

ON CORPORATE GOVERNANCE, MANAGEMENT AND ENTREPRENEURSHIP IN OECD COUNTRIES

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Abstract

This paper studies corporate governance and its effect on corporate performance. It gives an explicit exposition of the shareholder and stakeholder models of corporate governance. It accounts for specific aspects of management and entrepreneurship. Special attention is paid to the financial mechanisms of corporate governance. Moreover, the legislative background is considered as a factor of effective corporate governance.

Keywords : corporate governance, corporate performance, financial mechanisms

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Introduction

This paper studies corporate governance and its effect on corporate performance. It gives an explicit exposition of the shareholder and stakeholder models of corporate governance. It accounts for specific aspects of management and entrepreneurship. Corporate governance systems can be identified by the degree of ownership and control and the identity of controlling shareholders. In outsider systems characterized by wide dispersed ownership as in the U.S and UK, the main specificity is the conflict of interest between strong managers and widely-dispersed weak shareholders. In insider systems characterized by concentrated ownership or control as in Germany and Japan, the main specificity is the conflict of interest between controlling shareholders (or blockholders) and weak minority shareholders. There are several models of corporate governance since each country has developed a variety of mechanisms to overcome agency problems arising from the separation of ownership and control.

One way to describe corporate governance regimes has been to distinguish "outsider" and "insider" systems. This distinction draws heavily on the shareholder and stakeholder models. In particular, the relative performances of each system are centered around the degree of ownership concentration, the respective role of banks, stock markets and institutional investors, the protection of minority shareholders or the legal framework.

Section 1 studies corporate Governance and the effects on firm performance. It develops some alternative explanations. It studies corporate governance with respect to management and entrepreneurship.

Section 2 develops a comparative analysis of corporate Governance systems.

Section 3 presents a legal view of Corporate Governance Systems.

Section 4 develops the legal view of Corporate Governance in OECD countries.

Section 1. Corporate Governance and the Effects on Firm Performance : alternative explanations

1. The Shareholder and Stakeholder Models of Governance, Management and Entrepreneurship: the General Framework

Corporate governance has been often regarded in the context of the "principal-agent" relationship when the owner of the firm is not the person who manages or controls it. There is a separation between the financing and the management decision or a separation between ownership and control (Berle and Means (1932)).

The effect of corporate governance on the firm behavior and economic performance depends on the definition of purpose of the firm. In economic literature, there are mainly two models of the corporation: the shareholder model and the stakeholder model.

In the shareholder model, corporate governance studies the system of accountability of senior management to stockholders. In the stakeholder model, corporate governance studies the network of formal and informal relations involving the corporation.

1.1. The Foundations of the Shareholder Model and Entrepreneurship

The objective of the firm in this model is to maximize profits. Performance is appreciated by the market value of the firm. Managers and directors must ensure that the firm is run in the interests of shareholders. The principal-agent relationship arising from the separation of ownership and decision-making causes the firm's behavior to diverge from the profit-maximizing ideal. Since managers are not the owners of the firm, they can have other objectives such as maximizing their salaries or an attachment to particular investment objectives rather than maximizing the shareholder wealth. The principal-agent problem enters also under the scope of the "incomplete contracts" view of the firm developed by Coase (1937), Williamson (1975), Jensen and Meckling (1976), Hart (1995) among others. It is nearly impossible to design complete contracts allowing investors to align the interests and objectives of managers with their own because of the impossibility to foresee all future contingencies. Therefore, Hart (1995) views corporate governance structures as a mechanism for making decisions that have not been specified in an initial contract between owners and managers.

The "agency" problem appears also as an asymmetric information problem since managers are better informed regarding the firm's actual and future cash-flows. As a consequence, managers have substantial residual control rights and discretion in the process of allocation of resources. In this setting, corporate governance deals with the limits on managers' discretion and accountability.

The opportunistic behavior of managers can reduce the amount of resources that investors are willing to put up ex-ante to finance the firm. This represents the "hold-up" problem discussed in Grossman and Hart (1986) and Williamson (1975) among others.

In the shareholder model, an effective corporate governance framework must minimize the agency costs and hold-up problems. It is possible to align the interests and objectives of managers with those of shareholders by aligning directly managers interests with those of shareholders using executive compensation plans, stock options, direct monitoring

by boards, etc. Another method consists in enhancing the rights of shareholders through legal protection and enforcement of shareholder rights and prohibitions against insider-dealing. A final method consists in using indirect means of corporate control like capital markets and markets for corporate control and managerial labor markets.

To this end, the shareholder model assumes that the conflicts are between strong managers and weak dispersed shareholders. This represents one of the critiques of this model. Work in this spirit is interested on the role of the board of directors, stock options, the effectiveness for take-overs, shareholder protection.

In this respect, the dominant organizational form of the firm is one characterized by concentrated ownership because ownership concentration allows to resolve the monitoring problem. Since the benefits from monitoring are shared with all stockholders, some of them have an incentive to "free ride" when the ownership is not concentrated.

Thereby, the main problem of corporate governance in this context is to develop reforms that retain the benefits of monitoring provided by concentrated ownership and encouraging at the same time the flow of external funds to corporations.

1.2. The foundations of the Stakeholder Model

The stakeholder model considers a broader view of the firm by incorporating all the stakeholders such as employees, suppliers, customers, creditors and the society at large. In this context, corporations must fulfill wider objectives and have responsibilities to parties other than shareholders.

In this context, the implications of corporate governance on economic performance must account for the incentives and disincentives faced by all stakeholders who contribute to firm performance. Blair (1995) defines stakeholders as actors who have contributed firm-specific assets.

In the stakeholder model, the "best" firms are ones with committed suppliers, customers and employees. This approach is consistent with the transaction costs and incomplete contract theories of the firm as in Coase (1937), Williamson (1975), Jensen and Meckling (1976) among others.

In this more general context, corporate governance must look for the appropriate mechanisms that elicit firm specific investments on the part of different stakeholders and must develop active cooperation amongst stakeholders in creating wealth. (See CECD 1999 a).

When an opportunistic behavior exists, the principal-agent problem can lead to under investment problems. For example, suppliers and distributors can under invest in firm specific investments such as distribution networks. In this context, corporate governance becomes a problem of searching for the appropriate mechanisms that reduce the scope of

opportunism and expropriation and lead to efficient resource allocation.

Thus, Blair (1995) views corporate governance as a set of institutional arrangements for governing the relationships among stakeholders that contribute firm specific assets. The stockholder model is criticized because managers can use "stakeholder" reasons to justify poor company performance. The benefit of this approach is in its emphasis on overcoming problems associated with opportunistic behavior and in encouraging active co-operation between stakeholders to obtain a long-term profitability of the firm.

Section 2. A Comparative Analysis of Corporate Governance systems

In this section, we briefly describe outsiders corporate governance systems and insiders corporate governance systems. Then we review the traditional equity versus debt debate and the legal approach of corporate governance.

2.1. Outsider Corporate Governance Systems

'Outsider' systems as in the US and UK are characterized by widely dispersed share ownership and high turnover. These systems tend to place a stronger emphasis on the protection of minority investors. The absence of concentration ownership may discourage active corporate governance. Regulation in this system provides adequate shareholder protection and allows investors to assume the risk-reward trade-off with an equal access to information. In theory, shareholders have the power to select members of the board and to vote upon key issues facing the company, but in practice this is limited by the fragmentation of ownership. The strong protection of minority shareholders and transparency characterize the outsider system. The board of directors plays a major role in the corporate governance framework. The board is responsible for monitoring managerial performance and preventing conflicts of interests. The board is also responsible for reviewing key executive and board remuneration. The board must have some degree of independence from management in outsider systems. However, this independence poses a problem in reality when the board can become entrenched. This is the case when board members are compensated for their activities and are at the same time responsible for overseeing executive and board remuneration. In theory the board should represent the interests of shareholders, but in practice, they often become part of the management. Therefore, the board is often regarded as a relatively weak monitoring device.

Outsider corporate governance systems are also characterized as a market based system and a "disclosed-centered" system. On one hand, there

have been two traditional channels of financial intermediation. Thereby, finance tends to be short-term and banks tend to develop arm's length relationships. Most outsider systems have developed independent investment banking and specialized securities markets. In this respect, the stock market plays an important role. Thus, equities tend to represent a high share of financial assets and a large part of GDP. In addition, shares ownership in the US and UK are characterized by the domination of institutional investors. This trend can be attributed to the tax incentives extended by governments to collective schemes, the growth of mutual funds and the tendency for companies to issue shares directly to institutional investors. On the other hand, outsider systems can also be described as "disclosed-based" (Fox, 1998). The corporate governance framework in 'outsider' systems favors the use of public capital markets. Capital markets influence the behavior of key parties. Firstly, minority investors are afforded a high degree of protection in securities law. Secondly, the monitoring of management is based on the discipline of capital markets. This assumes liquid stock markets and an adequate disclosure of information. An effective corporate governance framework can limit the scope for managerial discretion. Thus, the market for corporate control can represent a more effective disciplinary device than either the board of directors or the monitoring by institutional investors.

In fact, when managers fail to maximize the firm's value, they expose it to the threat of a take-over and the removal of inefficient management. The threat of a take-over may be an effective disciplining mechanism. The intensity of mergers and acquisitions can be justified by rent seeking behavior, empire building and tax minimization.

2.2. Insider Corporate Governance Systems

'Insider' systems are characterized by concentrated ownership or voting power and several inter-firm relationships and corporate holdings. Examples include Europe (except UK), Japan and Korea among others. These dominant features in the insider systems are banks, holding companies, and familial control. Insider systems reveal close relationships with banks, cross-shareholdings and pyramidal structures of corporate holdings. Shareholders can extend their control at relatively low cost by resorting to cross-holdings, pyramiding, proxy votes, dual-class shares, etc.

In insider systems, cash flow rights and control rights are aligned. This gives majority shareholders the incentive and the power to monitor management. When ownership is dispersed and voting power is concentrated, controlling blockholders have an incentive to engage in active monitoring. In fact, with concentrated ownership, the majority shareholders and blockholders obtain a significant

fraction of the benefits from monitoring. Hence, the main problem in insider systems is the conflict between controlling shareholders (or blockholders) and outside minority shareholders. In other words, the basic conflict is between "strong voting blockholders, weak minority owners" or "weak managers, weak minority owners, strong majority owners".

In the presence of dispersed ownership but concentrated voting power, management entrenchment is possible when blockholders are also managers. Among others, the argument of one-share-one vote in this context makes takeovers very difficult. The concentrated voting power can increase monitoring and performance but gives the possibility to the controlling owner to extract private benefits or to collude with management at the expense of small shareholders. Shleifer and Vishny (1997) show that ownership concentration and voting power concentration can become detrimental because small investors can avoid holding shares and the flow of external capital to firms is impeded. The problem of rent extraction by controlling shareholders is that it raises the cost of capital since minority shareholders demand a premium on shares issued.

One of the consequences of rent extraction in insider systems is the lack of opportunities for risk diversification as a consequence of illiquid markets. Concentrated ownership can increase the incentives for monitoring and encourage more long-term relationships amongst stakeholders. Even if capital markets are less developed in insider systems, the long-term nature of relationships can encourage a greater investment in firm-specific assets.

Long-term relations with banks and financial institutions, which can affect the performance of the corporate sector because the available financing to firms affects the cost of capital, can also characterize insider corporate governance systems. In insider systems, debt/equity ratios are typically higher. For example, the German and Japanese systems of corporate governance are typically based on long-term relationships with banks who perform monitoring and screening functions. This can lower the overall cost of capital faced by firms. The 'bank-based' systems reduce asymmetric information and enable banks to supply more external finance to firms at a lower cost. This increases monitoring and investment and ensures that firms are run more efficiently. Since small and illiquid public capital markets characterize insider systems, the dominant pattern for small firms is debt financing. However, banks face an asymmetric risk when assessing small firms and new start-ups. Thadden (1995) shows that the long-term relationships with banks can also reduce biases that might favor investments that generate improvements in performance.

The role of financial institutions in financing failing companies makes a distinction between different corporate governance systems. Asymmetric information problems are important in the

refinancing of failing firms. Mayers (1996) shows that restructuring of poorly performing firms is an important feature of the Japanese financial system. He states that UK (and US) financial institutions intervene too late in corporate restructuring.

In addition, insider systems are characterized by long-term relationships between the contractual partners of the firm. These long-term relations are important in high technology industries or activities with high asset specificity. Ownership by one corporation in another reduces transaction costs and 'hold-up' problems related to opportunistic behavior. Complex patterns of ownership and cross-shareholdings allow insiders to exercise control over a group with a small share of the total outstanding equity of the firm. Pyramidal groups provide a wide access to capital and minimize the agency costs associated with the monitoring of management. Horizontal and vertical arrangements can protect both the group and lower level holdings from hostile take-overs. As a consequence, the market for corporate control in insider systems seems to be less well developed than in outsider systems. The arrangements can also result in collusive behavior.

2.3. Relative Performances of Bank-based and Market-based Corporate Governance Systems

As discussed previously, corporate finance and governance systems can be defined by the degree to which securities markets compete with intermediaries (typically banks) to provide external finance to firms. In addition, the nature of the ties between financiers and firms, and the degree of influence and monitoring on a firm's decisions of financiers are important characteristics of corporate governance systems. For example, securities markets in the United States and the United Kingdom have been much more important in funds' provisions to firms than in Germany and Japan. In this respect, the debate has mainly focused on the way to provide external finance and the respective advantages of each system. In theory, a large amount of literature has compared debt contract versus equity contract for solving agency problems (Schleifer and Vishny, 1997).

Thereby, policy makers and economists have generally compared the relative merits of bank-based and market-based systems. On one hand, the "banketeers" generally argued that securities markets are an ineffective device for exerting corporate control. Second, liquid equity markets may facilitate takeovers, which may be socially inefficient (Schleifer and Summers, 1988). Third, more liquidity may reduce incentives to undertake careful corporate governance. Fourth, markets will typically induce "free-rider" problems where an outsider expends lots of resources to get information while others have an incentive to wait for results. Fifth, existing managers often take actions, which deter

takeovers and thereby weaken the market as an effective disciplining device. Sixth, although shareholder should be able to control management through boards of directors, an incestuous relationship may appear between boards of directors and management. However, a growing body of empirical and theoretical literature tends to show that the functioning of equity markets affects liquidity risk diversification, acquisition of information about firms and corporate control. Firstly, whereas high-return projects generally require a long-run commitment of capital, investors are not enthusiastic to relinquish their savings for a long period. Thus, a liquid stock market or other financial arrangements used may promote high return project. Secondly, the stock market may provide a vehicle for risk diversification. Investors may prefer to invest in a large number of firms and diversify their portfolio. Thirdly, as pointed out by Grossman and Stiglitz (1980), Holmstrom and Tirole (1993), stock markets may also induce the acquisition of information about firms. Opinions differ, however, on the importance of stock markets in stimulating the acquisition of information. In effect, well functioning stock markets can reveal very quickly information through price changes (Stiglitz, 1985, 1994). Finally, corporate control can be influenced by stock market development. Among others, Diamond and Verrechia (1982) and Jensen and Murphy (1990) have shown that stock market development may reduce the principal-agent problem. Moreover, Laffont and Tirole (1987) and Scharfstein (1988) argue that take-over threats induce managers to maximise the value of the firm or a firm's equity price. Thus, well-functioning stock markets that ease corporate take-overs can mitigate the principal-agent problem. Stiglitz, however, claims that outsiders will be reluctant to take over firms because they have worse information about firms than owners. Then, the corporate control of market is only efficient under specific conditions. The take-over threat is not necessarily a useful mechanism for exerting corporate control and, in some cases, stock market development will not improve corporate control (see further). Schleifer and Summers (1988) also show that welfare-reducing changes in ownership and management can result in firm's take-overs. Schleifer and Vishny (1986) and Black (1993) claim that an active stock market may encourage more diffuse ownership and the diffusion of ownership increases effective corporate governance.

On the other hand, "marketeters" have mainly centered their criticisms on the problems created by power banks. First, banks as debt issuers have an inherent bias toward prudence (Allen and Gale, 1999), so that bank can significantly reduce corporate innovation (especially in case of high technologies). In particular, Sahman (1990), Porter (1992) claim that the US system appears to be better at funding emerging companies and new (often high technology) business activities than German and

Japanese systems. Franck and Mayer (1992) outline that such a comparative may explain the predominance of high technology firms in internet and communication technologies, and biotechnology. As pointed out by Porter (1992), liquidity of US capital markets allows better reallocation of capital from low to high growth sectors. Wurgler (1999) shows that countries with stock markets that impound more firm-specific information into individual stock price do have a better allocation of resources. In addition, state ownership companies have a poor allocation of capital. The literature also suggests some other link between institutional structures and corporate governance. On one hand, the literature suggests a relation between the institutional structures of countries and the type of activities that are undertaken in these countries. The first strand is based on information theories (see Allen and Gale, 1993, 1999). The second strand focuses on commitment theories: concentrated ownership is associated with activities that involve investments by other stakeholders and dispersed ownership with the adoption of new technologies that could be resisted by other stakeholders. The third strand relies on control theories. According to Dewatripont and Maskin (1995), fragmented banking systems are associated with short-term investments and concentrated with long-term investments. Similarly, dispersed ownership systems are associated with high-risk research and development investments and concentrated ownership systems with lower risks, more imitative investments.

Second, banks have a powerful position as active monitors (for example in Germany and Japan). They may therefore exercise influence through their control of the firm's access to external funds. Their large shareholder status insures that they have both the incentive and the ability to directly monitor management through their presence on the board and the vote they can exercise at the general meeting. In this case, the major problem is "who monitors the monitors?". Therefore, bankers can act in their own interests. In effect, bankers may become captured by firms or collude with firms against other creditors (Black and Moersch, 1999; Wenger and Kaserer, 1998). However, bank-based systems may partly overcome these issues. For example, according to Aoki (1996), the main bank in Japan may administer three types of monitoring: ex-ante, interim and ex-post. On one hand, banks can monitor ex-ante investment decisions by examining loan applications. On the other hand, interim monitoring concerns performance of the on-going business and projects carried out by company. Finally, ex-post monitoring involves evaluating the financial performance of the company and intervening in the management of the firm when the firm is in distress. Recent studies (Edwards and Nibler, 2000; Gorton and Schmidt, 2000) also show that one of the main characteristic of the German corporate governance system is the role of banks (universal banking)

Based on the choice between the German and Anglo-Saxon styles of financing, Black and Moersch (1999) provide a very useful distinction between the relative merits of bank-based and market-based. They compare the factors affecting the choice of financial system. Therefore, the cost of information gathering is low (high) in bank-based systems (market-based systems). Second, the liquidity risk is more important in market-based than in bank-based. Third, the market price risk is low in bank-based whereas high risks and return in financial markets characterize it. Fourth, the market-based system is more sensible on the principal-agent hazard than the bank-based system. Fifth, the diversification of risk is provided by banks and by savers in market-based systems. Sixth, the corporate control is thinning ("robust") in bank-based (market-based). Finally, accounting costs are lowering in bank-based than in market-based systems.

At the end, the particular advantages of each system do not appear to translate into overall measurable aggregate differences in either the cost of external funding or the effectiveness of the corporate control mechanism. In this respect, the pertinent question is not "which system is the best?" but "How well do financial system perform?".

Section 3. A Legal View of Corporate Governance Systems

The legal approach of corporate governance is a natural extension of the work of Jensen and Meckling (1976). Jensen and Meckling consider financial claims as contracts between investors and firms. These contracts give shareholders and creditors claims to the cash-flows of firms. Research by Grossman, Hart and Moore (Hart, 1995) extend previous work and distinguish between the contractual and residual control rights of investors. In this respect, financial instruments are not defined in terms of cash-flows but rather in terms of rights they provide to their holders. Both approaches outline the importance of investor's rights and their protection. In addition, as noted by Levine (1998), the "legal-based view" as opposed to the "economics and law" tradition, builds on this financial services view. La Porta, Lopez-de-Silanes, Schleifer and Vishny (hereafter, LLSV, 1999) argue that, "in the end, the rights create finance". The legal view is based on the incentives for investors to give their money to managers when both the theory and the evidence suggest that managers have strong incentives to deviate for the optimal profit-maximizing behavior and may expropriate much of the rent. Two sets of explanations have traditionally competed in the literature. The first set merely relies on firms' and managers' reputation. Investors are gullible and get taken this reputation. The second set explains that investors provide external financing to firms because they receive control rights in exchange. In particular, the legal protection of

shareholders becomes the key factor. As pointed out by Hart (1995), external financing is a contract between the firm (or the legal entity) and the investors or financiers. In this respect, Schleifer and Vishny (1997) argue that what explains (much of) differences in corporate governance systems stems from varying legal environments (shareholders rights, creditors rights, legal enforcement) and ownership concentration. Their works starts from legal families and the difference between Common Law versus Civil Law. But "what is special about legal families?"

The literature is based upon two explanations: the judicial explanation (Coffee, 2000; Johnson et al., 2000) which underlines the difference in the legal philosophies using the organization of the legal system and, the political explanation which is based on the differences in political history (Rajan and Zingales, 1999; see further). Contrary to the "Economics and Law" tradition which is based on the theory on financial contracting, (financial contracts take place between sophisticated issuers and sophisticated investors) most regulations of financial markets are necessary. LLSV (1998) discuss a set of key legal rules protecting shareholders and creditors as well as legal enforcement efficiency and accounting standards. Classifying countries by legal origin, they document the prevalence of these rules in 49 countries around the world and find evidence of significant legal framework. In particular, they show that Common Law countries have the strongest protection of outside investors – both shareholders and creditors – whereas the Civil French law has the weakest protection. German Civil law and Scandinavian Civil law fall in between. LLSV (2000) argue that the legal approach is more appealing to understand corporate governance than the usual distinction between bank-centered and market-centered financial systems. In particular, LLSV (2000) show that large differences among countries in ownership concentration in publicly traded firms, breadth and depth of financial capital markets, dividend policies and access of firms to external finance, are explained by how well investors (shareholders and creditors) are protected by law from expropriation by the managers and controlling shareholder firms. In addition, civil law countries are more interventionist than Common Law countries. LLSV (1997) also found evidence of higher valuation of firms in countries with better protection of minority shareholders, and weaker evidence of the benefits of higher cash flow ownership by controlling shareholders for corporate valuation. LLSV (1999) examine patterns of control in the largest firms from each of 27 wealthy economies. The data show that countries with poor investor protection typically exhibit more concentrated control of firms than do countries with good investor protection.

Comparing the growth performances of a sample of industrialized and developed countries,

Levine (1998) has shown that the legal view is much more appropriate than the dichotomy of bank-based and market-based. Kugler (1999) argues that good shareholder protection is one determinant of liquid securities' markets. Therefore, when expropriation of minority shareholders is constrained by laws, investors anticipate high returns and are ready to pay more for shares, which in turn induces controlling shareholders to reduce their stakes and / or give and up control.

Demirguç-Kunt and Maksimovic (1998) examine whether the underdevelopment of legal and financial systems does prevent firms in some countries from investing in growth opportunities that may be profitable. Thus, they show the link between financial markets and institutions and a firm's ability to obtain debt and equity financing. Data show evidence that an active stock market and a well-developed legal system are important in facilitating a firms' growth. Second, there is no evidence that firms use external financing differently if they are in countries classified as bank-based or market-based (using the development of their banking sector relative to their securities markets). Beck, Levine and Loayza (1997) show that the legal origin variables help explain cross-country differences in creditor rights, enforcement quality and accounting standards. In addition, the component of financial development defined by general characteristics of the legal and accounting framework is positively associated with growth. Rajan and Zingales (1997) examine the mechanisms through which financial development affects economic growth. In particular, they study whether industries that are more dependent on external grow relatively faster in countries that essentially have developed financial market and institutions. Data support evidence that industries depending more on external finance grow relatively faster in economies with a higher level of financial development. Second, industries that generate cash flow from operations grow relatively faster in economies with underdeveloped financial systems. Beck and Levine (2000) show that there is evidence neither for the bank-based nor the market-based hypothesis. Second, empirical evidence shows that countries that are heavily dependent on external finance grow faster in economies with a higher level of overall financial development and with better protection of outside investors. Levine (1998) shows that the legal rights of creditors and the ability to enforce those rights are strongly tied to the ratio of bank credit to the private sector. The legal origin has a profound impact on bank development. Empirical evidence also suggests that the components of banking development, defined by legal environment or creditors rights and the efficiency of contract enforcement is positively and robustly correlated with long-run rates of economic development.

However, legal differences may not explain all existing corporate governance schemes or the predominance of a type of financial system. In this

respect, Rajan and Zingales (2001) develop a theory based on the politics of financial development. They claim that a Common Law system allows for more contractual and legal innovation. Hence, it is more conducive to financial development. But they argue that the greater financial development in Common Law countries is not because laws are better in those countries. Because of the decentralization that accompanies Common Law, it makes it easier for financial markets to develop in spite of political opposition and makes it difficult to reverse this development when political changes occur.

Section 4. The Legal View of Corporate Governance in OECD Countries

This section analyzes legal rules covering shareholders protection, creditors protection, law and enforcement and ownership concentration in OECD countries. Based on indicators of La Porta et al. (1998), we compare the characteristics of the four legal families: Common English Law, French Civil law, German Civil Law and Scandinavian Civil Law. Conclusions are close to previous studies and draws heavily on Leahy et al. (2001). One step further, we construct compound measures of shareholders rights, creditors rights and legal enforcement using a principal component analysis. We also build an aggregate measure of "corporate governance" including ownership concentration. Finally, we present new evidence on issues of general shareholders meeting, on the board's structure, on the corporate ownership and control and on the capital structure of company in OECD countries by legal origin.

4.1. Shareholders' and Creditors' Rights, and Legal Enforcement

When investors finance firms, they typically obtain certain rights or powers that are generally set out in bankruptcy codes, company laws, commercial codes and other regulatory framework. Here, we focus on shareholders rights, creditors rights and legal enforcement. We also include ownership concentration. To study these indicators in OECD countries, we report the measures of La Porta et al. (1998). In particular, as mentioned by La Porta et al., the data set does not incorporate measures about mergers and acquisitions activity, disclosure rules, regulations imposed by security exchanges, markets and restrictions in banking and financial institutions. These elements are from being negligible, as we will show later.

Shareholders rights

Shareholders rights are one of the distinct elements between insiders and outsiders systems. We study seven measures of shareholders protection and an aggregate measure (anti director rights). The first –

one share / one vote – provides the basis for an alignment of management incentives with the interests of shareholders. Only Greece and Japan require that ordinary shares offer the equivalent of one vote per share.

Some voting provisions can result in a distortion of the voting mechanism in favor of managers or of dominant shareholders at the expense of minority shareholders. Two measures capture these effects. One is the prohibition of voting by proxy through the mail. Although many of the English Common Law countries, as well as France and Norway, allow proxy voting, most Civil Law countries prohibit it. The second is a requirement that shareholders intending to vote in a shareholder meeting deposit their shares with the company or with a designated financial intermediary several days prior to the meeting. All the English Common Law and Scandinavian Civil Law countries carry the requirement that shares be blocked prior to the general meeting.

Features supportive of minority shareholder representation include the possibility of cumulative voting, in which shareholders are permitted to cast all their votes for one candidate, or for a proportional representation on the board. Except for the United States, Canada, Spain and Japan, such protections are not common in the OECD countries. In addition, some countries give minority shareholders (defined as shareholders who own less than 10 per cent of capital) additional legal rights, such as the right to challenge managers' decisions in court. Only English Common-law countries and Japan give such rights.

The sixth measure – preemptive rights to new issues – is a standing provision giving existing shareholders the option to be first in line to purchase new issues of stocks. It can be seen as a preemptive measure that prevents the dilution of the voting power of existing shareholders, which might come about by measure that prevents dilution of the voting power of existing shareholders. About half of the listed OECD countries offer this right, with the European countries more heavily represented here.

The seventh measure – percentage of share capital for an extraordinary meeting - captures the idea that minority rights are more fully represented when it is possible to call a shareholder meeting at the request of shareholders controlling only a minority percentage of capital. This percentage varies considerably among OECD countries and legal origin. In particular, German Civil Law requires less percentage of share capital than other countries.

Finally, a summary index – anti director rights - is given by counting the number of times these indicators support minority shareholders rights with the index receiving an additional point if the percentage of share capital to call an extraordinary meeting lies at or below the median of ten percent. Common Law countries have the best protection of shareholders whereas French Civil Law has the

weakest protection. German Civil Law and Scandinavian countries fall in between.

Creditors rights

Creditors rights are often more effective than shareholders rights “since default is reasonably straightforward violation of a debt contract that a court can verify” (Schleifer and Vishny, 1997). However, bankruptcy provisions and creditor rights can influence the efficiency with which managers use the resources at their disposal. Thereby a strong bankruptcy policy may elicit more efficient decision-making. When firms experience financial distress and fail to make promised payments to creditor, two possibilities are generally available for creditors: liquidation and reorganization. Creditors' rights may depend on their seniority. This may help them to repossess collateral. Aside from affecting the efficiency of the firm through the effect on managers' willingness to maximize firm value, bankruptcy may also affect the willingness of managers to undertake high potential and high return projects. In addition, once a firm has entered into a situation of financial distress, liquidation errors become a key criterion for judging the efficiency of bankruptcy code (Franks and Torous, 1996). To the extent that a bankruptcy code provides greater protection to the firm, the risk of deferred liquidation rises but the risk of premature liquidation falls. Finally, the bankruptcy code may also be judged on the extent to which it minimizes other costs: the explicit costs of legal and accounting fees, the cost to stakeholders such as employees, suppliers, customers and the state, and the cost of re-negotiation.

Data, however, do not capture all these effects. We use four measures of creditors' rights (La Porta et al., 1998) and an aggregate one (Creditor Right). The first, “No automatic stay on assets” equals one if an automatic stay on the assets of the firm is not required during the reorganization procedure. The second, “Secured creditors first paid” referred to the seniority' right (see below) and equals one when secured creditors are ranked first from the disposition of the assets of a bankrupt firm. The third, “Restrictions for going into reorganization”, equals one when restrictions (creditors consent) are imposed in the reorganization process. The fourth, “management does not stay during reorganization” equals one when a civil person or the creditors do the operation of the business during reorganization.

Data on creditor rights show different patterns across OECD countries. In two-thirds of the listed OECD countries, an automatic stay on assets is required in the reorganization procedures, preventing secured creditors from repossessing their collateral. These provisions protect the interests of managers and other creditors at the expense of secured creditors. Only the United Kingdom, New Zealand, Belgium, Spain, Austria, Germany and Denmark do not impose such a requirement.

In most OECD countries, secured creditors are ranked first in the distribution of the proceeds when a firm goes into bankruptcy. In New Zealand, France and Greece, however, secured creditors are not necessarily paid first during a reorganization process, but after other stakeholders, such as the employees.

The absence of restrictions on initiating bankruptcy filings can put secured creditors at a disadvantage. In many OECD countries, bankruptcy filings may be initiated by management, as they typically are in the United States, or more generally entered into without restrictions, such as the consent of creditors. More than half of the sample does not restrict management from initiating reorganization procedure especially in French Civil Law origin. Because reorganization makes it more difficult for creditors to liquidate the firm and is typically protective of management, the absence of restrictions on bankruptcy filings can be seen as weakening of creditor rights. Incentives for management to initiate bankruptcy filings are strong in the United States, where creditors bear the burden of proving that the firm is in default. While in many European countries the burden of proof is on managers to show that the firm is in default, reducing incentives for management to initiate bankruptcy proceedings, there are penalties for managers and even firms' bank in some cases for delaying filing (White, 1996).

Finally, in New Zealand, the United Kingdom, Greece and Japan managers must be replaced under reorganization; this feature clearly provides a signal to managers about the consequences of default. This could be analyzed in terms of reputation and selection effects. In other countries, management can remain employed during the reorganization. In the United States, Chapter 11 proceedings allows managers to keep control and authority while the bankruptcy court provides only limited surveillance. In France, an outside official is nominated to analyze the situation and to decide whether or not the firm should go into bankruptcy. During this period, the court can explicitly order the managers to be replaced. In Germany, management can, in principle, stay on during reorganization. Nevertheless, this sort of procedure is rarely used in practice given the absence of an automatic stay for secured creditors. Without the stay, secured creditors have no incentive to agree to a reorganization plan in which they would receive only a percentage of the value of their collateral. Thereby, the possibility that management could stay on during reorganization provides them with very little protection in this case.

Finally, a summary index is given by adding the scores for each of these four types of provisions. The overall value is higher in German-origin average and English-origin average. The weakest protection of creditors' rights is in French Civil law. However, these average values mask some important disparities within each legal group. Therefore, in the United Kingdom, creditors rights are stronger than in

other Common Law countries. Therefore, creditors rights may enhance corporate governance to the extent that managers behave more efficiently when they fear losing their job as a result of bad decisions. It may also affect the decisions that managers make regarding risk reducing risk-taking and incentives to innovate. Secured creditor rights are likely to be somewhat ambiguous in terms of their effects through financial market arrangements. Stronger secured creditor rights may lower the cost of collateralised borrowing, but it is likely to raise the costs of non-secured borrowing and issuing equity, since creditors with lower priority and investors often must accept what is left after secured creditors take their compensation. In addition if diversification opportunities are as available for creditors as they are for investors, then idiosyncratic firms can, in principal, be eliminated with proper portfolio management.

Legal enforcement

Debtor, creditor and investor rights are of little consequence without enforcement. In most countries, market regulators enforce laws and regulations, in part by courts and in part by market participants themselves. In this respect, we use five measures of legal enforcement. We do not take into consideration accounting standards (see La Porta et al., 1998). In effect, this measure is based on annual reports from 1990 and does not include the harmonization procedure in the European Union and in the International Accounting standards or US GAAP (Germany, 1998).

The first measure - the efficiency of the judicial system²¹ - provides an assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms. Except for Greece, Italy, Portugal and Spain, OECD countries score high for these variables. The pattern of French Civil Law compared to other legal families is significantly different (part B, table 3). The second measure - Rule of Law - is an assessment of the law and order tradition. The OECD countries in general score high. Greece and Spain received the lower scores. The third measure is an assessment of the corruption in government. Many of the same countries received the top score again, and the same group of countries came in with lower scores. As previously, French Civil Law in terms of corruption is significantly different from other OECD countries and legal families. However, Belgium and France score high in all measures suggesting that the within variation is large in French Civil Law tradition. The next two variables are respectively an assessment of the risk of "outright confiscation" or "forced nationalization" and an assessment of the "risk of

²¹ This measure must be interpreted with caution as it represents an average of scores for the period 1980 to 1983.

modification in a contract taking the form of a repudiation, postponement or scaling down [due to] budget cut-backs, indigenization pressure, a change in government, or a change in government economic and social priorities". Aside from Greece and to a lesser extent Australia, Portugal and Spain, OECD countries score quite high.

By these measures, legal enforcement seems to be reasonably strong in OECD countries. Differences in OECD countries appear to be less important than in the paper of LLSV (1998).

4.2. Ownership concentration

General assessment on ownership concentration

Some corporate governance systems reveal a widely dispersed ownership (outsider systems) and others show a concentrated ownership (insider systems). The controlling shareholder may be an individual, family holding, bloc alliance or financial institution and or corporations acting through holding companies or via cross shareholdings. As it appears in most papers on corporate governance, two basic conflicts concern the controlling manager and 'outside' widely dispersed shareholders and the conflict between 'inside' controlling shareholders and outside minority shareholders. This latter relationship is found in OECD and non-OECD countries.

The international comparisons of ownership concentrations across countries in Maher and Anderson (1999) show that the average equity holding of the largest shareholder varies from 40 % to 80 % in most continental European countries. This ownership concentration is lower in the UK, the US, Japan and the Netherlands. The largest shareholder refers to the equity holdings of a single entity. However, in the absence of one share- one vote, data on direct ownership concentration can under or overestimate the true control exercised by the shareholders on the corporation. It is possible to distinguish between cash-flow rights and control rights. In general, dispersed ownership and dispersed voting power characterizes a structure with many small shareholders. In this case, managers end up with substantial residual control rights. It is possible to have dispersed ownership but concentrate voting power. This situation characterizes the presence of dual class shares, golden shares, proxy votes, etc. This situation leads to strong controlling blockholders and weak minority owners. In corporations where ownership is concentrated and voting rights are aligned with ownership rights, minorities are in a weak position. These three situations characterize most corporate governance systems in OECD countries. It is also possible to be in a situation with concentrated ownership and dispersed voting power. This can be done via voting caps when for example a restriction allows only 5 %

of the shares to be voted (for a large shareholder with 40 % of the shares). This system is rarely observed in practice. The evidence regarding voting power concentration OECD countries in Maher and Anderson (1999) shows that blockholdings in Continental Europe are higher than in the US and the UK. They reveal the presence of differences in ownership concentration, the identity of owners and the legislative framework across OECD countries.

Here, we use two measures of the ownership concentration (La Porta et al., 1998). The first (respectively second) is the average (respectively median) percentage of common shares owned by the three largest shareholders in the 10 largest non-financial, privately owned domestic firms in a given country. Results tend to show that English Common law is characterized by a dispersed ownership concentration. Within this legal family, the United States and the United Kingdom are better dispersed than other countries. Moreover, there are significant differences between Common Law and Civil law.

Structure of corporate ownership

The ownership structure also differs when comparing the importance of banks as shareholders of firms and the nature of the firms.

On one hand, Prowse (1997) claims that the aggregate shareholding pattern does not seem to bear out the traditional distinction between a market-centered system and a bank-centered system. Thereby, in terms of the weight of the financial sector in aggregate holdings, the United Kingdom (respectively the United States) is closer to Japan (respectively Germany).

On the whole, the role of banks, as direct owners, differs substantially across countries in the OECD area. In Germany, proxy voting, pyramiding voting pacts and other devices confers an advantageous position of banks. But Edwards and Mibler (2000) show that the German corporate governance system is based on high ownership concentration rather than a special role of banks. In Spain, banks hold a larger number of smaller voting blocks and a substantial number of large voting blocks (Crespi, 1997). In Belgium, France and Sweden, banks are generally part of business groups and provide the link between different business group. In Japan, recent trends tend to show a weakening of controls by banks due to shift in corporate finance.

On the other hand, as Becht (1997) pointed out, for listed companies, the concentration of ownership and voting power is higher in insiders systems (especially in Europe) than in outsiders systems whereas the reverse is true for non-listed companies (especially in UK).

Becht (1997) also argues that the shape of distribution of voting blocks and direct stakes are partly influenced by the presence or absence of takeover legislation (see further).

Firm Performance and Ownership concentration

One of the main issues to the debate surrounding corporate governance practices is whether or not owner-controlled firms are more profitable than manager-controlled firms. Several empirical studies reveal the beneficial effects of enhanced monitoring as a result of higher ownership concentration. Gugler (1999) provides a comprehensive survey of empirical studies of the effects of ownership concentration on corporate performance. The majority of studies from the US and UK show that "owner-controlled" firms significantly outperform "manager-controlled" firms. The proxies used for performance of the firm are the net income/net worth, rate of return on equity or Tobin's Q, or the riskiness of returns. Shleifer and Vishny (1998) among others find that at low levels of concentration, performance increases as concentration increases, but then decreases as concentration levels keep increasing. Nevertheless, the result of the comparisons between the performance of owner-controlled firms and manager-controlled firms may depend on several factors such as the initial levels of ownership concentration, the life-cycle model of the firm, the effects of product market competition on managerial behavior, etc.

To sum up, results show that better shareholder protection is accompanied with a better protection of creditor's rights, a dispersed ownership and a strong legal enforcement. In this context, we find the main components of the insider systems. Similarly, a weak protection of shareholders is associated with weaker creditor rights, a concentrated ownership structure and less efficiency of legal enforcement. In addition, a significant negative correlation exists between ownership concentration and a shareholders right, that is a more concentrated structure is linked with less shareholders' rights. Finally, results show some important differences among countries in the same legal origin. Thus the question of interest is how to explain these differences. The traditional legal view does not answer this question.

To examine cross-country differences we build some compound measures based on previous indicators.

4.3. Compound Indexes of Shareholders Rights, Creditors Rights and Legal Enforcement

To summarize information given by each variable, we construct composite indicators based on principal component analysis for shareholders' rights, creditor's rights and legal enforcement. Due to sensibility in our analysis, Greece is excluded from our sample²². The first measure – shareholders rights

– is the first principal component²³ of five shareholders rights variables: allowance of proxy mail, right to block shares before a general meeting, cumulative voting versus proportional representation, the rights of minority shareholders, the preemptive right to new issues and the necessary percentage of share capital for the convening of an extraordinary shareholders meeting. This first component explains nearly 45 per cent of the total variance. This component is positively explained by minority shareholders rights and negatively by the preemptive rights to new issues and the necessary threshold for an extraordinary meeting. Results indicate that our index is similar to the "anti-directory rights" variable. However, it permits a better comparison of individual countries. There are strong differences among OECD countries. As previously, shareholders rights are better protected in English Common Law than in Civil Law. Canada, the United States and Japan have the highest score.

The second measure is the first principal component²⁴ of the four creditor rights variables defined previously. This compound measure – creditor's rights – explains 42 per cent of the total variance. Results are analogous to those obtained previously. In particular, New Zealand and the United Kingdom have the greatest score.

The third measure – legal enforcement – is the first principal component of four legal variables: efficiency of judicial system, rule of law, risk of expropriation and risk of contract repudiation. Our index confirms the previous results. The legal enforcement is strongest in Scandinavian Civil Law countries and in German Civil Law. Highest scores are obtained in case of the Netherlands, Norway, Switzerland and United States. This indicator shows important differences between countries belonging to the same legal origin (English Common Law and French Civil Law).

The fourth measure – investor protection - is the first principal component of shareholders' rights variables, creditors' rights variables and legal enforcement variables used before. This component accounts for 23 per cent of the total variance and is positively explained by shareholders' rights and negatively explained by creditor rights. In fact, three components were extracted. The second component accounts for 22 per cent of the total variance. Creditor's rights and legal enforcement positively explain this component. The third component accounts for 12 per cent of the total variance (that is the cumulative total variance explained by the factor analysis is 57 per cent). We only report the first principal component. The highest scores are obtained

²³ The factor analysis only extracts one component.

²⁴ The factor analysis reveals two components. In this case, the cumulative total variance explained is near 70%. The first component is explained by reorganization procedures (restrictions, management stays and the automatic stay on assets) whereas the second component is explained by the seniority variable.

²² Results (including Greece) are not shown here, but are available on requests.

in Canada, Japan, New Zealand and the United States. Ranking the countries from the highest to the lowest tends to show that English Common Law protects better shareholders and creditors and insures a better legal enforcement.

The fifth measure – overall – is the first principal component of shareholders rights variables, creditors rights variables, legal enforcement and the median concentration of ownership. This measure might be more appealing to compare the insider and outsider systems. On one hand, results induce subsequent changes compared with “investor protection”, but does not alter the previous classification. In this respect, the inclusion of ownership concentration is particularly useful (for example, Portugal’s ranking). On the other hand, countries with the highest scores are characterized by an insider system (except for Japan) whereas countries with the lowest scores mainly present an outsider scheme.

4.4. Recent Trends in the Legal View

To extend the previous analysis, we report new data on issues and procedures of general shareholders’ meeting, on board and capital structure and on ownership and control in OECD countries. Data have been collected during the OECD Steering group on corporate governance (2001). They only refer to limited liability corporation or joint companies whose shares are listed on an authorized stock exchange. Thus, non-listed companies are excluded from our analysis. Following answers on a questionnaire, we quantify the results by using binary variables (when possible). Due to lack of data, results for New Zealand, the Netherlands and Norway are not reported here.

Issues of General Shareholders’ Meeting

As mentioned before, the general meeting of shareholders is typically considered as the ultimate decision unit in the firm. In particular, we are interested in issues decided or authorized by the general shareholders’ meeting. When ownership is concentrated and minority shareholders are not well protected, a power general meeting can exacerbate agency and principal-agent problems. There are large differences among OECD countries. Therefore, the issuance of new shares, the issuance of convertibles and subscription rights or the reduction of share capital are not decided by the general meeting in English Common Law countries. Evidence is more mixed for shares’ repurchases. French and Scandinavian Civil Law countries authorize them by participants of the general meeting. The next two variables – approval of the annual accounts and distribution of profits – show a sharp difference between Common Law countries and Civil Law countries. This clearly poses the problem of the protection of minority shareholders. The seventh

variable – appointment and removal of board directors – has to be decided or authorized during the general meeting except for Australia. However, the discharge of board members is not permitted by English-Law countries, France, Spain and Japan (see further). Finally, while mergers and acquisitions activities need the approval of a general shareholders meeting in most OECD countries, sales of a substantial part of the company is suborned to a shareholders’ agreement in English Common Law countries and in two-thirds of French Civil Law countries.

Procedures of General Shareholders’ Meeting

Given the issues that have to be decided or authorized by the general meeting the rights to participate and the participation procedures reveal a particular importance. On one hand, if minority shareholders do not have the right to participate and vote at the general meeting, controlling blockholders or majority shareholders can expropriate rents at the expense of minority shareholders and other stakeholders. This ex-post expropriation can lead to a sub-optimal level of investments by minority investors and stakeholders. If control is associated with the ability to expropriate private benefits, then the market must value it and controlling shares must trade at a premium. Schleifer and Vishny (1997) and Gugler (1999) show that the market values control. Similarly, since expropriation by controlling shareholders can deter minority investors the result is often a small and illiquid public equity market. This might explain why in some countries where expropriation is a major problem, capital markets remain underdeveloped relative to the United States and the United Kingdom. On the other hand, when minority shareholders are well protected and legal enforcement is strong, the incentives to participate at the general meeting are considerably reduced.

The first to be measured – general participation and general vote– describe the rights to participate at the general meeting for all shareholders, regardless the size of their holdings. Except for the United Kingdom and the United States, where the participation and voting is subject to articles, and France (where articles can require a minimum of 10 shares) most OECD countries confer such shareholders’ rights. However, there are strong restrictions concerning the possibility for shareholders to include items on the agenda at the general meeting and on procedures for shareholders’ resolutions. Thus, English Common Law countries impose a 5% detention of capital (10% in Ireland) or quorum rules (United States) to place an item on the agenda. Scandinavian Civil Law countries require no restriction. French Civil Law countries require a minimum detention between 10 and 20% (Belgium). In addition, in two third of the sample, there is a record date. However, the way of notice and time of

notice vary considerably across OECD countries. For example, the time notice is comprised between 10 to 60 days in the United States whereas it is only of 7 days in Belgium or 14 days in Austria.

The Board Structure

The board of directors plays a major role in the corporate governance framework. The board is responsible for monitoring managerial performance and preventing conflicts of interests. The board is also responsible for reviewing key executive and board remuneration. The board of management must have some degree of independence for management in outsider systems. However, this independence poses a problem in reality when the board can become entrenched. This is typically the case when board members are compensated for their activities and are at the same time responsible for overseeing executive board and remuneration. In theory, the board should represent the interests of shareholders, but in practice, they become part of the management. Therefore, the board is often regarded as a relatively weak monitoring device.

Board structures and the distribution of power on boards vary substantially both among OECD countries and within individual countries. Board functions and structures are not only differently defined by law, but the law has been applied in some circumstances very flexibly in determining how corporate governance is fulfilled by boards. On one hand, in the United States and the United Kingdom, direct representations on the boards are mainly restricted to shareholders. However, recent trends seem to indicate that boards directors may represent all shareholders. In the United States, insider trading rules penalize trading activity based on contacts with management or boards. Thus, portfolio-oriented shareholders have strong incentives to avoid taking seats on the board or even to have close contact with it. Most English Common Law boards had great difficulty in fulfilling the oversight function, because they have principally worked on a collegial basis under the predominance of senior management. In this respect, remuneration setting, nominations of board members and audits have been instated to improve this oversight function. For example, the "Cadbury Code" in the United Kingdom goes in this sense. In addition, English Common Law countries only play a minor role in conflict resolution. On the other hand, in most Civil Law countries, the existence of identifiable large groups of shareholders has kept the concept of representation of particular interests on boards and of direct accountability of board members alive.

In particular, direct representation of particular interest groups on boards has been applied. This concept has allowed for reconciling conflicts between shareholders and management as well as different groups of shareholders represented. Moreover, various measures to improve the

supervisory function of the board have been taken in OECD countries. These measures aim at reforming the board to be more accountable for the shareholders. The first type of measures focuses upon enhancements to the functioning of statutory auditors. The second set of measures is based on the introduction of new mechanisms that are popular in the United States. These measures include the appointment of independent directors and the establishment of remuneration and appointment committees. In this respect, the structure of the board and the nature of the remuneration are of particular interest.

Thus, the first variable – Compulsory unitary or dual board system– confirms if the Companies Act prescribes a unitary or dual board structure consisting of a supervisory and a management board/director. Most English Common Law countries and French Civil Law countries are characterized by a unitary board whereas German and Scandinavian Civil Law countries have a dual board system. However most English legal origin countries use an optional dual board system such as committees. In addition, the board size tends to vary among OECD countries or is subject to articles.

The last two variables concern the remuneration of the board and the possibility to possess stock options. Executive remuneration packages are designed to induce managers to act in interests of shareholders.

In practice managerial compensation is tied to the performance of the firm in the form of salaries bonuses and stock options. The mechanism exposes managerial wealth to some of the risks to which shareholders and the firm are exposed. If the use of the mechanism is effective, then there must be a positive relationship between managerial compensation and firm performance. Excluding stock options, evidence indicates that the sensitivities of pay to performance are small. Several empirical findings raise serious concerns regarding the motives behind executive remuneration contracts. In fact in the presence of severe agency problems and a weak monitoring of management, executive remuneration can become a vehicle for managerial expropriation of rents. Executive compensation plans can also serve to exaggerate short-termist behavior. The empirical evidence seems to indicate that these contracts are enabling managers to expropriate some of the rents from shareholders. Data show that the remuneration of board is principally decided by the general meeting of shareholders in Civil Law countries. Evidence is more difficult to capture for English Common Law countries. Therefore, the board itself in the United States executes the remuneration of the supervisory/unitary board whereas remuneration committees regulate it in the United Kingdom and in Ireland. Finally, in almost all OECD countries, stock options may be granted as part of remuneration.

Conclusion

The shareholder approach to corporate governance looks for the appropriate means to align the interests of managers and shareholders and to insure the flow of external capital to firms. This approach is often criticized because it ignores the interests of other investors, employees, creditors, suppliers, distributors and customers and the relationships between the different stakeholders.

Market frictions create incentives for the creation of financial contracts, markets and intermediaries. Thereby the various components of the financial system provide financial services: they evaluate projects, exert corporate control, facilitate risk management and ease the mobilisation of savings. In effect, the greatest differences concern these corporate functions. The financial service view focuses on them. It stresses that the type of financial system, bank-based or market-based, is not as important as the overall level of financial development. The most important is how the financial system provides key services. It is possible that more than one structure can provide these services, that the relative efficiency of differing structures varies with the nature of the situation, and that having more than one mechanism for the provision of financial services provides an economy with more flexibility. In this case, markets and banks may provide complementary services or provide the same financial services.

The degree of business autonomy and the company's cost of capital may be substantially influenced by the capital structure of the company law. In particular, rapidly developing financial instruments are offering a wide range of flexibility in this respect, which has to be weighted against the proper protection and fair treatment of all different categories of claimants. Results indicate that English Common Law countries differ importantly on the concept of legal capital, the requirements for legal capital, pre-emptive rights and shares without voting rights. In countries where existing shareholders do not receive pre-emptive rights for new issues, private placements may often be used for realigning the influence of different group of shareholders. This is the case in Japan where general meeting can decide to make private placements with particular entities. However, all OECD countries have a special regulation for instruments that do entail a right of conversion to or subscription of new shares. In addition, except for Switzerland and the United States, the general meeting must approve share redemption procedures and share repurchase procedures.

An efficient allocation of capital may require a free transferability of shares. In this case, present and potential investors have an incentive to insure that the ownership and control structures of the company are transparent. Less transparency may increase the costs of buying and selling the company's share.

Securities laws generally require large shareholders in listed companies to be promptly disclosed to investors. As pointed out by Coffee (1984), these requirements are important for the efficiency of stocks markets. Therefore, in Europe, the Directive 88/627 mentions that "a policy of adequate information of investors in the field of transferable securities is likely to improve investor protection, to increase investors' confidence in securities markets and thus to ensure that securities markets function correctly". However Ferrarini (2000) claims that the impact of shareholders disclosures on the market for corporate control should also be considered. Ferrarini (2000) suggests that there might be a decrease in the number of take-overs with subsequent negative effects on investor protection due to the reduction of bidders' incentives.

Most of OECD countries do not impose restrictions on how much an individual owner can hold in a publicly listed company or the amounts held by different categories of owner. But the "regulatory framework" imposes restrictions on cross-shareholdings in most French and German Civil Law countries. Except for Germany, Greece, Italy and Japan "voting caps" are not of common use. Capped voting rights, which limit the voting right of any one shareholder to a maximum ceiling, help to preserve the features of corporate governance power of dispersed ownership. Voting caps are a classical instrument used to protect management against hostile take-overs (see *infra*), though often they are implemented under the pretext of protecting minority shareholders. There are other mechanisms or regulations that can prevent hostile take-overs. Finally, the nature of disclosure rules and the level of such disclosures mainly depend on legal origin. These disclosures are mostly edited by Securities regulation. Evidence on take-overs is more mixed.

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