increased cost burden on companies for regulatory compliance has been disproportionately larger for smaller companies. There is some evidence that these costs are large enough to discourage some smaller start-up companies from applying for new listings on stock exchanges. In this sense the achievement of the goal of increased investor trust conflicts to some extent with the goal of encouraging high-risk finance for high-tech industry.

International Attempts at Harmonization and Regulation

New actors in the corporate governance debate are international organizations, including the OECD and UN, and private organizations such as the International Corporate Governance Network. These organizations have been concerned with disseminating "best practices" in corporate governance, and a number of them have developed codes in an attempt to define it.[6]

These codes have had a particularly strong impact on developing and post-communist countries and in some cases have been used to develop national corporate governance legislation. But they have also had some influence on developed countries, including Germany and the United States. In April 2004 all thirty OECD countries agreed on a broad set of principles concerning the role of institutional investors, the regulation of conflicts of interest and the role of auditors, stakeholder rights, and board responsibility. The principles are broad and non-binding and are intended mainly to assist national governments in drawing up and enforcing their own regulations. They are also intended to be adapted to different cultural, economic, and legal environments.

In addition to codes of best practice, another important development at the international level has been the extension of International Accounting Standards, as developed through the International Accounting Standards Board (IASB). The ultimate aim of this initiative is to allow European companies to list on U.S. exchanges without the need to restate their accounts according to U.S. Generally Accepted Accounting Principles (US GAAP). It received a strong impetus when the European Union required all listed companies to use IASB standards in their financial reporting as of 2005. There is also some speculation that the United States will in the long run adopt the same standard. In October 2004 the IASB and U.S. Financial Accounting Standards Board (FASB) agreed on a joint project to develop a common conceptual framework.[7] However, the path to harmonization does not promise to be easy, particularly given the differences between the IASB's principles-based and the U.S. rules-based approaches to accounting.[8]

Finally, the European Union has taken a stand on corporate governance issues, both in response to demands for capital market integration and as a consequence of the Enron, Parmalat, and other scandals. In 2003 the Commission considered, but then backed away from a European code of corporate governance for best practice in favor of a gradual harmonization of national systems. It did however issue non-binding recommendations over directors' remuneration and independent board members. There have been a number of other legal developments at the supra-national level. The most significant of these was the promulgation of a European Company Statute, which became available for use in October 2004.[9]

Socially Responsible Investing/Corporate Social Responsibility

A final force is that more and more small investors are becoming concerned with the environmental, social, and economic impact of their investments (SRI, or socially responsible investment). An intimately related trend is the increasing concern of companies with the impact of their activities (CSR, or corporate social responsibility). Both of these are placing increasing demands for the definition of criteria for "good" behavior, and on the monitoring and reporting of compliance with these criteria. This involves both the investment community and companies themselves. Over half the top 250 companies in the U.S. Fortune 500 list now publish some form of CSR report.[10] The trend is also well established in Europe, where the European Commission itself has taken an interest in promoting it.[11] Topics covered typically include environmental performance, labor standards, working conditions, and community involvement. Despite criticisms of its usefulness, many companies on both sides of the Atlantic have come to value CSR as a tool for managing reputational risk, as well as for its direct impact on shareholder value.[12]

Table 1: Issues Covered in Major CSR Principles and Codes

CODE: ISSUE	UN CG	AMNESTY	ETI	SULLIVAN	OECD	WHO/ UNICEF	ECCR/ICCR
Financial	●				●●		
Economic Development	●●	●	●	●	●		
Consumer Affairs	●					●●	●
Human Rights	●●●	●●●	●●●	●●●	●	●●	●
Employee Relations	●●●	●●	●●	●			●
Community Investment	●●						●
Bribery and Corruption	●	●●	●		●●		
Bio-diversity	●●						
Air Quality and Noise Pollution	●						
Energy and Water	●						
Waste and Raw Materials	●						

Note: ●●● = issue included, with major coverage
●● = issue included, with some coverage
● = issue included, with minimum reference
= no reference

Source: Derived from European Commission (2003: Table 4).

03 CHAPTER THREE

THE SEARCH FOR A NEW MODEL OF CORPORATE GOVERNANCE IN GERMANY

Germany has long been known for its distinctive “stakeholder” model of corporate governance involving a dual board system, strong employee representation, and a high concentration of share ownership (including significant ownership by the large banks). Since the mid-1990s, however, a growing number of business leaders and policymakers have been increasingly unhappy with this postwar system of corporate governance. In the second half of the 1990s significant legislative measures were implemented in order to try to move Germany away from a bank-based system, and more towards a market-based system of corporate finance and corporate governance.

These measures briefly appeared to have achieved some success, particularly in encouraging the development of a new stock exchange segment for high-tech startups (the *Neuer Markt*). However, the 2000-2002 stock market crash has created a new crisis of confidence in Germany’s corporate governance system. New measures have been implemented, and a new round of reforms has started. The impact of these reforms on investor confidence and on the ability of new firms to raise equity capital remains uncertain, and the search for new solutions is likely to continue.

Basic Features of the Postwar German System

The system of corporate governance predominant in postwar Germany has three core characteristics which distinguish it from the Anglo-Saxon model: 1) concentrated ownership; 2) a dual board structure (supervisory board and management board); and 3) extensive worker representation on the supervisory board (“board codetermination”). This section considers each of these characteristics in turn.

CONCENTRATED OWNERSHIP

In contrast with the Anglo-Saxon pattern of dispersed shareholding, Germany (as well as the rest of continental Europe) has a system of concentrated ownership. Firstly, the proportion of companies listed on the stock market is much smaller than in the United States or UK. Even large companies like the appliance and auto parts manufacturer Bosch or the publishing house Bertelsmann are owned by founding families or a small handful of private investors. Relatively few companies are listed on the stock market in comparative context. La Porta et al. show that Germany has only one-sixth as many listed companies as the United States and one seventh as many as the UK, on a per capita basis.[13]

Secondly, ownership of public companies is much more concentrated than in the Anglo-Saxon world. Over half of German public companies have a major shareholder controlling at least 50 percent of voting rights. A recent comparative study by Barca and Becht found that the median size of the largest voting block for listed German companies was 52 percent. In this respect Germany is typical of continental European countries, and contrasts sharply with the case of firms listed on the NYSE, of which roughly half have no blockholder (i.e. shareholder with at least 5 percent of shares).[14]

Thirdly, the distribution of type of owners in Germany is quite different than in Anglo-Saxon countries, where institutional investors (e.g. pension funds, mutual funds, and insurance companies) predominate. This is illustrated in Table 2, which shows the distribution of ownership of stock in listed German companies since 1960. Non-financial companies in fact have been the most important stockholders throughout the postwar period, accounting for roughly 40 percent of shareholdings, up until the mid-1990s. Despite a substantial decline in the past decade they still account for over 30 percent of holdings, as of the end of 2003. Banks increased in importance as shareholders for about three decades, up from holding eight percent of all shares in 1960 to just under 15 percent in 1992. The voting power of banks has been estimated at two to three times greater than their direct holdings of shares, since they have exercised proxy voting rights at annual meetings on behalf of many private owners.

Table 2: Distribution of Shareholdings in German Listed Companies
(By Owner Type, in percent)

Owning sector	1960	1970	1980	1990	1992 (1)	1992 (2)	1995	2000	2003
Non-Financial Companies	40.7	37.4	42.8	39.0	41.4	45.8	45.8	36.2	32.5
Private Households	30.3	31.3	21.2	20.0	17.6	19.8	18.8	16.5	13.9
Public Sector	12.0	9.6	8.5	4.4	3.9	2.1	1.8	0.6	0.9
Banks	8.0	9.1	11.6	14.0	14.7	13.0	12.9	11.5	9.0
Insurance	3.4	4.2	4.8	7.8	9.0	5.1	6.3	8.2	13.2
Other Financial						4.6	6.2	14.4	13.5
Rest of World	5.6	8.5	11.1	14.8	13.2	9.7	8.2	12.5	17.1

Source: Deutsche Bundesbank Flow of Funds Accounts.

Note: Due to a change in classification in 1992, a break in the series in that year is shown. Prior to that date, mutual funds were accounted for mainly in other groups, and after 1992 have accounted for the bulk of the owner type “other financial.”

DUAL BOARD STRUCTURE AND "LIFELONG" MANAGEMENT

In contrast with the single-board system predominant in the Anglo-Saxon world, large German companies are required by law to have a dual board structure.[15] No person is allowed to simultaneously serve on both boards of the same company. The top managers responsible for day-to-day operations are represented on the management board (sometimes referred to as the executive board). Stakeholders in the company (i.e. shareholders, creditors, employees, and major suppliers and/or customers) are represented in the supervisory board, which is responsible for appointing and overseeing members of the management board and for approving key policies and strategic decisions.

In contrast with the "strong CEO" model predominant in many U.S. corporations, the German dual board system supports a consensus approach to corporate governance. Members of the management board are equally responsible for decision-making, and the head of the management board is typically referred to as the "speaker" rather than the "chair." Consensus decision-making is also supported by the fact that members of the management board typically sign three- to five year contracts, approved by the supervisory board. As a result each member is directly responsible to the supervisory board rather than to the speaker/chair. This consensus approach is also applied within the supervisory board itself, where typically an effort is made to find unanimous support, and decisions that could gain only a narrow majority are not pushed through.

A key indicator of bank influence is the presence or absence of a bank manager in the company's supervisory board.[16] Throughout the postwar period, banks have had at least one representative in the supervisory boards of most of the largest listed companies. Banks also typically appointed the supervisory board chair of the companies in which they were the largest or most influential shareholder.

An important consequence of the consensus management approach is that management turnover in Germany is relatively low in comparison with Anglo-Saxon countries. A good manager can reasonably expect to spend his or her management career at one large company. This system has its strengths and weaknesses. On the one hand, it enables the accumulation of considerable firm specific human capital among managers. On the other hand, collective decision-making results in responsibility for poor decisions or substandard performance being shared among managers, rather than being clearly tied to an individual manager who may have to leave the company as a consequence. The lack of management mobility also leads to a relatively weak mid-career labor market, making it difficult and risky for managers to switch companies or start up their own firms.[17]

BOARD-LEVEL CODETERMINATION

A third characteristic that distinguishes the German corporate governance system from the Anglo-Saxon countries is the mandatory inclusion of worker representatives on the supervisory boards of large companies. In companies with between 500 and 2000 employees, one third of the supervisory board seats go to employee representatives. In companies with more than 2000 employees, half of the seats go to employee representatives (so-called "parity" codetermination).

Worker participation enjoys widespread support among the German population, with an opinion survey done in 2004 showing that 82 percent of Germans had a positive view towards codetermination.[18] Leading academics argue that economic theory offers no clear guidance on the question of whether codetermination is positive or negative.[19] On the one hand, codetermination may be used by workers to increase wage demands and decrease the pace of layoffs. On the other hand, codetermination may increase workers' trust in the company and willingness to make firm-specific investments. Although two studies suggest that codetermination may have a negative impact on share prices, the majority of newer econometric surveys indicate that codetermination probably has a slight positive impact on productivity and innovation.[20]

Reform Efforts of the Second Half of the 1990s

In Germany, one of the major concerns in the 1990s leading to the reform of the postwar system of corporate governance and financial market regulation was a perceived backwardness with regard to practice in the Anglo-Saxon countries. In contrast to the Anglo-Saxon world, very little new money was flowing into the stock market, and relatively few new companies were obtaining listings on the stock market. Furthermore, negative comparisons regarding the profitability and innovativeness of German companies also raised the question of the adequacy of the corporate governance system. Because of the central concern of improving the flow of equity capital, the issues of corporate governance and financial market reform have been closely linked in Germany.

A particularly strong interest group supporting these reforms was the large German banks. Due to the slowdown in economic growth since the 1980s companies were not expanding as rapidly as before, and did not need as much credit from banks as they used to. Furthermore, increased international competition in financial services meant that the profit margins on bank lending were decreasing. As a result of the decreasing attractiveness of traditional lending activity, the large banks actively supported measures that would promote the development of the stock market. The banks hoped that a larger and more active stock market would result in more business opportunities in fee-based services, such as asset management, underwriting of new company listings (IPOs), and company mergers and acquisitions (M&A).

A second group supporting these reforms was a set of company managers who believed that the U.S. corporate governance system–or at least certain elements of it–was superior to the postwar German system. In particular the ability of companies to grant stock options to managers and employees and to buy back their own stock when it was undervalued or when the company had excess cash (share buyback programs) were severely circumscribed.

As a result, a broad coalition of actors supported corporate governance and financial market reform loosely based on the U.S. model. Three major changes were introduced in the mid-to-late 1990s by this broad coalition: the establishment of a new securities markets regulator in 1994, the introduction of the *Neuer Markt* in 1997, and the passage of the Law on Transparency and Control of Large Companies in 1998.

NEW SECURITIES MARKET REGULATOR

Up until the mid-1990s, enforcement of rules of conduct on stock exchanges was for the most part a matter of self-enforcement. Special committees made up of members of these exchanges were responsible for investigating and ruling on complaints that these rules had been violated. Appeals to the prosecutor's office or the courts were for the most part denied, despite widespread accusations of market manipulation and exploitation of small shareholders.

In order to improve the fairness of securities markets for small shareholders, a new securities markets regulator, the *Bundesaufsichtsamt für den Wertpapierhandel* (BAWe), was established by legislation passed in 1994. The BAWe was modeled in large part on the U.S. Securities and Exchange Commission (SEC), in the sense that it was to oversee financial markets and to help develop and enforce rules for proper conduct on these markets. It was to be staffed in large part by professionals (lawyers, accountants, and economists) specialized in different aspects of market behavior.

Although the BAWe initially was not given a large staff, and its enforcement powers were fairly weak, nevertheless it did represent a major structural change in a country in which corporatist self-regulation played such a strong role. The financial system had been one of the strongest bastions of self-regulation in Germany during the twentieth century.

INTRODUCTION OF THE *NEUER MARKT*

One of the major criticisms of the German stock market throughout the 1990s was that it was more suited to the needs of larger established companies than to smaller high tech startups. One drawback was that the stock market was effectively run by the large banks, which were generally conservative when it came to financial matters. These banks essentially acted as gatekeepers, deciding which new companies would come onto the market. Generally they applied conservative criteria in these decisions, for example, in demanding a long period of profitability before allowing companies on the market. According to critics, many successful high tech companies in the United States, which had obtained listings before they had reached profitability, would not have been admitted into the German stock market.

In an effort to overcome this problem a special segment of the Frankfurt Stock Exchange dedicated especially to equity finance for high tech startups, the *Neuer Markt*, was started in 1997.[21] Based in part on the model of the NASDAQ, it explicitly allowed loss making companies to obtain listings, thus contradicting normal bank prudential standards that only profit-making companies should obtain external finance. In return, the *Neuer Markt* required a higher degree of transparency and greater protection for minority shareholders than the regular segments of the Frankfurt market. For example, the *Neuer Markt* required financial reporting from companies on a quarterly basis, as in the United States, rather than the traditional norm of annual reporting in Germany. In this sense the *Neuer Markt* represented a significant step towards adopting the U.S. system of corporate governance in Germany.

1998 COMPANY LAW REFORM

A third important step in corporate governance reform taken in Germany was the revision of company law in 1998 through the Law on Transparency and Control of Large Companies (KonTraG).[22] One important change introduced by KonTraG was the introduction of the "one share, one vote" principle, which prohibited multiple voting rights or limits on the number of votes that could be exercised by one investor. KonTraG also weakened proxy voting rights, which had been extensively used by banks, ostensibly on behalf of small shareholders, to extend their own influence by a considerable degree. The law also for the first time explicitly authorized companies to establish share buyback programs and grant their managers and employees share options; both of these had been used for decades by companies in the United States.

The establishment of a securities regulator, the introduction of the *Neuer Markt*, and the passage of the KonTraG legislation represented substantial changes in Germany in the direction of U.S. practice. However, it is important to note that two core features of the postwar German Corporate Governance System, namely the two-tier board structure and workers' board representation, were not fundamentally modified. Thus properly speaking there has only been a partial convergence towards the Anglo-Saxon model of corporate governance as a result of the reform efforts of the 1990s.[23]

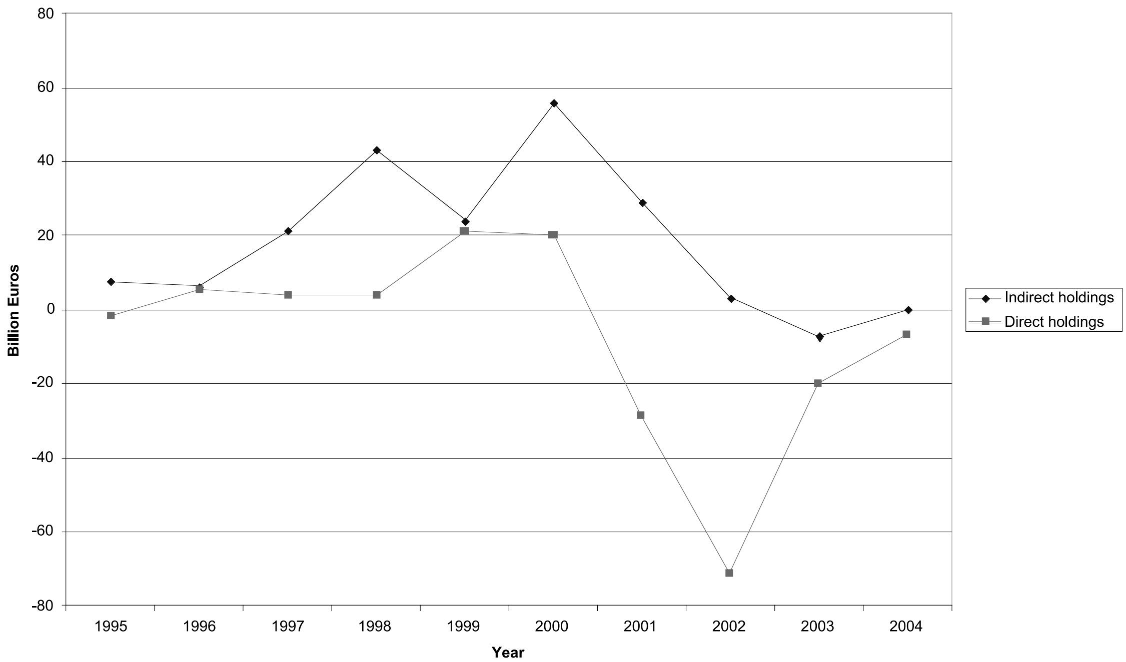
The Stock Market Crash and its Aftermath

Originally it appeared as though the corporate governance reform efforts reviewed above had been successful. Households appeared to gain more trust in equity finance, and began to invest greater amounts of their savings in the stock market, both directly (though individual company shares) and indirectly (through mutual funds). Chart 2 shows that direct net investment was around zero in 1995, but increased in the next half a decade, reaching a peak of about 20 billion Euros in the years 1999 and 2000. Similarly, indirect net investment was less than 10 billion in 1995, but accelerated to a peak of almost 60 billion Euros in 2000.

However, the euphoria over having established a strong "equity culture" in Germany turned out to be short lived. During the stock market crash, households became net sellers of stocks, particularly of direct holdings, 80 billion Euros of which were liquidated in 2002. Although the situation has improved somewhat since 2002, nevertheless households still withdrew funds from the stock market on a net basis in 2004, representing a worsening of the situation since the pre-bubble environment.

Similarly, the reforms initially appeared to have been a major success in improving the flow of funding to high-tech startups. Chart 3 shows the number of IPOs (i.e. new companies being listed on the stock market and obtaining new equity capital) per year in Germany since 1986. From the mid-1980s to the mid-1990s the rate of IPOs per year averaged about 20, only a fraction of the rate of IPOs in the Anglo-Saxon countries.[24] This rate on the main Frankfurt

Chart 2: Net German Household Investment in Equities, 1995-2004



Source: Frankfurt Stock Exchange

stock exchange did not substantially increase in the second half of the 1990s. The *Neuer Markt*, however, did attract a large number of IPOs after its creation in 1997, reaching a peak of about 130 IPOs in each of the years 1999 and 2000. For a brief period, the *Neuer Markt* was hailed the most successful "growth market" for high-tech startups in Europe.

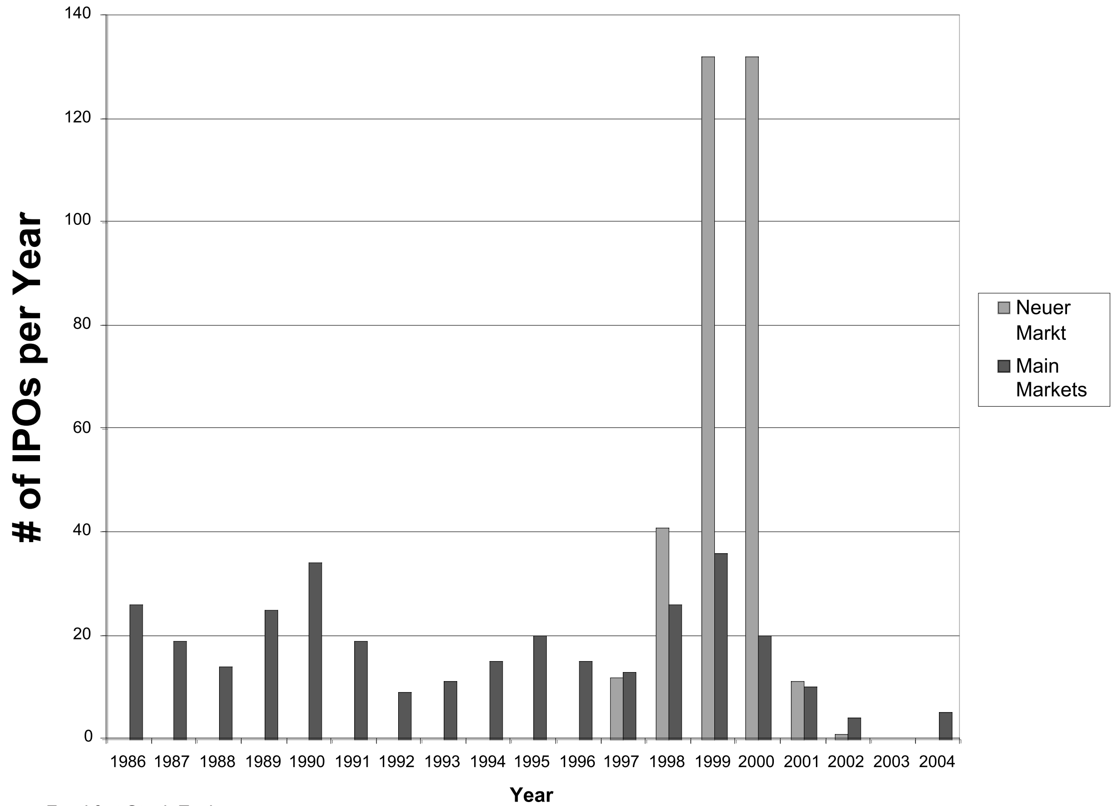
After the peak of the bubble in March 2000, however, IPO activity rapidly waned, slowing to about 30 in 2001 (*Neuer Markt* and main market combined) and grinding to a complete halt in 2003. The Frankfurt Stock Exchange made the decision to close the *Neuer Markt* completely by the end of that year. In addition to a decrease of over 90 percent in the value of the *Neuer Markt* All-Shares Index (NEMAX), a major factor in the decision to close was the large number of financial scandals at *Neuer Markt* companies that were emerging. One of the most prominent of these was the case of Comroad, an internet company, where an investigative journalist found that 98 percent of the sales for the first half of 1999 were accounted for by one contract with a nonexistent Hong Kong firm. Investment bankers and fund managers were also implicated, including the manager of the largest fund specializing in *Neuer Markt* companies, Kurt Ochner, who was popularly entitled "Mr. *Neuer Markt*" for his advocacy of investing in these companies in frequent public appearances.

The Regulatory Response to the Crash

The stock market crash and the accompanying company scandals shook the public's faith in Germany's shift toward a more U.S.-based system of corporate governance and financial regulation. Nevertheless, in searching for a solution to these problems, leading academics and policymakers generally have advocated further steps in the direction of U.S. practice, rather than a retreat towards traditional German practice.

Unlike the measures of the 1990s, however, which generally took a liberalizing (permissive) approach towards corporate governance, for example in the authorization of stock option grants and share buyback programs, steps taken after 2000 generally

Chart 3: IPOs in Germany: *Neuer Markt* and Main Markets (1986-2004)



Source: Frankfurt Stock Exchange

emphasized tighter regulation and more restrictions on behavior. Two major initiatives here were the appointment of a corporate governance commission and the announcement of a ten-point plan for restoring investor confidence.

CORPORATE GOVERNANCE COMMISSION

In May 2000 the federal government appointed a commission on corporate governance to develop a series of recommendations for improved practice in Germany. The commission was informally called the "Baums Commission," based on the name of its chair Theodor Baums, one of the leading legal experts on corporate governance in Germany. The commission was appointed only two months after the peak of the stock market boom, and thus was started in an atmosphere of optimism. However, the work of the commission was influenced by the increasing environment of gloom, as the equity prices of almost all listed companies (especially of the previous "high fliers") plummeted further and further.

The commission's final report, which was submitted in July 2001 to the general public, included almost 150 recommendations for improved corporate governance practice. Many of these focused on the adoption of best practice in company boards: However, some of the recommendations made were more sweeping, for example in suggesting the passage of new legislation. The appointment of a permanent commission, which would be responsible for developing a corporate governance code, modifying it with regard to new best practice, and monitoring the implementation of the code, was also recommended.

TEN-POINT PLAN FOR INVESTOR CONFIDENCE

As the stock market continued to plummet throughout 2002 and the beginning of 2003, it became clear that more serious action was needed to bring investors back to the stock market. Based in part on the recommendations of the Baums Commission, the response of financial regulatory agencies and the government to the crash and the emerging financial scandals was to advocate a continuation of the reform path. The major initiative here was the government's proposal for a ten-point program for restoring investor confidence, made in 2003. This program called for the following actions, most of which had been passed into law by the time of the writing of this report:

1) Strengthening the rights of shareholders by introducing the right to claim compensation from the company from its board members in the case of wrongdoing;

2) Creation of direct liability of boards in case of intentional or grossly negligent misleading information dissemination, and strengthening of rights for collective assertion of shareholder claims;

3) Further development of the Corporate Governance Code;

4) Further development of accounting rules;

5) Strengthening the role of the auditor;

6) Supervision and enforcement of financial account statements by an independent authority;

7) Further development of stock market regulation and the law for supervisory authorities;

8) Introduction of a prospectus obligation for the (less regulated) "grey capital market";

9) Formalization of methods for company valuations by financial analysts and rating agencies; and

10) Tightening of criminal laws for capital market-related offenses.

Unsolved Problems and Controversies in German Corporate Governance

As of late 2005 most of the ten points have been implemented into law. Altogether these points represent a major reform of the German corporate governance system in the direction of further adoption of Anglo-Saxon style elements.

Despite these extensive changes, corporate governance reform in Germany is far from "settled" and will remain a source of controversy in the foreseeable future. Further reforms are being suggested, and some of these will likely be implemented. The reasons for this "open" nature of the current state of corporate governance are as follows:

- More company scandals: During the course of 2005 the German public was exposed to a number of company scandals, including accusations of kickbacks and corruption at Volkswagen, money laundering at Commerzbank, trading on inside information on developments at DaimlerChrysler, and conflicts of interest in managers close to both Porsche and Volkswagen. These scandals arguably are small in comparison to cases like Enron, and in many cases more a matter of internal risk control than external corporate governance. Nevertheless the result has been to increase the domestic public's distrust in the soundness of Germany's corporate governance system.

- Lack of investor confidence: Despite adoption of the ten point plan agenda, domestic investor confidence has not yet been fully won back. Although the rate of household sales of equities has slowed down, it has not stopped. On the whole households have turned back to "safer" financial assets such as bonds and real estate funds.

- Codetermination: Workers' board participation has been a source of controversy in the past, but has usually disappeared from the agenda after a fairly short time. Recently, however, business associations and the liberal party (FDP) appear to be making a more concerted attempt to stimulate discussion about workers' participation. A joint report by the major business association and the major employers' association (BDI and BDA) suggested scaling back codetermination. In particular, the presence of some trade union representatives on the board (2 or 3 for companies with at least 2000 employees) and the high proportion of workers' representatives on the board (up to half of board members) are aspects of corporate governance which are coming under attack. Although it is unlikely that board codetermination will be fully dismantled, the possibility of some changes here cannot be excluded.

- Political debate on management pay: The salaries of top managers at the largest German companies are still considerably below U.S. levels, where the CEOs of the top 100 listed companies on average currently earn roughly 500 times the annual income of the average production worker. Nevertheless the increase in recent years has been quite rapid in certain companies, and the German public for the most part still has difficulties accepting annual pay in the millions. The proposals of some politicians and the trade unions to regulate management pay have, therefore, found some resonance among the public. Regulation, however, would conflict with a number of companies' goals to gradually increase management pay to U.S. levels.

- Political debate on foreign investors: German citizens are aware that foreign funds are becoming increasingly important players on German capital markets, and that some of these funds may be using investment strategies that deviate from the long-term "patient" strategies of many domestic investors. That this point can be politically exploited as a source of anxiety was illustrated by the widely-publicized characterization by the SPD's head (Müntefering) of foreign funds as "locusts." It is quite possible that this controversy could reemerge in the future more frequently, perhaps being exploited by the new "Left" party, which managed to get more than 5 percent of the votes in the last national election (18 September 2005) and thus has representation in the German parliament.

- Impact of increasing costs of regulation: The debate around the Sarbanes-Oxley Act, which originally focused on the danger of the definition of independent directors in the legislation to the ability of German companies to list in the United States, meanwhile, has moved on to the costs of regulatory compliance. A number of German companies have complained that they have to spend millions of dollars per annum in order to comply with Sarbanes-Oxley reporting requirements. At the same time many of the hoped-for advantages of listings in the United States, and of the adoption of a U.S.-style regulatory regime in general, have not materialized. This is likely to spark a backlash in favor of an insider based model of corporate governance more along the lines of the traditional German model.

- Impact on small firms: The costs of regulatory compliance are much higher in relative terms for small firms, since there are a number of fixed costs involved in reporting. Thus the goal of increasing investor confidence through stricter regulation, due to the increased costs of compliance, directly conflicts with the goal of encouraging risk capital and more listing of high-tech startups. As long as the same standards are applied to all listed companies it is difficult to see an easy solution to this dilemma.

All in all, these problems add up to considerable challenges for policymakers for the foreseeable future. Given the criticisms of the traditional German corporate governance system, and of the increasing criticisms of the U.S. system, there does not appear to be a clear "leading model" of best practice to follow. Further reforms are thus likely to be piecemeal, rather than wholesale attempts to adopt other models. The formation of a Grand Coalition after the September 2005 elections is likely to reinforce the tendency towards incremental change over the next few years.

04 CHAPTER FOUR

THE U.S. RESPONSE TO CORPORATE SCANDALS

This chapter discusses the emergence and basic features of the U.S. corporate governance system, the major reform attempt through the Sarbanes-Oxley Act (SOA), current criticisms of SOA, and calls for further reforms. Much like the German situation, corporate governance has entered a period in which there are unlikely to be easy solutions to the fundamental questions and problems that have been raised. As a result, corporate governance reform will remain on the policymaking agenda for the foreseeable future.

Basic Features of the U.S. System

The basic features of the U.S. corporate governance system were put in place during the Great Depression through the Securities Act of 1933 and the Securities Exchange Act of 1934. In contrast with the German system, the U.S. system early on attempted to provide a high level of protection for small shareholders. This was achieved through the following mechanisms:

- Requirements for a high level of company disclosure of financial and other information (high transparency);
- Development of specific rules for conduct and policing of these rules through the Securities and Exchange Commission (SEC); and
- Strong legal rights for shareholders for recourse through the courts.

As such, the United States has generally been considered a "model" system for small shareholders (sometimes referred to as "minority" shareholders). Since there appears to be a long-term trend away from concentrated shareholding by large shareholders, towards dispersed ownership through small shareholders, the U.S. system has frequently been called the system most suitable for the future. "Stakeholder" systems such as Germany's have generally given much more weight to the interests of larger shareholders, who enjoy "inside" information through board representation or through other mechanisms.[25]

The U.S. system has not always been seen as the "best" system. In fact, in the 1970s and 1980s a deep-seated criticism of the "short term" orientation of stock markets in the United States and other Anglo-American countries emerged.[26] Critics claimed that small investors lacked the incentives and capacity to closely monitor company management, and tended to exercise "exit" (i.e. quick sales of shares) when companies underperformed, rather than exercising "voice" (i.e. engaging in dialogue with management). It was argued that Anglo-Saxon companies were fearful of undertaking long-term investments, since this might impair short-term profitability and thus discourage stock market investors. Countries such as Germany and Japan, in contrast, in which most stock listed companies had at least one large blockholder (i.e. owner with effective voting power on at least 5 percent of shares), were seen as better able to encourage the long-term investments needed for competitive advantage. This story seemed to be supported by the fact that the Anglo-Saxon countries generally had economic performance below the OECD average throughout the 1970s and 1980s.

Since the mid-1990s, however, when the relative position of the Anglo-Saxon and non-Anglo Saxon countries in the OECD reversed, and the former group has enjoyed superior performance. As a result, criticism of the U.S. corporate governance system faded out. Although some level of criticism has reemerged since the Enron and other financial scandals, the U.S. system still is seen by most policymakers around the world as the superior system.

In contrast with the German situation, where corporate governance reform preceded the stock market bubble, the debate on corporate governance and the recent round of reforms in the United States was triggered mainly after the bursting of the bubble and by the wave of corporate scandals, i.e. after 2000.

Financial Scandals and the Sarbanes-Oxley Act

The size and extent of the financial scandals that grabbed the headlines in 2002 and 2003 were quite unexpected.[27] Perhaps one of the most disturbing facts was that, although the number of scandals increased dramatically around the world in the wake of the "internet bubble," the problem seemed to be particularly severe in the United States. One of the strongest points of the U.S. corporate governance system was supposed to be its high level of transparency and the strong alignment of the interests of management and small shareholders. Some have suggested that the problem lay with the explosion in management compensation tied to stock market performance, which greatly increased the incentives for management to "cheat."[28]

The approach of Congress was to reform the U.S. corporate governance system rather than to replace it with another type of system (e.g. the system of "insider control" known in most stakeholder systems). The major initiative here was the Sarbanes-Oxley Act (SOA), which aimed at closing the gap between theory and practice. The main provisions of SOA were as follows:

- Oversight: The self-regulation of the accounting industry is replaced by supervision through a new public oversight body, the Public Company Accounting Oversight Board (PCAOB);

- Contracting Restrictions: The type and amount of non-auditing work the auditing firms are allowed to do for listed companies is restricted;

- Audit Committee: Companies listed on the stock market must establish an audit committee under the board of directors composed entirely of independent directors. The audit committee is to choose the auditor and to supervise the auditing procedure (Section 301);

- Disclosure Controls and Procedures: Companies are required to tighten up their external reporting controls and procedures (Section 302);

- Internal Controls and Procedures for Financial Reporting: Companies are required to make a major effort to document the tightening up of internal controls and procedures for financial reporting (Section 404);

- Code of Ethics: Companies are required to disclose whether senior officers comply with a Code of Ethics. If not, companies are required to explain why. (Section 406).

One important consequence of the SOA has been to transform the traditionally close relationship between accounting firms and listed companies.[29] This relationship is now seen as more distanced, or even adversarial, with many managers saying that they are now much more careful about the type and amount of information they will share with the auditors. In this sense SOA seems to have been successful in reducing some of the conflicts of interest that had arisen during the 1990s, for example the extensive non-auditing work that auditing firms were doing for listed companies.

The Corporate and Political Response to SOA

Although the legislation is not without its critics, most people appear to agree with the spirit and most of the provisions of SOA. There is a consensus that political intervention was necessary to restore faith in the markets. Most of the criticism has focused on the Act's implementation and in particular on the costs of compliance.

The principal bone of contention is Section 404. This requires managers to document their internal controls and financial disclosure procedures and calls on auditors to report whether these controls are adequate. Most managers view it as an inefficient imposition, the benefits of which are impossible to quantify and the costs, in terms of audit fees and the diversion of personnel from more productive tasks, much higher than expected.

Most estimates of the annual costs of complying with SOA put them in the region of $4-5m for large companies in fiscal year 2004, well above the $91,000 originally mooted by the U.S. government. According to a survey by Financial Executives International, companies with sales greater than $5 billion expect to spend an average of $8.1 million per year.[30] General Electric put its own cost of compliance at $30 million.[31] The burden is especially trying for small and medium sized companies, which generally have to set up the necessary procedures and committees from scratch. Many private firms have delayed or cancelled going public as a result, and some public firms have considered de-listing.[32]

The SEC has responded sympathetically to companies' concerns on the whole, seeking to balance the continuing need for investor confidence with a realistic assessment of the difficulties of compliance. At several points it has issued clarifications aimed at making the process more efficient, including setting up a task force to explore the difficulties faced by smaller companies. In September 2005 it exempted companies with a market capitalization of under $75 million from compliance with Section 404 until after June 2006.[33] It also granted the same extension to foreign companies, including European ones. This process of accommodation will need to continue if the SEC wants to avoid further backlash in 2006.

On some other issues the regulators have given ground to business interests. One is the treatment of stock options, which reappeared on the policy agenda after the scandals of 2000-1. In December 2004 the FASB ruled that options be considered a normal business expense and accounted for in the income statement. However the decision ran into strong opposition from technology companies, which were able to delay its introduction for six months. Perhaps more worryingly for investors, the SEC has also been forced to stand down on proposals to give minority shareholders more powers to nominate directors. And in March 2005 measures that would have made it more difficult for companies and executives to shelter assets from creditors in the event of bankruptcy were blocked by Republicans in the Senate.[34]

But despite these setbacks it appears that the main provisions of Sarbanes-Oxley are here to stay. There has been no serious suggestion from executives that Congress revise the law—merely, that regulators provide sufficient guidance and time for companies to comply with it. Moreover, the institutional investors who bear the ultimate cost of compliance continue to be supportive of the legislation and are unlikely to countenance any backsliding without a fight. Though the political will for further reform is weak, there is little likelihood of Congress undoing what has already been done.

Open Questions for U.S. Corporate Governance

SOA represents the most significant overhaul of corporate governance legislation in the United States since the 1930s. Nevertheless the task of reforming the system is not yet complete. The following issues still require attention:

- Foreign listings: There have been concerns that foreign companies will find it less attractive to list on U.S. exchanges. The most important reason has been the cost of compliance with Section 404 of SOA. But there are also other issues involved, among them the risk of lawsuits by investors, since U.S.-listed companies are liable under U.S. law. This has led to concerns that European markets, in particular the London Stock Exchange, may attract business away from the NYSE and NASDAQ. However, delisting in the United States is not as simple as it might seem.[35] Companies considering it should be aware that most European exchanges are also tightening their rules to increase checks on executives, raise auditing standards and improve disclosure. Furthermore, European companies seen as deliberately opting for a weaker control regime may find they experience a sharp increase in their cost of capital.

- International accounting standards: The scandals of 2000-2 exposed serious weaknesses in US GAAP. In particular, they demonstrated the vulnerability of a rules-based accounting system to manipulation by fraudulent executives. SOA therefore required the SEC to study the possibility of a transition to a principles-based system for U.S. companies, similar to that used in the United Kingdom and proposed by the IASB. The result was to encourage cooperation between the U.S. FASB and international standards setters. Indeed most of the recent opposition to the IASB's work has come from European, not U.S. regulators and companies. And in April 2005, the SEC said that it was ready to release U.S.-listed European companies from the need to restate in US GAAP to by 2007 at the earliest and 2009 at the latest.[36] It therefore seems more likely that the United States will move in the direction of IAS than vice versa.

05

CHAPTER FIVE

CONCLUSION AND POLICY RECOMMENDATIONS

The basic conclusion of this report is that the search for a “good system of corporate governance” is not yet finished, and is likely to be a major public policy problem for the foreseeable future. Both the United States and Germany have taken steps in corporate governance reform in an effort to achieve policy goals. However, these goals have been only partially fulfilled, and the search for new solutions will continue.

We believe that this involves a combination of further innovation and experimentation in conjunction with a more realistic set of expectations about what corporate governance reform can reasonably be expected to achieve. In particular, we make the following recommendations:

- Recommendation #1: Efforts to coordinate and harmonize corporate governance regulation for the largest, internationally active companies should be strengthened. However, the cost impact of regulatory compliance on companies should be more seriously considered.

The process of internationalization in the investor base of the largest listed companies appears to continue, even if not at the pace of the late 1990s. Many large companies report that the proportion of foreign investors in their shareholder base continues to increase. Many large institutional investors want to further increase the proportion of assets allocated to foreign shares and to adopt international indexes (such as MSCI - Morgan Stanley Capital International indexes, or FTSE – Financial Times Stock Exchange indexes) instead of national indexes as their investment benchmarks.

This process of internationalization, however, appears to be hindered by continuing regulatory differences between the countries. In particular, non-U.S. countries need to increase the degree of legal protection for minority shareholders. The United States, on the other hand, should consider the adoption of international accounting standards (at least for its largest listed companies), or at a minimum encourage the convergence of US GAAP towards international accounting standards. Internationalization can best be supported by promoting harmonization or convergence for the corporate governance framework for this type of company.

However, greater consideration should be given to the costs of regulatory compliance for companies. A frequently-made criticism of the Sarbanes-Oxley Act is that the costs of some of its provisions, particularly of Section 404, are out of line with potential benefits. The Sarbanes-Oxley Act should therefore be revised with a view to bringing costs more in line with benefits. Although German companies have by and large not complained about the costs of regulatory compliance in Germany, nevertheless German policymakers should pay greater attention to the cost issue when considering further legislative measures.

- Recommendation #2: Consideration should be given to strengthening the “two tier” nature of corporate governance systems in Germany and the United States in order to improve startup firms’ access to capital without undermining investor confidence.

A strong tendency in modern legal systems is to try to achieve equal treatment and equal protection for all individuals and firms. However, with the further development of financial systems, there appears to be increasing differentiation between different classes of investors in the financial world. The needs of investors in large, stable firms are quite different than the needs of investors in smaller, generally higher risk firms.

The type of corporate governance regime promoted by Sarbanes-Oxley and similar legislation is most suited to investors in large companies, which can be better monitored through frequent and transparent quantitative financial reporting. Internationalization in the investor base is growing most rapidly for these types of companies, since large institutional investors increasingly avoid investing in smaller and mid-size companies. The costs of monitoring individual companies are more or less fixed, but the size of investments large investors can make in smaller companies is limited, since institutional investors generally wish to avoid making investments of more than 1-2 percent in any one company.

Policymakers in Germany and the United States should therefore consider whether strengthening "dual" elements of corporate governance systems would be desirable, i.e. to create one "higher standard" (but more costly) regime for larger, more international companies, and one "lower standard" (less costly) regime for smaller, domestically oriented companies. Since smaller companies are generally more risky anyway, this explicit recognition of two classes of investors (and the companies they invest in) would help close the gap between formal regulation and actual reality. This would help reduce the regulatory burden and costs on smaller listed companies, which are hit the hardest by SOA in the United States, and the lack of new equity capital in Germany. The experience in Germany, where the corporate governance regime has traditionally relied more on large shareholders with close links to firms, could be helpful in designing such a regulatory system especially oriented towards smaller companies.

- Recommendation #3: Attention should be partially shifted from the legal framework to the problem of "liquidity" on financial markets.

In Germany, as well as in many other European countries with stakeholder corporate governance systems, household "equity culture" seems to have taken a step backwards, despite the introduction of significant regulatory reforms. Smaller firms in particular have been hit by this development, since larger firms have been able to attract a certain amount of foreign investors to compensate for the loss in domestic investment.

We believe this stems in part from too much emphasis on legal regulation, and conversely too little attention to the sources of "liquidity" (i.e. new investment) on stock markets. Legal reforms can only have a certain amount of success in encouraging new investment, if funding flows are not directed towards investors of the kind that are willing to invest in the stock market. In particular, countries with a strong "equity culture" (the United States, UK, Canada, Australia, etc.) have generally emphasized much more private (rather than public) retirement savings, and have encouraged households to accumulate their savings in investment vehicles that put a major proportion of their funds in the stock market.

This is a problem in Germany, since retirement savings is still overwhelmingly provided through a pay-as-you-go public social security system. As a result, very little money has been accumulated in pension funds, or in savings vehicles comparable to the U.S. 401(k) plans, which invest to a large degree in the stock market. Policymakers in Germany need to recognize that encouraging a strong equity culture requires more legislative steps to support private retirement savings vehicles.

- Recommendation #4: Current discussion of corporate governance reform is too focused on shareholder rights. A better balance should be achieved between shareholder rights and shareholder responsibilities.

Current discussion of corporate governance reform, particularly in Germany, is focused very much on strengthening the rights of institutional investors vis-à-vis management. Much less discussion focuses on the rights of households vis-à-vis institutional investors. Although the United States has set a high standard for financial reporting for mutual funds (i.e. quarterly reporting on all investments), other important financial investors (in particular hedge funds) have much lower reporting standards. The requirements for reporting by German institutional investors also fall far behind the reporting standards for U.S. mutual funds.

In order to help restore household trust in financial markets, households need to be reassured that institutional investors are acting in their interests, rather than against their interests. The characterization in Germany of foreign investors (hedge funds and private equity funds) as "locusts," which apparently was popular among the voters of the Social Democratic party, reflects the skepticism of German households with regard to this issue. An important step in the direction of restoring household confidence in the stock market would be to require the same level of transparency and disclosure for institutional investors as is currently being required for listed companies.

- Recommendation #5: Expectations of what can be achieved through corporate governance reform should become more realistic, and other alternative approaches strengthened.

One issue is that the incentives that are supposed to help align management and shareholder interests may be part of the problem. Linking a greater proportion of management remuneration to share price performance may make management more responsive to shareholder interests, but at the same time it may also increase the incentives of management to inflate share prices or misrepresent company performance. Thus corporate governance measures should be linked with an emphasis on improving internal company controls to help increase the probability that wrongdoing will be deterred or discovered at an early stage. The issue of strengthening the culture of management ethics, as currently being discussed at a number of business schools, is also an approach that should be seriously considered.

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NOTES

1 An earlier report for AICGS by the same authors (2004) explored the tensions in the U.S.-German relationship caused by these reform efforts, as well as possible solutions to these tensions. This second report, written almost two years later, also addresses corporate governance, but focuses instead of the perceived effectiveness of the reforms.

2 http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0704en01.pdf, 6.

3 See here for example Lutz Engelhardt, "Entrepreneurial Business Models in the German Software Industry: Companies, Venture Capital, and Stock Market Based Growth Strategies on the 'Neue Markt'." *Competition and Change* 8 (4) (2004); and Sigurt Vitols and Lutz Engelhardt, *National Institutions and High Tech Industries: A Varieties of Capitalism Perspective on the Failure of Germany's "Neuer Markt"* Berlin: Wissenschaftszentrum Berlin Discussion Paper SP II (2005) 3.

4 Earnings restatements by U.S. companies rose from an average of 49 a year during 1990-7 to 156 in 2000 and 414 in 2004. A study by the U.S. General Accounting Office found that the average restating firm lost 10 percent of its market capitalization in the three days surrounding the announcement—strongly suggesting that the market regarded such restatements as indicative of fraud. Coffee, 2005, 3-4.

5 "Collateral Damage: The Scandal at Volkswagen taps into two German Taboos," *Financial Times*, 13 July 2005.

6 See for instance, http://www.oecd.org/document/42/0,2340,en_2649_34813_2048554_1_1_1_1,00.html

7 See http://www.fasb.org/project/conceptual_framework.shtml#highlights

8 The IASB has also run into difficulties in Europe, particularly in the UK, where it has been criticized for adopting an overly complex and technical approach to standards setting. Barney Jopson, "Shareholder Body Criticizes New Reporting Rules on Accounts," *Financial Times*, 10 November 2005.

9 For an overview of these developments, see http://www.euractiv.com/Article?tcmuri=tcm:29-137147-16&type=LinksDossier

10 Tobias Buck, "More Companies Reveal Social Policies," *Financial Times*, 15 June 2005.

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17 Sigurt Vitols and Lutz Engelhardt, *National Institutions and High Tech Industries: A Varieties of Capitalism Perspective on the Failure of Germany's "Neuer Markt,"* Berlin: Wissenschaftszentrum Berlin Discussion Paper SP II 2005, 3.

18 The opinion survey was commissioned by the trade union-oriented Hans Böckler Foundation, and is available under the website www.boeckler.de

19 Theodor Baums and Bernd Frick, "Codetermination in Germany: The Impact of Court Decisions on the Market Value of the Firm." *Economic Analysis* 1 (2):143-161.

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27 Some of the more prominent financial and accounting scandals in the United States were: Enron, Nortel, Lucent, Qwest, Global Crossing, Adelphia, WorldCom, Rite Aid, Xerox, Computer Associates, AOL Time Warner, HealthSouth, and Hollinger. For updated information see for example CBS Marketwatch Corporate Scandal Sheet http://www.marketwatch.com/news/features/scandal_sheet.asp

28 See here in particular the work of John Coffee, Law Professor at Columbia University. John C. Coffee, *What Caused Enron? A Capsule Social and Economic History of the 1990s*. Columbia Law and Economics Working Paper No. 214 (2003), John C. Coffee, *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*. Columbia Law and Economics Working Paper No. 274, March 2005.

29 Thomas E. Hartman, *The Cost of Being Public in the Era of Sarbanes-Oxley* (Foley & Lardner LLP, 2005).

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31 Dan Roberts, "GE Says it Faces $30m Bill for Governance," *Financial Times*, 29 April 2004.

32 According to the FEI Survey, 20 percent of respondents said they were considering going private as a consequence of high corporate governance costs.

33 See http://www.sec.gov/news/press/2005-25.htm. These companies account for less than 5 percent of the market by capitalization but around two thirds of the number of listed companies. Floyd Norris, Guidelines Aim to Ease Accounting Costs for Small Companies, *New York Times*, 27 October 2005.

34 Stephen Labaton, “A New Mood in Congress to Forgo Corporate Scrutiny,” *Financial Times*, 10 March 2005.

35 In principle it is not allowed as long as there are more than 300, or in some cases 500, U. S. shareholders for a given company. Since large foreign companies typically have thousands of U.S.-based shareholders, this makes it virtually impossible for such a company to de-list from a U.S. exchange.

36 See http://www.sec.gov/news/speech/spch040605dtn.htm. This speech by SEC Chief Accountant Donald T. Nicolaisen also sets out a possible roadmap for convergence.

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