14

AICGSPOLICYREPORT

CORPORATE GOVERNANCE IN GERMANY AND THE UNITED STATES: KEY CHALLENGES FOR THE TRANSATLANTIC BUSINESS COMMUNITY

Thomas Kenyon
Sigurt Vitols

AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES THE JOHNS HOPKINS UNIVERSITY

AICGS

AMERICAN INSTITUTE FOR CONTEMPORARY GERMAN STUDIES

THE JOHNS HOPKINS UNIVERSITY

The American Institute for Contemporary German Studies strengthens the German-American Relationship in an evolving Europe and changing world. The Institute produces objective and original analyses of developments and trends in Germany, Europe, and the United States; creates new transatlantic networks; and facilitates dialogue among the business, political, and academic communities to manage differences and define and promote common interests.

©2004 by the American Institute for Contemporary German Studies

ISBN 0-941441-84-9

ADDITIONAL COPIES:
Additional Copies of this Policy Report are available for $5.00 to cover postage and handling from the American Institute for Contemporary German Studies, 1755 Massachusetts Avenue, NW, Suite 700, Washington, D.C. 20036. Tel: 202/332-9312, Fax 202/265-9531, E-mail: info@aicgs.org Please consult our website for a list of online publications: http://www.aicgs.org

The views expressed in this publication are those of the author(s) alone. They do not necessarily reflect the views of the American Institute for Contemporary German Studies.

TABLE OF CONTENTS

Foreword 03

About the Authors 05

Executive Summary 07

Ch.1: Introduction 11

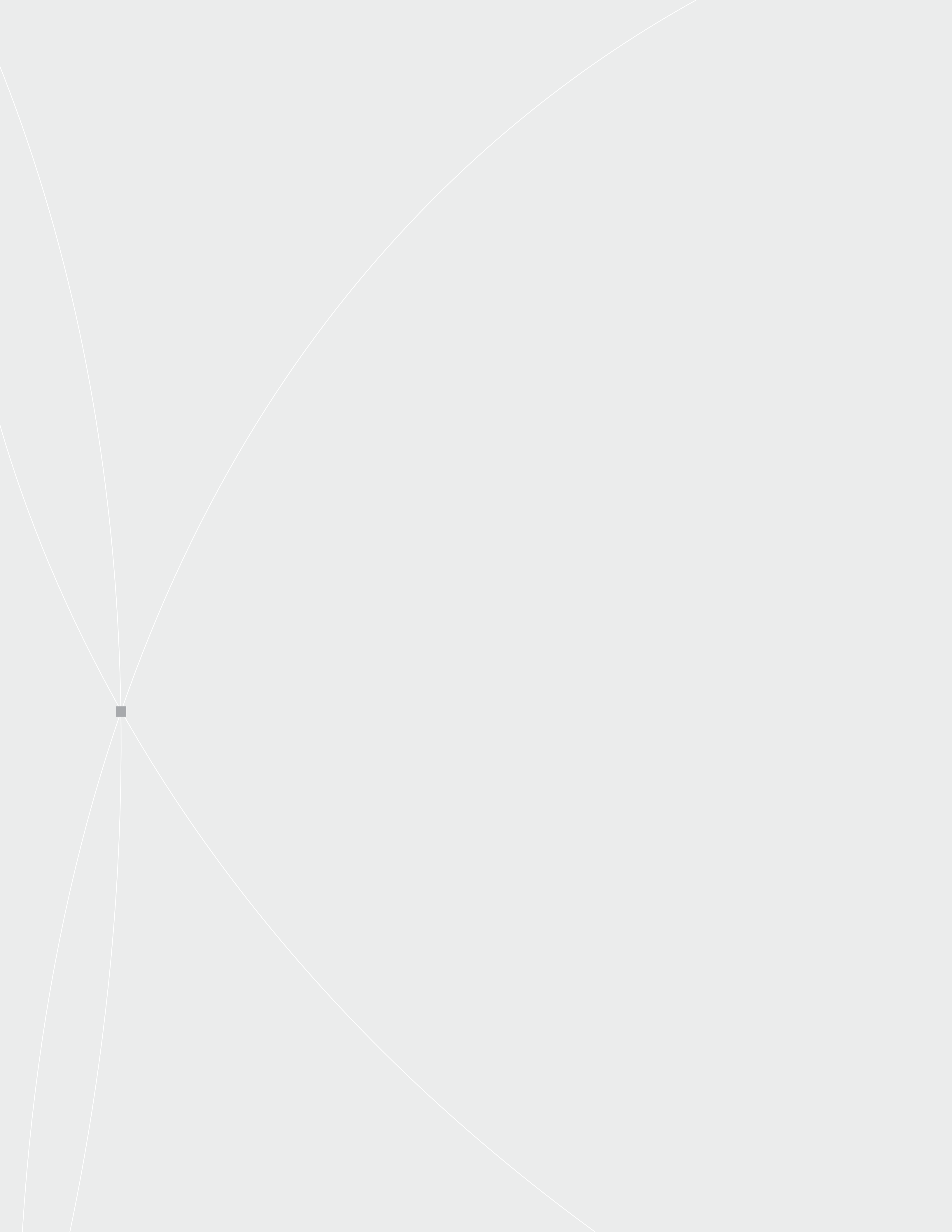
Ch.2: The German Corporate Governance Infrastructure and the European Context 15

Ch.3: The U.S. Corporate Governance Infrastructure 23

Ch.4: Germany, the European Union, and the United States 31

Ch.5: A Transatlantic Reform Agenda: Policy Recommendations 37

References 41



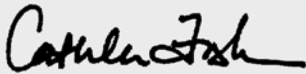
FOREWORD

The last decade has seen significant increases in foreign direct investment (FDI) and mergers and acquisitions across the Atlantic. The German and American economies intersect more tightly than during the Cold War and, as a result, many firms now function in two separate regulatory environments. To effectively operate in the transatlantic economy, corporate leaders need to understand not only the legal and regulatory requirements and the political pressures for change, but also the societal, historical, and cultural contexts of rule-making. Different attitudes toward transparency, individual versus government responsibility, as well as attitudes toward the market and intervention—all may play a role in shaping our respective responses to the challenges posed by growing transatlantic economic interdependence and the pressures of globalization.

A series of corporate scandals and the growing internationalization of production and finance have forced policymakers in both Germany and the United States to rethink national regulatory systems. Although Germany has, in the last decade, adopted elements of U.S. capital market regulation, the German and U.S. systems of corporate governance remain distinct, as do the institutional configurations necessary to support them. These differences retain significant potential for conflict, as the much publicized case of Josef Ackermann, the CEO of Deutsche Bank charged with breach of trust for granting $56 million in "appreciation" awards and accelerated pensions to executives of telecommunications company Mannesmann, recently highlighted. The most fundamental difference between German and U.S. systems of corporate governance is the ownership of public companies—large U.S. companies are usually owned by a large number of small investors, while the largest German companies are controlled by a small number of block holders, mainly banks. These high levels of ownership translate into expansive voting rights for German shareholders in comparison to their U.S. counterparts. These differences are the kind of issues that shape corporate culture and contribute to the complex set of factors that corporate leaders must grapple with in navigating the complexities of transatlantic corporate relations.

This publication is the second in a series, sponsored by the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft, examining the political, social, and economic causes of several key regulatory disputes and the prospects for reconciliation of transatlantic differences in the areas of product standards, corporate governance, and taxation. In this Policy Report, Thomas Kenyon and Sigurt Vitols provide an in-depth look at the historical and social background of the U.S. and German corporate governance systems and examine current reform issues on both sides of the Atlantic. They show that there is no one "best" system of corporate governance. Instead, each system is suited to a different type of production, each with its strengths and weaknesses. In order to take advantage of these differences, companies and investors must recognize them and take steps to adapt to them. Kenyon and Vitols argue that policymakers and regulators must be willing to accommodate the needs of foreign companies and, where appropriate, engage in mutual recognition. Such a pragmatic approach should be continued. They also contend that firms in both the United States and Germany would benefit from a better understanding of their respective systems, particularly the historical context and functioning of corporate governance regulation.

AICGS is grateful to the authors for their insightful analysis and to the DaimlerChrysler-Fonds im Stifterverband für die Deutsche Wissenschaft for its generous support of this publication.

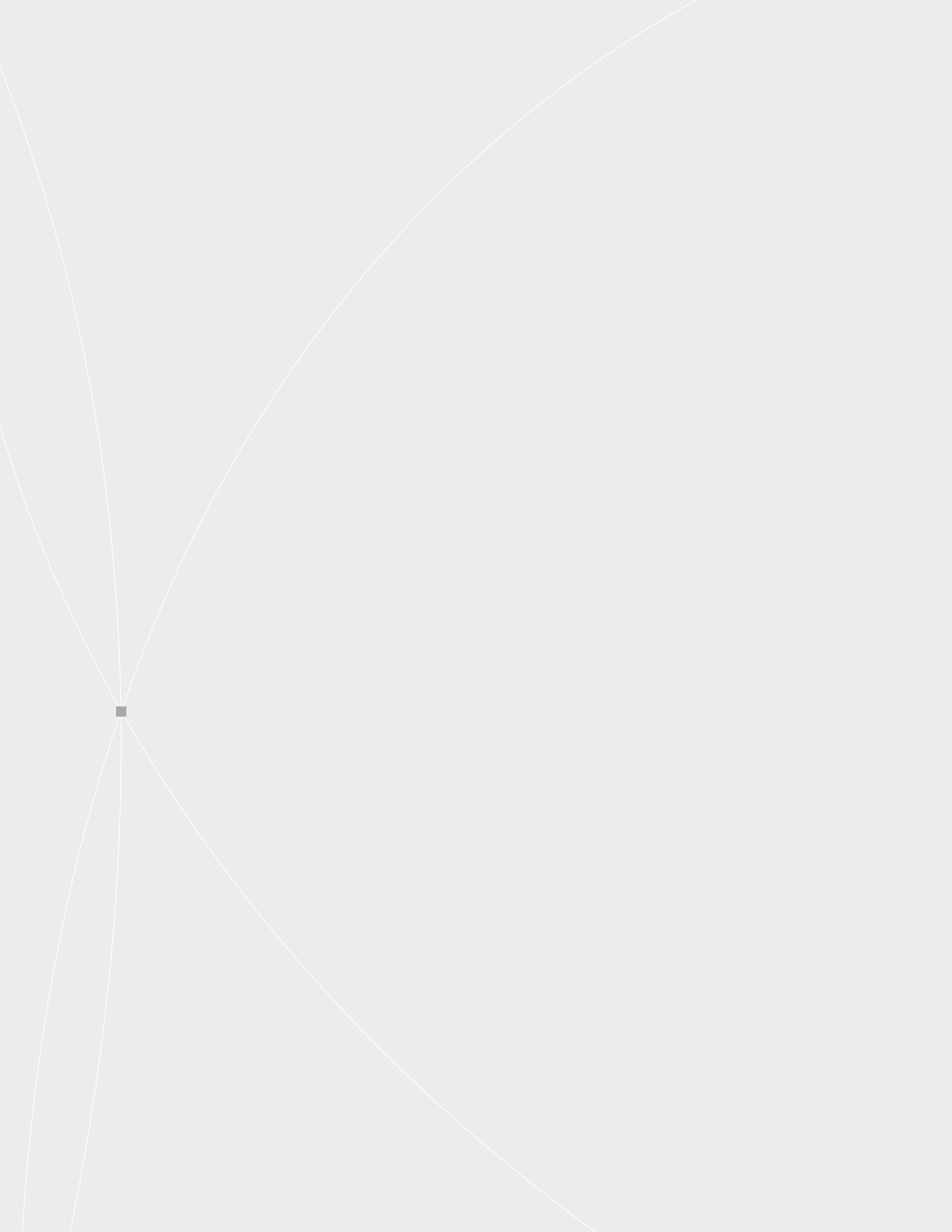


CATHLEEN FISHER
Deputy Director
AICGS

ABOUT THE AUTHORS

THOMAS KENYON is a Consultant with the Investment Climate Unit at the World Bank and a Research Fellow at the Center for the Study of Globalization at Princeton University. He was formerly employed as a financial analyst and economist at Fitch Ratings.

SIGURT VITOLS is a Senior Research Fellow at the Wissenschaftszentrum Berlin für Sozialforschung. He has advised both the European Commission and the German trade union federation on international corporate governance issues. His publications are targeted at both policymaking and academic audiences.



EXECUTIVE SUMMARY

The issue of corporate governance has acquired greater significance in Germany and the United States in recent years. A series of corporate scandals and the growing internationalization of production and finance have forced policymakers in both countries to rethink national regulatory systems. Because these systems remain quite distinct, the process has often brought regulators into conflict with each other and with the companies and investors they oversee. An example is the recent dispute over the application of new U.S. corporate governance rules to German companies listed on the New York Stock Exchange. In so far as these conflicts interfere with cross-border flows of trade and investment they are detrimental to public welfare.

There is no one 'best' system of corporate governance; instead, each is suited to a different type of production. The United States, for example, excels in high-tech manufacturing while Germany does best in capital goods industries. The financial risks and management incentives required for these two areas of activity differ greatly; so do the institutional configurations necessary to support them. This specialization, based on different national comparative advantages, is one of the principal benefits of internationalization and should be encouraged. It follows that the best way forward is through mutual recognition of differing governance practices; harmonization should be employed only when absolutely necessary.

Convergence has gone furthest in the area of transparency and disclosure, particularly with the adoption of international accounting standards and quarterly reporting by large German companies. The United States has also taken a step in the direction of the German 'two-tier' board system through the imposition of restrictions on executive representation on audit committees. However, major differences remain. These concern the extent of employee representation on company boards, the role of large shareholders in corporate governance, and the extent to which stock options and performance-oriented financial incentives are used to motivate managers and employees.

Fortunately, regulators in both countries have taken a pragmatic approach towards these structural differences. Mutual recognition has defused many potential conflicts. Such a pragmatic approach should be continued. U.S., German, and European firms would benefit from a better understanding of the two systems among companies, investors, and policymakers, including the historical context and functioning of corporate governance regulation in Germany and the United States.

Policy Recommendations

(see chapter 5 for more background):

- The SEC should make a clear statement outlining its general approach and commitment to the mutual recognition of corporate governance systems;
- A high-level group with official recognition should be brought together at the international level to examine and issue recommendations on best practices in mutual recognition of different national systems of corporate governance;
- Provided that U.S. concerns over investor protection are met, the SEC should allow foreign companies listed in the United States to report based on IAS rather than U.S.-GAAP. Furthermore, the SEC should consider extending IAS to all companies listed in the United States;
- German companies should improve their implementation of international accounting rules and German policymakers and regulators should step up their efforts to enforce standards aimed at improving transparency in German companies;
- Research institutes and other organizations concerned with transatlantic relations should increase their efforts in promoting mutual understanding of the two systems. These efforts should be based on the thesis that each system may have its strengths and weaknesses, rather than on the assumption that there is one 'best' system;
- German unions and works councils should follow the approach used in the state of North Rhine-Westphalia, which is to address potential investors' concerns about employee representation through direct meetings. Furthermore, German unions and works councils should extend their efforts to "internationalize" employee representation and promote understanding of codetermination among international unions.

01 CHAPTER ONE

INTRODUCTION

The Purpose of the Study

The purpose of this study is to outline the principal differences between the German and U.S. systems of corporate governance and to highlight how and why they matter for transatlantic investors. Over the course of the twentieth century, Germany and the United States developed quite distinct systems of industrial organization. Although there has been some convergence in the past decade (mainly in the form of Germany adopting elements of U.S. capital market regulation), the two remain very different despite considerable capital and product market integration. And as recent controversies over the application of U.S. reforms to German companies and over the adoption of U.S.-style remuneration practices in Germany show, these differences retain significant potential for conflict.

This report is guided by the belief that neither system is inherently superior. Rather, they have different strengths and weaknesses. Corporate governance is part of the institutional endowment that determines how national economies compete in global markets. It leads to cross-national specialization in different forms of industrial activity. This is natural and to be encouraged. But in order to take advantage of these differences, companies and investors must be aware that they exist and be cognizant of the need to adapt to them. To allow them to do so, policymakers and regulators must also be willing to accommodate the needs of foreign companies and, where appropriate, to engage in mutual recognition.

This study is aimed at companies, investors, and policymakers in Germany and the United States. Since many aspects of German practice are widespread in continental Europe, it also has relevance at the European and international level. It begins by discussing the historical and social background of the two corporate governance systems, provides an overview of current reform issues, and concludes with a number of policy recommendations.

What is Corporate Governance?

The term ‘corporate governance’ refers to the set of rules governing relations between shareholders, managers, employees, and other stakeholders in public companies. These rules are concerned with how the company’s officers are appointed, how decisions are taken, and ultimately with how profits are distributed. They are necessary because most large modern enterprises are run by professional managers and not by their owners and because the interests of these two groups do not always coincide. While shareholders are principally concerned with increasing the value of their investment, some managers may have other objectives. Inducing investors to part with their money requires at least some legal guarantee that those to whom it is entrusted will not abuse that trust.

How do Corporate Governance Systems Differ between the United States and Germany?

The American and German systems of corporate governance both address this same fundamental problem: how to mitigate the conflict of interest between shareholders and managers. But they do it in very different ways. This is in part a matter of historical circumstance–as described below, the two have evolved in response to varying pressures and needs. The profound crises that afflicted Germany over the course of the twentieth century have no counterpart in the United States. But it is also a function of the different social and political systems in which they operate. As this report should make clear, corporate governance systems do not exist in an institutional vacuum. Politics and society define who participates in corporate governance and shape the expectations that govern their interaction.

Probably the most fundamental difference between the German and U.S. systems of corporate governance has to do with the ownership structure of public companies. In the United States, most large companies are owned piecemeal by a large number of small investors, mainly financial institutions such as pension and mutual funds. In Germany, on the other hand, the largest industrial companies are controlled by a small number of block-holders, such as banks, family foundations, or other companies. The contrast is striking: a recent cross-national comparison of ownership structure found that the median largest shareholder in Germany controlled 52 percent of the voting rights, as opposed to less than 5 percent for companies listed on the NYSE. Most other continental European countries have similarly high levels of ownership concentration compared to the United States. Although block holding has declined slightly in the past five years, it appears to be an enduring feature of German and continental European corporate governance.

This difference in ownership structure has several consequences. The most important concerns the way in which shareholders monitor managers. Because most American shareholders own only a small fraction of the companies in which they invest, they do not generally have the wherewithal to oversee them directly. Instead, the U.S. system seeks to control managers through a series of legal restraints and duties. The system emphasizes shareholder rights, buttressing them with institutional rules–such as antitrust and anti-insider trading laws–and relying on a high degree of disclosure and transparency. The purpose of transparency is to provide diffuse external shareholders with a clear basis on which to make investment decisions. The principal means investors have at their disposal to express dissatisfaction is to sell their shares. For these reasons the U.S. system has sometimes been described as an outsider system of corporate governance. The German system, on the other hand, empowers shareholders by concentrating voting rights and giving them direct influence over managers through supervisory boards. It allows a greater degree of insider control than the U.S. system and requires less public disclosure.

A third and very important difference between the two governance systems concerns the constituencies they represent. It has become common to refer to the United States as a shareholder-oriented system and Germany as an example of stakeholder capitalism. The reason for this characterization is that U.S. law prioritizes the rights of equity holders, while the German system privileges creditors and employees. By law, up to half of the seats of the supervisory boards of large German companies are reserved for employee representatives. Although Germany probably has the strongest system of employee codetermination in the world in this respect, many other continental European countries also require or explicitly enable employee participation in corporate governance. The passage of recent legislation by the European Union, emphasizing information and consultation rights for employees, suggests that this is likely to remain the case for the foreseeable future.

Table 1: Median Size of Largest Shareholding Block, 1999

Country	Largest Voting Block: Median (%)
Italy	54.5
Germany	52.1
Austria	52.0
Belgium	50.6
Netherlands	43.5
Spain	34.2
France (CAC 40)	20.0
UK	9.9
U.S. - NYSE	0*
-- NASDAQ	0*

Source: Barca and Becht (2001: 19)
*U.S. figures are below the 5% disclosure threshold.

What are the Comparative Advantages and Disadvantages of the Two Systems?

There is considerable evidence that globalization is leading to increased specialization of national economies in different types of activities rather than to convergence in industrial structure. The greater competition resulting from lower trade barriers and transport costs encourages countries to focus on the production and service activities that their institutional frameworks best support. The United States has developed a very strong focus on high technology activities, such as information and communication technology (ICT), biotechnology, and pharmaceuticals. Germany, in contrast, is focusing more on research-intensive manufacturing, such as automobiles, chemicals, and machine tools.

Corporate governance is a key part of the national institutional infrastructure within which companies operate. The German system, which privileges ‘insiders’ such as employees and large shareholders, appears to have a comparative advantage in stable industries, in which the acquisition of company-specific skills and long-term job tenure are key for employee development, and in which the financial risks—but also the potential rewards—to outside investors are limited. The U.S. system, in contrast, has a greater capacity to reward employees and investors willing to undergo the risks that come with involvement in new and rapidly changing industries.

How and Why Do these Differences Matter to Foreign Investors?

These differences are both a source of opportunity and an obstacle for companies and investors operating in the transatlantic marketplace. They are a source of opportunity in that they offer businesses a chance to relocate production in the institutional environment to which it is best suited. Many German pharmaceutical and IT companies, for example, are now shifting their R&D activities to the United States. They also allow portfolio investors to diversify their holdings. But cross-national differences are a potential obstacle in that they require adjustment and accommodation. Some corporate governance practices, particularly those relating to employee relations and financial reporting, have over time created very country-specific, highly regulated structures. While country-specific structures can to some extent be contracted around—as the Daimler-Chrysler merger shows—there are many more instances in which they have become a deterrent to cross-border investment flows. It is the purpose of this report to show how best to manage them.

02 CHAPTER TWO

THE GERMAN CORPORATE GOVERNANCE INFRASTRUCTURE AND THE EUROPEAN CONTEXT

The Historical and Political Context

Germany's system of corporate governance is one of the prominent examples of a 'stakeholder' system, which differs in a number of respects from the U.S. system.

Though the German system has undergone significant changes recently, it retains the following key elements:

- A two-tiered board system, which separates the roles of top managers (who comprise the management board or *Vorstand*) from overseers (including a variety of stakeholders), who are represented in the supervisory board (*Aufsichtsrat*);

- A significant role for large shareholders (blockholders) not only in company ownership but also in corporate governance, mainly through representation on the supervisory board. These large shareholders include founders and their families, banks, and the state;

- A management culture favoring a technical orientation, long-term career development within a single company, and a higher degree of autonomy for top managers (and a correspondingly weaker role for the CEO) than in most U.S. companies;

- Employee participation in company decision-making, not only at the plant level via works councils (*Betriebsräte*) and union collective bargaining, but also through representation on the supervisory boards of larger companies. Employee representatives are in part chosen through internal elections and in part nominated by external unions;

- A financial system in which banks have been more significant and capital markets less prominent than in the United States and United Kingdom;

- A set of accounting standards and bankruptcy law that has favored debtors and conservative financial practices over the interests of small shareholders and external transparency.

Some historians have claimed that the fundamental characteristics of the German corporate governance system (such as the prominent role of banks) emerged in the late 1900s as a consequence of late industrialization and economic development. In fact, the main features of the postwar system were the consequence of a series of economic and political developments that together spanned more than a century.[1] These developments have included a number of serious economic crises–the 'founders' crisis' of the 1870s, two world wars, the hyperinflation of the 1920s, and the banking crisis of the early 1930s–as well as the experience of postwar occupation and reconstruction, and the Cold War division of the country.

Historical research has shown that the role of banks in the financial system during industrialization was not very different from other countries, including the United States. Their prominent role in German corporate governance is attributable largely to political measures undertaken in response to the banking crisis of 1931 and in postwar reconstruction. Repeated waves of bankruptcies and business failures induced the banks to convert bad loans into equity stakes. In their position as large shareholders the banks then naturally demanded a strong role in company oversight and lobbied for the reform of company law. This led to the emergence of the two-tiered board system for larger firms and to a regulatory system that emphasized 'responsible' self-regulation by a small number of large banks rather than a U.S.-style transparent capital market regime.

The role of employees in corporate governance also developed relatively late. It is closely associated with the post-WWII management of the coal and steel industries–a sector whose support of the war and physical destruction made it a prime candidate for root and branch corporate governance reform. After the war, German workers had occupied the coal mines and steel plants and organized production to a large degree by themselves. As it happened, most of these mines and factories were in the British-occupied zone, and the postwar British Labour government was particularly well disposed to employee participation, even to nationalization. It therefore strongly encouraged the passage of the 1951 Codetermination Law for the Coal and Steel Industry (*Montanmitbestimmungsgesetz*), which required equal representation of employees and shareholders on the supervisory board.

In keeping with its commitment to democratization, the German labor movement subsequently tried to extend this parity codetermination model to all large companies. But the 1952 Works Constitution Act (*Betriebsverfassungsgesetz*) restricted it to the coal and steel sector, limiting other companies to a watered-down form of codetermination that allocated only a third of supervisory board seats to employee representatives. In the 1970s worker unrest and renewed demands for economic democracy prompted legislative reforms that strengthened employee representation in large companies, though not to the extent of full parity. The end result was to give employees and shareholders equal representation on the supervisory boards of the largest companies, but to allow shareholders to nominate the chairperson and thereby control the casting vote in case of a tie.

In the 1970s and 1980s the weakening performance of shareholder-oriented systems such as those in the United States and United Kingdom sparked a wave of interest in the German model. Many scholars attributed the poor showing of the Anglo-Saxon economies to financial 'short-termism' and lauded the superiority of bank-based systems such as Germany and Japan in supplying 'patient' long-term capital to industry.[2] In the 1990s the economic resurgence of the United States and United Kingdom undermined these arguments and prompted concerns that the German system might itself be in need of fundamental reform. These concerns have since given rise to a number of changes in German practices both at the political and the company level. Nonetheless, it is probably more accurate to characterize these changes as incremental modifications of the existing system rather than as a wholesale adoption of the U.S. model.

Key Institutions and Actors

Responsibility for corporate governance regulation in Germany is currently divided among the following institutions:

- Federal Financial Services Authority. Until the 1990s securities and stock market regulation was largely the responsibility of regional governments (*Länder*) and the courts. In 1994, partly due to U.S. and EU pressure, Germany passed the Second Financial Markets Promotion Act and established a specialized national agency for securities regulation, the Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel*).[3] In practice, the new agency's regulatory efforts have fallen considerably short of the standards set by the SEC. In 2002 the agency was merged with the

regulatory agencies for banking and insurance to form a new consolidated body, the Federal Financial Services Authority or BaFin (*Bundesanstalt für Finanzdienstleistungsaufsicht*). The BaFin has been much more aggressive than its predecessor in prosecuting infringements of securities and other financial services law. In 2002, for example, it initiated fifty-six actions against financial services companies;[4]

- Stock exchange. The Frankfurt stock exchange plays an important role in German corporate governance. Its main participants are the large universal banks and, as a consequence, their concerns have often shaped the exchange's attempts at financial modernization and corporate governance reform. In 1997 the exchange established the *Neuer Markt*, a special segment for newer, high-growth companies. In an important regulatory innovation, the *Neuer Markt* required listed companies to use international accounting standards and provide quarterly reporting to investors;

- Commissions and boards. Since the mid-1990s a number of boards and commissions have been established to deal with corporate governance issues. These include the Takeover Commission, established to oversee the voluntary takeover code introduced in the late 1990s, and two commissions established in 1999 and 2001, respectively, to craft recommendations for corporate governance reform and develop a voluntary code of practice.

ACTORS

The key actors and interest groups in the German corporate governance system are the following:

- The large universal banks. Much has been written on the key role of the big three banks (Deutsche Bank, Dresdner Bank, and Commerzbank) in German corporate governance.[5] In addition to lending money, universal banks own blocks of stock in many large companies, vote on behalf of small shareholders who deposit their shares with them (often controlling 90 percent or more of votes exercised at shareholders' meetings), and sit on supervisory boards (often as chairperson). As commercial lending has become less profitable and the banks have diversified into investment banking activities, they have also sought to loosen their ties to non-financial companies.[6] Their reasons for doing so include the wish both to reduce conflicts of interest in takeover situations and to manage their shareholdings in closer accordance with shareholder value principles. This has been a gradual and long-term process, however, due in part to the post-bubble slump in investment banking activity. For the time being, Germany's largest companies still routinely consult their banks before taking major business decisions;

- Investment funds. Mutual funds acquired a more significant voice in corporate governance in the 1990s, as U.S.- and UK-based funds stepped up their holdings of German securities, and German households shifted some of their savings into investment funds. Companies have intensified their efforts to communicate with institutional investors and are increasingly taking their views into account in taking decisions.[7] However, it probably is better to view institutional investors as supplementing rather than replacing other members of the 'stakeholder coalition.' There is as yet little sign of their contributing to the emergence of a shareholder system along U.S. lines. German-based investment funds are generally 'captive' (i.e. owned by a bank or insurance company), and the financial incentives investment funds face appear to be longer-term than those for their U.S. counterparts. Recent pension reforms to encourage private saving for retirement (the *Riester Rente* reforms) may contribute to the growth of investment funds. But the government's attempt to kick-start a German pension fund industry appears to have had limited success;

- Family foundations. Family foundations remain a strong force in German corporate governance. Founders or family foundations are the largest shareholders in seven of the thirty largest listed German companies (also known as the DAX 30—see table 2). Some family-owned companies, such as Bertelsmann, have considered a stock market flotation but would almost certainly do so only subject to maintaining majority control;

Table 2: Largest Shareholdings in the DAX 30, December 2002

company			Shareholding company
	% Shares	of Shareholder	Type
Adidas-Salomon AG	> 5		
Allianz AG	23	Münchener Rückversicherung	Insurance
Altana AG	50.1	Quandt Family	Founder/family
BASF AG	9.2	Allianz AG	Insurance
Bayer AG	5	Allianz AG	Insurance
Bayerische Hypo- und Vereinsbank AG	26.3	Münchener Rückversicherung	Insurance
Bayerische Motoren Werke AG	48	Quandt Family	Founder/family
Commerzbank AG	10	CoBra Beteiligungs GmbH	Financial services
DaimlerChrysler AG	12.5	Deutsche Bank	Bank
Deutsche Bank AG	> 5		
Deutsche Lufthansa AG	10.1	Bundesrepublik Deutschland	State
Deutsche Post AG	71.3	Bundesrepublik Deutschland	State
Deutsche Telekom AG	43.1	Bundesrepublik Deutschland	State
E.ON AG	7.6	Allianz AG	Insurance
Epcos AG	12.5	Siemens AG	Company
Fresenius Medical Care AG	50.3	Fresenius AG	Company
Henkel KgaA	58.2	Henkel Family	Founder/family
Infineon Technologies AG	71.9	Siemens AG	Company
Linde AG	13.1	Allianz AG	Insurance
MAN AG	36.1	Regina-Verwaltungsgesellschaft mbH	Founder/family
Metro AG	56.5	Beshaim/Haniel Families	Founder/family
MLP AG	27.3	Manfred Lautenschläger	Founder/family
Münchener Rückversicherung AG	24.8	Allianz AG	Insurance
RWE AG	13.3	Allianz AG	Insurance
SAP AG	62.5	Klaus Tschira Stiftung GmbH	Founder/family
Schering AG	10.6	Allianz AG	Insurance
Siemens AG	6.9	Siemens Family	Founder/family
ThyssenKrupp AG	16.9	Alfried von Bohlen und Halbach Krupp-Stiftung	Founder/family
TUI AG (formerly Preussag AG)	29.1	Westdeutsche Landesbank	State
Volkswagen AG	20	Land Niedersachsen	State
Median	21.5		

Source: Company annual reports and websites.

- State-owned companies. Although privatization has reduced the government's influence over state-owned companies, only a fraction of their shares are publicly traded. Of the DAX 30, the federal government retains large shareholdings in Lufthansa, Deutsche Telekom, and Deutsche Post. Regional governments also have major stakes in many DAX 30 companies, including Volkswagen (Lower Saxony) and TUI (North Rhine-Westphalia);

- Insurance Companies. Large insurance companies are likely to become more influential in German corporate governance. Significant shareholders in the past and represented on many company supervisory boards, insurance companies often have been overlooked in the debate about corporate governance. But increasing concentration and new rules allowing them to increase their equity exposure will strengthen their position. Allianz, the largest German insurance company, is already the principal shareholder in seven of the DAX 30 companies;

- In theory, trade unions and works councils have a major influence on corporate governance through employee representation. In practice, however, union power is underutilized. Works councils have more influence, but generally limit their involvement to issues directly affecting employment and pay such as mass layoffs.[9]

Recent Reform Issues

Corporate governance has been the subject of vigorous debate in Germany and the European Union in recent years. This has resulted in a number of legislative changes both at the national and supranational level. But instead of a regulatory 'big bang,' these developments have for the most part been piecemeal and incremental.[10] The most conspicuous innovations have been in the area of German company law, European takeover regulation, and German financial market development.

CORPORATE GOVERNANCE IN GERMAN COMPANY LAW

Until the mid-1990s it was still difficult to find an adequate German language equivalent for the term 'corporate governance.' Instead, most policymakers and practitioners adopted the English phrase. This is perhaps apposite. The main impetus to reform—along with a series of corporate scandals fit to rival those in the United States—has been the internationalization of financial and product markets. The principal developments in this process are the following:

- The first significant German debate over corporate governance took place in the context of the 1998 Law on Control and Transparency in Large Companies (KonTraG). The debate was prompted by a number of instances of company mismanagement that had gone undetected by supervisory boards. The 1998 Law did not touch the most fundamental features of the system, namely the dual-board system and employee codetermination. It did, however, make a number of other important changes, among them: strengthening the responsibilities and rights of the supervisory board, allowing companies to issue stock options and establish share buyback programs, and encouraging the loosening of ties between banks and large companies;

- In the wake of the Holzmann bankruptcy in late 1999, the German government established a commission of experts under law professor Theodor Baums. This commission, which submitted its report in mid-2001, saw no need for a major overhaul of the German corporate governance system, but did make 150 detailed recommendations for change, many of which were aimed at improving the functioning of the supervisory board;

- Following the Baums Commission's recommendations, the Justice Ministry established a second commission in 2001, composed of practitioners and tasked with the development of a voluntary Corporate Governance code. Given Germany's tradition of formal legal regulation, the move to create a voluntary code represented something of a novelty. The code was issued in February 2002 and permits companies to deviate somewhat from its guidelines—provided that companies indicate clearly their reasons for doing so;

- Parallel to the work of the second commission, the Justice Ministry prepared a draft Law for Transparency and Publicity, which was passed in mid-2002. This law implemented a number of the Baums Commission's recommendations for improving transparency in company financial reporting and practice. It also established a legal basis for the Corporate Governance Code, described above;

- At the European level, attempts to harmonize company law have long been thwarted by differences in national practice with respect to board structure, employee representation, financial reporting, and taxation. Employee representation has been a particularly contentious issue. Unions from countries with employee board representation like Germany have long feared that weak transnational regulation might allow national companies to escape codetermination by re-incorporating at the European level. Conversely, employers from countries with no legal requirement for employee board representation have opposed mandatory co-determination. Nonetheless, in 2001 the EU passed the European Company Statute, which established the legal basis for incorporation at the European level. Though the details regarding employee participation have still to be worked out, it appears that the Statute will emphasize continuity with national practices for existing companies.

EUROPEAN REGULATION OF TAKEOVERS

Takeover regulation has also become an important issue in the last five years. Until recently, the variety of defense mechanisms available to management made hostile takeovers almost impossible in Germany, and there were only a handful of such takeovers in the postwar period.[11] An attempt in the mid-1990s to implement a voluntary takeover code failed in part because it was perceived as unnecessary.

In the late 1990s two events turned hostile takeovers into a public issue almost overnight. The first was the 1997 attempt by the steel and machine tools producer Krupp to take over Thyssen, a considerably larger group with a similar industrial profile. The move was controversial for several reasons. For one, Deutsche Bank, which was advising Krupp, had representatives on the supervisory boards of both companies. Critics naturally pointed out that this placed the bank in a conflicted position. They also noted that Deutsche Bank had not notified Thyssen of Krupp's intentions prior to the public announcement of the bid. Critics also raised questions about Krupp's proposed financing of the takeover, which involved the acquisition of a large amount of debt and the sale of workers' company housing. After union protests and a complaint from the regional government of North Rhine-Westphalia, Krupp eventually gave up and arranged a merger on friendly terms.

The second case occurred in 2000, when British telecommunications company Vodafone began a prolonged takeover attempt of the German Mannesmann group.[12] A traditional steel producer, Mannesmann had expanded into mobile and business communications and become one of the largest players in the newly deregulated German telecommunications market. That a foreign firm was involved contributed to the controversy. Both companies enlisted press campaigns to try to influence shareholder votes. After lengthy negotiations involving, among others, the Mannesmann works council and union board representatives, the two sides reached agreement on a friendly bid. Vodafone's success led many commentators to predict that the German market for corporate control was now 'open' and that other hostile takeover bids would follow.[13] The bursting of the stock market bubble appears to have put somewhat of a damper on this expectation, at least temporarily.

Although the number of European hostile takeover bids has declined sharply in the past few years, the European Commission has pressed on regardless and lobbied for the passage of a Takeover Directive (formally, the draft Thirteenth Directive on company law concerning takeover and other general bids). In particular, the Economic and Financial Affairs Directorate (ECFIN) of the Commission has put a high priority on creating a unified and open takeover market. The most controversial aspect of the proposed Takeover Directive was its requirement that management obtain approval from shareholders prior to implementing defense measures commonly used to frustrate hostile takeover bids (Article 9). Such defensive measures include poison pills and anti-greenmail provisions.[14] Another controversial section (Article 11) prohibited special voting rights (e.g. multiple voting rights or restrictions on maximum votes exercisable by one investor). This draft directive attracted strong opposition from unions and leftist parties and was defeated by one vote in the European Parliament in 2001. Following this setback, the German government introduced draft legislation that would have implemented the draft directive's provisions at the national level. The German parliament subsequently made a number of changes that strengthened the defenses available to management.[15]

FINANCIAL MARKET REFORM

The decade-long modernization of the German financial system has also had important implications for corporate governance. Attempts to strengthen *Finanzplatz Deutschland* in earnest date back to the banks' strategic decision to shift their focus to investment banking activities. The latter in turn required a strong home base–something that Germany lacked in comparison with the United Kingdom and United States. The weakness of domestic financial markets was illustrated in the fact that London, and not Frankfurt, was the principal market for trading in the German *Bund* futures (futures contracts on the benchmark ten-year German government bond).

Perhaps the most important change was the establishment of an SEC-style regulatory agency for securities markets (see the description of the Federal Financial Services Agency above). Prior to 1994 the German financial system had relied to a great degree on self-regulation by the large universal banks. The establishment of this agency represented a major step towards a U.S.-style regulatory and enforcement regime.

Other important changes have included measures to increase financial transparency (via the implementation of transnational accounting standards, either U.S.-GAAP or IAS), and the authorization of a much wider range of investment fund vehicles than was previously permissible, including most recently hedge funds. The impact of these changes has been to make Frankfurt look much more like Wall Street.

PENSION REFORM

A final point worth mentioning is pension reform. Pension funds constitute one of the largest sources of equity investment capital in the United States and the lack of such funds in Germany has been cited as an obstacle to financial market development. The year 2001 saw an important reform of the pension system, popularly called the *Riester Rente* after the then-minister for Labor and Social Affairs Walter Riester.[16] The goal of reform was to encourage private retirement savings and reduce the financial burden on the public pension system. The law created company and individual savings vehicles and backed them with public subsidies. Although the principal intention was to relieve the strain on the public purse, the government also hoped to strengthen domestic equity markets as a by-product. Popular demand for these saving plans has been limited so far but they may in future contribute to the growth of German equity markets.

Conclusions

Corporate governance has become a major public issue in Germany in the last five years. There have been a number of important changes in laws and regulations. These have included greater transparency and improved disclosure, modifications to the role of the supervisory board, the introduction of takeover regulation, financial modernization, and the development of a private pension industry. These changes have been prompted by several factors, including perceived weaknesses in the postwar corporate governance system, demands from the largest banks and some industrial companies for reform, and external pressure. As a whole, it can be said that Germany has taken some steps in the direction of U.S. practice. Nonetheless, many fundamental features of the German corporate governance system remain in place. The most important are the dual board system and the system of employee representation. These are unlikely to change in the foreseeable future and must be taken into account by regulators and companies in dealing with cross-border issues.

03 CHAPTER THREE

THE U.S. CORPORATE GOVERNANCE INFRASTRUCTURE

The Historical and Political Context

Though often considered a model for other countries, the United States is almost unique in its financial structure, in the way its industrial relations are ordered, and in the way it regulates relations between managers and shareholders.

The primary characteristics of the U.S. system are as follows:

- A pattern of fragmented ownership, in which shareholders typically own far smaller blocks of shares than in Germany and are consequently unable to exercise a comparable monitoring role;

- A regulatory system that emphasizes transparency and minority shareholder rights and is reliant on audit companies, rating agencies, and other market intermediaries;

- A culture and legal system that emphasizes shareholder rights at the expense of other stakeholders, particularly labor;

- A financial system dominated by capital markets and, in particular, equity markets in which banks play a far smaller part than in continental Europe.

The U.S. financial structure was not always organized this way. In the nineteenth century the United States in some ways resembled what is typically thought of as the German-Japanese model. It had vast industrial combines with inter-locking shareholdings in which banks and insurance companies owned large blocks of shares. Its financial markets were relatively underdeveloped, even by contemporary standards: by one calculation the ratio of stock market capitalization to national output was lower in the United States in 1913 than it was in France.[17]

This picture began to change around the turn of the century, when the federal government imposed aggressive anti-trust laws to split up and prevent mergers between financial institutions. From the 1860s onwards a succession of laws—from the National Bank Act of 1864 to the Sherman Anti-trust Act of 1890 and the Securities Acts of the 1930s—were introduced to discourage concentrated financial ownership and control. The motivation for these changes was largely political. Populist distrust of financiers found expression in an alliance of farmers, small businessmen, and small savers that pushed for the curtailment of monopoly financial power.[18] Following the stock market crash of 1929, this distrust combined with a climate of risk aversion to produce a regulatory regime that mandated the separation of commercial and investment banking and precluded financial institutions from holding large equity stakes in industrial corporations. The outcome was the U.S. financial

system as it is today–one of predominantly local banks, small shareholders, and fragmented ownership. This is a very different situation from that in Germany and most of the rest of continental Europe, where there are fewer public companies and large firms still tend to be owned either by families or by financial institutions, mainly banks.

The separation of ownership and control that underpins U.S. public corporations has given rise to a well-known difficulty for shareholders. As has become clear in recent years, the interests of shareholders and managers often diverge: shareholders are concerned principally with maximizing the value of their investment, while managers–at least in the short term–may be concerned more with other objectives. The principal challenge for shareholders, therefore, has been to find a way of monitoring managers effectively, particularly since shareholders may have either the resources or incentive to provide effective oversight individually.

The U.S. system of corporate governance has developed to address this problem. It is in effect an 'arms-length system,' in which responsibility for supervising managers is delegated to a board representing external shareholders. Shareholders' interests are safeguarded by a set of rules aimed at ensuring transparency and disclosure, and by intermediaries whose function is to monitor corporate performance. The principal mechanism shareholders have at their disposal for disciplining errant managers is to sell their shares. Thus, the United States has an active market for corporate control, supported by the takeover mechanism. This takeover mechanism has less bite than it once did, due to the proliferation of anti-takeover measures during the 1990s (anti-merger statutes, judicially sanctioned poison pill defenses, and the like), but it is still more effective than in most European countries. The United States also has adopted notions of 'shareholder value' and experimented with instruments for aligning the interests of shareholders and managers, such as stock options.

To function effectively, this system depends on a distinct set of political and social conditions. For understandable reasons related to their country's historical development, Americans tend to believe more strongly than Europeans that high performance and risk-taking should be rewarded. As a consequence, they also have a greater tolerance for income inequality. This combination of social preferences makes the use of stock options and performance related-pay more feasible than in continental Europe, where the political atmosphere is still somewhat suspicious of U.S.-style corporate governance practices.

Key Institutions and Actors

The U.S. regulatory system operates at three institutional levels: federal, state, and market. Historically the federal government has assumed primary responsibility for securities market regulation, while state governments have generated U.S. corporate law, self-regulation has substituted for government intervention in some areas. This situation has changed somewhat in the wake of the corporate scandals of 2000-1, as the federal government has intervened in the law governing company organization–hitherto the prerogative of states–and state regulators, the New York attorney's office in particular, have intervened in securities markets regulation. In addition, certain previously self-regulated activities such as accounting and auditing have come under mandatory regulation.

FEDERAL INSTITUTIONS

U.S. securities market regulation is primarily the responsibility of the Securities and Exchange Commission (SEC), an independent federal agency established in 1934. The SEC's function is to ensure that investors have access to information that companies would not otherwise provide and to protect shareholders from market abuses and fraud. Its principal task is therefore to draft and enforce disclosure rules governing securities issuers and market participants. These rules are bolstered by strong anti-fraud provisions and are mandatory in the sense that state governments cannot dilute them or introduce lower standards for local issuers.

STATE INSTITUTIONS

In contrast to securities market regulation, U.S. company law is the responsibility of state governments. Unlike in Germany, the legal requirements governing the creation and operation of U.S. corporations are minimal.[19] Generally, companies are required to have a board of directors, nominally appointed by the shareholders and responsible for the appointment, provision for oversight, and to compensate the CEO. State laws typically give shareholders little direct influence over company decision-making. The principal legal requirement is that managers act in a manner compatible with 'fiduciary duty,' but the concept is poorly defined and has generally provided little protection for shareholders.[20]

MARKET INSTITUTIONS

The New York Stock Exchange (NYSE) and NASDAQ, though under the authority of the SEC, have listing criteria that supplement federal rules. These concern the disclosure of financial statements, the composition of the board of directors, and the staffing of the audit committee. The NYSE has proved willing to exempt foreign-owned companies in part or full from those criteria that run contrary to home country practice.[21]

Until recently, the accounting profession was largely self-regulating. The Financial Accounting Standards Board (FASB), an autonomous private body, was responsible for developing and promoting accounting standards. This arrangement changed in 2002 with the establishment of the Public Company Accounting Oversight Board (PCAOB), which is now responsible for the registration and inspection of public accounting firms. Under Sarbanes-Oxley[22] the PCAOB is also charged with developing ethical and quality standards in relation to the preparation of audit reports. In April 2003, the board announced that the FASB would continue to set accounting standards.

ACTORS

- Senior Managers. The most important figures in U.S. corporate governance are the chief executives of public companies. Senior managers occupy a far stronger position in the United States than in Germany. They are also more highly remunerated, both in relation to other workers and to their counterparts elsewhere;

- Board. Senior managers are accountable to the board, whose members are elected by shareholders (even if, in practice, they do little more than ratify the board's own nominations). In contrast to Germany, U.S. boards are single-tier. Since the 1970s there has been a tendency for corporate boards to contain a majority of 'independent' directors—independent in the sense that they have no other connection to the company (i.e., are not employed or receive remuneration from the company other than in their capacity as a member of the board)—a characteristic now required by law.[23] Though often regarded as a safeguard against management abuse, the merits of outsider participation are unclear: many independents are passive and statistical analysis shows no relation between board composition and firm performance.[24] The principal functions of the board are to elect and dismiss senior executives, review the company's financial performance, and ensure compliance with the law. All have at least one functional committee, and most have at least three or four, the most important of which are the audit, compensation, and nomination committees. The requirements for audit committee membership have been revised substantially since 2002, as discussed in greater detail below;

- Financial Institutions. The third group of actors comprises financial institutions, such as pension funds and mutual funds. Financial Institutions now control the single largest stake in U.S. public companies, owning on average 50 percent of the equity of the top fifty U.S. companies and 60 percent of the next fifty—a far larger fraction than in Germany. Their importance has grown steadily over

the last three or four decades, driven by the increase in demand for funded retirement schemes. Their role in corporate governance has also been widely debated: some experts have called for greater shareholder activism, arguing that only large institutional investors have the incentive and means to monitor managers effectively; others have argued that it is unrealistic to expect institutions to be effective when the stakes they hold are typically very small—usually no more than 10 percent.[25] For the most part, institutional investors appear to have abstained from direct involvement in firm governance. The principal exceptions have been the large public funds such as TIAA-CREF and CALPERS, which in the early 1990s began to exercise their voting rights.[26] But as yet their effect on company performance appears to be marginal. It remains to be seen whether the role of financial institutions will change significantly in the wake of recent corporate scandals;

- Retail Banks. U.S. retail banks are less involved in monitoring firm performance than their German equivalents. By law they are prohibited from holding controlling stakes in companies not closely related to banking and are discouraged from acting in concert with other institutional investors.[27] In addition, their leverage over management is often curtailed by the availability of funding on better terms from the capital markets. Investment banks have played a greater role in governance, though not as shareholders but as proponents of and participants in takeover bids;

- Employee Unions. The role of employees in corporate governance is also weaker in the United States than in Germany. American unions are generally organized at the firm or industry level and lack ties to government, through formal bargaining arrangements, or to corporate decision-making through board representation, both characteristics of the German model. U.S. corporate law protects managerial prerogatives, such as decisions over investment, marketing and production, from union influence. Unions have consequently been less effective in opposing potentially detrimental regulation—particularly takeover legislation—than their continental European counterparts.

Recent Reform Issues

The current debate over corporate governance reform in the United States has been influenced overwhelmingly by the rash of recent scandals—including the bankruptcy of Houston energy-trader Enron—that emerged in the aftermath of the burst of the stock market bubble in 2000.

ENRON AND AFTER

The Enron episode was notable for the failure of at least two mechanisms that were crucial to the U.S. governance system.[28] First, there was a failure on the part of three market intermediaries that should have alerted investors to problems with the firm: the audit firms who approved inflated financial statements (inflated in the case of Enron by over $500 million); the rating agencies that failed to identify off-balance sheet transactions and hidden liabilities; and the securities analysts who maintained positive recommendations on companies they privately acknowledged to be worthless. Second, the linkage between shareholder value and executive compensation broke down as the short term nature of options contracts and the volatility of the stock prices on which they were based provided managers with an overwhelming incentive to engage in market manipulation.

These failures were at least in part attributable to three broad trends that weakened regulatory oversight during the 1990s. First, the sanctions facing auditors guilty of misconduct was eroded by a series of judicial and legislative developments. These included the strengthening of the requirements for proving intent to commit fraud and the elimination of racketeer-influenced and corrupt organizations (RICO) liability for cases involving securities fraud. These developments all worked to raise the legal hurdles facing plaintiffs seeking to prove misconduct and favor the position of managers. Second, accounting firms had strong incentives to engage in questionable conduct because of their growing tendency to take on non-audit work with audit clients. Between 1981 and 2000, the largest five accounting firms' share of revenue from 'management advisory services' increased from 13 to 50 percent, providing accounting firms with strong incentives to refrain from 'aggressive' audits for fear of losing consulting work.[29] Third, the SEC repeatedly failed to introduce

legislation requiring companies to treat stock options as expenses, a move that would have curbed the temptation for executives to manipulate their company's share price (for personal gain), but one that was strongly opposed by technology companies who relied on options as a substitute for cash salaries.

Responses to the Crisis

SARBANES-OXLEY

The scandals' most significant legal consequence to date has been the Sarbanes-Oxley Act of July 2002. The legislation imposed a series of additional responsibilities on corporate entities and on securities market participants and also signaled a willingness on the part of the federal government to step in where self-regulation had failed. With some exceptions, the Act's provisions apply equally to U.S. companies and to foreign-owned companies whose securities are traded in the United States. The reporting and certification requirements, in particular, are very similar. For this reason, it is worth setting out the Act's provisions in some detail.

- The primary concern of the legislation's drafters was to counter the perceived tendency of managers to dominate boards. The Act therefore strengthens the position of 'independent' directors and increases their role in company management. The law requires that boards appoint a majority of independents and that these exclusively comprise the firm's audit committee. It also strengthens the role of the audit committee, endowing it with sole responsibility for the appointment, compensation, and monitoring of outside auditors;[30]

- A second primary concern of the legislators was to deal with the conflict of interest inherent in the relationship between accounting firms and their corporate clients–a conflict that had been particularly visible in the case of Arthur Andersen. To address this situation, the Act first created a new regulatory body, the Public Company Accounting Oversight Board, to enforce accounting standards, effectively ending the regime under which auditors had policed themselves. To underline its independence from the accounting profession, the new accounting Board is required to be composed of a majority of persons with a non-accounting background.[31] The new legislation also places direct restrictions on the activities of auditors, limiting the scope of non-audit services accounting firms may provide to audit clients and requiring partners from auditing firms to rotate after five years service on a particular account. The Act also requires the SEC to study the advisability of rotation not merely of audit personnel, but also of audit firms, and to review the possible legal liability of other market intermediaries–investment banks, lawyers, and financial advisors–for securities laws violations;

- The legislators' third principal objective was to tighten up reporting and disclosure requirements and stiffen the sanctions facing errant executives. Thus, the Act requires the reconciliation of 'pro forma' accounts with standard U.S. GAAP and calls for more transparent treatment of off-balance sheet items. It also requires CEOs and CFOs to certify public accounts on a quarterly basis and expands the penalties for non-compliance, creating several new offenses and increasing the exposure of individuals to legal liability.[32] In addition, Sarbanes-Oxley requires the SEC to study the possibility of a transition from rules-based to principles-based accounting.

Sarbanes-Oxley is the most important U.S. corporate governance reform since the 1930s. But though almost universally recognized as necessary, it was also highly contested. The investment banks were divided over the draft legislation. As insiders, investment banks had benefited from the status quo, but they were also dependent on restoring public confidence. Institutional investors, who should have been among the law's strongest advocates, were lukewarm. Accounting firms, who had most to lose, fought passage of the legislation tooth and nail. In the end, the Act's provisions reflect the outcome of a political struggle between Congressional Republicans, who attempted to dilute the Act's provisions to placate influential donors, and Congressional Democrats, who sought to make capital out of a populist issue. The Act was, as critics

pointed out, a rushed and, in some respects, ill thought-out response to a crisis.[33] Many of its provisions—in particular, those relating to the treatment of foreign companies—have required substantial further clarification and revision. Fortunately, as discussed below, these have been largely resolved through dialogue and accommodation.

Whether Sarbanes-Oxley will have any effect on curbing future excesses is as yet uncertain. As of the time of this report, a weak economy has not dampened executive pay raises: in 2002, according to a Fortune Survey, the typical CEO received an increase of 14 percent.[34] Furthermore, most companies have continued to use stock options as remuneration, even though Microsoft declared in 2003 that it would no longer do so. One suspects the true test of the Act's effectiveness will come only once the U.S. economy next enters a long boom, perhaps tempting corporate executives to once more inflate their companies' performances.

04

CHAPTER FOUR

GERMANY, THE EUROPEAN UNION, AND THE UNITED STATES

The Potential for Conflict

The differences between the U.S. and German systems of corporate governance have, at times, given rise to misunderstanding and disagreement. This has been most pronounced in cases where the application of domestic rules to foreign companies has brought those companies into conflict with home country requirements. This section discusses several such instances and the remedies that have been applied.

PROBLEMS FOR GERMAN COMPANIES OPERATING IN THE UNITED STATES

The principal conflict arising from German companies operating in the United States has been over the SEC requirements for trading on the New York and other stock exchanges. These differences have been sharpened by the recent imposition of additional requirements under Sarbanes-Oxley and by the exchanges themselves.[35] Though of relevance to all foreign companies seeking a U.S. listing, some—in particular those relating to audit committee independence—are of particular relevance to German companies because of their distinctive governance arrangements.

The SEC in general does not follow a policy of mutual recognition towards other jurisdictions. Rather, its philosophy is to develop a "consistent, long-term approach that clarifies the application of the U.S. securities laws to the U.S. activities of foreign markets."[36] While it may accommodate the needs of foreign companies, it has tended to require that they meet the same standards as U.S. companies.[37] Fortunately, it has also proved reasonably flexible in accommodating the concerns of foreign market participants over Sarbanes-Oxley. The main points of friction, which have now been resolved or are in the process of resolution, are described below:

- The requirement for audit committee independence. This provision has been problematic for German firms because the management boards of German companies have no outside members. Although the supervisory board does consist in part of independents, it is also obliged to have employee representation—contradicting the U.S. requirement that its members have no other tie to the company. This issue was resolved when the SEC in April 2003 agreed to allow employees to sit on their board's audit committees, as required under German law. The SEC also agreed to recognize the supervisory board of German companies as the 'board of directors' referred to in Sarbanes-Oxley, thus allowing the supervisory board to function as an audit committee, provided all its members were independent. Controlling shareholders—including foreign governments—may be represented on non-U.S. companies audit committees, provided they are there only as observers. Finally, where their

home country's legislation requires it, foreign companies may also have a board of auditors separate from the board of management;[38]

- The harmonization of accounting standards. At present the SEC requires the reconciliation of financial statements prepared under international rules with U.S. generally accepted accounting principles (GAAP).[39] European companies listing on U.S. exchanges must therefore adopt GAAP rules in addition to or instead of alternative accounting systems. This requirement has proved divisive for several reasons. First, as numerous commentators have pointed out, the sanctity of U.S. GAAP has been severely undermined by the corporate scandals of the last few years, raising questions about its suitability as an international standard. Second, using GAAP outside the U.S. context may present a distorted picture of a company's financial position.[40] Third, conversion from international (or German) standards to GAAP is time-consuming, costly, and potentially misleading to non-U.S. investors. Though it has agreed to adopt a principles-based approach to accounting rules, the SEC has not yet decided on this matter except to reiterate its commitment to work with the FASB and IASB towards a single set of standards and to set a tentative date of 2005 for completion of the review process;[41]

- The treatment of foreign audit companies. Section 102 of Sarbanes-Oxley requires that accounting firms register with the Public Company Accounting Oversight Board. Some European countries, in particular the United Kingdom, viewed this requirement as an unwarranted exercise of extra-territorial jurisdiction.[43] Market participants complained that application of the Act's provisions would involve unnecessary regulatory duplication and require the disclosure of information that is confidential or has no clear non-U.S. equivalent. The Board initially determined in May 2003 that foreign audit companies involved in preparing reports on U.S. companies would have to register in the same way as domestic U.S. audit firms. In a concession to foreign audit firms, the Board allowed a longer registration period for foreign companies and exempted them from providing information to the Board when this would contravene home country laws.[44] Following further consultation, the PCAOB and European regulators appeared by October 2003 to have reached a compromise. In return for the European Union relaxing its opposition to registration for non-U.S. companies, the United States agreed to adopt a more collaborative approach to inspections and investigations;[45]

- The requirement that CEOs certify financial results. At first sight, this requirement appeared to contradict the German principle of collective responsibility for board decisions. It also caused concern among some German companies because it implied the prospect of criminal liability for their executives. In September 2002 Porsche decided to postpone its New York listing in consequence, complaining that it was absurd to expect one individual to take responsibility for the work of an entire company.[46]

For the most part these differences have been resolved through dialogue and accommodation. Many German companies applaud the purpose behind Sarbanes-Oxley and recognize the need to improve governance standards in Europe as well.[47] Their complaints have concerned the overly hasty manner in which the legislation was implemented and the initial failure of the SEC to take into account the differing needs of foreign companies.

Another more general issue for German companies operating in the United States is the use of U.S.-style stock option plans and performance-oriented financial incentives. German companies report that they need to introduce these plans in their U.S. operations in order to attract and motivate good managers and employees. But since these managers and highly qualified employees are internationally mobile, it is very difficult to introduce such plans in only one part of a company's operations. A number of large German companies therefore have felt it necessary to substantially increase their overall levels of executive pay. Although these are still far below U.S. norms, the move to increase executive compensation company-wide has caused controversy in the German press and provoked opposition by some interest groups, among them the national federation of trade unions

(DGB), which has called for greater regulation of top management remuneration.

PROBLEMS FOR U.S. COMPANIES OPERATING IN GERMANY

A principal issue of concern for U.S. companies operating in Germany is codetermination, or the requirement for mandatory labor representation on the supervisory boards of large companies. U.S. managers, accustomed to an environment in which they enjoy largely untrammeled discretion, have often bridled at the prospect of sharing power with German works councils and unions. In private interviews, officials in the regional (*Länder*) offices responsible for attracting inward direct investment indicate that many U.S. companies refuse to consider Germany as a candidate country and cite difficulties arising from codetermination as a reason.

However, the long and successful history of many U.S. subsidiaries in Germany shows that codetermination need not be an insurmountable barrier to doing business there. Interviews with the human resource managers of U.S. multinationals indicate that U.S. companies can adapt to local conditions, including codetermination. One strategy adopted by U.S. companies has been to use native managers with experience within the company, rather than expatriates who may be unfamiliar with local customs.[48] In fact, most of the U.S. managers interviewed considered high taxes and energy costs a greater obstacle to doing business than the German system of labor relations. Many even viewed codetermination in a positive light, pointing out that, although it slows down decision-making it also improves communications between management and labor and makes business decisions easier to implement.

In reality, codetermination may be, as former Deutsche Bank CEO Hilmar Kopper put it, more part of Germany's international 'image problem' than a real hurdle to doing business in Germany. Upon his retirement, the federal government commissioned Kopper to lead an effort to inform the international business community about the advantages of doing business in Germany and to dispel a few myths along the way. One means of doing so has been to organize meetings between potential investors and local union representatives to explain exactly how the system works. Carried out under the auspices of the regional offices for direct investment, these meetings have also brought together foreign investors and managers from the same home country that are already active in Germany and can share their experiences. The fact that inward investment in Germany has increased dramatically since the late 1990s may be evidence that some foreign companies are changing their attitudes towards German codetermination and the labor relations system.

The Potential for Convergence

It is sometimes observed that international economic integration is leading countries to adopt common standards of corporate governance. This process of convergence, it is argued, is taking place both through legal harmonization and through the diffusion of market practices at the company level. The remainder of this chapter examines the extent of and potential for convergence in the following areas: disclosure standards and reporting requirements, internal corporate governance and board structure, and external financial structure.[49]

WHY CONVERGENCE

There are several reasons to expect convergence in corporate governance systems. The most salient is capital market integration. Some legal scholars have gone so far as to predict the end of national company law as competitive pressures force countries to a common regulatory standard. It is often argued, firms operating in liberal market economies—like the United States—benefit from access to capital at lower cost and face stronger incentives to pursue efficient investments.[50] It is also often argued that where investors are unable to monitor the progress of a company closely—as is the case in many cross-border transactions—they generally prefer to supply capital on arms-length terms and on a market basis and that the U.S. model, for all its recent failings, still may provide the most effective means of doing this. It is largely for this reason that, as already observed, Germany has adopted elements of U.S.-style disclosure and accounting practices.

CONVERGENCE IN DISCLOSURE STANDARDS

Convergence in standards of disclosure and transparency has probably gone further than in any other area of corporate governance. The greater liquidity of U.S. capital markets and attractions of obtaining a NYSE listing have persuaded many German companies to adopt U.S. rules, including GAAP accounting standards. Initially introduced by the more 'shareholder value' oriented German companies on a voluntary basis, U.S.-style practices such as quarterly accounting are now being pushed by policymakers as well (e.g. the 2002 Law for Transparency and Publicity). For some time, many German companies have published IAS-based results alongside their German HRG accounts. It is true that certain deep-seated differences persist. For example, hidden reserves are still an important item in the balance sheet of German banks and insurance companies, and German accounting law remains more hospitable to creditors than to shareholders. But in so far as there has been convergence, it has been towards the U.S. model. This is hardly surprising: where equity investors are unable to engage in close monitoring they naturally prefer to supply capital subject to a maximum of shareholder protection.[51]

CONVERGENCE IN INTERNAL STRUCTURE

There has so far been less convergence towards a single model of internal company organization. The distinction between U.S. single-tier and German two-tier boards remains.[52] However, the nature and functions of the board are developing along similar lines, namely, towards greater outside participation and oversight. On the U.S. side, the Sarbanes-Oxley requirement that audit committees be composed entirely of independents is a significant step in this direction. So too, on the German side, was the composite board model that emerged from the Daimler-Chrysler merger.[53] The legal standards of care for directors are also evolving along similar lines, although the propensity to enforce shareholder claims via lawsuits is still very much stronger in the United States than in Germany—a difference that accounted for some European qualms over the enforcement aspects of Sarbanes-Oxley. A more enduring difference between German and U.S. governance systems concerns the notion of stake holding. For the foreseeable future, German companies will continue to be held accountable to a broader set of interests—in other words not only to shareholders, but to creditors and employees as well. They will also remain subject to mandatory labor codetermination—a practice that is unthinkable in the United States. As already noted, however, codetermination need not constitute an obstacle to U.S. companies operating in Germany.

Convergence in External Structure

There has also been relatively little convergence in patterns of ownership or broader financial structure. The United States remains a system dominated by fragmented industrial shareholding and equity finance. Although the large German banks have begun to divest themselves of their holdings, they remain important shareholders and—despite recent attempts to develop financial markets—the main providers of finance. This may change as German pension reforms encourage the development of institutional investors along Anglo-Saxon lines, but for the time being, the fundamental distinction between market-oriented and control-oriented governance systems remains valid.

In Europe as a whole there has been a general movement towards adopting U.S.-style corporate governance practices, though varying considerably from country to country. Many large French companies, for example, have been prominent advocates of shareholder value, particularly in the divestment of non-core subsidiaries from large conglomerates. In Sweden, the Wallenberg family, which is the prime investor in many of Sweden's largest companies, has also divested some of its holdings and announced that it wishes to pay more attention to the profitability of its remaining holdings. The fact that this adoption has been uneven and controversial, however, is reflected in the fact that the European Parliament in 2001 narrowly rejected a draft takeover directive. This directive would have been a key driver for the establishment of an open takeover regime on a European-wide basis.

Although the European Parliament has for now rejected an open, European-wide takeover regime, Germany passed a takeover law in 2002 that goes some way towards U.S. practice. Interestingly enough, the draft European directive and the originally proposed German legislation were much more restrictive of management defenses against hostile takeovers than most U.S. state law. The final outcome is closer to the current U.S. situation, in which the market for corporate control is subject to a number of legal restraints.

Conclusions

The potential for conflict between Germany and the United States over regulatory issues will persist as long as there are divergences in corporate law, financial structure, and informal market practice between the two countries. Since this is likely to remain the case for some time, the focus of policymakers should be on mutual accommodation. The next chapter puts forward some more specific policy recommendations.

05

CHAPTER FIVE

A TRANSATLANTIC REFORM AGENDA: POLICY RECOMMENDATIONS

Ironically, the intensity of conflict between Germany and the United States over corporate governance issues has diminished since this series of reports was conceived. The main reason has been the pragmatic approach taken by the SEC and other parties to address European concerns over Sarbanes-Oxley. Disagreements that had seemed the consequence of fundamental structural differences now appear to be the result of overly hasty policymaking.

In rushing through new laws to stem a public crisis of confidence, U.S. regulators perhaps understandably neglected to take into account their effect on foreign companies and investors. The SEC took an important step towards redressing this failure when it recognized the supervisory board of German companies as independent for the purposes of Sarbanes-Oxley.

Nevertheless, this ruling alone does not amount to a commitment to mutual recognition. In keeping with the U.S. legalistic tradition, the concession is highly specific to the issue at hand and of limited general applicability. This is of concern because there are several similar points on which European and U.S. regulators may disagree in the future. An obvious issue is the prominent role of large shareholders in German corporate governance. It is not difficult, for example, to imagine a conflict between U.S. insider information laws and the traditionally close relationship between German shareholders and managers. For this reason a stronger statement by the SEC regarding its attitude towards mutual recognition would provide welcome clarity. Specifically, this report recommends the following actions be taken:

- Recommendation #1: The SEC should make a clear statement outlining its general approach and commitment to the mutual recognition of corporate governance systems.

Second, it would be useful to build on previous attempts to define 'best practice' in corporate governance—such as the 1999 OECD Working Group—and arrive at some guidelines for best practice in mutual recognition. Therefore:

- Recommendation #2: A high-level group with official recognition should be convened at the international level to issue recommendations on mutual recognition across different national systems of corporate governance.

Though mutual recognition is preferable, harmonization appears unavoidable in the area of accounting standards. Until now the main alternatives have been U.S.-GAAP and IAS. The claim that U.S.-GAAP is superior no longer appears tenable, and U.S. regulators seem to have acknowledged as much in moving toward a principles-based approach. It would thus make sense for the United States to accept the current effort to develop a best-practice, principles-based IAS, if not for all U.S. companies, then at least for foreign U.S.-listed companies. Therefore:

- Recommendation #3: Provided that U.S. concerns over investor protection are met, the SEC should allow foreign companies listed in the United States to report based on IAS rather than U.S.-GAAP. Furthermore, the SEC should consider extending IAS to all companies listed in the United States.

One concern of the SEC has been that, even if European companies and regulators adopt IAS or U.S.-GAAP, their enforcement practices may fall far short of U.S. standards. Unfortunately, this concern indeed appears to be borne out by practice. A recent study by the Deutsches Aktieninstitut found that companies listed on the *Neuer Markt* claiming to apply U.S.-GAAP standards actually implemented on average fewer than half of them. The German government has recognized that there is currently a shortage of enforcement capacity and has made efforts to expand the staff and activities of the German Financial Services Authority. But more needs to be done. Therefore:

- Recommendation #4: German companies should improve implementation of IAS, and German policymakers and regulators should step up their efforts to enforce standards aimed at improving transparency in German companies.

One of the principal deterrents to U.S. direct investment in Germany is a lack of understanding of the German stakeholder system. Some of its main features—such as employee board representation and the role of large shareholders—are common in other European countries and have been strengthened by recent European Union legislation. A fuller understanding of the stakeholder system among U.S. policymakers, companies and the general public should be encouraged. Specifically:

- Recommendation #5: Research institutes and other organizations concerned with transatlantic relations should increase their efforts to promote mutual understanding of the two governance systems. These efforts should be based on the thesis that each system may have its own strengths and weaknesses, rather than on the assumption that there is one best system.

The German codetermination system, in particular, currently suffers from a severe image problem. This problem is exacerbated by the great skepticism in the United States about traditional labor relations systems. One way to help deal with this problem is to explain in greater detail how the German system works in practice. Unlike in countries such as the United States, where relations with unions have been quite adversarial and arms-length, partnership plays a much greater role in the German labor relations system. This is particularly the case for works councils, who not only represent employees of a single company but also are employees of that company themselves.

As key actors in the stakeholder system, German unions and works councils can help address this problem by entering into dialogue with potential investors. But foreign companies are not alone in their poor understanding of the German system. Foreign unions (including U.S. unions) also have little experience with codetermination. There is, therefore, substantial scope for German unions to work more closely with their international counterparts, for example, by bringing them onto German company boards as representatives of foreign employees. Thus:

- Recommendation #6: German unions and works councils should follow the approach used in the state of North Rhine-Westphalia, which addresses potential investors' concerns about employee representation through direct meetings. Furthermore, German unions and works councils should extend their efforts to 'internationalize' employee representation and promote understanding of codetermination among international unions.

As recent conflicts have illustrated, the distinctive national approaches to solving corporate governance problems and the uncertainties about how to resolve these differences have substantial costs. At the same time, a pragmatic approach based on mutual recognition and mutual learning has proven to be an effective way of solving some of these conflicts. These recommendations are offered in the belief that a commitment to and extension of this pragmatic approach is the most fruitful way forward in order to secure the potential benefits of an increasingly integrated world economy.

REFERENCES

Bartos, James M. *United States Securities Law: A Practical Guide*. The Hague: Kluwer Law International, 2002.

Barca, Fabrizio, and Marco Becht, eds. *The Control of Corporate Europe*. Oxford: Oxford University Press, 2001.

Beyer, Jürgen. Deutschland AG a.D. "Deutsche Bank, Allianz und das Verflechtungszentrum des deutschen Kapitalismus," *Alle Macht dem Markt? Fallstudien zur Abwicklung der Deutschen AG,* W. Streeck and M. Höpner eds. Frankfurt a.M.: Campus Verlag, 2003.

Bhagat, Sanjal, and Bernard Black. "The Relationship between Board Composition and Firm Performance," *Comparative Corporate Governance: Essays and Materials*, K. J. Hopt and E. Wymeersch eds. Berlin: deGruyter, 1997.

Black, Bernard. "Agents Watching Agents: The Promise of Institutional Investor Voice," *UCLA Law Review* 39 (4): 811-893, 1992.

Bruce, Robert. "Europeans Protest over US Fraud Law," *Financial Times*, September 16, 2002.

Burgmaier, Stefanie, Volker Müller, and Hauke Reimer. "Harter Hund," *Wirtschaftswoche*, August 14, 2003, 36-39.

Cioffi, John W. "Governing Globalization? The State, Law, and Structural Change in Corporate Governance," *Journal of Law and Society* 27 (4):572-600, 2000.

Cioffi, John W. "Restructuring 'Germany, Inc.': The Corporate Governance Debate and the Politics of Company Law Reform," *Law & Policy*, 2002.

Coffee, John. "The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?" Testimony before the Senate Committee on Commerce, Science and Transportation, December 18, 2001.

Franks, Julian, and Colin Mayer. "Capital Markets and Corporate Control: A Study of France, Germany and the UK," *Economic Policy* 5 (1): 191-231, 1990.

Gerschenkron, Alexander. *Economic Backwardness in Historical Perspective: A Book of Essays*. Cambridge, Mass.: Belknap, 1962.

Jeffrey Gordon. *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany: Deutsche Telekom and Daimler Chrysler*, Columbia Law School, Center for Law and Economic Studies, Working Paper No. 161. January 2000.

Höpner, Martin. *Wer beherrscht die Unternehmen? Shareholder Value, Managerherrschaft und Mitbestimmung in Deutschland*. Frankfurt am Main: Campus, 2003.

Höpner, Martin, and Gregory Jackson. "Entsteht ein Markt für Unternehmenskontrolle? Der Fall Mannesmann," *Alle Macht dem Markt? Fallstudien zur Abwicklung der Deutschland AG*, W. Streeck and M. Höpner eds. Frankfurt a.M.: Campus Verlag, 2003.

Hopt, Klaus J. "Common Principles of Corporate Governance," *Corporate Governance Regimes: Convergence and Diversity*, J. A. McCahery, P. Moerland, T. Raaijmakers and L. Reeneboog eds. Oxford: Oxford University Press, 2002.

Hopt, Klaus J. *Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron*. Working Paper Nr. 05/2002: European Corporate Governance Institute, 2002.

Hopt., Klaus J. et al. eds. *Comparative Corporate Governance: The State of the Art and Emerging Research*. Oxford: Oxford University Press, 1998.

Jacobs, Michael. *Short-Term America: The Causes and Cures of our Business Myopia*. Boston: Harvard Business School Press, 1991.

Jürgens, Ulrich; Joachim Rupp, Katrin Vitols unter Mitarbeit von Bärbel Jäschke-Werthmann. *Corporate Governance and Shareholder Value in Deutschland - Nach dem Fall von Mannesmann*. Paper revisited. Berlin: Wissenschaftszentrum Berlin für Sozialforschung, 2000.

Lütz, Susanne. *The Revival of the Nation-State? Stock Exchange Regulation in an Era of Internationalized Financial Markets*. MPIFG Discussion Paper 96/9. Cologne, 1996.

New Yorker. "Business as Usual," *New Yorker*, August 4, 2003.

Parker, Andrew. "SEC may limit Regulator's Global Reach," *Financial Times,* July 9, 2003.

Pfeiffer, Hermanus. *Die Macht der Banken. Die personellen Verflechtungen der Commerzbank, der Deutschen Bank und der Dresdner Bank mit Unternehmen*. Frankfurt: Campus Verlag, 1993.

Porter, Michael. *Capital Choices.* Washington: Council on Competitiveness, 1992.

Postelnicu, Andrei. "A Little Breathing Space," *Financial Times*, July 7, 2003.

Romana, Roberta. "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Control," *Yale Journal of Regulation* (174), 2001.

Sevastopulo, Demetri. "US and EU Close to Deal on Auditing," *Financial Times*, October 14, 2003.

Skorecki, Alex. "Research Shows ADRs Boost Common Shares," *Financial Times*, June 2, 2003.

Smith, Michael P. Shareholder Activism by Institutional Investors: Evidence from CALPERS. *Journal of Finance* 51 (1):227-252, 1996.

Steil, Ben. "American Investor Protection is Protectionist," *Financial Times*, January 16, 2003.

Vitols, Sigurt. *The Origins of Bank-Based and Market-Based Financial Systems: Japan, Germany, and the US. In The Origins of Nonliberal Capitalism*, edited by W. Streeck and K. Yamamura. Ithaca, N.Y.: Cornell University Press, 2001.

Vitols, Sigurt. *Unternehmensführung und Arbeitsbeziehungen in deutschen Tochtergesellschaften großer ausländischer Unternehmen.* Gütersloh: Forum Mitbestimmung und Unternehmen, 2001.

Vitols, Sigurt. "Varieties of Capitalism and Pension Reform: Will the Riester Rente Transform the German Coordinated Market Economy?" *Focus on Austria: Quarterly Bulletin of the Österreichische Nationalbank 2003* (2):102-108.

Vitols, Sigurt. "Verhandelter Shareholder Value: die deutsche Variante einer angloamerikanischen Praxis," *Vom Zukunfts- zum Auslaufmodell? Die deutsche Wirtschaftsordnung im Wandel*, edited by J. Beyer Wiesbaden: Westdeutscher Verlag, 2003.

Vitols, Sigurt, Steven Casper, David Soskice, and Stephen Woolcock. *Corporate Governance in Large British and German Companies: Comparative Institutional Advantage or Competing for Best Practice*. London: Anglo German Foundation, 1997.

Ziegler, Nicholas, J. "Corporate Governance and the Politics of Property Rights in Germany," *Politics & Society* 28 (2):195-221, 2000.

NOTES

1 See Alexander Gerschenkron, Economic Backwardness in Historical Perspective. A Book of Essays (Cambridge: Belknap, 1962) and Sigurt Vitols, "The Origins of Bank-Based and Market-Based Financial Systems: Japan, Germany, and the US" in *The Origins of Nonliberal Capitalism*, edited by W. Streeck and K. Yamamura (Ithaca, N.Y.: Cornell University Press, 2001).

2 Michael Jacobs, *Short-Term America: The Causes and Cures of our Business Myopia* (Boston: Harvard Business School Press, 1991) and Michael Porter, Capital Choices. (Washington: Council on Competitiveness, 1992).

3 Susanne Lütz, *The Revival of the Nation-State? Stock Exchange Regulation in an Era of Internationalized Financial Markets.* MPIFG Discussion Paper 96/9., Cologne, 1996.

4 Stefanie Burgmaier, Volker Müller, and Hauke Reimer, "Harter Hund," *Wirtschaftswoche*, August 14, 2003, 36-39.

5 Hermanus Pfeiffer, Die Macht der Banken. *Die personellen Verflechtungen der Commerzbank, der Deutschen Bank und der Dresdner Bank mit Unternehmen* (Frankfurt: Campus Verlag, 1993).

6 Jürgen Beyer, Deutschland AG a.D. "Deutsche Bank, Allianz und das Verflechtungszentrum des deutschen Kapitalismus," *Alle Macht dem Markt? Fallstudien zur Abwicklung der Deutschen AG*, W. Streeck and M. Höpner eds. (Frankfurt a.M.: Campus Verlag, 2003).

7 Martin Höpner, *Wer beherrscht die Unternehmen? Shareholder Value, Managerherrschaft und Mitbestimmung in Deutschland* (Frankfurt am Main: Campus, 2003).

8 Sigurt Vitols, "Verhandelter Shareholder Value: die deutsche Variante einer angloamerikanischen Praxis," in *Vom Zukunfts- zum Auslaufmodell? Die deutsche Wirtschaftsordnung im Wandel*, edited by J. Beyer. (Wiesbaden: Westdeutscher Verlag, 2003).

9 Sigurt Vitols, Steven Casper, David Soskice, and Stephen Woolcock, *Corporate Governance in Large British and German Companies: Comparative Institutional Advantage or Competing for Best Practice* (London: Anglo German Foundation, 1997).

10 John W. Cioffi, "Governing Globalization? The State, Law, and Structural Change in Corporate Governance," *Journal of Law and Society* 27 (4):572-600, 2000; John W. Cioffi, "Restructuring 'Germany, Inc.': The Corporate Governance Debate and the Politics of Company Law Reform," *Law & Policy*, 2002; and Nicholas, J. Ziegler, "Corporate Governance and the Politics of Property Rights in Germany," *Politics & Society* 28 (2):195-221, 2000.

11 The phrase 'defense mechanisms' refers to measures available to managers to render a company less attractive to a potential hostile acquirer. One example of a defensive mechanism is the so-called 'poison pill,' which grants all other shareholders the right to buy stock at a large discount, thus diluting the acquirer's holding. See Julian Franks and Colin Mayer, "Capital Markets and Corporate Control: A Study of France, Germany and the UK," *Economic Policy* 5 (1): 191-231, 1990.

12 Martin Höpner and Gregory Jackson, "Entsteht ein Markt für Unternehmenskontrolle? Der Fall Mannesmann," *Alle Macht dem Markt? Fallstudien zur Abwicklung der Deutschland AG*, W. Streeck and M. Höpner eds. (Frankfurt a.M.: Campus Verlag, 2003).

13 Ulrich Jürgens, Joachim Rupp, Katrin Vitols with Bärbel Jäschke-Werthmann. *Corporate Governance und Shareholder Value in Deutschland - Nach dem Fall von Mannesmann*. Paper revisited. (Berlin: Wissenschaftszentrum Berlin für Sozialforschung, 2000).

14 Poison pills are securities with special rights for holders, such as purchase of additional shares at lower prices. Anti-greenmail provisions discourage hostile takeover bids by prohibiting management from "buying out" the stock of hostile bidders at above-market prices.

15 A revised draft directive that makes the application of Article 9 and Article 11 provisions optional for member states is currently under consideration by the European Council.

16 Sigurt Vitols, "Varieties of Capitalism and Pension Reform: Will the Riester Rente Transform the German Coordinated Market Economy?" *Focus on Austria: Quarterly Bulletin of the Österreichische Nationalbank 2003* (2):102-108, 2003.

17 Raghuram G. Rajan & Luigi Zingales, *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity* (New York: Crown Business, 2003).

18 Mark J. Roe, *Strong Managers*, *Weak Owners: The Political Roots of American Corporate Finance* (Princeton: Princeton UP, 1994).

19 As discussed below, this has changed somewhat as a result of Sarbanes-Oxley.

20 'Fiduciary duty' specifies that managers owe a duty of 'care' and 'loyalty' to the company, meaning two things: first, that they must conduct themselves as a 'reasonably prudent person' would in similar circumstances (the duty of 'care'); second, that they must exercise their responsibilities in such a way as to further the corporation's interests and not for other purposes (the duty of 'loyalty'). The duty of loyalty also requires that managers impart relevant information to shareholders, though the precise nature of this obligation is not spelled out. In theory, shareholders may enforce these obligations via lawsuits, but in practice this has seldom happened. The courts have for the most part enforced a weaker standard of accountability, exempting those decisions taken in good faith by managers in the ordinary course of business. See Hopt, Wymeersch, et al. 1998, 316.

21 See James M. Bartos, *United States Securities Law: A Practical Guide.* Kluwer Law International, 2002, p. 201. In particular, the NYSE does not oblige foreign companies to conform to its requirements for audit committee independence.

22 The Sarbanes-Oxley Act of 2002 was a response to the accounting scandals that rocked corporate America in 2002. Its principal aim is to ensure greater accuracy in financial reporting by strengthening the independence of firms' audit committees, regulating the activities of audit companies, and stiffening penalties for non-compliance

23 In 1996, for example, a survey of the boards of 100 of the largest U.S. corporations found that half had at most one or two inside directors. See Sanjal Bhagat and Bernard Black, "The Relationship between Board Composition and Firm Performance," *Comparative Corporate Governance: Essays and Materials,* K. J. Hopt and E. Wymeersch eds. (Berlin: deGruyter, 1997).

24 Sanjal Bhagat and Bernard Black, "The Relationship between Board Composition and Firm Performance," *Comparative Corporate Governance: Essays and Materials*, K. J. Hopt and E. Wymeersch eds. (Berlin: deGruyter, 1997).

25 See Bernard Black, "Agents Watching Agents: The Promise of Institutional Investor Voice," *UCLA Law Review* 39 (4): 811-893, 1992 and Roberta Romana, "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Control," *Yale Journal of Regulation* (174), 2001.

26 Typically intervention has taken the form of opposition to excessive compensation packages, the removal of under-performing chief executives and senior management, and ensuring the election of independent directors. See Michael P. Smith, "Shareholder Activism by Institutional Investors: Evidence from CALPERS," *Journal of Finance* 51 (1):227-252, 1996.

27 These prohibitions follow from the provisions of the Bank Holding Company Act. For details of this legislation, see http://www.fdic.gov/regulations/laws/rules/6000-1300.html#6000sec.225.21

28 This discussion draws substantially on Coffee (2001).

29 John Coffee, "The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?" Testimony before the Senate Committee on Commerce, Science and Transportation, December 18, 2001.

30 Section 301 defines as an 'independent' someone who may not 'other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee i) accept any consulting, advisory, or other compensatory fee from the issuer; or ii) be an affiliated person of the issuer or any subsidiary thereof.'

31 Thus Section 101 stipulates that while two of its five members must have been or must be certified public accountants, the remaining three must not be and cannot have been. The Chair may be held by one of the CPA members, provided that he or she has not been engaged as a practicing CPA for five years.

32 In case of false disclosure, for example, senior management may now have to return bonuses earned during the period in question, even if they were not directly responsible.

33 Among the other charges leveled against Sarbanes-Oxley were that it would lead to a rash of litigation by shareholders and that it would lead executives to err on the side of excess caution in exercising business judgment.

34 "Business as Usual," *New Yorker,* August 4, 2003.

35 Several foreign companies, including Porsche, have listed Sarbanes-Oxley as a reason for not listing ADRs on U.S. exchanges. See Alex Skorecki, "Research Shows ADRs Boost Common Shares," *Financial Times*, June 2, 2003.

36 http://www.sec.gov/rules/concept/3438672.txt

37 The SEC's stated rationale is that to do otherwise would encourage investors in the erroneous belief that they were subject to the same standards of protection as in the United States. The justification for this position has weakened somewhat in the aftermath of Enron since it is no longer evident that U.S. standards of disclosure exceed those in other countries.

38 http://www.sec.gov/rules/final/33-8220.htm#foreign. See Andrei Postelnicu, "A little breathing space," *Financial Times*, July 7, 2003.

39 http://www.sec.gov/rules/concept/34-42430.htm; also, http://www.sec.gov/rules/final/33-8176.htm

40 In the case of Deutsche Bank, for example, the use of GAAP led to a huge distortion of net income in 2002, reflecting a tax charge required under GAAP that was not indicative of any real tax liability. See Ben Steil, "American Investor Protection is Protectionist," *Financial Times*, January 16, 2003.

41 Speech by SEC Commissioner Roel C. Campos to the Centre for European Policy Studies, 'Embracing International Business in the Post-Enron Era,' June 11, 2003 at www.useu.be. On the issue of a proposed shift to a principles-based accounting standard, see http://www.sec.gov/news/studies/principles-basedstand.htm.

42 http://www.sec.gov/rules/pcaob/34-47990.htm

43 Andrew Parker, "SEC may limit Regulator's Global Reach," *Financial Times*, July 9, 2003.

44 See http://www.pcaobus.org/rules/Release2003-007.pdf

45 Demetri Sevastopulo, "US and EU Close to Deal on Auditing," *Financial Times*, October 14, 2003.

46 Robert Bruce, "Europeans Protest over US Fraud Law," *Financial Times*, September 16, 2002.

47 Klaus J. Hopt, *Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron*. Working Paper Nr. 05/2002: European Corporate Governance Institute.

48 Sigurt Vitols, *Unternehmensführung und Arbeitsbeziehungen in deutschen Tochtergesellschaften großer ausländischer Unternehmen*, (Gütersloh: Forum Mitbestimmung und Unternehmen, 2001).

49 Klaus J. Hopt, "Common Principles of Corporate Governance," *Corporate Governance Regimes: Convergence and Diversity*, J. A. McCahery, P. Moerland, T. Raaijmakers and L. Reeneboog eds. (Oxford: Oxford University Press, 2002).

50 The argument has gone back and forth: in the 1980s it was widely argued that Japanese combination of long-term contracting and main bank monitoring gave it a competitive advantage over the United States with its market-oriented financial system. In the 1990s the implosion of the Japanese economy restored commentators' faith in the U.S. model. Whether or not this faith withstands the rash of corporate scandals in 2001-2 remains to be seen.

51 There is also some evidence that companies themselves prefer to issue securities in jurisdictions with stronger shareholder protections and that companies in jurisdictions with weak shareholder and other protections may seek to be acquired by companies from more developed jurisdictions in order to inherit their governance systems. See Arturo Bris and Christos Cabolis, *Corporate Governance Convergence by Contract: Evidence from Cross-Border Mergers*, Yale ICF Working Paper No. 02-32, September 2002.

52 In reality, the two-tier model is mandatory only for stock corporations and larger limited liability companies (GmbH). Small and mid-sized limited liability companies–of which there are many more–are free to have either a one or two-tier board. See Hopt (2002).

53 It may be that the trend in this area is not towards convergence but towards hybridization. The Daimler-Chrysler merger provides an example. The largest ever by absolute value, it created a new entity that combined elements of the German and U.S. models of corporate governance. Registered in Germany, the merged company incorporated a two-tier board system with employee representation. But it also had an 'Integration Committee' consisting of shareholder representatives from the supervisory board plus two co-chairs. The intention was to provide institutional investors with an alternative monitoring mechanism. See Gordon (2000).

AICGS

1755 Massachusetts Ave., NW
Suite 700
Washington, D.C. 20036 – USA
T: (+1-202) 332-9312
F: (+1-202) 265-9531
E: info@aicgs.org
www.aicgs.org

AMERICAN INSTITUTE
FOR CONTEMPORARY
GERMAN STUDIES

THE JOHNS HOPKINS UNIVERSITY

Located in Washington, D.C., the American Institute for Contemporary German Studies is an independent, non-profit public policy organization that works in Germany and the United States to address current and emerging policy challenges. Founded in 1983, the Institute is affiliated with The Johns Hopkins University. The Institute is governed by its own Board of Trustees, which includes prominent German and American leaders from the business, policy, and academic communities.