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The European Corporate Governance Framework: Issues and Perspectives

Law Working Paper N°. 214/2013
May 2013

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Abstract

This is the first chapter in a volume on "Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms" (M. Belcredi and G. Ferrarini eds., Cambridge University Press forthcoming 2013). We offer an overview of the volume, placing the same in the context of recent EU reforms and of corporate governance theory, and summarizing the main outcomes of the various chapters. In addition, we offer some policy perspectives based on the theoretical and empirical outcomes of the research project of which this volume is the product. We analyse four main topics in the corporate governance of European listed firms: board structure/composition and its interaction with ownership structure, board remuneration, shareholder activism and corporate governance disclosure based on the "comply-or-explain" approach. For each of them, this volume provides new evidence and derives specific implications, relevant for the policy debate. Basically, proposals aimed at increasing disclosure and accountability at the European level look generally well-grounded: this is true, in particular, for disclosure about managerial compensation and compliance with national governance codes based on the "comply-or-explain" principle. On the opposite, we suggest caution when evaluating proposals targeting specific governance arrangements, which may actually lead to unintended consequences. Even though the Commission has – so far – refrained from adopting an excessively intrusive stance, further analysis may be needed before intervening in the fields of board composition and shareholder activism.

Keywords: Board of Directors, Active Shareholders, General Meeting, Corporate Governance

JEL Classifications: G34, G38, K22.

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Abstract

This is the first chapter in a volume on "Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms" (M. Belcredi and G. Ferrarini *eds.*, Cambridge University Press forthcoming 2013). We offer an overview of the volume[3], placing the same in the context of recent EU reforms and of corporate governance theory, and summarizing the main outcomes of the various chapters. In addition, we offer some policy perspectives based on the theoretical and empirical outcomes of the research project of which this volume is the product. We analyse four main topics in the corporate governance of European listed firms: board structure/composition and its interaction with ownership structure, board remuneration, shareholder activism and corporate governance disclosure based on the "comply-or-explain" approach. For each of them, this volume provides new evidence and derives specific implications, relevant for the policy debate. Basically, proposals aimed at increasing disclosure and accountability at the European level look generally well-grounded: this is true, in particular, for disclosure about managerial compensation and compliance with national governance codes based on the "comply-or-explain" principle. On the opposite, we suggest caution when evaluating proposals targeting specific governance arrangements, which may actually lead to unintended consequences. Even though the Commission has – so far – refrained from adopting an excessively intrusive stance, further analysis may be needed before intervening in the fields of board composition and shareholder activism.

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1. Introduction

1.1. Purpose and scope

In this chapter, we offer an overview of the present volume, placing the same in the context of recent EU reforms and of corporate governance theory and summarising the main outcomes of the following chapters. In addition, we offer some policy perspectives – as to boards, incentive pay and shareholder activism – based on the theoretical and empirical outcomes of the research project of which this volume is the product. In drawing such a broad picture, we particularly underline that variances in ownership structures of listed companies and in the adoption of either a shareholder value or a stakeholder approach have pervasive implications for corporate governance issues. For example, board composition criteria may reflect a stakeholder orientation, such as that found in the German codetermination system (Schmidt 2004). Also the board's function, the role of independent directors and incentive pay arrangements may vary depending on whether diffuse shareholders or blockholders own the company. Similarly, diffuse ownership companies represent the natural setting for shareholder activism, which may not be a cost-effective solution in controlled corporations[3].

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

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

approach in order to catch the richness of governance models and diversified experiences (as particularly shown by the study of family firms in chapter 3).

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

1.2. EU Reform

In the present paragraph, we review the legal reforms that approached EU corporate governance since the beginning of the current century. These reforms addressed the main corporate governance failures which governments and legislators identified in the 2001-2002 corporate scandals and the 2008 financial crisis (Enriques and Volpin 2007; Bainbridge 2012). Similar failures affected both the internal governance structures of corporations – including those relating to the audit of accounts – and the essential mechanisms for capital market efficiency, such as securities underwriters, financial analysts and rating agencies (Gilson and Kraakman 2003; Skeel 2012). This chapter focuses mainly on corporate boards and shareholders, in line with the rest of this volume. Indeed, boards have a key governance role and perform monitoring and advisory tasks with respect to firm's managers. Shareholders have fundamental governance rights, including that of appointing the board, which derive from their function as residual risk-bearers. In line with recent Commission Green Papers, this chapter and

the whole volume take into consideration both shareholder activism (which mainly occurs in diffuse ownership companies) and the protection of minority shareholders (which typically concerns controlled corporations).

1.2.1. After Enron

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

Wide reforms were sought both at EU and domestic levels, often modelled along the US Sarbanes-Oxley Act, which had however been enacted in a remarkably brief period, with minimal legislative processing (Bainbridge 2012). The European response to the financial scandals was relatively less hasty, given that the epicentre of the 2001-02 turmoil had been the US and also considering the more complex political process for EU legislation. Moreover, the final response in Europe was not as strong and pervasive as that in the US (Ferrarini *et al.* 2004). The EU Action Plan was set by the 2003 Communication from the Commission on *Modernising Company Law and Enhancing Corporate Governance in the European Union*[4], which was prepared on the basis of a report by the High level group of company law experts appointed by Commissioner Bolkestein and chaired by Jaap Winter ("Winter Report")[5]. The Commission's Action Plan envisaged four main pillars for corporate governance reform.

(i) The first referred to *enhancing corporate governance disclosure*, with the argument that more than forty corporate governance codes had been adopted in Europe, their contents

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

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

being widely convergent, however "information barriers" undermined shareholders' ability to evaluate the governance of companies. The Commission proposed that companies be required to include in their annual reports and accounts a comprehensive corporate governance statement covering the key elements of their corporate governance structures and practices. This statement should carry a reference to a code on corporate governance, designated for use at national level, that the company complies with or in relation to which it explains deviations. This proposal led to the adoption in 2006 of new Article 46a of Directive 78/660/EEC on the annual accounts of certain types of companies, which required companies with securities admitted to a regulated market to publish a corporate governance statement in their annual report[6]. The content and implementation of the EU "comply or explain" principle are briefly analysed in the following paragraph and more extensively in chapter 2.

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

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

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

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

board members for key financial and non-financial statements should be clearly recognised under national legal systems.

The proposals relative to board composition found detailed specification in the Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board[8] (briefly commented upon under para. 4.2.); the proposals relative to directors' remuneration found specification in Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (para. 5.2. and chapter 6); and those on collective responsibility were translated into Articles 50b and 50c of Directive 78/660/EEC on the annual accounts of certain types of companies[9].

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

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

1.2.2. The recent financial crisis

It is uncertain whether and to what extent corporate governance contributed to the recent financial crisis. While policy makers generally offer a positive answer (Kirkpatrick 2009), the topic is still debated amongst academics. For sure, a distinction should be made between financial institutions – banks in particular – and other companies, given that the former were at the epicentre of the financial crisis, both in the US and in Europe, while non-financial companies were affected by the crisis but did not show risk management or other governance

[8] O. J. 25.2.2005, L 52/51.

[9] See Article 1, para. 8 of Directive 2006/46/EC (note 6 above), inserting a new Section 10A (Duty and liability for drawing up and publishing the annual accounts and the annual report) in the Directive on annual accounts.

failures similar to those experimented by financial institutions (Cheffins 2009). Moreover, empirical research has proven that banks which failed in the crisis had adopted "good" corporate governance standards (Beltratti and Stulz 2012). However, other research has shown that banks which fared better in the crisis had better risk management systems in place, suggesting that the criteria defining "good" governance need to be reconsidered (Ellul and Yerramilli 2012). The European Commission sided with governments and international organisations arguing that corporate governance had failed in the crisis, but appropriately distinguished between financial institutions and other firms. Two Green Papers were therefore published, one in 2010 on *Corporate governance in financial institutions and remuneration policies*[10] and the other in 2011 on *The EU corporate governance framework*[11].

The 2010 Green Paper was part of a programme for reforming the regulatory and supervisory framework of financial markets announced in a Commission Communication of 4 March 2009[12], which was based on the conclusions of the de Larosière report[13]. In the Green Paper's introduction, the Commission stated: "As highlighted by the de Larosière report, it is clear that boards of directors, like supervisory authorities, rarely comprehended either the nature or scale of the risks they were facing. In many cases, the shareholders did not properly perform their role as owners of the companies. Although corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed significantly to excessive risk-taking on the part of financial institutions". This statement helps understand the remaining contents of the Green Paper, which include the role and composition of the (supervisory) board; risk management as a key aspect of corporate governance; appropriate shareholder monitoring and the role of supervisory authorities with respect to the internal governance of financial institutions. We pay some attention to the specificities of bank governance in para. 1.3.2. and to the role of banking regulation and supervision in para. 2.4.. However, the discussion found in the 2010 Green Paper largely overlaps with the analysis developed in the 2011 Green Paper, so that they can be bundled in our analysis.

Indeed, the 2011 Green Paper extends the arguments applicable to financial institutions to other firms, assuming that "corporate governance is one means to curb harmful short-termism

[10] COM(2010) 284 final.
[11] COM(2011) 164 final.
[12] COM(2009) 114 final.
[13] Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009, http://ec.europa.eu/internal_ market/finances/docs/de_larosiere_report_en.pdf .

and excessive risk-taking" for firms in general and suggesting that the Green Paper should "assess the effectiveness of the current corporate governance framework for European companies". Similar to the 2003 Commission Communication on *Modernising company law*, the 2011 Green Paper focuses on the *board of directors*, emphasising that "effective boards are needed to challenge executive management"; on *shareholders*, arguing that they must "engage with companies and hold management to account for its performance"; and on the *"comply or explain" approach*, claiming that the informative quality of explanations published by companies is "not satisfactory" and the monitoring of the codes' application is "insufficient". We shall make specific references to the 2011 Green Paper throughout the present chapter, highlighting some of its main features in connection with the individual topics touched upon in our analysis.

1.3. Varieties of corporate governance

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

1.3.1. Shareholder v. stakeholder governance

There is no clear-cut, generally accepted definition of corporate governance. Many definitions are found in the academic literature and in codes of best practice, but differences, though rarely spelled out, are substantial. The dominant approach in the financial literature (Tirole 2006) focuses on the relationship between firms and suppliers of funds (debt and equity). An often cited work argues that "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return to their investment" (Shleifer and Vishny 1997). In other words, corporate governance concerns how corporate insiders can credibly commit to return funds to investors, so as to attract outside financing.

Suppliers of debt and equity may benefit from several control mechanisms, based on either *legal protection* (through contract and/or regulation) or *sheer power* deriving from concentration of claims.

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

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

(Kirkpatrick 2009; Beltratti and Stulz 2011; Fahlenbrach and Stulz 2011; Admati *et al.* 2012; Becht *et al.* 2012).

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

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

1.3.2. Bank governance

Banks are different from other firms for several reasons that matter from a corporate governance perspective (Adams and Mehran 2003; Macey and O'Hara 2003; Mülbert 2010; Ferrarini and Ungureanu 2011). First, they are more leveraged than other firms, with the consequence that the conflict between shareholders and fixed claimants, which is present in all corporations, is more acute for banks. Second, banks' liabilities are largely issued as demand deposits, while their assets, such as loans, have longer maturities. The mismatch between liquid liabilities and illiquid assets may become a problem in a crisis situation, as we vividly saw in the recent financial turmoil, when bank runs took place at large institutions, threatening the stability of the whole financial system. Third, despite contributing to the prevention of bank runs, deposit insurance generates moral hazard by incentivizing shareholders and managers of

insured institutions to engage in excessive risk-taking (Corrigan 1982; 2000). Moral hazard is exacerbated when a bank approaches insolvency, because shareholders do not internalize the losses from risky investments, but instead benefit from potential gains (for example, by having an implicit put option at strike price zero) (Macey and Miller 1992; Polo 2007). While risk taking by non-bank corporations close to insolvency is constrained by market forces and contractual undertakings, banks in a similar condition can continue to attract liquidity, thanks to deposit insurance (Macey and O'Hara 2003; Sorkin 2009). Fourth, asset substitution is easier in banks than in non-financial firms (Levine 2004). This allows for more rapid risk-shifting, which further increases agency costs between shareholders and stakeholders (and bondholders and depositors in particular). In addition, banks are more opaque – it is difficult to assess their risk profile and stability. Information asymmetries, particularly for depositors, hamper market discipline and, in turn, increase managers' moral hazard.

For all these reasons, "good" corporate governance (that is aligning the interests of managers and shareholders) may lead bank managers to engage in more risky activities (Laeven and Levine 2009), since a major part of the losses would be externalized to stakeholders, while gains would be internalized by shareholders and managers (if properly aligned by the right incentives). Prudential regulation and supervision aim to reduce the excessive risk propensity of shareholders and managers in order to guarantee the safety and soundness of banks. An exogenous regulatory cost is allocated on excessively risky behaviour of bank managers, reducing agency costs between shareholders and stakeholders.

Recent empirical research confirms that "good" governance may not be enough for bank soundness. Beltratti and Stulz (2012) investigate whether banks' poor performance in the recent crisis was the outcome of a financial Tsunami that hit them unexpectedly or the result of some banks being more inclined to experience large losses. The authors analyse possible determinants (regulation, corporate governance, balance sheet and income characteristics) of bank performance measured by stock returns during the crisis for a sample of ninety-eight large banks across the world, of which nineteen are U.S. banks. They find no evidence for the thesis advanced in a report by the Organization for Economic Co-operation and Development (OECD)[14] that the financial crisis can be, to an important extent, attributed to failures and weaknesses in corporate governance arrangements (Kirkpatrick 2009). In particular, they find

[14] OECD, Corporate Governance and the Financial Crisis: Key Findings and Main Messages, June 2009.

no evidence that banks with better governance performed better during the crisis. On the contrary, banks with more pro-shareholder boards performed worse.

Adams (2009) reaches similar results assessing to what extent the crisis can be attributed to bad governance of financial firms. She shows that banks receiving bailout money from the U.S. government under the Troubled Asset Relief Program (TARP) had more independent boards, larger boards, more outside directorships for board members, and greater incentive pay for CEOs than non-TARP banks. Except for the finding of more independent boards, these results are consistent with the idea that TARP banks had worse governance. However, Adams (2009) finds it striking that TARP banks had boards that were more independent. One explanation could be that independent directors are less likely to have in-depth knowledge of their banks and the financial expertise to understand complex transactions like securitizations. In other words, greater independence may be detrimental for a bank board because a more independent board will not have sufficient expertise to monitor the actions of the CEO.

The criteria for examining corporate governance employed by the studies mentioned above are open for debate. For instance, independent directors are used as a proxy for good monitoring by the board, but this monitoring depends on professional qualities and levels of engagement in board activities that are not necessarily captured by current definitions of independence (Ferrarini and Ungureanu 2011). Similarly, international corporate governance indexes make reference to aspects such as internal controls, which do not necessarily reflect the detailed requirements for proper monitoring of complex risk management processes by a bank board (Bhagat *et al.* 2008; Stulz 2008). Thus, while establishing a prima facie case for excluding corporate governance as a main determinant of the crisis, the above studies cannot be used for asserting that what appeared to be "good" governance at banks that failed was satisfactory in practice and in no need of reform. A similar statement calls for proof that banks failed despite best monitoring efforts deployed by their boards, a proof no doubt difficult to offer, particularly in light of the egregious risk management failures seen in most troubled banks (Senior Supervisors Group 2008; Stulz 2008). Moreover, recent empirical research proves that banks that had strong risk control systems in place – as measured by the importance attached to the risk management function within the organisation and, in particular, by the existence and role of the Chief Risk Officer – were more judicious in their exposure to risky financial instruments before the crisis and, generally, fared better post-crisis (Becht *et al.* 2012; Ellul and Yerramilli 2012).

2. Controlling agency costs

Agency problems stem from the information asymmetries characterising modern business, which create an opportunity for principals to hire better informed agents[15]. However, specialisation comes at a cost. The delegation of discretionary powers, which are necessary to exploit the agents' superior capabilities, carries conflicts of interest. Agency costs include those of writing and enforcing contracts. First, there are the costs of structuring, monitoring, and bonding contracts with conflicted agents. Second, output is lost whenever the costs of full enforcement would exceed the benefits (Fama and Jensen 1983). Several mechanisms and institutions keep agency problems under control. In this paragraph, we consider the impact of product and financial markets; the role of corporate law; soft-law and the related "comply or explain" mechanism; and the impact of prudential regulation on banks' internal governance.

Two preliminary remarks are, however, necessary with reference to corporate law and its impact on European corporate governance. The first is that the EU dimension of the topic adds an additional complexity, to the extent that not all cases in which corporate law has a role to play are also cases in which EU intervention is appropriate. Under the subsidiarity principle (Article 5 TEU), legal harmonisation should only occur when national legislation is unfit to address existing cross-border externalities (ECLE 2011). This explains why the role of European corporate law is rather limited and its impact on corporate governance overall modest with respect to the role played by national legislation and case law (Enriques and Volpin 2007). The second remark is that EU law acknowledges the importance of soft law in corporate governance and attempts to enhance, particularly through disclosure ("comply or explain"), the role of private codes. This reflects a general trend in Europe, given that codes of best practice are widely employed to address corporate governance issues in Member States; on the other

[15] Agency problems come in many guises. Tirole (2006) offers the following classification: a) insufficient effort, such as leisure on the job and inefficient allocation of work time to various tasks; b) extravagant investments, like suboptimal allocation of capital – i.e. negative NPV decisions – due to conflicts of interest; c) entrenchment strategies, including actions taken by the managers to secure their own position, without regard to the impact of the same on company value; and d) self-dealing, ranging from benign to illegal activities, such as consumption of perquisites, tunnelling and other behaviours including thievery. Roe (2005) groups agency costs in two main categories: "stealing and shirking", i.e. expropriation and waste of resources.

hand, it may also be seen as a reflection of the inherent limits of EU powers in this area, since EU legislation can easily cover disclosure by European listed issuers, but would find more problematic to directly address the typical agency issues affecting internal corporate governance. The recourse by the Commission to non-binding instruments, such as the 2004, 2005 and 2009 Recommendations examined in this chapter, confirms this approach (Armour and Ringe 2011).

2.1. Market solutions

Competition in the product and factor markets may reduce the most serious agency costs, to the extent that inefficient firms do not survive. In other words, competition has a disciplinary function, pushing firms and managerial teams to seek efficient performance (Fama 1980)[16]. Financial markets also play a role in reducing agency costs. A firm tapping the market for new resources is subject to the scrutiny of potential investors. Therefore, it issues new information about its current management and perspectives and possibly about corporate governance arrangements. In addition, market prices generate incentives to value maximisation. If agency costs are perceived as low by investors, the price of the firm's securities will be enhanced. Furthermore, well-developed financial markets allow to re-package expected cash-flows and to restructure the set of financing contracts, so as to minimise agency costs (Barnea *et al.* 1981)[17].

The market for corporate control concurs to reduce agency costs. Both theory and evidence support the idea that hostile takeovers may solve governance problems (Manne 1965; Jensen 1988; Scharfstein 1988). Takeover targets are often poorly performing firms and their managers are removed once the takeover succeeds. A different view, focussing on the UK,

[16] The true extent to which agency costs are limited by product markets is disputed. Jensen and Meckling (1976) argue that: "If my competitors all incur agency costs equal to or greater than mine I will not be eliminated from the market by their competition". Jagannathan and Srinivasan (2000) produce evidence consistent with a disciplinary role of competition in product markets.

[17] Financial structure decisions may reflect the relative pros and cons of debt and equity in controlling conflicts of interest: debt is more appropriate where free cash flow production is high, since it forces management to seek approval (and re-financing) for new investment projects; on the opposite, equity financing is more appropriate where free cash flow production is lower (and/or unstable), since the risk of leniency in corporate decisions is naturally lower and lower leverage allows to reduce the risk of costly bankruptcy. An inefficient financial structure (implying higher than necessary agency costs) may be easily restructured by the firm's management or by a large investor buying out – at market prices – all the securities issued by the firm, which could then switch to the most efficient solution.

argues that hostile takeovers are not so much about correcting poor performance, but changing the strategy of middle of the road performers, so that they become top performers (Franks and Mayer 1996; Mayer 2013). In general, unfriendly takeovers are widely seen as a corporate governance mechanism directed to control managerial discretion where ownership is dispersed (Easterbrook and Fischel 1991). At the same time, bidder decisions may also be affected by agency problems (Masulis *et al.* 2007), while hostile takeovers may transfer wealth from stakeholders to shareholders of target firms (Shleifer and Summers 1998). However, in corporate systems like those prevalent in continental Europe, where controlling shareholders are often the norm in listed companies, the role of hostile takeovers is naturally limited, while mandatory bids contribute to protecting minority investors by granting the same a right of exit in change of control situations (Ferrarini and Miller 2010).

Also the market for managerial labour may play an important role, for individual managers are disciplined by competition from within and outside the firm. Compensation packages for managers, both incumbent and recruited on the job market, represent a market price for their services. If remuneration fully reflected a manager's past/expected performance, including possible misbehaviour, the value of human capital would be adjusted accordingly and the moral hazard problem would disappear (Jensen and Meckling 1976). However, the managerial labour market does not exert this disciplinary role perfectly, especially when managers have a short residual work life (Fama 1980). Moreover, the idea that remuneration is the result of arm's length contracting has been recently criticised, to the extent that the setting of pay may be influenced by the executives through capturing of the board or as a result of information asymmetry (Bebchuk *et al.* 2002; Bebchuk and Fried 2004), especially where shareholders are weak and dispersed (see Sections 3 and 5 below).

2.2. Corporate law

Market solutions do not eliminate agency problems altogether in the real world because financial, product and labour markets are not perfectly information-efficient. If prices do not incorporate the information available to individual agents in a timely and correct manner, they will not provide a complete solution to agency problems (Barnea *et al.* 1981). Indeed, distorted prices produce a distorted set of incentives, aggravating the agency problems that the relevant markets would otherwise reduce. As we shall see in section 5, for instance, CEO incentive pay

packages may give rise to agency problems rather than reducing the ones that they were intended to cure.

Similar market failures explain why corporate law affords protection to outside investors, such as shareholders and creditors. In general, corporate law sets the requirements and limits to contracts that may be entered into by private parties. State powers are also available to the same parties for enforcing contractual performance and/or the collection of damages for non-performance. All this affects both the kinds of contracts that are executed and the extent to which contracting is relied upon (Jensen and Meckling 1976). Of course, this mechanism is more effective to the extent that the contracts at issue are "complete".

However, legal protection may go far beyond guaranteeing compliance with contractual clauses explicitly stipulated by the parties (Armour *et al.* 2009b). Mandatory rules requiring or prohibiting some types of agents' behaviour may be dictated (Coffee, 1989; Gordon 1989). As a result, agents and principals do not need to negotiate detailed provisions in their contracts, and transaction costs are minimised. Furthermore, when discretion is given to an agent, the law offers standards (rather than rules) against which the agents' behaviour will be adjudicated *ex post* (Kaplow 1992). Fiduciary duties - like the duty of care and that of loyalty, as specified by the courts - provide a set of incentives even in the absence of a contractual clause (Easterbrook and Fischel 1991)[18].

Nonetheless, there are limits to corporate law as a mechanism for controlling agency costs other than "stealing". No doubt, well-structured (and thoroughly enforced) corporate law provisions may deter controlling shareholders from diverting value to themselves and managers from putting firm assets into their own pockets. However, corporate law is less effective in preventing the sheer mismanagement of corporate resources ("shirking") (Roe 2002). The US business judgment rule and its equivalents in European jurisdictions typically insulate directors and managers from courts' interference, absent fraud or conflict of interest, exempting them from *ex post* legal scrutiny (Hopt 2011)[19]. Indeed, courts regularly second-guessing managers would be a cure worse than the disease, for judges are generally less informed than managers

[18] The protection afforded by legal standards of conduct is lower than that offered by rules. Since standards are general, their enforcement is problematic. Their aggressive enforcement may discourage risk-taking and favour conformism, ultimately damaging the principles.

[19] In Germany the business judgment rule is embodied in statute law rather than being solely a creation of the courts (as in the US and other countries). In countries like the UK, the business judgement rule is not stated explicitly, but seems to emerge from the courts' lack of willingness to review management business decisions in the absence of conflicts of interest (Enriques *et al.* 2009).

and lack the incentives to take business decisions. Furthermore, judges may be affected by hindsight bias, finding reckless *ex post* managerial conduct which was perfectly reasonable when performed. As a result, if systematic review of business decisions by the courts were permitted, the incentives inherent to agency relationships would be inevitably distorted (Rock and Wachter 2001).

2.3. "Comply or explain"

Since informational asymmetry characterises agency relationships, disclosure is crucial for controlling the related costs. *Ex ante* disclosure allows prospective principals to select agents on the basis of their intrinsic qualities and to better decide on which terms the agency relationship should be entered into. *Ex post* disclosure is crucial for enforcement, as principals can better detect contract violations, or deviations from the expected standards of conduct. Even in the absence of a breach, informed principals can revise their expectations about the risks and rewards of the agency relationship and take appropriate actions (Mahoney 1995).

The "comply-or-explain" principle – which is widely applied in Europe and was harmonised under the 2006 Directive cited above (para. 1.2.1.) – reflects this "governance" function of disclosure (Kraakman 2004). Listed companies must state whether they apply a corporate governance code, specify if they comply with its provisions and, in case of non-compliance, explain the reason for their choice. The need for disclosure, combined with obvious reputational concerns – most firms want to appear good at corporate governance or at least do not want to appear non-compliant with best practices – push companies to comply with a code that, however, remains voluntary in nature. Therefore, disclosure performs a "legislative" function by lending support to soft law and its enforcement (Kraakman 2004). At the same time, the flexibility of soft law is protected, to the extent that a code can be easily displaced, provided that a motivation is given for non-compliance with one or more of its provisions.

These and other key issues of corporate governance codes are analysed by Wymeersch in chapter 2. Corporate governance codes are usually the outcome of "private" initiatives. At the same time, they respond to the public interest and are considered as an alternative to public regulation. However, codes mainly reflect the concerns of business leaders, addressing issues confronted by the same as board members or *vis-à-vis* shareholders. Their business bias may explain the declining trust in corporate governance codes by the political world, save for cases in which the codes are promoted by securities regulators or under the aegis of governments. In a

few jurisdictions, two layers of recommendations or codes have been adopted, respectively for boards and shareholders, the latter referring particularly to institutional investors (an issue that will be further considered at para. 6.2.3. below).

The "comply or explain" principle is ambiguous and has stirred debate with respect to its place in the legal system. Wymeersch favours a broad interpretation, arguing that a company should explain if and how it complies with a corporate governance code and, in the case of non-compliance, give the reasons for this and the solutions adopted as an alternative. The principle at issue caters to the private autonomy of companies. As a result, some of the main pillars of today's corporate governance – such as independent directors, audit committees and lead directors – derive from corporate governance best practices, rather than regulation. However, the same freedom makes the code system fragile. Much depends on what explanation is deemed as "proper" in a given system. Company reports frequently include boilerplate explanations, carried over from year to year; however, a similar practice should be rejected. In several jurisdictions guidelines exist about the appropriateness of an explanation.

In most countries, certain entities systematically analyse corporate governance statements. The nature of these monitoring bodies and the scope of their action differ considerably. Usually, the substance of disclosure and explanations are not verified, as this would require questioning corporate boards and analysing the reasons given for non-compliance. As a result, monitoring is generally limited to statistical analysis and comments. Moreover, individual breaches and the company's identity are kept confidential, generally for fear of committing libel and slander. Moreover, publication of the breaches could be considered *per se* as a sanction, triggering human rights concerns. On the other side, public authorities are reluctant to lend their assistance to enforcement of the codes, which are private in nature.

Wymeersch concludes that further Europe-wide harmonisation is problematic. Different ownership and governance structures, as well as different legal regimes, counsel avoiding a uniform approach to corporate governance issues. Rather, corporate governance commissions should better explore how they can learn from each other and possibly align their recommendations and terminology. At the same time, companies should streamline their governance practices and disclosures. European business associations could usefully support the convergence of best practices. High-level principles, reflecting the common denominator amongst best practices, might then be developed, but the national standard setters should remain free to adopt only those which fit best to their legal order.

2.4. Bank prudential regulation

As already noted, banks are different from other enterprises to the extent that even "good" corporate governance (that is aligning the interests of managers and shareholders) may lead bank managers to engage in more risky activities. Given high leverage and other special features of banks, a major part of the losses would be externalized to stakeholders, while gains would be fully internalized by shareholders and managers (if properly aligned by the right incentives). As a result, prudential regulation and supervision aim to reduce the excessive risk propensity of shareholders and managers in view of guaranteeing the safety and soundness of banks. In a similar framework, corporate governance works as a complement to prudential regulation by contributing to keep risk management under control. This explains why banking supervisors have become so interested in corporate governance in the last decade (Basel Committee 2010).

By fixing the standards under which bank boards should operate in their monitoring activities *vis-à-vis* the managers and by supervising their implementation in practice, bank regulators indirectly control risk-taking by banks and assure their safety and soundness. As a result, the corporate governance of banks (and financial institutions in general) is clearly directed not only to maximise shareholders' wealth, but also to protect the interests of depositors (and other stakeholders) and to prevent systemic risk in all cases in which these could materialise (large institutions, interconnected ones, etc.) (Becht *et al.* 2012). As underlined by the 2010 Green Paper, "it is therefore the responsibility of the board of directors, under the supervision of the shareholders, to set the tone and in particular to define the strategy, risk profile and appetite for risk of the institutions it is governing".

3. Ownership

The differences in ownership structures amongst listed companies in Europe need to be emphasised: diffuse shareholders are prevalent in the UK and Ireland, while controlling shareholders are the norm in other countries (Barca and Becht 2001; McCahery *et al.* 2002; Gordon and Roe 2004). The importance of these differences on regulatory grounds is highlighted by the 2011 Green Paper, where the European Commission discusses the issue of shareholder "engagement" – which is understood as engaging in a dialogue with the company's

board and using shareholder rights to improve the governance of the investee company – mainly with reference to diffuse ownership companies. The Commission then introduces the topic of minority shareholder protection by stating that "minority shareholder engagement is difficult in companies with controlling shareholders, which remain the predominant governance model in European companies". The Commission also comments that similar difficulties may make the 'comply or explain' mechanism much less effective, hypothesising that legal rules may be needed for either reserving some of the board seats to minority shareholders (a theme analysed in chapter 8) or controlling related party transactions.

In this paragraph, after sketching the different types of agency problems deriving from the two main ownership structures, we consider the special case of family companies, which show interesting dissimilarities from other companies controlled by non-family blockholders.

3.1. Dispersed v. concentrated ownership

Agency problems may arise either between managers and shareholders (as a class) or between controlling shareholders (as agents) and minority shareholders (as principals). When shareholders are dispersed, an appropriate set of constraints is required to guarantee that self-interested managers – who have discretion over the allocation of the company's resources – act primarily in the shareholders' interest. Alternatively, one or more investors may acquire a large equity stake (Shleifer and Vishny 1997). The ensuing concentration of claims makes concerted action amongst investors easier, given that transaction costs are reduced, while blockholders are entitled to a higher (proportionate) share of the expected benefits. However, the interests of blockholders are not always aligned with those of the remaining investors. Indeed, the dominant shareholders (and the managers appointed by the same) may use their discretion to expropriate minority investors and get a disproportionate share of the firm's benefits.

Ownership structures vary across countries and firms. In the UK, US and other common law countries, ownership is typically dispersed and separate from control (La Porta *et al.* 1999). In the rest of the world, large shareholdings of some kind are the norm: ownership is typically concentrated in the hands of families and the State (Claessens *et al.* 2000; Becht and Mayer 2001; Faccio and Lang 2002)[20]. Consequently, different countries generally witness different kinds of agency problems (Roe 2005).

[20] Precise numbers may vary according to sample size, reference years and methodology of analysis. However, a clear distinction may be traced between UK, US and a handful of other countries, on one

A third category of agency costs may be identified with regard to the relationship between the controllers of a company (as agents) and non-shareholder stakeholders (Armour *et al.* 2009b, ECLE 2011). However, not all relationships of this kind are easily defined in terms of agency[21]. While debt contracts fit an agency perspective, the same cannot be said for other relationships such as those with the firm's clients or local communities. Nonetheless, contracts with stakeholders and the applicable regulatory framework may have an impact on corporate governance to the extent that the relevant prohibitions and/or obligations directly or indirectly affect the firm's directors and shareholders (Braithwaite 2008).

The interaction between ownership structures and total agency costs is widely discussed in the economic literature. According to some scholars (La Porta *et al.* 1997; 1998 and 2000), ownership concentration leads to suboptimal diversification. When a firm goes public, the founder should therefore relinquish control altogether, provided that institutions are available for keeping managerial agency costs under control. Consequently, good investor protection leads to both ownership dispersion and higher firm values. This "law matters" theory of corporate governance has been criticised from different perspectives. First, the underlying legal analysis and the measures of investor protection adopted are not always accurate (Cools 2005; Armour *et al.* 2009a). Second, the theory at issue does not fit the evidence available for a number of countries (Cheffins 2001; Coffee 2001; Dyck and Zingales 2002; Gilson 2006). Third, it is unclear whether shareholding blocks persist in some institutional contexts because minority shareholders fear the controlling ones or because they fear the managers, who might dissipate shareholder value if the controlling shareholders disappeared (Roe 2002).

Briefly, an optimal ownership structure is not easily found, which may be due to the complexities of the "common agency" problem. It has also been argued that ownership structures, as well as corporate governance institutions in general, are path-dependent (Bebchuk and Roe 1999), i.e. their pros and cons may depend on a country's existing pattern of corporate

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hand, where the average (or median) largest shareholding block is below the conventional 10% threshold, and continental European (and Asian) countries, where the average (or median) largest block is much higher (between 25% and 50%) and allows to control the decisions of the general meeting.

[21] Jensen and Meckling (1976) define an agency relationship "as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent".

structures and institutions[22]. Therefore, the optimal solution to the "common agency" problem may be country-specific, when not specific to the individual firm.

In all cases, ownership structure decisions involve a choice between alternative sets of agency problems. The same is true for institutions aimed at keeping these problems under control. A given mechanism may mitigate one type of agency problem, but reinforce another: for instance, entitling shareholders to remove the managers may mitigate the agency problems of shareholders as a class, but reinforce those of minority shareholders (ECLE 2011).

3.2. The case of family firms

Andres, Caprio and Croci analyse in chapter 3 how family-controlled firms compare with non-family firms in responding to crises. On one side, they confirm what has been already acknowledged, i.e. that family firms in Europe generally outperform non-family firms (Barontini and Caprio 2006; Maury 2006; Sraer and Thesmar 2007; Andres 2008; Franks *et al.* 2012). On the other, they provide new information on the ways in which family firms behave in booms and busts. Their findings are in stark contrast with the private benefits hypothesis, which assumes that ownership remains concentrated in the hands of families where low investor protection allows the same to extract higher private benefits. Andres, Caprio and Croci show that family firms react to downturns more efficiently than non-family firms, as the former adjust their investment decisions more quickly. They also show that the engagement of long-term investors does not necessarily produce more stable performance and investments, contrary to what is assumed by most literature. The better performance of family firms derives from their more efficient investment policy, which includes rapid downsizing in crises. Moreover, family firms apparently do not take advantage from a crisis to expropriate minority investors.

Andres, Caprio and Croci find evidence that family firms reacted to the credit crisis by reducing their workforce and wages. This could imply the break-up of long-term implicit contracts with employees and a possible wealth transfer from labour to shareholders (Shleifer and Summers 1988). Similar adjustments would be more difficult to carry out quickly if employees owned a significant fraction of the equity capital and/or if they were represented on the board of directors. Employees' ownership and/or board membership, despite being deeply rooted in some Member States, may work as a double-edged sword during crises. On one hand,

[22] Which may include also historical accidents, due to non-CG factors, such as wars, upheavals and other less dramatic "political" influences (Morck and Steier 2005).

they could lead to a smoother transition; on the other, they could prevent or slow down the restructuring of ailing firms.

These results suggest that ownership structures in different countries may be determined by causes other than the degree of investor protection prevalent in each country. The complexity of corporate governance arrangements can hardly be captured by a simple measure of investor protection or a "governance index". Moreover, similar arrangements, in order to be effective, should fit the underlying legal and institutional structure, rather than be dictated by the same. The simple transplant of corporate governance solutions may be ineffective and could even backfire, where the regulatory and institutional contexts are not receptive.

4. Boards

Whatever the firm's ownership structure, both the markets and corporate law provide incomplete solutions to agency problems, which are too complex to be solved solely through *ex ante* mechanisms. Discretionary powers, which are the essence of agency relationships, survive in a world of incomplete contracts. This leaves room for governance mechanisms allocating decisional powers *ex post*, i.e. after the contract has been stipulated, in a state-contingent manner. These governance mechanisms are characterised by flexibility, for they allow new information generated after the making of the corporate contract to be exploited in the management of the firm (Williamson 1988). The first mechanism of this type is the board of directors which, in the two-tier system of governance foreseen in some European countries, finds its equivalent in the supervisory board.

4.1. Theory

Given contractual incompleteness, the (supervisory) board is entrusted with the required discretion to take the core business decisions and monitor the managers on behalf of the shareholders (and possibly other stakeholders). Boards are found in all jurisdictions and all types of organisations (profit and non-profit), and were generally developed before specific legal provisions were introduced to regulate them. Boards can therefore be regarded as a market solution to agency problems, i.e. an endogenously determined institution that helps keep agency costs under control (Hermalin and Weisbach 2003).

Board discretion covers the monitoring of managerial actions and the taking of high-profile decisions, which should not be left to the managers alone. In Williamson's (2008) words, boards are meant to "serve as vigilant monitors and as active participants in the management of the corporation". Their monitoring regards corporate organisation and management performance. It also includes the "hiring and firing" of the CEO and other key executives and the setting of their incentives and compensation packages. The monitoring extends to the information flows to investors, such as financial statements, event-related price-sensitive information, etc. The board's management role mainly relates to fundamental corporate actions, such as the approval of major business transactions and of corporate strategy and relevant plans. Other board roles are the offering of advice to the managers and networking with other firms and institutions.

The board's appointment gives rise to a discrete agency relationship under which agents (directors) monitor other agents (managers) and to the ensuing conflicts of interest. Nonetheless, the board is usually considered a successful governance mechanism because of its collegial nature, which increases the information set collectively available to the monitors and grants superior decision-making under a number of circumstances (Bainbridge 2002). Board collegiality also makes bribery of delegated monitors more expensive and easier to detect (Hermalin and Weisbach 2003).

The theoretical framework for the board as a governance mechanism is straightforward. Distant shareholders lack information and focus. They could not run the company directly, truly understand its business, select and motivate the CEO. They rather entrust the board to direct the company's business, hire the executives and delegate day-to-day management to the same. However, problems often arise in practice, for the board may be captive to senior managers and/or controlling shareholders. In companies with dispersed shareholders, the CEO may influence the selection of board candidates and easily dominate the board, by controlling information flows. In controlled companies, majority shareholders appoint the board and can either dismiss or simply not renew the directors that do not follow their directives.

That boards may depart in practice from their theoretical model should not lead to their replacement as alternatives – such as direct monitoring by investors – would likely cause a net loss, at least in general (Williamson 2008). Moreover, in egregious cases of underperformance, the market for corporate control already allows investors to replace the board through a hostile takeover.

4.2. Practice

The (supervisory) board is widely accepted as a governance mechanism and presents common features internationally. However, its composition and structure, and the allocation of powers between the board and the general meeting of shareholders differ across countries and change over time. Boards rely on either non-executive or supervisory directors, depending on whether they reflect a one-tier or two-tier board structure (Hopt 2011). Some board members must also comply with independence requirements – aiming to assure their objectivity of judgment – and with certain professional requirements, particularly accounting and financial experience (Gordon 2007). More recently, board composition requirements were introduced in some countries to promote gender diversity. In general, the organisation of boards greatly improved over the last twenty years, after the Cadbury Report in the UK marked the soft law approach to corporate governance reform, which was followed also in Continental Europe (Weil Gotshal & Manges 2002). Whether organisational reforms also translated into effective improvements of boards' functioning is still an open question, one that it is difficult to answer in general terms (Williamson 2008).

The main criteria embodied in European corporate governance codes concerning the composition and organisation of boards (both one-tier and two-tier) are usefully summarised in the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board[23]. Section II of the Recommendation deals with the presence and role of non-executive (supervisory) directors on (supervisory) boards. One of the core criteria is that boards should have an appropriate balance of executive (managing) and non-executive (supervisory) directors, so that no individual or small group of individuals can dominate decision-making within the relevant bodies. Another criterion is that a sufficient number of independent non-executive (supervisory) directors should be elected to the (supervisory) board of companies, to ensure that any material conflict of interest involving directors would be properly dealt with.

Furthermore, boards should be organised in such a way that a sufficient number of independent non-executive (supervisory) directors play an effective role in key areas where the potential for conflict of interest is particularly high. To this end, nomination, remuneration and audit committees should be created within the (supervisory) board, where that board plays a role

[23] See note 8 above and accompanying text.

in the areas of nomination, remuneration and audit under national law. Interestingly, every year, the (supervisory) board should carry out an evaluation of its own performance, which should encompass an assessment of its membership, organisation and operation as a group, an evaluation of the competence and effectiveness of each board member and of the board committees, and an assessment of how well the board has performed against any performance objectives which have been set.

Section III of the Recommendation deals with the profile of non-executive (supervisory) directors, including their qualifications and independence. The (supervisory) board should determine its desired composition in relation to the company's structure and activities, and evaluate this periodically. The (supervisory) board should ensure that it is composed of members who, as a whole, have the required diversity of knowledge, judgement and experience to accomplish their tasks properly. The members of the audit committee should, collectively, have a recent and relevant background and experience in finance and accounting in listed companies appropriate to the company's activities. As to independence, a director should be considered independent only if he is free of any business, family or other relationship with the company, its controlling shareholder or the management of either, that could otherwise create conflicts of interest such as to impair his judgement. A number of criteria for the assessment of the independence of directors are indicated in the guidance set out in Annex II to the Recommendation. However, the determination of what constitutes independence is fundamentally an issue for the (supervisory) board itself to determine.

The 2011 Green Paper specifically addressed the issues of professional, gender and international diversity on the board. The *Feedback Statement* on the consultation[24] shows that most respondents agreed on the importance of board diversity; however, no consensus seems to exist on the need to increase diversity through regulation (or on the most appropriate regulatory instruments). In particular, the majority of respondents rejected the idea of listed companies being required to ensure a better gender balance in boards. Nonetheless, gender diversity has been addressed by a recent Directive proposal setting, for the under-represented sex, a minimum target of 40% by 2020 as to the non-executive directors of publicly listed companies (2018 for

[24] See Feedback Statement Summary of Responses to the Commission Green Paper on the EU Corporate Governance Framework, November 2011, available on the Commission's website www.ec.europa.eu..

those of listed public undertakings)[25]. Board diversity and its possible effects on board effectiveness, firm value and performance are still a controversial issue (Carter *et al.* 2003; Adams and Ferreira 2009; Ahern and Dittmar 2012); the evidence available so far has proved inconclusive and is often plagued by endogeneity problems (Adams *et al.* 2010).

4.3. Empirical analysis

Ferreira and Kirchmaier analyse in chapter 4 a cross-section of board characteristics – board size, independence and gender diversity – across Europe. Country characteristics explain a significant part of the variation in board independence and gender diversity, suggesting that country-level governance rules play an important role in the determination of these variables. In contrast, board size is mostly explained by firm and industry characteristics. Differences in board structure between European and US firms are seemingly persistent. In the US almost three out of four directors are independent, while in Europe (particularly Continental Europe) only a minority of directors are independent. This might be associated, at least in part, with differences in ownership structure.

Board characteristics are not necessarily stable over time. European firms have reduced the size and increased independence of their boards over the last decade. This is partly due to a composition effect, since the coverage of small firms by commercial databases used for research purposes has increased over time. However, Ferreira and Kirchmaier show that European firms that performed poorly during the crisis chose to reduce both the size and independence of their boards. This might be a response to the evidence relating pro-shareholder boards in financial firms to poor performance in the crisis, which clearly questions the conventional wisdom that more board independence is always beneficial. Listed firms appear to consider the (changing) wishes of investors when proposing new board candidates, with the result that solutions to corporate governance issues evolve over time. A related question is whether board composition (like other issues of corporate governance) may be subject to fashions and fads, having less to do with value creation than with the influence of consultants and "experts" responding to their own incentives. Further research could usefully address this aspect.

[25] See the Proposal for a Directive of the European Parliament and of the Council on improving the gender balance among non-executive directors of companies listed on stock exchanges and related measures available on the Commission's website www.ec.europa.eu.

Board gender diversity is a fairly recent topic in the policy debate. Ferreira and Kirchmaier show that, despite being on the rise, diversity is still limited in Europe, except for countries having quota-based regulation of board membership. Regulation is in fact the single most important factor explaining differences in board gender diversity across European countries. However, it is unclear whether gender diversity is a corporate governance issue or one concerning equal opportunities. More diverse boards are not clearly superior in terms of economic performance. In the case of superior performance, it is difficult to establish whether diversity was the cause or the effect of the same. Ferreira and Kirchmaier show that cultural norms are correlated with female participation in non-executive positions even after controlling for labour force participation. This raises the question of whether policies targeting boardroom diversity directly are sustainable in the long run.

Furthermore, while protection of equal opportunities may hardly be disputed, it is difficult to see what is special about boards (of listed companies). Why should shareholders (and boards) be trusted to make the correct (i.e. value-maximizing) choices in all respects but for gender diversity? A claim that boards are entrenched would have implications going far beyond gender diversity. From another viewpoint, why does equal access deserve more protection in board elections of business corporations than in other areas of human activity (such as non-profit institutions, regulatory agencies, parliaments etc.)?

4.4. Limits of a quantitative approach

Of course, all theoretical models, including board models, form an incomplete description of reality. Directors in particular have a complex objective-function, which may be only partially described through theoretical (agency) models. The risk is always present to overestimate the contribution given by "hard" sciences to the analysis of human interaction. In a similar vein, Winter and van de Loo argue in chapter 5 that lawyers and (financial) economists often follow a narrow approach to the functioning of boards, which cannot fully explain board performance in reality and the factors determining it. A comprehensive and integrated approach touching upon behavioural aspects may better describe boards as social institutions, i.e. as an organisation through which people co-operate, debate and take decisions in view of certain corporate objectives. The behaviour of directors, either as individuals or as a group, unavoidably affects board performance.

Winter and van de Loo suggest therefore an alternative and broader description of the interaction between executives and non-executives within boards. They advance, in particular, a new concept – the board "on task" – which should be used to understand and assess board performance in practice, whilst opening new perspectives to research on board performance. Winter and van de Loo also warn against the overconfidence generated by current research on boards, for empirical analysis may suffer from incomplete data availability and the presence of non-measurable factors. Noting that "actual board performance occurs in a black box that cannot be observed by outsiders", they recommend caution in deriving policy implications from studies purely relying on "hard" data (a recommendation that we no doubt follow in this volume when formulating policy suggestions).

5. Incentive pay

While there are multiple characterisations of the executive pay question (e.g. Loewenstein (1996) describing executive pay as a wealth transfer issue), the dominant model examines executive pay in terms of the principal/agent relationship and incentives. In this section, after briefly analysing the main theories related to incentive pay and agency costs, we review recent EU reform of executive pay, distinguishing between non-financial firms and financial institutions (banks in particular) and summarise the outcomes of the empirical study on pay practices at large European companies described in chapter 6.

5.1. Two views

The principal/agent model generates two competing views of executive pay. According to the first, executive pay remedies the agency costs generated by the misalignment of management and shareholder interests in the dispersed ownership company. Shareholders in dispersed ownership systems have only a fractional interest in the firm profits, are not fully incentivised to discipline and have limited opportunities to monitor management (Jensen and Meckling 1976). Management's unobserved actions, particularly where personally costly decisions (e.g. laying off employees) and privately beneficial activities (e.g. consuming perquisites) are involved, can prejudice shareholder wealth and give rise to agency costs.

Whether, and the extent to which, a manager will fully pursue shareholders' interests depends on how that manager is incentivised. Agency theory suggests that the performance-

based pay contract, which links pay to shareholder wealth via performance indicators such as share prices or accounting-based targets, is a powerful way of attracting, retaining, and motivating managers to pursue the shareholders' agenda (Jensen and Murphy 1990 and 2004; Conyon and Leech 1994; Hall and Liebman 1997). In the dispersed ownership context, this paradigm has dominated the pay debate and pay practices since the early 1990s and still enjoys considerable support as making management more sensitive to shareholders' interests (Holmstrom and Kaplan 2003; Kraakman 2004).

However, executive pay can also be regarded as an agency cost in itself, providing a powerful and opaque device for self-dealing by conflicted managers (Bebchuk *et al.* 2002; Hill and Yablon 2002; Bebchuk and Fried 2004). In practice, pay is not set by the shareholders, it is rather set on their behalf by the board of directors, which should align shareholder and managerial incentives (Jensen and Murphy 2004). Nonetheless, a conflicted board may use the pay-setting process to influence pay and extract rents in the form of pay in excess of that which would be optimal for shareholders, given weaknesses in the design of pay contracts and in their supporting governance structures (Bebchuk *et al.* 2002; Bebchuk and Fried 2004). In other words, executive pay raises an additional agency problem: how can the effectiveness of the executive pay contract as a remedy for manager/shareholder agency costs be protected from conflicts between the board, as pay-setter, and shareholders (Jensen and Murphy 2004). The equity-based incentive contract may, as post-Enron scholarship argues, deepen conflicts of interest between shareholders and management by generating perverse management incentives to manipulate financial disclosure (particularly earnings) and distort share prices, which can lead to catastrophic corporate failures (Coffee 2002; Gordon 2002; Ribstein 2003). The consequences of such a cycle of ever higher share prices and their impact on pay have been examined as "the agency costs of overvalued equity" (Jensen and Murphy 2004).

The relationship between agency problems and the executive pay incentive contract takes on an additional complexity in continental European firms, characterised by concentrated shareholdings and long-term shareholder commitment (Ferrarini and Moloney 2004; 2005). Here, incentives and conflicts change. Here, concentration of control (possibly intensified by cross shareholdings, pyramidal ownership structures, proxy voting by financial institutions connected to the company, and voting pacts) recasts the agency problem which executive pay is designed to resolve. The agency costs which trouble the dispersed ownership company are reduced, as block-holding shareholders have both incentives and resources to monitor managers

effectively (Garrido and Rojo 2003). As a result, there is less need for an incentive contract to control the conflict between management and shareholder interests, which is remedied by executive pay. There is also less probability of an agency problem deriving from executive pay contracts.

In concentrated ownership conditions, however, different profiles arise, which have varying implications for executive pay and the management of conflicts of interest . Where a shareholder/owner manages the company, the need for an incentive contract, in principle, recedes, as the owner is incentivised by his own equity interest. Where a professional/outside manager performs management activities for the owner-shareholder (who may also be a non-executive director), the owner monitors the manager's performance directly, thereby reducing the need for an incentive contract. Nonetheless, monitoring by the owner may not be sufficient, given that not all actions taken by the professional manager are easily observable, so that an incentive contract can further align managerial interests with those of shareholders. Protection may rather be needed to prevent collusion between blockholders and managers on pay-bargaining, given that controlling shareholders might overcompensate the managers to reward their cooperation in the extraction of private benefits from the company.

5.2. Non-financial firms

The 2004 Commission Recommendation was the EU's first attempt to address best practice with respect to pay governance. It used disclosure and shareholder voice mechanisms to support efficient pay and recommended disclosure of company pay policy and process, either in a distinct remuneration report or in the annual report; detailed disclosure concerning individual directors' pay; a shareholder vote on company pay policy, either binding or advisory; and prior approval of share-based schemes. The Commission also recommended to disclose the mandate and composition of the remuneration committee, and the names of the external consultants whose services have been used in setting the remuneration policy. The role of the board, its independence in the pay process and the creation of remuneration committees were addressed in the 2005 Recommendation on the role of non-executive directors, where the Commission highlighted remuneration as an area in which the "potential for conflict of interest is particularly high".

Member States were entitled to adopt these two Recommendations either through legislation or (as was generally the case) soft law, typically represented by a corporate

governance code and the related "comply or explain" principle[26]. However, the effectiveness of the "comply or explain" mechanisms with respect to executive remuneration and relevant investor monitoring proved doubtful, given the low levels of conformity with the Recommendations also at Europe's largest companies (Ferrarini *et al.* 2010). As a result, significant differences continued to exist across Member States' regulatory regimes and pay governance practices. No doubt, all this could not be taken *per se* as an argument for legal reform. On one side, a failure of self-regulation would need to be proven, showing that non-conformity concerns provisions which companies should mandatorily follow, such as those on disclosure (as further suggested under para. 7.4.). On the other, non-compliance could depend on the fact that soft law might either not entirely match the needs of companies and/or investors' expectations, or require more time to be fully assimilated by corporate practice.

Although switching some of the focus on pay structure, the Commission's 2009 Recommendation on directors' pay at non-financial companies identified major weaknesses in the existing disclosure practices, emphasising the need for the remuneration statement to be clear and easily understandable and providing greater detail on how disclosure of performance-related pay should be implemented. It also set further related requirements, i.e. that an explanation be provided concerning how performance criteria relate to firms' long term interests and that sufficient information be provided concerning termination payments, vesting and the peer groups on which the remuneration policy is based.

Remuneration committees are also more extensively considered under the 2009 Recommendation, which addresses their composition, role and functioning. The criteria suggested are relatively non-controversial: the committee should periodically review the remuneration policy for directors; exercise independent judgment and integrity; address conflicts of interests concerning consultants by ensuring that they do not at the same time advise the human resources department or the executive directors. The committee should also report to the shareholders on its functions.

However, the implementation of the 2009 Recommendation in the Member States was only partial, as argued by Ferrarini *et al.* (2010) showing that firms' disclosure levels still vary

[26] Commission, Report on the application by Member States of the EU of the Commission Recommendation on directors' remuneration (2007) (SEC(2007) 1022); Commission, Report on the application by the Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2007) (COM SEC(2007) 1021).

from country to country and are strongly dependent on the existence of either regulations or best practice guidelines in each Member State. Firms widely comply with binding rules, but only partially follow guidelines. In the absence of binding rules, firms appear reluctant to provide full disclosure of remuneration, particularly of the pay/performance link and termination payments. It is not easy to compare how Europe's largest companies approach executive pay and, in particular, performance conditions. As to the governance process, while the remuneration committee is generally well-established, composition problems (including independence) remain and the 'say on pay' mechanism is underdeveloped.

The present discussion on remuneration at non-financial firms concerns the alternative between mandatory rules and soft law, specifically in the areas of pay disclosure, remuneration report and shareholders' vote on pay. Supporters of mandatory disclosure argue that the same contributes to establish a level playing field internationally, improving comparability of information between companies in different member states (Bhagat *et al.* 2008; Posner 2009). Standardisation of the format in which disclosure is provided also supports better monitoring and positive externalities, given that it is difficult to compare remuneration across companies (Ferrarini *et al.* 2010). On the other side, critics claim that mandatory disclosure interferes with board decisions on executive remuneration, affects the privacy of directors and could have a ratcheting effect on remuneration levels[27].

The European Commission's Green Paper on the corporate governance framework specifically considers mandatory disclosure and 'say on pay'. In particular, the Commission investigates whether it should be mandatory to put the remuneration policy and the remuneration report to a shareholder vote (however leaving open the question as to whether this vote should be binding or advisory); and whether disclosure of a company's remuneration policy, the annual remuneration report and individual remuneration of directors should be enacted by the Member States through mandatory legislation. The feedback on the consultation[28] shows a wide consensus for mandatory disclosure, while mandatory say-on-pay turns out to be more controversial; furthermore, many respondents who are in favour of a mandatory shareholder vote add that such vote should be advisory only.

5.3. Financial institutions (banks in particular)

[27] See Feedback Statement, note 24 above.
[28] Feedback Statement, note 24 above.

The financial crisis has reshaped the context within which executive pay at financial institutions is examined (Bebchuk and Spamann 2010; Ferrarini 2012). First, the rescue of large banks by governments investing taxpayers' money enhanced public resentment against the excessive pay-outs at the helm of international banks. As a consequence, executive pay was drastically reduced and bonuses almost disappeared at financial institutions rescued by the states, whilst compensation structures were tightly regulated to avoid paying taxpayers' money to undeserving executives (Ferrarini and Ungureanu 2010). Soon similar initiatives were voluntarily adopted also by sound banks in an effort to pre-empt investors' and authorities' concerns for inappropriate risk management. Several regulators extended the treatment originally conceived for bankers' pay at rescued institutions to all financial institutions. Second, the national measures adopted by the governments rescuing banks in crisis led to the generation of the international FSB Principles and Standards on compensation practices at financial institutions (Ferrarini and Ungureanu 2011).

The FSB issued these Principles following coordinated action by the G20 governments, which rapidly responded to heavy political pressure deriving, both domestically and internationally, from the financial crisis and repeated bank failures. Through swift adoption, authorities intended to show that reforms of the international financial system were timely put in place with respect to executive compensation. The Principles are addressed to 'significant financial institutions', which are considered to deserve an internationally uniform regime. Some principles are not new to the extent that they require a balanced pay structure and long-term approach, alignment of pay with performance, independence of the pay-setting process and disclosure of remuneration policies. Relatively new is the emphasis on effective alignment of compensation with prudent risk-taking and compensation practices that reduce employees' incentives to take excessive risk.

The Principles cover four main compensation areas: governance, structure, disclosure and supervision. As to compensation governance, they incorporate well-known best practices concerning the strategic and supervisory role of the board. In addition, they reflect post-crisis emphasis on bank risk management and monitoring by the board of directors, who should determine the risk appetite of the firm. They reiterate the role of the remuneration committee, also requiring its liaison with the risk committee to ensure compliance with the relevant requirements.

Compensation structures are considered along lines that reflect, to a large extent, general best practices already adopted before the crisis. While pre-crisis practices mainly emphasised the alignment of managers' incentives with shareholder wealth maximisation, the FSB Principles break new grounds by requiring financial institutions to align compensation with prudent risk-taking. Accordingly compensation needs adjustment with all types of risk, including those considered difficult-to-measure, such as liquidity risk, reputation risk, and capital cost. Deferment of compensation, traditionally used as a retention mechanism, has been introduced to make compensation pay-out schedules sensitive to the time horizon of risks. Furthermore, the Principles require that a substantial portion of variable compensation be awarded in shares or share-linked instruments, as long as the same create incentives aligned with long-term value creation and the time horizons of risk. Malus and clawback mechanisms could further enable boards to reduce or reclaim variable compensation paid on the basis of results that are unrepresentative of the company performance over the long term or later prove to have been misstated.

The Principles also consider 'guaranteed' bonuses as conflicting with sound risk management and the pay-for-performance principle, whilst severance packages should be related to performance achieved over time and designed in a way that does not reward failure. While before the crisis disclosure was seen as one of the main mechanisms for aligning managers with shareholder interests, after the crisis remuneration disclosure is considered to benefit not only shareholders, but also other stakeholders (e.g. creditors, employees, financial supervisors), at least in financial institutions. The FSB Principles add new items of disclosure, such as deferral, share-based incentives, and criteria for risk adjustment. Moreover, disclosure should identify the relevant risk management and control systems and facilitate the work of supervisors in this area. In the case of a failure by a firm to implement 'sound' compensation policies, prompt remedial action should be taken by supervisors and appropriate corrective measures should be adopted to offset any additional risk that may result from non-compliance or partial compliance with the relevant provisions.

The Principles represent a reasonable political compromise between the various interests at stake in the area of compensation, incorporating traditional criteria and adapting these to new circumstances emerged from the financial crisis. They were implemented along different models (Financial Stability Board 2010). In many jurisdictions, the model includes a mix of regulation and supervisory oversight, with new regulations often supported by supervisory

guidance that illustrates how the rules can be met. Other jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews. To a great extent, legislative and regulatory responses depend on the type of equilibrium found in each country between the different interests at stake. Where public criticism of bankers and hostility to their remuneration practices are strong, the risk of regulatory capture is lower and a tougher regime for executive pay may emerge. Culture may contribute to similar outcomes, given that high levels of executive pay are less tolerated in some countries (Levitt 2005; Posner 2009).

However, no domestic regulatory solution could be effective without agreement at international level. One-sided reforms (i.e. adopted only by some countries) do not prevent contagion from other countries choosing not to regulate compensation at financial institutions. In addition, they could jeopardize a country's competitive position as a financial centre, by determining a flow of financial firms' headquarters and top managers to other countries adopting a more liberal stance relative to executive compensation (Ferrarini and Ungureanu 2011).

The EU adopted the FSB Principles through amendments to the Capital Requirements Directive (CRD III), which took effect in January 2011 and are further analysed in chapter 6 of this volume.

5.4. Empirical analysis

Barontini, Bozzi, Ferrarini and Ungureanu analyse in chapter 6 the evolution of various aspects of remuneration structure, governance and disclosure among large European firms (both financial and non-financial).

They show that the implementation of EU recommendations concerning remuneration governance and disclosure (of both remuneration policy and individual compensation) has increased over the last few years. Compliance with European standards for governance variables (existence and independence of remuneration committees and consultants) already relatively good before the crisis has further increased; general information about the remuneration policy and disclosure of individual pay (including also termination agreements) has remarkably increased over time, with Italian, German and French firms showing the fastest progress on disclosure practices, toward the best practice model represented by the UK; information on other aspects (forward-looking information and details of stock-based

compensation) is still lagging behind. The general picture shows, nonetheless, that compliance is on the rise, and is significantly affected by firm size, industry (higher in financial companies, which have been targeted by specific regulations), ownership concentration (higher in companies without a control blockholder) and country.

Barontini, Bozzi, Ferrarini and Ungureanu also analyse the dynamics of the level and structure of remuneration packages (for the whole board and for CEOs) before and after the crisis. They show that remuneration packages are remarkably variable across countries, reflecting the differences in board structure and, possibly, the national job markets for managerial talent. These differences may possibly attributed, at least in part, to differences of the institutional context, allowing segmentation to persist. International mobility of CEOs is still relatively uncommon across Europe.

Directors' pay in Europe is lower than in the US, and makes less use of stock-based compensation (25 percent against 50 percent in US). However, the variable remuneration of EU CEOs is definitely non-trivial, amounting to 60 percent of total compensation (decreasing to 54 percent in 2010, due to the consistent reduction in the amount of cash-based variable pay). The structure of CEO pay (in terms of the relative weight of fixed/variable components) is affected by firm size, growth opportunities and past firm performance. The recourse to stock-based compensation is lower in closely held companies; this is consistent with the hypothesis that stock-based incentives are less important where control blockholders exert a monitoring role and also with blockholders being more sensitive to the implicit cost (in terms of dilution) of new share issues.

After the crisis, directors' remuneration has decreased remarkably in financial institutions (especially for the CEOs), while it has slightly increased in non-financial companies. The decrease is substantially due to the cash portion of variable compensation (bonuses), while other components have remained more or less stable (this is true for both fixed salary and stock-based compensation; however, stock grants are apparently becoming more popular, at the expense of stock options). The change in the proportion of incentives detected in 2010 for financial firms seems to be only partially explained by the negative performance in the 2007-2010 period. It is totally plausible that a concurrent factor was the pressure exerted on financial firms by the national and international regulators for a rethinking of their compensation structure. Actually, the changes observed in the pay structure of financial firms go in the direction indicated by the regulators, pushing for an "adequate" balance of variable

and fixed components and for a portion of variable compensation being deferred and awarded, at least partially, in shares or share-linked instruments.

6. Shareholder activism

According to Gillan and Starks (1998), a shareholder activist is "an investor who tries to change the status quo through 'voice', without a change in control of the firm". Armour and Cheffins (2009) propose a more specific definition of activism as "the exercise and enforcement of rights by minority shareholders with the objective of enhancing shareholder value over the long term". In this section, we examine the main strategies for shareholder activism. We then explore some key aspects of the legal framework for shareholder activism and EU reform proposals. We finally comment on the outcomes of empirical analysis in chapters 7 and 8.

6.1. Types and role of activism

Activist strategies are by no means uniform[29]. Individual investors usually hold small equity stakes and submit proposals to the general meeting concerning governance (including social responsibility) issues. Institutional investors are diverse and track different trading styles and regulatory models. Consequently, they respond to different incentives and skills as to active monitoring. While mutual fund and public pension fund activism tends to be incidental and *ex post* (Kahan and Rock 2007)[30], hedge fund activism is strategic and *ex ante*. Hedge fund managers first determine whether a company would benefit from activism, then take a position and become active. They prefer short-time strategies, possibly including a public challenge to management. Hedge fund activism is often labelled as "offensive", while the strategies of other institutional investors are defined as "defensive" (Armour and Cheffins 2009). The incentives of active investors are not necessarily aligned with those of shareholders as a class. While pension funds are criticised for not being sufficiently interventionist, hedge funds are sometimes criticised for being too active (ECLE 2011) or for acting for the "wrong" reason.

[29] The identity of shareholder activists and the focus of their efforts changed over time. Until the end of the '70s, shareholder activism was mainly practiced by individual investors. The '80s saw a mounting involvement of institutional investors (public pension funds in particular) and corporate raiders. Starting in the '90s, hedge funds have taken the lead (Gillan and Starks 1998, 2007).

[30] These institutions are long-period investors which prefer quiet negotiations with company management to high-profile initiatives (Becht *et al.* 2009).

Activism interferes with corporate decision-making and, in a sense, contradicts delegation and specialisation. The decision to become active should be based on a comparison between expected costs and benefits. Since costs are predictable[31], while benefits are uncertain and limited (since insurgents will receive only a fraction of the improvements in shareholder returns generated by their efforts), activism is an exception, rather than the rule (Easterbrook and Fischel 1991).

The role of activism in controlling agency costs is controversial. Bebchuk (2005) and Harris and Raviv (2008) claim that proxy proposals by active shareholders mitigate managerial agency problems. Other scholars argue that activists lack the capacity and ability to engage in, or even evaluate corporate decision-making, which should be the sole responsibility of the board (Woidtke 2002; Prevost *et al.* 2009). In the wake of the financial crisis, active investors are often considered as a possible complement or substitute for other corporate governance institutions (such as boards of directors and takeovers) in controlling agency costs. Gilson and Gordon (2011) convincingly argue, however, that "specialization" is needed to develop the skills required by activism and overcome the problems of what they define as "agency capitalism"[32]. In particular, a new set of actors is required to complement the diversified investing and portfolio optimisation that institutional investors engage in. These actors would develop the skills to identify governance shortfalls, acquire a position in a company, and then present to "reticent institutions" their value proposition: "the institutions will vote in favour of the specialised actors perspective if the issue is framed in a compelling way. From this perspective, the overall obligation to beneficial owners is split between the portfolio management undertaken by institutional investors, and the active monitoring of portfolio company strategy and execution undertaken by activist investors" (Gilson and Gordon 2011).

[31] There are both direct and indirect costs for activism. The former relate to the time spent by senior executives and the out-of-pocket expenses for the selection of board candidates, coordination with other shareholders, proxy solicitation and other campaign efforts. Indirect costs are less visible, but substantial, and include limitations to trading implied by market abuse regulation, suboptimal diversification (where activism requires a large and/or long-term investment in the company), legal liability for acting in concert and potential litigation costs (Pozen 2003).

[32] Gilson and Gordon (2011) argue that investment managers have no private incentive to proactively address governance and performance problems, and therefore do not engage in that activity, even if it would benefit their beneficiaries. This gap between the clients' and the fund's interests represents an agency cost that locks in another agency cost: managerial slack at the portfolio companies. Together these are the "agency costs of agency capitalism", which "result in the chronic undervaluation of governance rights".

6.2 Regulatory impact and reform proposals

Regulation may favour or hinder activism. Roe (1994) claims that shareholder apathy in the US is largely due to limitations imposed to institutional investors, notably under the rules on "acting in concert". Rules applicable to shareholder participation and voting in general meetings may also affect investors' behaviour. In this paragraph, we analyse similar rules included in the Shareholder Rights Directive and the national regimes concerning the division of powers between boards and shareholders. We then briefly consider EU policy perspectives as to shareholder "engagement".

6.2.1 Shareholder rights

The 2003 Communication on *Modernising Company Law* proposed strengthening shareholders' rights along lines which were implemented in 2007 by the Shareholder Rights Directive[33]. As stated in the 3rd *considerandum* of the Directive, effective shareholder control is a prerequisite to sound corporate governance; these should, therefore, be facilitated and encouraged, while obstacles which deter shareholders from voting (such as making the exercise of voting rights subject to the blocking of shares during a certain period before the general meeting) should be removed. In particular, certain minimum standards should be introduced with a view of protecting investors and promoting the smooth and effective exercise of shareholder rights attached to voting shares (4th *considerandum*). The Directive was also intended to solve the problems related to cross-border voting, given that significant proportions of shares in listed companies are held by shareholders who do not reside in the Member State in which the company has its registered office (5th *considerandum*). In particular, non-resident shareholders should be able to exercise their rights in relation to the general meeting as easily as shareholders who reside in the home Member State of the company. Obstacles which hinder the access of non-resident shareholders to the information relevant to the general meeting and the exercise of voting rights without physically attending the general meeting should, therefore, be removed.

The main issues dealt with by the Directive concern the organisation and functioning of the shareholder meeting and touch upon issues such as: a) information prior to the general meeting and convocation of the same; b) right to put items on the agenda of the general meeting

[33] See note 7 above and accompanying text.

and to table draft resolutions; c) requirements for participation and voting in the general meeting (excluding the need for a prior deposit of the shares); d) participation in the general meeting by electronic means; e) proxy voting, including the right to appoint a proxy holder and the limits which may introduced by Member States in order to address conflicts of interest; f) voting by correspondence; g) publication of the voting results. On the whole, the Directive makes shareholders' participation to general meetings easier, particularly in cross-border situations, but does not promote *per se* the "shareholder engagement" which is envisaged by the 2010 and 2011 Green Papers as an essential component of an effective corporate governance environment. Indeed, the Directive harmonises some important aspects of the regimes applicable to shareholder rights, removes obstacles to the exercise of those rights and possibly reduces the costs for the same, but does not act on the basic incentives for institutional and other investors to engage in activism.

6.2.2 Shareholder powers

Shareholder engagement also depends on the substantive powers attributed to shareholders *vis-à-vis* the (supervisory) board under national company law. On a comparative ground, the distinction is made between "board-centric" and "shareholder-centric" systems (Davies *et al.* 2012). The latter are in principle more open to shareholder activism, even though activist investors are present and successful also in board-centric systems, particularly in the U.S. (as shown in chapter 7). Board-centric systems (like those of Germany, Italy, the Netherlands and Poland), reserve only certain key powers to the general meeting (Rock *et al.* 2009; Bruno and Ruggiero 2011). These powers are defined in the law either by a catch-all clause (such as "economically important decisions") or by a catalogue of fundamental decisions, such as charter amendments, share issuance, mergers, divisions etc. In shareholder-centric systems, like the U.K., the division of powers between the board and the shareholders is left to the articles of association, but the shareholders may decide in all matters that lie in the competence of the board and may change its decisions by reaching a 75 per cent majority of the votes (Enriques *et al.* 2009).

However, the distinction between board-centric and shareholder-centric systems may become blurred in practice, depending on the power relationship between the board of a company and its shareholders. In the case of controlling shareholders, a weak board may ask the general meeting to decide matters that are in its own competence. On the other hand, if directors

can be easily removed by shareholders (e.g. without cause and possibly even without receiving any compensation for departure), the board may become weak even in a formally board-centric system, since shareholders will hold the ultimate decisional power. This will, in turn, create an incentive for entrepreneurs to retain a control stake when the firm goes public. When shareholders are diffuse, the general meeting may be weakened either by absenteeism or by lack of shareholder engagement, with the result that the board and the managers *de facto* enjoy greater powers than those formally attributed to them (Davies *et al.* 2012).

As a general rule, the appointment and removal of (supervisory) directors are tasks for the general meeting, except for cases where some board members are elected by the workforce (as in the German codetermination system) or by a third party. When ownership is diffuse, the role of the general meeting is often formal in practice, as shareholders elect candidates that are proposed by the board (Davies *et al.* 2012). Only exceptionally, candidates are proposed to the general meeting by the shareholders themselves and are successfully elected; an example is offered by the Italian slate voting system (analysed in chapter 8). On the other hand, in controlled companies, the ultimate power rests with the general meeting, and the role of the board is often formal in practice: candidates are usually proposed by the board under controlling shareholders' instructions, so that controlling shareholders ultimately select and appoint the full board. This creates, in turn, an incentive to keep ownership concentrated in first place.

It is debated whether additional protection should be granted to minority investors in controlled companies. The 2011 Green Paper's asked whether "minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders". A positive answer would justify the recourse to multiple-winner voting systems, granting board representation to qualified minority shareholders through cumulative voting (like in Poland), proportional voting (as in Spain) or to quotas (as in the Italian slate voting system). However, as reported in the *Feedback Statement* on the consultation, "the vast majority of respondents that provided an answer to this question share the view that minority shareholders are already sufficiently protected"[34]. Many respondents advanced two arguments in particular: one being that additional rights are only likely to increase the potential for abuse by minority shareholders and are contrary to shareholder equality; the other that minority shareholders do not form a homogenous group.

[34] Feedback Statement, note 24 above.

The rules on removal of (supervisory) directors, to some extent, reflect the characterisation of a system as either "board-centric" or "shareholder-centric" (Davies *et al.* 2012). The most shareholder-friendly rule is removal without cause and without compensation. Other rules, which require compensation and/or a cause for removal, tend to be board-friendly. In any case, the provisions on duration of office should also be considered, with shorter terms foreseen in shareholder-friendly regimes (one year in the U.K. and Sweden) and longer terms (between three and five years) in more board-friendly ones (Italy, France and Germany).

On the whole, the division of powers between boards and shareholders has an impact on the potential for activism. Shareholder-centric systems offer, in principle, a broader scope for activism, while board-centric systems may need regulatory support for activism to arise. The EU regulatory debate shows that such regulatory support is not necessarily justified. On one hand, a shareholder-centric system may not offer the incentives sought by institutional (and other) investors to become active. In other words, the greater potential for activism in company law does not imply that shareholders will be interested in exploiting it (Black 1990). On the other hand, the "abuse" argument means that activism may be the result of a conflict of interests, instead of the solution to it, i.e. investors might become active for the "wrong" reason.

6.2.3 Reform proposals

The 2011 Green Paper claims that the lack of shareholder engagement in European listed companies may derive from widespread short-termism of investors, including those who have long-term obligations towards their beneficiaries (such as pension funds, life insurance companies, state pension reserve funds and sovereign wealth funds) and should therefore be interested in improving long-term returns to shareholders. A similar stance of investors may reflect the short-termism of modern capital markets, but also the agency problems in the relationship between long-term investors and their asset managers, who may not be adequately incentivised to seek long-term benefits for their principals[35].

The Commission, moreover, conjectured that short-termism may derive from "regulatory bias" and asked participants in the consultation on the Green Paper to identify EU legal rules that could be changed to prevent such behaviour. Interestingly, all respondents

[35] The Commission states (at p. 12 of the Green Paper): "It appears that the way asset managers' performance is evaluated and the incentive structure of fees and commissions encourage asset managers to seek short-term benefits". A similar point is made and further explored by Gilson and Gordon (2011), as mentioned also at note 32 above.

invited to caution before any action is taken[36]. ECLE (2011), in particular, claimed that "we do not have a very sophisticated understanding of the relationship between investment strategies and intervention in portfolio companies or the links between such intervention and the long-term success of portfolio companies. Some intervention by investors with short-term goals is good because it brings about change which long-term investors also want but cannot themselves cheaply bring about. Sometimes long-term support for a company means keeping inefficient incumbent management in place. But equally, the opposites of these propositions also hold true in some cases".

Furthermore, the 2011 Green Paper highlights the lack of transparency about the performance of fiduciary duties by asset managers, suggesting that "information about the level of and scope of engagement with investee companies that the asset owner expects the asset manager to exercise, and reporting on engagement activities by the asset manager could be beneficial". A different but complementary proposal was made by the 2010 Green Paper, which suggested disclosure by institutional investors of their voting practices at shareholders' meetings as a way to motivate shareholder engagement. A good example for similar policy proposals is offered by the U.K. Stewardship Code, which was first issued by the Financial Reporting Council in July 2010 with the aim to enhance the quality of engagement between institutional investors and companies. Principle 6 of this Code states that institutional investors should have a clear policy on voting and disclosure of voting activity, while Principle 7 provides that institutional investors should report periodically on their stewardship and voting activities.

In general, however, the case for enhancing shareholder activism in Europe through regulatory harmonisation is rather weak. First, the decision to engage in activism should be left to individual investors who will proceed on the basis of a cost-benefit analysis (save for cases in which their incentives are clearly distorted). Second, investors' incentives, in order to become active, crucially depend on the characteristics of the firm, such as its ownership structure. In controlled companies, minority shareholders may rationally choose to stay passive, knowing that they can hardly influence corporate decisions. Third, the diversity of institutional contexts in the EU – for instance, the divergence of national rules dealing with the distribution of powers

[36] The rules more frequently cited were the following (*Feedback Statement* p. 12): Solvency II (in particular the provisions not enabling long term-investors to keep long-term provisions); MiFID (as regards high frequency trading); financial reporting (especially quarterly reporting); accounting (mark-to-market and fair value accounting in general).

between boards and shareholders – undermines regulatory harmonisation, which would have different impact across countries. In fact, EU regulation has so far followed a less ambitious "enabling" approach, aimed at removing some impediments to activism from Member State regulation. The final say is still left to the individual shareholders, within the different national regulatory frameworks.

6.3. Empirical analysis

6.3.1. Management and shareholder proposals

Renneboog and Szilagyi in chapter 7 analyse management and shareholder proposals at the general meetings of listed firms in a number of European countries, comparing the relevant data with those collected for the US. In Europe, activists target firms that underperform and are, at the same time, subject to governance concerns. This suggests that, just as in the US, shareholder activism may produce nontrivial control benefits. Shareholder proposals, in particular, may be regarded as a useful disciplinary tool and their sponsors as valuable monitoring agents. Shareholders, however, submit proposals much less frequently than in the U.S., particularly in Continental Europe. Furthermore, their success in terms of voting results is limited across Europe, irrespective of the issues addressed. There is also no evidence that the recourse to shareholder proposals is on the rise as a result of the financial crisis or the adoption of the EU Shareholder Rights Directive. While it is too early to fully gauge its effects, this Directive aimed at minimum harmonisation and left a number of important aspects untouched.

Renneboog and Szilagyi argue that the different recourse to shareholder proposals on the two sides of the Atlantic can be attributed to differences in the cost of activism and the regime of shareholder proposals, which are nonbinding in the US, while binding in most of Europe. Furthermore, incentives to become active crucially depend on firm characteristics, in particular on ownership structure. This is confirmed by the fact that fundamental differences exist in the objectives of shareholder activism between the UK – where shareholdings are dispersed and activists often use proposals to replace the board – and Continental Europe where ownership is concentrated and proposal objectives are generally confined to governance issues.

Renneboog and Szilagyi suggest that there might be scope for further harmonisation in the areas of investor coordination and voting. For example, the EU rules on acting in concert may deserve clarification, so as to reduce regulatory disparities across Member States and

facilitate effective monitoring. However, further harmonisation looks problematic: it would probably require tilting the current balance of power between shareholders and boards, which may be both unwarranted and could be in contrast with the subsidiarity principle. On the other hand, a tailor-made intervention by national legislators could make the playing field more uneven.

Policy choices in this field imply trade-offs. Making shareholder coordination easier mitigates the agency problems between managers and shareholders as a whole, but aggravates the agency problems between different classes of shareholders (ECLE 2011). In fact, institutional investors will find it easier to coordinate their voting *ex ante*. However, blockholders may also benefit form a looser treatment of concert actions, which may allow them to enhance their control powers and exercise the same to the detriment of minority shareholders.

The need for more transparency also applies to the voting behaviour of institutional investors and the role of proxy advisors. In this regard, it remains to be seen whether the adoption of UK-style codes of conduct (on a "comply-or-explain" basis) is sufficient or if specific areas require a direct, regulatory intervention[37].

6.3.2 The Italian slate voting system

Belcredi, Bozzi and Di Noia in chapter 8 analyse board elections in Italy, offering further insights into the pros and cons of shareholder activism. Board elections came to the forefront after the financial crisis. In the US, shareholders' influence over board elections is – apparently – at a historical minimum, so that a number of regulatory proposals were put forward to increase the role of shareholders (Gordon 2008; Kahan and Rock 2011). In Europe, the adoption of multiple-winner voting rules granting board representation to minority shareholders is one of the measures mentioned by the Green Paper on the EU Corporate Governance Framework to support the alignment of managerial incentives, particularly in companies with a controlling shareholder. The analysis of previous national experiences allows a better assessment of similar regulatory proposals. The Italian case looks particularly interesting in this regard, as the introduction of a multiple-winner system has been quite effective in stimulating activism.

[37] The point is specifically analysed by Wymeersch (2013).

Belcredi, Bozzi and Di Noia show that the submission by minority shareholders of a board candidates' slate is associated with firm characteristics (above all, ownership structure and firm size), while voting rules are comparatively less relevant. In particular, shareholder activism is hardly affected by the quorum required to submit a list, which is, on average, one-fourth of the stake held by the second-largest shareholder (the ideal candidate to seek board representation). The identity of active investors also varies with firm characteristics. Mutual funds are active in a small number of blue-chips and other well-established companies (satisfying criteria of prudent investment), while individual minority shareholders holding a relevant stake submit slates in family firms. Mutual funds' activism is affected by transaction costs and portfolio composition and, possibly, by the "political returns" expected from becoming active. Furthermore, they face regulatory hurdles (the "acting in concert" regime being perhaps the most conspicuous), which are not easily overcome save for a favourable stance taken by the supervisory authorities.

These results have a number of implications for the policy debate on activism (not necessarily limited to corporate elections). A multiple-winner voting rule spurs activism in a minority of cases. Where apathy is nonetheless prevalent, board representation might simply not be a cost-effective way to monitor management. In addition, the impact of regulation may differ according to firm characteristics. This is particularly relevant at the EU level, since regulatory harmonisation would regard industrial and ownership structures which are quite diverse across Member States.

Once a multiple-winner system is in place, however, activism is relatively insensitive to the voting rules specifically adopted at company level. Moreover, transaction costs of activism are likely substantial, while benefits from additional monitoring are, at best, uncertain. The incentives to activism depend on characteristics of the institutional context (such as ownership structure, regulatory and supervisory approaches, etc.) which may vary across Member States. No clear case for EU harmonisation can be made as a result. Decisions in this field are best left to individual shareholders, who can fully appreciate costs and benefits of alternative strategies.

7. Policy

It is unclear whether, and to what extent, dysfunctional corporate governance has contributed to the recent financial crisis. In order to answer this question, financial institutions

should be distinguished from other companies. Recent empirical studies show that corporate governance may have contributed to excessive risk-taking by banks, in the sense that firms characterised by "good" corporate governance fared worse during the financial turmoil. One could infer that corporate governance has been too successful in aligning managers' incentives with the interests of shareholders. However, it is also important to consider that financial institutions are highly levered and that the agency costs of debt are therefore important for them. These costs create a last-stage problem, which materialises when the risk of default is non-trivial, leading shareholders (and the managers appointed by the same) to deviate from value maximisation. If regulation of risk-taking by financial institutions is insufficient or ineffective, corporate governance may exacerbate managers and shareholders' incentives to gamble with creditors' money. In other words, corporate governance standards are not necessarily "wrong", but may create perverse incentives in firms which are not properly regulated and supervised. As a result, banks may need better prudential regulation and supervision rather than corporate governance reform.

A different question is whether corporate governance standards are correctly defined. No doubt, corporate governance mechanisms have intrinsic limitations. For example, independent directors may be fit to supervise related party transactions, but less to control the conflicts of interest between shareholders and creditors (for possible lack of professional skills and experience). We still know very little about the relative merits of different mechanisms and should therefore be cautious in extending corporate governance standards along a 'one size fits all' model. Codes of best practice play a key role in this regard by allowing individual firms and countries to benefit from experience and improve on their practices incrementally.

As to non-financial companies, the evidence of dysfunctional corporate governance (and of a possible causal link with the recent turmoil) is even more limited. Consequently, also the need for EU reform finds limited support. Let us consider the four main corporate governance areas analysed in this volume (board structures, directors' remuneration, shareholder activism and "comply or explain") and draw some policy implications.

7.1. Board structures

The arguments and evidence provided in this volume suggest restraint in the design of new standards for board structures. For instance, increasing board diversity carries costs as well as benefits. If board members differ as to nationality, language differences may determine

communication problems which are no less dangerous than "groupthink". No easy recipe exists for board diversity. Optimal governance structures, to a large extent, depend on firm-specific factors, the evaluation of which is best left to shareholders. A similar argument can be advanced for minority investors' access to the boardroom, the benefits of which depend on the ownership structure and size of companies.

No clear case for regulation can derive from anecdotal – and, so far, unsystematic – evidence of market failures. Shareholders' decisions have not been proven to be systematically flawed and in need of correction. Nor is it clear why national (or EU) legislators may be expected to produce a superior outcome. Gender diversity is different to the extent that the protection of the general interest to granting equal opportunities to women is at stake, which has however little to do with shareholder value. EU intervention in this regard may add a separate layer of rules which are not necessarily fully consistent (as to substance and timing) with national approaches to gender diversity. It seems therefore important at least to keep some flexibility in the formulation of uniform standards. A general argument against EU regulation is that board structures should vary depending on social and institutional features, which greatly differ across Member states, including ownership structures; the board-centric or shareholder-centric orientation of each governance system; the prevailing management culture; other aspects of the legal system, such as the quality of private and public enforcement. Governance models are "sticky" and path-dependent (Bebchuk and Roe 1999; Schmidt 2004), so that new rules on boards would yield different results across Member states.

Similar arguments hold for non-binding standards. As the EU recommendations on board structure, composition and functioning grow in size and impact, their basis appears to be thinner, especially if it consists of theoretical models rather than observable best practices. Moreover, abstract analysis is easily bent to serve individual constituencies, so that the new standards may be influenced by fashions and fads. No doubt, any adverse consequence of innovation as to codes of best practice is tempered by their non-binding nature. This may lead to experimenting new solutions, however dubious their merits. In addition, possible deviations in practice from the new (arguable) standard may be exploited to support a call for binding rules, which would then crystallise solutions that are weakly grounded.

7.2. Directors' remuneration

Directors' remuneration is still a hot topic in the policy debate. Once again, a distinction should be made between financial institutions and other firms. Many have regarded managerial compensation as one of the causes of excessive risk-taking by financial institutions, if not as one of the determinants of the financial crisis. Nonetheless, the available evidence shows that managerial and shareholder interests were aligned in banks before the crisis and that short-term incentives not necessarily had an adverse impact on bank performance during the crisis. One of the likely main reasons for excessive risk taking was insufficient or ineffective prudential regulation, rather than flawed corporate governance.

However, some new rules concerning the disclosure, governance, level and structure of managerial remuneration have been enacted in response to the turmoil. Moreover, our evidence in this volume shows that the level and structure of managerial compensation in European financial institutions have indeed changed after the crisis. In particular, CEOs experienced a decrease of their cash bonuses, while other components of remuneration remained substantially unchanged. Furthermore, stock grants have apparently become more popular than stock options. It is, however, difficult to assess whether pay-performance sensitivity has increased or decreased as a result.

In non-financial companies leverage is generally much lower, so that excessive risk-taking, while troublesome, causes less concern. The main worry is that managers may use their power to extract rents from the company through their compensation to the detriment of shareholders. "Excessive" compensation may, in particular, derive from unduly complex structures adopted to "camouflage" the true amounts paid and to avoid shareholder scrutiny. There is no easy way to cope with this problem, since the informational asymmetry inherent in the manager-shareholder relationship is not easily overcome.

As a result, no clear case can be made for regulatory intervention on the level/structure of managerial remuneration at non-financial companies. For example, schemes that have somehow become popular, such as malus and clawback clauses in compensation arrangements, are less needed for this kind of firms. Two types of remedies have rather been adopted at EU level, which either regard the corporate governance structure (remuneration committees and say-on-pay) or remuneration disclosure. Governance solutions are generally non-binding (like the EU recommendation on remuneration committees), as they may also depend on the underlying national law and require further experimentation. Even when binding provisions are adopted at national level, as in the case of say-on-pay, flexibility is often preserved through the

adoption of an "advisory" vote (an unprecedented solution in some jurisdictions). Our evidence shows that conformity to EU recommendations concerning the governance of the remuneration process is generally good. We see no need to change the current approach in any fundamental way.

The same considerations do not apply to disclosure, for which mandatory provisions may be preferable. To be true, our evidence in this respect shows that the implementation of EU recommendations in the Member States has been rather diverse. Disclosure of individual remuneration has increased remarkably over the last few years, while transparency lags behind as to forward-looking policy, breakdown of pay components, performance parameters for the variable component and dynamics of stock-based compensation. No doubt, the implementation of recommendations takes time, but the issue requires careful monitoring, so as to better assess whether harmonisation of disclosure might be in order also for non-financial firms.

The optimal degree of transparency about remuneration packages is nonetheless debated. While disclosure may contribute to keep managerial rent-extraction under control, it could also determine a "ratcheting" effect in firms where remuneration is below average. As a result, additional disclosure could reduce the cross-sectional variance of compensation, which is not necessarily a desirable outcome. Moreover, remuneration disclosure is subject to intrinsic limitations, especially where it forms the basis for a shareholder vote. Indeed, remuneration packages are complex and shareholders may lack the incentive and expertise to analyse the relevant information and decide correctly. Say-on-pay may be insufficient to control rent-extraction or, worse, may favour herd behaviour (i.e. box-ticking and adherence to a conventional standard model). The role of proxy advisors may be crucial in this regard.

While it is difficult to say whether (and to what extent) managerial remuneration is "excessive" or "unduly complex", the evidence produced in this volume shows that level and structure of CEO pay in non-financial European firms have not changed much after the crisis. Of course, this evidence has no clear implications about the presence of rent-extraction by managers (which might alternatively be absent or have not changed with respect to the situation before the crisis) or the effectiveness of alternative governance arrangements. However, some evidence shows that remuneration is related to firm fundamentals, such as size, sector, growth opportunities and corporate results. This is consistent with the hypothesis that the market for managerial services is, at least to some extent, efficient.

7.3. Shareholder activism

It is uncertain whether regulation should promote shareholder "engagement" with the firm and managerial accountability. The EU Commission has already adopted a series of measures aimed at removing impediments to the exercise of shareholders' rights, thereby favouring cross-border mobility of capital. Further measures are being considered.

Our evidence about shareholder activism in Europe is mixed. Activists target firms that both underperform and are subject to governance concerns. This suggests that, as in the US, shareholder activism may be a useful disciplinary tool. Shareholders, however, submit proposals much less frequently than in the US, particularly in Continental Europe. Furthermore, both the frequency and targets of activism differ greatly across countries. Ownership structures and national corporate law have an impact on activism. Shareholder proposals are not on the rise and their success is limited across Europe irrespective of the issues addressed. The votes cast in favour of shareholder proposals are on the rise, which implies that shareholders' ability to dissent is greater than before (possibly an effect of the shareholders' rights directive). However, the exercise of "voice" led to surprising results only in a handful of "outrageous" cases. The effectiveness of this type of monitoring – particularly where ownership is concentrated – is open to question.

It is therefore unclear whether further regulatory intervention is needed, except for investor coordination and voting. In particular, the EU rules on acting in concert may deserve clarification, so as to facilitate engagement efforts, especially by institutional investors. Rules on insider trading and market abuse might also be amended to facilitate proper dialogue between companies and investors. There might also be some scope for reducing the limits to cross-border voting by institutional investors, even though it is unclear whether the procedural and information costs of activism would be substantially reduced as a result. Indeed, some limits to activism are beyond the reach of national and EU regulators, while the transaction costs of activism are higher in case of cross-border investments. In general, the decision to engage in activism should be left to individual investors, who will then proceed on the basis of their own cost-benefit analysis.

Similar conclusions apply to activism in board elections. The available evidence about the Italian investor-friendly voting system shows that the existence and identity of active shareholders are associated with firm-specific characteristics (mainly ownership structure and firm size), while voting rules are comparatively less relevant. Institutional investors concentrate

their efforts on a small number of blue-chips given transaction costs and portfolio composition, and also the "political returns" from being active. Furthermore, they face some regulatory hurdles, which are not easily overcome unless a favourable stance is taken by supervisory authorities.

However, activism in board elections takes place only in a minority of cases, despite the list voting regime. This seems to indicate that shareholder apathy is indeed rational and that shareholder-friendly rules generate a modest incentive to be active. Board representation of minority investors might simply not be a cost-effective monitoring instrument. As incentives to activism depend on the institutional context and this varies across Member States, no clear case for EU harmonisation can be made. Decisions in this field are best left to individual shareholders, who can fully appreciate the costs and benefits of alternative strategies.

There is also growing pressure to enhance transparency about the level and scope of asset managers' engagement with investee companies, along the lines of the U.K. Stewardship Code. Disclosure of engagement and voting policies may, however, end up as a mere box-ticking exercise with little value unless it is monitored by ultimate (individual or institutional) investors. Moreover, increased transparency can create an artificial demand for the services of proxy advisors, increasing the risk of "herding" behaviour. Additional analyses are needed to address these issues.

7.4. Comply or explain

"Comply or explain" is a core principle of European corporate governance, which was officially enacted through Directive 2006/46/EC mandating transparency as to the application of corporate governance codes. This principle enjoys broad support in practice thanks to its flexibility (Riskmetrics 2009). Codes of best practice allow individual firms and countries to take advantage from previous experience and to improve standards incrementally through a process of trial and error. The voluntary adoption of governance mechanisms diffuse in corporate practice (such as board committees, senior independent director, separation between chairman and CEO) has been impressive over the last decade.

However, flexibility constitutes also a weakness of "comply or explain", as it is often difficult to gauge the real conduct behind the words of a governance statement. Furthermore, some statements are poorly drafted and carry boilerplate explanations. Briefly, while the

principle receives broad support, its practical implementation is still far from perfect and improvements are no doubt possible.

First of all, codes usually include two layers of principles and the "comply or explain" regime generally applies to one of them. Codes should distinguish more clearly between these two layers, reserving the "comply or explain" mechanism to high-level principles and to provisions that are broadly recognized as "best practice". Once this distinction is made, deviations from the relevant provisions would, in principle, require a specific explanation. However, the question arises of how to mandate (and enforce) disclosure about conformity to a non-binding standard. Reputational mechanisms (relying on investor pressure and the media) are increasingly perceived as insufficient.

The analysis conducted in this volume shows that it is not yet time for further EU harmonisation. Different ownership and governance structures, as well as different legal regimes, counsel avoiding a uniform approach. Rather, corporate governance commissions should better explore how they can learn from each other and, possibly, align their recommendations and terminology. At the same time, companies should streamline their governance practices and disclosures, with the support of European business associations. Only after a careful preparatory work could reasonable high-level principles be developed at the European level. However, national standard setters should probably remain free to adopt only those which fit best to their context.

7.5. The Action Plan

When this volume was almost ready for publication, the European Commission disclosed its Action Plan on European company law and corporate governance, reflecting the outcomes of the 2012 public consultation[38]. Some of the proposals set out in the Action Plan are directly relevant for the topics addressed in this volume and deserve brief comment in this introductory chapter.

Board structure will not be targeted by specific regulation. The Commission acknowledges the coexistence of different board models, deeply rooted in national legal systems

[38] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan: European Company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies, COM (2012) 740/2.

(and possibly linked with different ownership structures) and does not pursue further harmonisation. This is consistent with the results of our analysis. However, we regard the Commission's proposals on board composition as problematic. The Commission will act in order to enhance diversity (in addition to having proposed a directive on gender diversity). No doubt, introducing disclosure requirements relative to firms' board diversity policy is a form of light-touch regulation. Nonetheless, we see a similar move as weakly grounded, since strong evidence that board diversity is suboptimal is currently lacking[39]. In addition, this move is not supported by the results of the consultation on the 2011 Green Paper, the responses to which were almost equally divided between those favouring and those opposing specific measures in this regard. Furthermore, disclosure requirements could pave the way to substantive regulation if the former were found insufficient to attain the stated regulatory objective. From a similar perspective, disclosure is problematic to the extent that it is used to indirectly attain a given governance structure on which no consensus presently exists.

A substantial part of the Action Plan's proposals aim at enhancing the engagement of shareholders. Firstly, the Commission plans to strengthen the transparency rules for institutional investors. While this development is welcome in principle, small investors usually lack either the competence or incentive to monitor the behaviour of investment managers. Therefore, initiatives in this direction may practically translate into box-ticking exercises or determine herding behaviour. We also suggest caution in devising the proposed regulation of proxy advisors, so as to avoid mistakes similar to those made in the past vis-à-vis rating agencies. Regulation should improve the transparency and limit the conflicts of interest of proxy advisors, but avoid creating perverse incentives to the use of their services (such as attaching legal consequences to the same, thereby protecting the business model of a conflicted participant in an oligopolistic market).

Our analysis shows that shareholder activism carries transaction costs, as well as benefits. Therefore, shareholders should ultimately decide on activism, as also suggested by the Action Plan which does not mandate engagement with listed companies. Rather, the Commission's strategy focuses on two goals. The first is to remove some of the regulatory obstacles to shareholder engagement. The Commission plans to work with national authorities

[39] In this regard, gender diversity is different, since regulatory proposals are clearly stakeholder-oriented. However, even in this case, the Commission has completely overlooked the practical issues potentially associated with the implementation of quotas.

and ESMA to increase legal certainty on the relationship between investor cooperation on corporate governance issues and the rules on acting in concert. The second goal is to encourage shareholder engagement on specific issues, with respect to which outside monitoring of managerial and/or board actions looks particularly useful and cost-effective. The Commission proposes to enhance oversight of directors' remuneration through harmonised disclosure and voting on the firms' remuneration policy *and* remuneration report, and to promote shareholder oversight of significant transactions with related parties. On the other hand, the Commission has abstained from proposing rules on minority representation in corporate bodies.

The Commission's approach to activism is in accord with our policy conclusions. However, increased activism may still raise some concerns, especially in area of "say-on-pay". On one side, the "mandatory shareholder vote" contemplated by the Action Plan should provide sufficient flexibility to accommodate also non-binding regimes, which have not been proven to be dysfunctional. On the other, remuneration packages are intrinsically complex and hard to evaluate. Moreover, the sheer number of investee firms is a formidable obstacle to specific analysis by institutional investors. As a result, investment managers wanting to comply with the new requirements may simply outsource the whole process to proxy advisors, who may come to dominate the same from their oligopolistic position in the relevant market.

Finally, corporate governance codes based on the "comply-or-explain" approach have, once more, substantially passed the Commission's scrutiny and will not be targeted by new regulation. However, the Action Plan remarks that the explanations provided by companies are often still insufficient, even though some national self-regulatory bodies try to improve the quality of explanations. The Commission wishes to encourage the exchange of best practices developed in different Member States and will take a further initiative – possibly in the form of a recommendation – to improve the quality of corporate governance reports. This development is also consistent with our analysis.

8. Concluding remarks

This volume analyses a number of topics concerning the role of boards and shareholders in the corporate governance of European listed firms. The evidence provided in the following chapters challenges the conventional wisdom that corporate governance arrangements in European firms are

systematically dysfunctional and have contributed to the financial turmoil. Even though our volume does not specifically target financial institutions, a growing body of evidence indicates that, when looking for the ultimate cause of the financial crisis, lack of proper regulation and supervision is a more likely candidate than flawed corporate governance.

We analyse four main topics in the corporate governance of European listed firms: board structure/composition and its interaction with ownership structure, board remuneration, shareholder activism and corporate governance disclosure based on the "comply-or-explain" approach. For each of them, we provide new evidence which allows us to derive specific implications relevant for the policy debate both at Member State and EU level. Basically, we show that proposals aimed at increasing disclosure and accountability are generally well-grounded, particularly in the areas of remuneration and of compliance with corporate governance codes. However, we suggest caution with respect to proposals targeting specific governance arrangements, as they may determine unintended consequences. Whilst the European Commission has – so far – refrained from adopting an excessively intrusive stance, further analysis would, in any case, be needed before adopting harmonisation measures in the fields of board composition and shareholder activism.

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