

RULING SELF-DEALING IN A GLOBAL MARKET: A REASSESSMENT OF THE CONVERGENCE VS. PATH- DEPENDENCY DEBATE

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Abstract

Self-dealing refers to all kinds of transactions and operations whose aim is to divert value from a company to corporate controllers. In order to tackle self-dealing, scholars and regulators have emphasised the importance of legal tools. However, although the *pro-regulatory* approach prevails on a wide scale in the academic arena, there still exists a marked divergence between theoretical positions supporting the existence of a benchmark model towards which to converge (*convergence hypothesis*) and those that underscore the importance of socio-economic factors on the efficacy of governance rules (*path dependency view*). The aim of this paper is to join in the *convergence vs. path dependency* debate by adding some considerations on the *efficiency* of mandatory rules to the well-known investigations on the effectiveness of legal frameworks. Specifically, considering the current market integration and associated opportunities and threats, the traditional cost-benefit analysis has been extended in order to embrace *direct* and *indirect* costs specifically associated to the issue of domestic rules in a global scenario. Such an economic analysis on self-dealing introduces new variables that may support the *convergence* view and encourage at least a partial and gradual adjustment of national legislations towards the Anglo-Saxon model. To test our hypothesis, an examination of the self-dealing rules adopted in Germany, Italy and UK has been conducted. In particular, spatial and temporal comparisons of conflict of interests and self-dealing legislations have been carried out in order to appreciate trends, differences and similarities of some of the most important European legal frameworks.

Keywords: legal framework, Europe, corporate governance

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outside investors. Shareholders and board approval, independent director ratification, disclosure or periodic releases, legal instruments, planned to ease shareholder litigation or even to ban self-dealing transactions, are often required by regulators and overseers where a conflict of interests exists. The academic literature has long since focused its attention on their effectiveness, questioning in particular the existence of a benchmark model to implement. Nonetheless, a unique answer to this problem is still far from being reached.

According to the seminal papers referable to the *Law & Finance* approach, the legal frameworks adopted by Common Law countries offer better shareholder protection than those governed by Civil Law and, as such, a convergence process towards an Anglo-Saxon approach should be encouraged (LA PORTA *et al.*, 1998; 1999; DJANKOV *et al.*, 2008). A *path dependency* view, instead, disproves the above conclusions, stressing the peculiarities of the different socio-economic environments and the ownership structure of firms operating there. Governance protections working effectively in one case might fail in another one (COFFEE, 2005) and the

1. Introduction

One of the most important corporate governance issues caused by the separation between ownership and control concerns the risk of asset diversion by the corporate controller (manager or dominant shareholder). The label of *self-dealing* has been introduced to underline the threat stemming from business choices adopted by the *agent* in a situation of potential conflict of interests, and both researchers and regulators have focused their attention on legal tools able to constrain or punish wealth expropriation. In actual fact, the role played by governance mechanisms in explaining the development of stock markets is intuitively understandable and empirically demonstrable (SHLEIFER, VISHNY, 1997; LA PORTA *et al.*, 1997; SHLEIFER, WOLFENZON, 2002). Legal frameworks and monitoring systems able to detect outright theft or to appreciate the economic soundness of equity operations and transactions with related parties enhance the opportunities of an efficient resource allocation and have a positive impact on social welfare (COOTER, ULEN, 2004).

As “law matters”, all jurisdictions provide stakeholders with a set of rules aiming to protect

(MARKARIAN *et al.*, 2007) provide clear evidence of an already widespread awareness by market participants and as such an implicit approval of Anglo-Saxon rules. Therefore, the need to minimize the *switching costs* associated to new conflict of interests rules appears to favour the necessary adoption of legislation consistent with the Anglo-Saxon model.

To test this assumption, the paper provides a picture of the legal frameworks of some of the most important European countries by examining doctrines and remedies on self-dealing adopted by Germany, Italy and UK. Spatial and temporal comparisons of the conflict of interests legislations will then be carried out in order to increase understanding of the issue and appreciate trends, differences and similarities among the European regulations.

The article proceeds as follows. The next part briefly summarizes the current debate on the topic, comparing the proposed solutions referable to the *Law & Finance* approach with the theoretical outcomes of the *path-dependency* thought. The third part carefully describes the economic consequences associated to a self-dealing legislation, focusing in particular on *direct* and *indirect* costs due to a lack of convergence among national rules in a global market. A detailed examination of self-dealing legislations adopted in each of the above-mentioned European countries is then developed in the fourth part. Some concluding remarks are finally put forward.

2. Convergence vs. Path-Dependency: a brief review of the current debate on self-dealing

Since the publication of the seminal article by Beale and Means (1932), the need for regulatory intervention to protect outside investors has been highlighted. The risk that corporate controllers (director or dominant shareholder) might maximize their own benefits to the detriment of the other stakeholders (JENSEN, MECKLING, 1976; PRATT, ZECKHAUSER, 1985) and the inability of the minority shareholders to monitor the agent are frequently described as the main factors justifying the issue of mandatory rules (RIBSTEIN, 2002).

In actual fact, although in theory shareholders might incorporate the perceived risk of expropriation in the securities price, the high information and transaction costs due to the inefficiency of the market make such a hypothesis hardly verifiable (GORDON, 1989; GOSHEN, 2003a) ⁽¹⁾. Moreover, corporate contracts are affected by an inevitable contractual incompleteness. In order to leave the corporate controller his managerial discretion, the contracts between the *agent* and the *principal* are characterized by an unavoidable partial vagueness, allowing the former to renegotiate, for his/her own benefits, the terms previously arranged with the latter (BRATTON, MCCAHERY, 2001).

implementation of a common set of rules could be loose and ineffective (GOSHEN, 2003b).

This paper aims to contribute to the *convergence vs. path dependency* debate by introducing some considerations on the mobility opportunities offered by the current globalization process and the consequent impact on the *efficiency* of domestic self-dealing rules.

In fact, while an assessment of corporate laws' effectiveness in preventing opportunistic behaviour of local insiders is quite common, their actual efficiency in a global market is rarely examined and this assessment neglects the overall effects on the shareholders' wealth.

As is known, the introduction of stricter rules on self-dealing – although justifiable in the light of narrowing the corporate controller's actions whenever a conflict of interests condition is detected – may reduce the net present value of non-controlling shareholders' investment. Such a circumstance has been firstly ascribed to the costs *directly* associated to the actual implementation of a new rule, and then *indirectly* connected to the loss of profitable opportunities due to the consequent managerial discretion constraint (ENRIQUES, 1998; PACCES, 2009). However, with increasingly integrated markets for capital, products and human resources, a cost-benefit analysis cannot neglect the *direct* and *indirect* costs deriving from the responses that global economic players would give to domestic conflict of interests legislations (MILHAUPT, 2003). First of all, differences among national legislations introduce substantial expenses, forcing globalized firms to become acquainted with several governance systems and also affect firms' hiring policy of foreign managerial talents and their internationalization plans. Moreover, the option to choose self-dealing rules to comply to by selecting quoting markets or countries where to incorporate, could be opportunistically exploited by corporate controllers to the detriment of outside investors. The *agent's* personal benefits deriving from the adoption of less demanding corporate governance systems might lead to carry out sub-optimal internationalization strategies whose costs would finally affect minorities and creditors' wealth. We label such a particular category of *indirect costs* as *induced costs*.

A deeper investigation on the above-mentioned costs allows us to point out the potential benefits associated to more intense cooperation between domestic institutions and to support a convergence process. In particular, we hypothesize and suggest, at least, a gradual and partial adjustment away from national conflict of interests rules towards the Anglo-Saxon model. Indeed, either the mandatory adoption of financial reporting standards (IAS/IFRS), whose theoretical framework clearly originates from an Anglo-Saxon perspective (MARKS, 2004), or the existing voluntary global convergence of codes of best practices towards the Anglo-Saxon system

methodology developed by La Porta *et al.* seems to be seriously invalidated by the “home bias problem” (SIEMS, 2005). In drawing up their indexes, *Law & Finance* scholars have been indirectly influenced by their knowledge of the US legal system. The Anglo-Saxon rules on self-dealing represent the yardstick for assessing other countries and no effort is made to appreciate the actual effectiveness of alternative solutions (COOLS, 2004; CONAC *et al.*, 2008) ⁽⁴⁾. Finally, these researchers seem to undervalue the impact of the cultural, social and economic features of each country (COFFEE, 2005; ENRIQUES, VOLPIN, 2007). In particular, differences in share ownership might shape the nature of self-dealing. In a dispersed ownership system, concerns on self-dealing operations could rise because of a conflict of interests between powerful controlling managers and small shareholders (*managerial self-dealing*) (BERLE, MEANS, 1932; JENSEN, MECKLING, 1976). In concentrated ownership structures, however, an agency relation has to be identified between the controlling shareholders and the outside investors (*dominant shareholders’ self-dealing*) (DEMSETZ, LEHN, 1985; SHLEIFER, VISHNY, 1997). Although managerial and dominant shareholders’ self-dealing partially overlap, legal tools able to tackle opportunistic behaviour could differ (CONAC *et al.*, 2008). For this reason, identical rules might have different effects on the conflict of interests issue as influenced by the context which they are implemented in (GOSHEN, 2003b). A “one-best-way” is an unsuitable solution and a *path-dependency* view could be the only effective strategy in ruling self-dealing (BEBCHUCK, ROE, 1999).

These founded criticisms on the research methodology adopted by *Law & Finance* scholars and the deductive considerations on the impact of socio-economic factors on the efficacy of conflict of interests legislations have strongly weakened the “convergence thesis” and neglected any deeper examination of the benefits associated to more intense cooperation among national institutions. However, as the globalisation process proceeds, a reassessment of the conclusions reached so far is required. Indeed, because of market integration, the negative effects on shareholders’ wealth due to the imposition of domestic legislations on global actors become greater and greater and oblige the effectiveness analysis on self-dealing regulations to be joined to an investigation of their efficiency.

For this reason, in the next part an examination of self-dealing regulation costs is undertaken, thereby widening the traditional cost figures with those *directly* and *indirectly* provoked by the lack of cooperation in the actual globalized world. Such an economic analysis enables us to take an important step forward in the *convergence vs. path-dependency* dispute and highlights some of the reasons supporting the convergence hypothesis.

On the other hand, strong empirical evidence supports the *pro-regulatory* approach about self-dealing. Countries with weaker investor protection and ineffective legal enforcement show less developed financial markets (LA PORTA *et al.*, 1997, 2006), while a higher cost of capital is frequently associated with poorer legislation on insider trading and conflict of interests (BHATTACHARYA, DAOUK, 2002). Since efficient debt and equity markets are a fundamental factor for economic growth (KING, LEVINE, 1993; LEVINE, ZERVOS, 1997; RAJAN, ZINGALES, 1998), a positive correlation between the strength of the legal system and economic development is expected.

Several strategies can be pursued to tackle self-dealing. Traditionally, the possible regulation tools are classified into two broad categories: “property protection rule” and “liability protection rule” (CALABRESI, MELAMED, 1972; GOSHEN, 2003a, 2003b). The former requires operations potentially detrimental to the outside investors’ claims to be directly or indirectly approved by the disinterested party. A “liability protection rule”, on the other hand, allows corporate controllers to impose conflict of interests transactions on minorities, requiring different instruments though, in order to reassure the disinterested party about their fairness ⁽²⁾.

Both the existence of the best mix of the above-mentioned legislation tools and the need for domestic institutions to converge towards such an ideal set of rules have always been important topics in the corporate governance literature.

By developing quantitative indexes in order to measure the strength of different self-dealing legislations ⁽³⁾, *Law & Finance* scholars have collected empirical evidence supporting the *convergence* hypothesis. In fact, according to such a research stream, legal frameworks characterizing Common Law countries apparently show greater concern on minorities and creditors’ claims, embodying more effective instruments to manage conflict of interests (LA PORTA *et al.*, 1998; JOHNSON *et al.*, 2000). Specifically, a combination of ex-ante disclosure and disinterested shareholder approval is described as the proper strategy in managing conflict of interests (DJANKOV *et al.*, 2008). For this reason, the implementation of such a protection system is implicitly suggested, and underscores the need for convergence towards the Anglo-Saxon legislation.

Although they are key contributions in the self-dealing discussion, *Law & Finance* papers have been strongly criticized, because of the normative considerations following their empirical outcomes (BRAENDLE, 2006).

First of all, evaluation of the quality of shareholder protection by using numerical indexes leads to excessively crude conclusions, and gives way to misrepresentation of the relative effectiveness of the different legal frameworks (SIEMS, 2005; BAUMS, SCOTT, 2005). Moreover, the comparative law

manager when applying local governance rules will be higher than those supported by native directors. Consequently, stricter and different self-dealing rules might decrease the percentage of foreign board members and negatively affect the correlated firms' international propensity. At the same time, they might limit the positive consequences - in terms of higher transparency and stronger investor protection - generally associated to a top management team diversity (RUIGROK *et al.*, 2007; RANDOY, OXELHEIM, 2001) ⁽⁵⁾.

An important category of indirect costs lies in the negative impact on the *principal's* wealth which is provoked by the ability of the *agent* to take advantage from differences among national legislations (*induced costs*). The existence of several domestic regulations and the inability of outside investors to immediately assess corporate controllers' incorporation or quoting choices allow the latter to orientate these internationalization plans towards less demanding governance systems and, in so doing, maximize their own benefits by pursuing sub-optimal strategies whose costs are finally borne by minorities and creditors.

A deeper analysis of the *induced costs* is carried out in the next section.

3.2 A special category of indirect costs: induced costs

The current globalization process offers new advantageous opportunities to companies. Legal deregulation on incorporation decisions and market for capital integration do affect the firms' equity value.

A deregulated environment, for example, favours countries' competition for attracting businesses through the issue of effective legal rules (FISCHEL, 1982; WINTER, 1989). The choice of the State of incorporation can be exploited by corporate controllers in order to introduce governance mechanisms that are able to minimize agency costs and, consequently, increase shareholders' wealth. For example, when observing the US market - where investors' protection system differs across the States - it has been demonstrated that firms incorporated in the Delaware State are worth more than firms incorporated elsewhere, thereby showing a positive and significant association between the quality of governance rules and the equity value (ROMANO, 1985; DAINES, 2001; SUBRAMANIAN, 2004) ⁽⁶⁾.

A different internationalisation strategy is also represented by a cross-listing choice. Firms listed in foreign countries experience lower cost of capital and increase their ability to fund their business operations and make their stocks more visible and liquid (MITTOO, 1992; FANTO, KARMEL, 1997; KAROLY, STULZ, 2001; LICHT, 2004; KAROLY, 2006). Indeed, a "cross-listing premium" is generally granted to foreign companies whose stocks are quoted on the

3. The Efficiency of Self-Dealing Regulations in a Global Market

3.1 Direct and indirect costs

Issuing a new rule on self-dealing should always be subject to a cost-benefit analysis where *direct* and *indirect costs* are assessed and compared with the expected benefits in order to appreciate the overall economic effects of the legislation.

"Out-of-pocket compliance costs" (*direct costs*) is the first figure traditionally considered in a cost-benefit analysis. In fact, a new rule on conflict of interests requires changes in internal control systems, whose design and implementation costs are directly borne by shareholders (ZHANG, 2007). Given the current global dimension of many companies, differences among the various jurisdictions clearly increases compliance costs. Firms with several administrative and production units settled in different countries are forced to invest a substantial amount of money in obtaining, translating and analyzing national legal frameworks (GEIGER, 1997) and in adopting internal administrative and control procedures. For this reason, the greater the degree of internationalization of a firm, the higher the costs *directly* incurred by shareholders to meet self-dealing rules and to adapt internal control and governance systems to domestic requirements.

Poor cooperation among national institutions also increases the burden of *indirect costs*. These usually refer to the negative effects indirectly associated to the loss of profitable business opportunities. Indeed, a corporate controller's attention could be diverted from doing business to ensuring full compliance with the imposed governance legislation (SOLOMON, BRYAN-LAW, 2004). Moreover, a stricter rule would probably expose managers and controlling shareholders to greater litigation risks and heavier penalties, narrowing the managerial discretion and consequently reducing the firm's value (RIBSTEIN, 2002; PACCES, 2009).

However, in the current global scenario, issuing a domestic self-dealing rule, when not consistent with internationally prevailing ones, could negatively impact on firms' value also by discouraging foreign directors from accepting company board appointments. It is reasonable to expect that greater litigation risks and penalties following stiffer self-dealing legislation will not only limit the managerial discretion of existing directors, but will also hinder the implementation of strategies whose purpose is to raise the degree of internationalization towards a higher top management team (TMT) diversity (ONADO, 2009), and this assumption may still be kept regardless of how rigorous the rules may be, when further differences are introduced. Because of cultural differences and a negligible awareness of the political and legal framework, the costs borne by a foreign

decision. The higher compliance costs presumably introduced by the new SEC regulation have often been pointed out as one of the main reasons for the observed firms' emigration. However, the *agent's* effort to maximize its own wealth by exploiting the freedom offered by the globalization of choosing the desired level of mandatory disclosure could be an equally important factor (COFFEE, 1984; EASTERBROOK, FISCHER, 1984). In actual fact, market inefficiencies cause a mismatch between private and social costs/benefits of disclosure. In particular, because of "proprietary" or "inter-firm" costs associated to a more detailed disclosure⁽⁸⁾, the marginal costs of additional disclosure borne by the corporate controller will be higher than the relative social costs. At the same time, information asymmetry and transaction costs will prevent the potential social benefits associated to higher transparency from being fully reflected in the share price (FOX, 1999). Therefore, the financial and corporate governance information that the corporate controller is willing to deliver will probably not be as significant as the optimal social disclosure level. The corporate controller is likely to emigrate towards less demanding countries, imposing on outside investors the associated negative effects (MARKS, 2004).

These considerations lead to the conclusion that the same reasons justifying the *pro-regulatory approach* to discipline conflict of interests conditions legitimise the issue of mandatory rules, thus boosting the need for convergence among national legislations. Because of high transaction and information costs, differences among self-dealing regulations are a source of private benefits for corporate controllers. For this reason, public intervention that encourages more effective cooperation among domestic institutions could replace market inefficiencies and decrease the probability of opportunistic behaviour.

However, suggesting a convergence process among national legislations is only part of the story. In order to complete our economic analysis on self-dealing, an examination of the model to be adopted by domestic legislations has to be carried out, selecting the governance system whose adoption is able to curtail the costs referable to the convergence process (*switching costs*).

3.3 The efficiency of self-dealing: which model to converge towards?

An examination of the *direct, indirect* and especially *induced costs* driven by domestic self-dealing rules in a global market points out the role that international cooperation could play in order to achieve the most efficient and protective solution.

However, the process of convergence, justified to decrease costs introduced by the different national legislations, is itself a costly activity. This is why in an economic analysis on self-dealing, the type of

major U.S. Stock Exchanges (DOIDGE *et al.*, 2004). This positive financial effect is attributed to a lower liquidity-risk (FOERSTER, KAROLYI, 1999; LOMBARDO, PAGANO, 1999), a more detailed disclosure (FUERST 1998; MOEL, 1999) and an enhanced investor protection system (COFFEE, 2002; REESE, WEISBACH, 2002). More generally, a cross-listing choice is probably also perceived as a signal of strong commitment by the corporate controllers to limit their expropriation activity and to use the raised capital in order to exploit growth opportunities (CANTALE, 1998)⁽⁷⁾.

The positive effects on firm value and investor protection systems associated with the globalization process help to explain the nature of *induced costs* potentially caused by a self-dealing regulation.

In the current economic scenario, where a more and more intense market integration, deregulation and international competition for equity capital prevail (KAMAR, 2006), every normative intervention carried out by a domestic institution may influence business decisions, inducing corporate controllers to carry out potentially sub-optimal strategies (GEIGER, 1997).

For example, stricter local legal rules on self-dealing could lead corporate managers and blockholders to change the State of incorporation, moving it towards countries with less demanding governance systems (CARY, 1974), and/or move some business or transactions to countries with more lax systems or with more legal loopholes. High information costs prevent outside investors from carrying out an intense examination on the reasons behind incorporation choices, and increase the probability of opportunistic behaviour by corporate controllers (GEIGER, 1997). On the other hand, it has been empirically proved that countries whose legislation seems to shelter the private benefits of managers and controllers show great attractiveness, while no particular penalization – in terms of a firms "emigration" – has been discovered for States adopting governance rules widely viewed as harmful to minorities and creditors (BEBCHUK, FERREL, 1999; BEBCHUK, COHEN, 2003). For this reason, a lack of coordination among national institutions could cause a "race to the bottom" phenomenon, neutralizing the theoretical effectiveness of a self-dealing rule and imposing higher costs on outside investors (BARGILL, 2006).

By affecting a firm's cross-listing strategy, unilateral intervention by a national securities commission on the conflict of interests topic can be considered a further source of *induced costs*. An analysis of the economic consequences associated to the Sarbanes-Oxley Act puts forward some evidence supporting this opinion (ZHANG, 2007). In 2002 the passage of SOX Act has reduced the number of foreign firms quoted on the NYSE (MARKS, 2004; BERGER *et al.*, 2005; ZINGALES, 2007), causing the loss of previously examined financial and corporate governance opportunities associated to a cross-listing

of Continental European countries self-dealing disciplines towards the Anglo-Saxon systems.

In order to test our hypothesis and to assess the degree of convergence, a detailed examination of the *scope* of national legislations is firstly carried out, followed by a comparison among the designed *authorization/monitoring* mechanisms. Some concluding remarks are finally developed.

4.1 Discipline scope

Since 2005 listed companies in the three countries under examination have been adopting IFRS; thus the IAS 24, *Related Party Disclosures*, has been applied too. This process of accounting harmonization has clearly introduced a common definition of *related party*, pointing out persons or organizations whose relation of control/significant influence towards the reporting entity might lead to unfair transactions⁽¹⁰⁾. However, as will be discussed further, the aim of IAS 24 focuses only on the disclosure that has to be periodically delivered whenever a *related party transaction* (RPT) occurs. Moreover, the IASB documents are only a specific source of financial reporting rules, as several domestic legislations concerning self-dealing and conflict of interests are still operative.

For these reasons, besides the common framework represented by IAS/IFRS, listed companies also have to comply with local rules and codes, where some differences may be found in terms of discipline scope:

- In Germany, the current Corporate Governance Code focuses only on the “conflicts of interest” issue: members of the Management Board (*Vorstand*) and of the Supervisory Board (*Aufsichtsrat*) are bound by the enterprise’s best interests; they may not pursue personal interests in their decisions or use business opportunities intended for the enterprise for themselves. Conflict of interests between a corporation and its controlling shareholders and the fairness problem concerning intra-group transactions are dealt with only in a specialized area of German corporation law (*Actiengesetz*)⁽¹¹⁾;

- Italy, unlike Germany, explicitly points to the question both in terms of “interests of directors” and RPT⁽¹²⁾. The local framework lacks an autonomous definition of RPT, referring for that to the IAS 24;

- in UK, the rules on self-dealing transactions handles the issue either in terms of “conflicts of interest”⁽¹³⁾ or in terms of RPT, providing an autonomous definition of the latter.

Therefore, while Germany focuses only on directors and controlling shareholders, Italy and UK concentrate on a wider category of *related party*. However, whereas the meaning attributed to the word “directors” is common to all countries, no convergence may be found for the term *related party*. Indeed, as already mentioned before, the UK Listing

governance model that reduces the inevitable *switching* costs has to be privileged.

The Anglo-Saxon legal framework might well represent such a model.

The instruments and knowledge deemed useful to implement this governance system are already widely known by market participants. A constant and voluntary convergence of disclosure and governance practices towards the Anglo-Saxon model has been empirically demonstrated (MARKARIAN *et al.*, 2007). Because of the active role played by US and UK institutional investors (GILLAN, STARKS, 2000; NESTOR, THOMPSON, 2000; CARLETON *et al.*, 1998; KARPOFF *et al.*, 1996), non Anglo-Saxon organizations have partially shaped their governance and corporate communication according to the Common Law system (CHANDLER, 1990)⁽⁹⁾. Moreover, some earlier evidence about a convergence of European firms’ corporate governance towards regulatory regimes associated with an Anglo-Saxon system has already been gathered (MILLMAN *et al.*, 1999; BRANDLE, NOLL, 2005). In addition, the mandatory accounting harmonization recently instituted in the EU zone with the adoption of the IAS/IFRS has introduced a common body of disclosure standards whose origins are clearly referable to the Anglo-Saxon financial reporting tradition (MARKS, 2004).

In such a scenario, the introduction of European conflict of interests regulations would imply an important step towards a significant convergence in corporate governance systems, and would also take advantage of the possible synergy between accounting standards and self-dealing guidelines.

The next part focuses on the rules adopted in Germany, Italy and UK. By carrying out a temporal and spatial comparison of their national legislations, the strength of the convergence process in Europe is evaluated and our hypothesis of a gradual and partial approach of continental European countries towards the Anglo-Saxon legal framework is tested.

4. A Comparative Overview and Analysis of European Self-Dealing Regulations

This section investigates how self-dealing is tackled in Italy, UK and Germany, and highlights differences and similarities in governance codes and legal rules addressed to listed companies. In the last 15 years European countries have enacted significant corporate law reforms aimed at strengthening corporate governance mechanisms, empowering shareholders and enhancing disclosure requirements. If the efficiency considerations put forward in the previous paragraphs really play a role in shaping domestic legislations, such a renewal process should have led to higher harmonization among self-dealing rules. In an attempt to minimise the unavoidable switching costs, we hypothesize at least a partial and gradual approach

disclose the nature of the related party relationship as well as information about the transactions and outstanding balances ⁽¹⁴⁾. Then, as already suggested before, the process of accounting harmonization has considerably boosted convergence among self-dealing rules, forcing entities to deliver a common disclosure through periodic financial statements.

However, entities also have to provide *further disclosure* and/or comply with procedures of *authorization/monitoring* in order to meet the requirements of their local codes.

In terms of disclosure, as a consequence of the latest CONSOB proposals and reform of the Civil Code, Italy has acquired a very detailed discipline, even more articulated than the German and UK ones. As already mentioned in the previous section the Italian framework addresses the broad category of RPT suggested by the IAS 24. Moreover, unlike UK and Germany, the Italian listed companies have to convey disclosure in all circumstances in which a director has an interest of his/her own or on behalf of a third party, even though this operation is not in conflict with the interests of the company.

In focusing our attention on the disclosure required when parties other than directors are involved, some differences among the three countries concern *type, detail and timing* of information.

With regard to these aspects, Italian companies have to:

- prepare a release (“*documento informativo*”) with general information regarding the transaction ⁽¹⁵⁾;
- for relevant transactions ⁽¹⁶⁾, in the interim financial report they have to disclose information concerning transactions that have occurred in the first six months, show their impact on the periodic performance, and describe the consequent risks and uncertainties with regard to the second half of the year. In addition, they also have to disclose: any weaknesses reported by experts, the evaluation methods adopted, and the sources used by the experts to assess the adequacy of the amount due. Finally, they also have to certify the consistency of the delivered information with the experts’ opinion.
- for transactions not considered relevant, they have to provide: full disclosure to the Board of Directors, at least on a quarterly basis; external disclosure, at least quarterly, of the operations approved against the advice of the independent directors.

UK discipline also distinguishes between relevant and non-relevant transactions, specifying that Chapter 11 of the Listing Rules does not apply to “small transactions” ⁽¹⁷⁾ and “transactions that do not have any unusual features”. When a relevant RPT occurs, according to the UK Listing Rules, companies must:

- provide notification to the Regulatory Information Service (RIS), showing the name of the

Rules have adopted a peculiar definition of *related party*, considering as such:

- a person (a company) who (which) is the *substantial shareholder* or someone exercising a significant influence;
- a *director* or *shadow director* of the listed company or of any other related company;
- an *associate* of the above mentioned related parties.

Moreover, according to the UK discipline, a transaction involving these subjects is considered an RPT even if it is carried out by persons who were *related party* within the 12 months before the date of the transaction or arrangement (*former director/substantial shareholder*).

Notwithstanding this broad definition of *related party*, the scope of the UK Listing Rules appear to be narrower than the IAS 24 one. In the latest versions of the International Accounting Standard, the category of the *directors* has been replaced with the wider definition of *member of the key management personnel*. In addition, *joint ventures* or *post-employment defined benefit* are not explicitly considered by the UK Listing Rules, whereas they constitute important *parties* according to the IAS 24. Moreover, by introducing the category of the “shadow director” and extending the focus of attention to *former directors/substantial shareholders*, the UK discipline - devised to emphasise the importance of the economic substance of relations - is characterized by a higher degree of vagueness than the international discipline.

This brief examination of the scope of national legislations though highlighting differences among national rules, points out a convergence pattern mainly driven by the International Accounting Standards. In actual fact, compliance with IAS n. 24 has narrowed Continental European legislations to the Anglo-Saxon one, introducing a common framework that will probably influence the domestic regulators’ acts. The adoption by the Italian Stock Exchange Commission of the IASB definition of *related parties* can be interpreted as a clue to this process which involves, as will be shown in the next section, not only the discipline scope, but also control mechanisms.

4.2 Regulatory frameworks: disclosure and authorization/monitoring mechanisms

The presence of one of the above-mentioned *related party transactions* obliges the entity to disclose information required by IAS/IFRS and local codes, and to comply with the authorization/monitoring mechanisms specifically considered by domestic legislations.

As is well-known, whenever an RPT occurs separately for each category of related parties, German, Italian and UK listed companies have to

themselves or for any other person, nor grant third parties unlawful advantages. *Supervisory Board Members*, now required to consist of an adequate number of independent directors, need the Supervisory Board's approval to take on advisory and other service agreements and contracts for the company. They, as well as their relatives, cannot receive loans from the company unless there has been prior approval from the Supervisory Board and they have to resign when conflicts are of a material nature or are not merely temporary. As Supervisory Board Members, *employees* ⁽¹⁹⁾ may not, in connection with their work, demand nor accept from third parties payments or other advantages for themselves or for any other person nor grant third parties unlawful advantages. German laws also deal with self-dealing between controlling shareholders and their company by qualifying such transactions as "concealed distributions" whenever carried out at unfair conditions ⁽²⁰⁾. In other terms, operations carried out with a shareholder on unfavourable terms are automatically regarded as "substantial distribution" to that shareholder and, as such, considered illegal since they are not conducted according to the rules for dividend distribution.

Looking at RPT, according to the UK Listing Rules, listed companies have to comply with the following procedures to be launched *ex-ante*:

- they must obtain the shareholders' approval before entering into the transaction/arrangement; or, if the transaction or the arrangement is expressly conditioned by this approval, before it is completed;
- they must ensure that the related party does not vote on the relevant resolution and that it takes all reasonable steps to ensure that not even the related party's associates vote on the relevant resolution.

In Italy the regulation is much more detailed. In accordance with the Audit Committee (*Comitato Controllo Interno*) the Board of Directors, has to ensure that transactions carried out with related parties are performed in a transparent manner, observing the criteria of substantial and procedural fairness. For this purpose, the Italian Code of Best Practices suggests the following procedures: Board approval for the more important transactions; a prior opinion by the Internal Control Committee; involvement in the transaction of one or more independent directors; recourse to external appraisers. Moreover, the CONSOB draft requires the following procedures to be applied differentiating between RPT and "relevant RPT" in order to prevent unnecessary costs and guarantee an adequate level of managerial discretion):

- for transactions not defined relevant: non-binding opinion from a committee of independent directors who are entitled to receive timely, *ex-ante*, adequate information; the possibility for independent directors to apply for independent advice at the company's expense; a thorough and documented examination, both in the preliminary investigation and

related party and the details of the nature and extent of the related party's interest;

- send a circular to its shareholders describing in detail the major aspects of the transaction; if the transaction involves an acquisition or a disposal of a social asset, where any percentage ratio is 25% or more and appropriate financial information is not available, the circular will also include a statement through which disinterested directors certify that the transaction is consistent with the social interest as verified by a qualified and independent consultant.

In Germany, listed companies have principally to perform the obligations required by the IAS n. 24, as local codes only discipline the case partially. Indeed, according to German corporate law, the management board of a controlled company has to prepare a report (the "dependency report") describing all intra-group transactions, within the first three months of the year. However, it is important to note that such a report is disclosed to the supervisory board only and not directly to the shareholders or to the market ⁽¹⁸⁾.

With regard to authorization/monitor mechanisms, German discipline is the most demanding of the three, although it applies only to directors and controlling shareholders, while Italy and UK rules provide a framework regulating the wider category of RPT.

Insofar as the interests of directors are concerned, the Italian framework only obliges the Board of Directors to take measures in order to ensure that transactions in which a director is conveying an interest (for him/herself or for third parties) are appropriately managed.

In UK, companies may not enter into the following transactions with their directors or with their holding company's director unless they have been approved by a resolution of the company's members: employment contract longer than two years; transaction concerning "substantial non-cash assets"; loan, quasi-loan transactions or give a guarantee or provide security in connection with such operations made by any person to the director; credit transaction as creditor for the benefit of a director of the company or of its holding company.

In Germany, *Management Board Members*, as well as persons they are close to or companies they have a personal association with, cannot undertake transactions with the company unless made at conditions consistent with current industry standard; they cannot hold other positions (especially Supervisory Boards' mandates outside the enterprise) and cannot receive loans from the company, unless approval has been given from the Supervisory Board. During their employment, *Management Board Members* are subject to a comprehensive non-competition obligation. Specifically, they may not, in connection with their work, demand nor accept from third parties payments or other advantages for

convergence process of domestic self-dealing legislations towards the Anglo-Saxon model.

Indeed, the endorsement by the European Commission of the International Financial Reporting Standards obliges listed companies in all three countries to draw up their financial statements according to the IAS/IFRS, adopting accounting standards whose theoretical foundations are closer to the UK GAAP than the Italian or German ones. With regard to self-dealing and conflict of interests, this accounting harmonization process has implied the implementation of IAS n. 24, with the introduction of a common definition of *related party* and the requirement of a periodic and detailed *related party disclosure*.

The increasing attention given to the role played by “independent directors” in preventing corporate controllers’ opportunistic behaviour is another important factor signalling a gradual approach of German and Italian self-dealing rules towards the UK discipline. According to the latest versions of the German Code, the Supervisory Board shall now include “what it considers an adequate number of independent directors”; the Chairman of the Audit Committee - set up by Supervisory Board members - must be an independent director too. Meanwhile, to carry out an RPT, the Italian Security Exchange Commission not only demands a favourable opinion by independent directors, but it also suggests the direct involvement of outside directors in negotiations and preliminary investigation phases.

The distinction between a relevant and non-relevant RPT, as well as the introduction of a *self-enforcing system* that provides for an *ex-ante* approval by independent directors or shareholders can be regarded as further evidence of the strong influence exercised by the UK regulatory framework on the Italian one.

For these reasons, it is possible to conclude that the differences concerning a firm’s ownership structure together with the socio-economic conditions of the three countries examined do not seem to prevent more and more intense cooperation between national regulatory agencies. In other words, our hypothesis of the centripetal effects exercised by the positive economic consequences (in terms of lower *direct* and *indirect costs*) associated to the rise of a common legal framework in a global market is at least partially verified. And this provides encouragement for further analysis of the factors leading to the development of European self-dealing regulations.

In particular, a deeper investigation into the nature of direct and indirect costs borne by the market participants, as a consequence of poor cooperation among national regulators, has to be carried out. Above all, a more detailed assessment of *induced costs* is required in order to better appreciate the corporate controller’s behaviour and his ability to take advantage of market imperfections and legal divergences. Obviously, the wider the sample of

in the deliberation phase, of the reasons behind the transaction and of the adequacy and accuracy of its material conditions; if the terms of transaction are defined equivalent to those of the market (or standard), elements of confirmation have to be attached to the prepared documents;

- for relevant transactions, the draft suggests providing more monitoring/authorization mechanisms: exclusive competence of the Board of Directors in the approval phase (after a favourable opinion from a committee of independent directors); involvement in negotiations and in the preliminary investigation of independent directors; in the event of unfavourable opinions from independent directors, the possibility (where provided by the company’s statute and upon justification of the choice) that the transaction is fulfilled through shareholders approval⁽²¹⁾.

The overlapping area among the monitoring mechanisms provided by national legislations becomes broader and broader. In particular, the Italian discipline is clearly moving towards that of the UK with regard to either the required disclosure or the implemented control systems. On the other hand, although the German legislation shows a slower pace in that direction, the increasing role played by the independent directors in carrying out the *Supervisory Board* functions also testifies to the strong influence of the Anglo-Saxon system over the Rhine one.

However, this overview of the European self-dealing rules supports the convergence hypothesis even through differences between countries whose legal and economic frameworks, according to the path dependency view, should have led to a common legislation on self-dealing. In actual fact, although the ownership structure of most German entities is not distant from that of Italian firms, and both countries are characterized by a strong Civil Law tradition, the conflict of interests discipline adopted in Germany diverges considerably from the Italian one. If these findings are interpreted as a clue to a weak relationship between self-dealing legislations and the economic and legal conditions of the countries in which they operate, it is reasonable to assume that the efficiency reasons described in the previous sections (decreasing *direct* and *indirect* costs and minimizing *switching* costs) will be strong enough to encourage a convergence process towards the Anglo-Saxon model.

5. Discussion and Conclusions

The European legal scenario concerning self-dealing and conflict of interests is still fragmented. The previous sections have stressed differences either in the *discipline scope* or in the *monitoring/authorization* mechanisms. However, notwithstanding these documented divergences, the brief analysis developed above has also highlighted several variables supporting the existence of a gradual

testified by smaller boards, more independent directors, more independent audit, nominating and remuneration committees. Moreover, a more detailed disclosure on governance matters is delivered.

10. According to the IAS n. 24, paragraph n. 9, (a) a person or a close member of that person's family is related to a reporting entity if that person: (i) has a control or joint control over the reporting entity; (ii) has a significant influence over the reporting entity; or (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (b) An entity is related to a reporting entity if any of the following conditions applies: (i) the entity and the reporting entity are members of the same group; (ii) one entity is an associate or joint venture of the other entity; (iii) both entities are joint ventures of the same third party; (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity; (v) the entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity; (vi) the entity is controlled or jointly controlled by a person identified in (a); (vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

11. See German Corporation Law, § 311 Aktiengesetz.

12. See art. 2391 and 2391-bis, Italian Civil Code; art. 71-bis Regolamento Emittenti; "Codice di Autodisciplina", Borsa Italiana, 2006.

13. The Companies Act 2006 contains specific provisions governing the procedures for the approval or ratification of "conflicts of interest". The discipline contained in this document is broadly in line with that of the previous version of 1985.

14. According to the IAS 24, pars. 18 – 19, the following information has to be disclosed separately for each category or related parties: a) the amount of the transactions; b) the amount of outstanding balances, including terms and conditions and guarantees; c) provisions for doubtful debts related to the amount of outstanding balances; d) expense recognised during the period in respect of bad or doubtful debts due from related parties.

15. This information concerns: risks related to potential conflicts of interest of related parties involved in the transaction; characteristics, rules, terms and conditions of the transaction; nature of the related party relationship and of their interests in the transaction; economic opinion of the company for the implementation of the transaction; methods for determining the transaction price and assessments regarding its adequacy compared to market values of similar transactions (indicating any assessments conducted by professionals in support of the fairness of that price, whether such assessments have been specially commissioned by the issuer); economic and financial effects of the transaction; reward of the board's members of the company and/or of its subsidiaries whether the amount of the reward is likely to vary as a result of the transaction. Regolamento Emittenti, CONSOB, article 71-bis.

16. According to the CONSOB Exposure Draft, a transaction is considered to be relevant whenever at least one of the following ratios is higher than 5%:

- price ratio: price exchanged / average market capitalisation over the last 6 months;
- assets ratio: net asset value of the exchanged good / total asset value of the involved company;

European countries involved in any future analysis, the more robust will be the outcomes achieved.

Notes

1. In actual fact, the *non-intervention approach* assumes that outside investors are able to price securities according to the effectiveness of the protections offered by firms whose stakes they hold. However, the high costs associated to the process of gathering and evaluating all relevant information useful in an appreciation of the quality of governance systems could discourage market participants from carrying out such a deep examination and eventually lead to a market failure situation.

2. Shareholder approval (the "majority of the minority vote") and independent directors/external appraisal ratification fall within a property-type protection. On-going disclosure and the enforcement of supervisory agencies and criminal sanctions are a direct expression of such a liability-protection rule.

3. We specifically refer to the well known "anti-director rights" (La Porta *et al.*, 1997, 1998) and "anti-self dealing" indexes (Djankov *et al.*, 2008).

4. On the other hand, recent scandals involving companies subject to Anglo-Saxon legislation offer some anecdotal evidence contrasting such a position and encourage a more careful examination of the rules rooted in Civil Law systems.

5. Previous researches have pointed out a positive association between the top management team (TMT) diversity and the firm's internationalisation process (Ruigrok *et al.*, 2007; Barkema, Shvyrkov, 2007; Lee, Park, 2006). A significant impact of foreign board membership on the firm's value has also been proved, ascribing such a correlation either to a stronger international posture or to a more demanding corporate governance mechanism that generally characterizes firms with a high TMT diversity (Randoy, Oxelheim, 2001).

6. An increasing corporate mobility is also expected in the European Union. Indeed, since the end of the 20th century, the European Court of Justice (ECJ) has repealed the so-called "real-seat rule", allowing companies to incorporate in countries different from those which they operate in (Ryan, 2005; Becht *et al.*, 2008). Firms can now freely choose where to incorporate, balancing between the quality of the proposed governance rules and the costs associated to similar legal systems (Kamar, 2006; Becht *et al.*, 2008).

7. Although U.S. markets are the main target for dual-listing firms (Pagano *et al.*, 1999), European ones have also widely increased their attractiveness for cross-listing activity. As a consequence of Stock Exchange mergers and the adoption of a common body of accounting standards, the implementation of cross-listing strategy into EU borders has become more feasible, and have positively affected shareholders' wealth and minorities' protection.

8. The "proprietary" or "inter-firm" costs concern the negative effects of a more detailed disclosure that the corporate controller has to bear because of the consequent disadvantages relative to its competitors, major suppliers or major customers. Outside investors will not be affected by similar costs because the "inter-firm" disadvantages to the issuer are counterbalanced by the advantages it confers on the other firms.

9. In particular, with respect to the governance mechanisms adopted in the last few years, non Anglo-Saxon firms show stronger independent mechanisms of control as

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liabilities ratio: total liabilities referable to the exchanged good / company's total assets;
sales ratio: price exchanged / company's revenues.
17. According to the Listing Rule n. 11 Annex, par. 1.1., a small transaction is defined as a transaction or arrangement where each of the applicable percentage ratios is equal to or less than 0.25%.
18. See German Corporation Law, § 311 Aktiengesetz.
19. In companies with more than 2,000 employees, the supervisory board must consist of equal numbers of shareholder-elected and employee-chosen members (so-called "co-determination). To break ties, the shareholder-selected chairman has a second vote.
20. Stock Corporation Act (Aktiengesetz), art. 57.
21. In this case, the deliberation mechanisms have to be devised in order to prevent the vote being determined by shareholders who are a related party in the transaction (*whitewash*, though conditional on the presence of a minimum share capital owned by minorities).

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