SNS ECONOMIC POLICY GROUP REPORT 2003

Corporate Governance *and* Structural Change

European Challenges

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Preface

The SNS Economic Policy Group (SNS Ekonomiråd) was established in the early 1970s by SNS – the Swedish Center for Business and Policy Studies – in response to a widespread demand for regular independent assessments of Sweden's economic situation and non-partisan evaluations of Swedish economic policy. The Group's composition varies from year to year, but it always consists of four to five economists of high academic standing. Their reports are meant to be brief, well-founded in modern economic research but non-technical in style. They are aimed at a wide readership of politicians, civil servants, business leaders, journalists, academics and economics students.

Over the years more than thirty Swedish – and eight non-Swedish – economists (mainly professors of economics) have served on the SNS Economic Policy Group. The reports have made a difference for Swedish economic policy. Their analysis has often formed the basis for domestic policy discussion and many specific policy proposals have (normally with a lag) been turned into actual policy. For this reason, the reports have aroused interest even outside Sweden. Summaries of some of the early reports have been translated into English, and all reports since 1991 are available in English, either in summary form or in full.

The summary that follows outlines the analysis in this year's report and presents its main conclusions. The subject matter this year is the role of corporate ownership and control for structural change in Sweden and other European countries. In particular, the various European models for control ownership – based on different instruments for separating ownership and control – have come under attack from reformers inspired by Anglo-Saxon capital market traditions.

More transparent and contestable control structures are widely regarded as a precondition for improvements in Europe's dismal growth performance. The report presents the strengths and weaknesses of the present control structures and discusses the pros and cons of various reform proposals.

The authors of this years report are (in alphabetical order): *Erik Berglöf*, Director of SITE, the Stockholm Institute of Transition Economics at the Stockholm School of Economics; *Bengt Holmström*, Paul A. Samuelson Professor of Economics at MIT; *Peter Högfeldt*, Associate Professor of Finance at the Stockholm School of Economics; *Eva M. Meyersson Milgrom*, Visiting Associate Professor at the Graduate School of Business, and research scholar at the Center on Development, Democracy and the Rule of Law, Stanford University, and *Hans Tson Söderström*, Research director at SNS and Adjunct Professor of Applied Macroeconomics at the Stockholm School of Economics, who has also served as chairman of the Group and editor of the report. The Group has received highly competent research and editorial assistance from *Stefan Sandström*, Licentiate of Philosophy, and Per Thulin, Master of Arts, both at SNS. Financial support from the Jan Wallander and Tom Hedelius Foundation for Social Science Research is gratefully acknowledged.

The SNS Economic Policy Group stands collectively behind the analysis and conclusions of the report. SNS as an organization does not take a stand on policy issues.

Stockholm in March 2003

Stefan Lundgren
President of SNS

Corporate Governance and Structural Change

Challenges to European Corporate Ownership and Control

Corporate governance, in the broad sense of the term, is a matter of great importance to the economy.

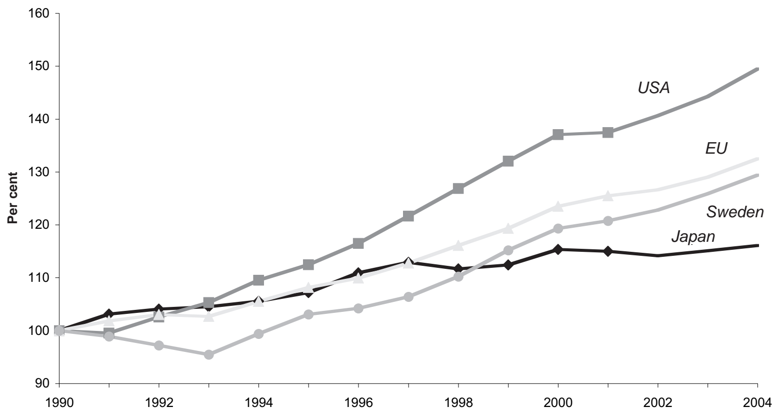
Good corporate governance is crucial for society's ability to mobilise domestic and international savings and channel them to productive ends at the lowest possible cost. An enormous amount of funds have been entrusted in the care of corporate boards and managements. In Sweden such funds currently amount to a couple of thousand billion kronor, or about a quarter of the nation's collective wealth. For the long-term stability and growth of the economy it is vitally important to have in place effective systems for determining who should manage these vast corporate assets and how those in charge should be monitored and held accountable.

We argue that the most important problems associated with corporate governance are not due to fraud of the sort that has come to light in recent corporate scandals on both sides of the Atlantic; fraud can be effectively taken care of with improved supervision and more stringent enforcement of rules. Rather, the fundamental corporate governance problems are to be found on an entirely different level. These problems have to do with the difficulty of regulating transactions between shareholders and management so that the interests of the shareholders are satisfied without unduly circumscribing the ability of management to act effectively. In addition, they have to do with regulating relations between small and large shareholders so that small shareholders get their share of the pie without destroying the benefits of having a large share-

holder monitor management and bear responsibility for the future of the company.

Europe's recent interest in corporate governance is not driven by business scandals as much as the ambition, set forth in the Lisbon Declaration, to make Europe the world's most dynamic economic region. As the difference between the rates of growth in the United States and the European Union has increased during the 1990s, Europe has come to realize that it needs to restructure its corporate sector more rapidly. According to the EU Commission and its expert group led by Jaap Winter, the slow pace of corporate change in Europe is largely due to shortcomings in European corporate governance.

Figure 1. *Index-linked GDP in Sweden, USA, Japan and the EU, 1990–2004 (1990 = 100)*



Source: OECD.

An additional reason for the interest in corporate governance is the aspiration to create an integrated European capital market with common (or at least similar) rules and a high degree of transparency by 2005. National differences in how investors are protected, how bankruptcies are dealt with, how stock exchanges are regulated, how audits are carried out, and how the public is supposed to be informed about corporate

events, amount to a regulatory jungle that creates road blocks for a common, transparent and well integrated European equity market. There is pressure to harmonise the regulatory frameworks and perhaps ultimately to create "a single European market for corporate control" as global capital tends to flow to the markets that are most liquid and transparent. Yet, in order to discover the best forms of corporate governance, and to take into account national idiosyncrasies, some degree of diversity is desirable.

The general discussion in Sweden has been coloured by a number of scandals, mainly due to the compensation paid to present and former managers and directors. In the midst of the election campaign, the Government appointed a Public Confidence Commission, led by the former Minister for Finance Erik Åsbrink. Nevertheless, the strongest challenge to the Swedish model of corporate governance, based on concentrated ownership, comes from outside. The EU Commission's ambition to break up existing control structures is one driver. The other comes from global pension and savings funds, which along Anglo-American lines have sought stronger protection for minority shareholders and more disclosure in areas where Swedish companies still lag behind.

Neither business leaders nor politicians can ignore the pressure from the international capital markets. Decision-makers in the political sphere and the business sector alike are forced to make tough choices between accepting international harmonization and adapting more gradually the Swedish model to the new demands. To further complicate matters, it cannot be assumed that the view Swedes have of how their own system works is correct. There is a widening gap between the dominant view in Sweden and the picture emerging from international research and different attempts to rank countries on the basis of corporate governance.

Our analysis is intended to provide a basis for taking a position on these issues. We wish, however, to emphasise that a comprehensive analysis of the entire complex problem of corporate governance in Sweden lies outside the scope of a re-

port of this kind. Our aim is confined to an attempt to enrich the Swedish debate in this area by adding a number of aspects that we consider to be both material and neglected. We wish, not least, to point out the contrast between the Swedish self-image and critical perspectives from international social science research and debate.

Our most important conclusions

This report, then, deals with general and fundamental matters relating to ownership and control in the business sector. Consequently, we have no reason to take a stance in the current discussion of what is commonly referred to as corporate governance, with its cookbook-like recipes for corporate managers, boards, shareholders' meetings, auditors, stock exchange regulations, etc. Many of the suggestions and standpoints in this debate seem to us, on the whole, to be reasonable and uncontroversial.

The outcome of our report is instead a number of conclusions that should be borne in mind in the shaping of the regulatory framework for ownership and corporate management, a framework that is now undergoing a process of remodelling. Some of the major conclusions are reviewed here.

A systemic view of corporate governance

Systems of corporate governance vary from country to country and change over time. These systems grow up in close interplay between economic and political forces, and they encompass not just company law and securities law, but also regulatory agencies, self-regulatory bodies, the practice of the courts, the banking system, media coverage and much else besides. The systems are driven by their own internal logic, in which the different parts interact and where a single component can have a decisive impact on the ability of the entire system to function and survive. The attempt to "transplant" a specific rule from one system to another can be associated with huge risks.

The most striking feature of the many different systems of corporate governance is their capacity for organic adaptation. We have shown that the "American system" is in fact a system in constant change. The wave of hostile takeovers in the 1980s (figure 2) and subsequent dividing up of over-consolidated conglomerates was followed in the 1990s by value-generating corporate alliances entailing the restructuring of entire industries. In both cases changes of ownership have been associated with structural transformation, but the pendulum has swung between enterprises and the market in directing capital to the most productive purposes.

Figure 2. *Hostile bids, USA 1974–2001, per cent of total bids*

Source: Steven Kaplan, Graduate School of Business, Chicago.

In Europe and – perhaps especially – Japan, the capacity for adaptation has in general been poorer. But internal economic problems and new external circumstances are forcing change here as well. The problem lies in finding the arrangements that can adapt most readily to the varying economic situations a country can confront. The developments in the United States demonstrate that adaptation can sometimes come about by means of self-regulation. In certain situations, however, new

regulation by the central political authorities may be called for. The United States is in such a situation at present and so are – for somewhat different reasons – Europe and Japan.

Two different systems

The systems of corporate governance found in most of Europe are based on strong controlling shareholders who monitor management and intervene in strategic decisions in most companies. The power of owners is often based on a separation of ownership and control by means of shares with special voting rights (table 1), share pyramids and other designs that make it possible to control the company with a limited investment of capital. These designs also mean that a small minority of the risk capital often suffices to defend a controlling position in the company. Power over companies, moreover, can generally not be challenged by other investors who believe they are better equipped to manage the company's resources.

Table 1. *Differentiated voting rights in Europe*

Country	Number of companies	Number of companies with differentiated rights	Proportion of companies with differentiated rights
Belgium	130	0	0.00
Portugal	87	0	0,00
Spain	632	1	0,00
France	607	16	0.03
Germany	704	124	0.18
Austria	99	23	0.23
Ireland	69	16	0.23
UK	1 953	467	0.24
Denmark	210	70	0.33
Finland	129	47	0.36
Italy	208	86	0.41
Sweden	334	185	0.55
Total	**5 162**	**1 035**	**0.20**

Source: Morten Bennedsen and Kasper Nielsen, "The Impact of a Break-Through Rule on European firms", Discussion Paper No. 2002–10, Centre for Economic and Business Research, Copenhagen.

In the system of ownership and corporate control that dominates in the Anglo-Saxon world (the United States, Canada and the United Kingdom), ownership power is more of a tradable good (table 2). Strong protection for minorities, in a broad sense, encourages a high level of public confidence in the stock market but also makes it difficult for controlling shareholders to obtain a return on active ownership, since smaller shareholders can be free riders on the work of the controlling shareholders. As a result, it can be an advantage even for large owners of capital to spread their portfolio over several smaller holdings rather than concentrating on a single company. The absence of controlling shareholders in turn gives managements greater power over their companies.

Table 2. *Ownership governance systems and supplementary instruments*

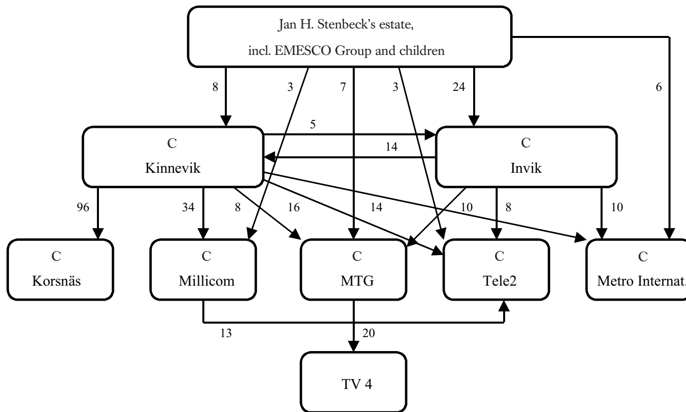
	Market-based system (USA/UK)	**Controlling-owner system (Europe)**
Ownership and control	Diversified ownership	Controlling owner
Minority protection	Strong	Weak
Board	Potentially autonomous	Close to controlling owner
Management	Strong, autonomous	Close to controlling owner
Bank relations	Arm's length, diversified, no ownership	Close, concentrated, possible ownership
Management incentives	Central, strong	Less central, weaker
Capital structure	Lower debt ratio	Higher debt ratio
Control market	Hostile bids important	Hostile bids rare

The Swedish control structure has its advantages ...

With respect to ownership and corporate control, Sweden belongs to continental Europe, even if the stock market incorporates certain Anglo-Saxon features by requiring more transparency and disclosure. Controlling ownership can be exercised in Sweden on the basis of a limited capital stake. In smaller companies (especially entrepreneurial companies listed on the stock exchange), this control is exercised by keeping shares with special voting power in the family owning the company.

In larger companies controlling ownership is exercised primarily by a combination of shares with special voting rights and ownership in the form of "pyramids" or "Chinese boxes". These can be means of levering very high voting power from the capital (risk) stake (figure 3).

Figure 3. *A Swedish ownership pyramid: Stenbeck's "Our Group"*



Note: Ownership rates refer to share of capital as per 9 February 2002. The share of voting rights was in most cases considerably higher. C indicates that Jan H. Stenbeck was chairman of the board at the time of his death.

Source: Anneli Sundin and Sven-Ivan Sundqvist, *Ägarna och makten i Sveriges börsföretag 2002* (Owners and Power in Sweden's Listed Companies), SIS Ägarservice AB, Stockholm.

The Swedish model of ownership and corporate governance has a number of strengths. One of the more obvious advantages is the fact that entrepreneur-managed companies can turn to the stock market for more risk capital at an early stage, without the entrepreneur having to lose control of the company. It has also proved possible to retain control over Swedish owned giant multinationals by means of a combination of techniques: shares with special voting power, the Chinese boxes model of ownership used by investment companies and – in some cases – cross-ownership. In many cases, the "active ownership" exercised by the owners of the controlling shares

or their representatives has been successful and has led to dynamic development in the companies concerned.

The Swedish control structure has also been associated with a relatively rapid rate of transformation in ownership and in companies, with controlling holdings able to change owner in response to changes in the conditions for production in Sweden and internationally. We need only point to a number of large international deals in recent years, such as AstraZeneca, Pharmacia–Upjohn–Pfizer, Volvo–Ford, Scania–Volkswagen, Nordea and Stora Enso. Only a few of the "fifteen families" who used to dominate Swedish industry remain major owners in a position of control, and they are now facing competition from new financiers and ownership groups.

... but also its disadvantages

At the same time, we have identified a range of "considerable" risks in the Swedish model of controlling ownership based on voting strength differentiation reinforced by the "Chinese boxes" and cross-ownership engaged in by investment companies.

- The temptation for controlling owners to exploit their position of power for their own purposes at the cost of the minority can sometimes become overpowering.
- Isolated cases of abuse of power can have a contagious effect, leading small savers or international capital to stay away from the Swedish stock exchange.
- Companies that are controlled by investment companies and have good potential for growth can be held back in their development because the investment company has difficulty issuing new shares.
- Controlling owners, on the other hand, may choose to over-invest in mature companies or invest in new activities that they know little about, instead of returning profits to all shareholders.
- What is applauded in public as looking to the long term

may thus prove to be unprofitable defensive investment in declining industries.

- Ownership groups that include a commercial bank may turn out, when taking crucial decisions, to be more concerned with the companies' credit rating than with their future growth.
- In family dynasties, heirs with little aptitude for enterprise can hold onto power in sinking corporate empires without any chance of their being challenged by new, more suitable owners.
- Finally, there is ultimately a risk that ties between the power spheres of the major controlling owners and the political power sphere will generate policies that mainly favour the interests of the strong power groups at the expense of the interests of the business sector as a whole and the economy in general.

None of these considerable risks associated with a control structure along the lines of the Swedish model is capable of watertight empirical proof. In fact, it is very difficult to demonstrate the existence of locking-in effects and high private values inherent in control in corporate Sweden. Moreover, the relatively high proportion of foreign ownership of Swedish listed companies (about a third of the total value of the stock exchange) indicates that international confidence in the Swedish regulatory framework is high. Furthermore, it is impossible to determine how individual companies and industries or the business sector as a whole would have developed given a different model of ownership and corporate control. Some of the problems that have been associated with the Swedish model have been linked in other countries to companies with diversified ownership. Nevertheless, the strength of the argument and the few empirical studies that have been carried out using Swedish and international data suggest that the risks should not be ignored. It is therefore a matter of weighing these risks against the advantages that the Swedish model of ownership is able to offer.

Better boards?

Given the structure of ownership in Sweden, which is characterised by strong controlling owners, there has been an understandable focus on the role and responsibility of boards of directors. The board is the body used by the owners to control the company. It is natural that controlling owners are well represented on the board and normally also hold the chairmanship. But each individual member elected at the annual general meeting is required to represent the interests of all owners, without respect of persons. It should therefore be possible to limit some of the risks involved in a system of control such as is described above by means of a board with an "all round" composition, i.e. a board composed of members from a range of different backgrounds.

It can hardly be claimed that any such "all-round" quality exists today. The boards of Swedish listed companies are homogeneous in terms of sex, age, education, career, social background, and so on. Men in advanced middle age with a background in corporate management are totally dominant. Increased heterogeneity would undoubtedly be capable of bringing to the work of the board better information about relevant circumstances outside the company, thereby leading to a healthy questioning of many strategic decisions. Many suggestions have also been made in the course of the debate regarding the size and composition of the boards of directors, demanding smaller boards, more "independent" board members, more women, more non-Swedes, etc.

However, we feel no great optimism about the prospects of achieving any substantial improvement in corporate governance in this way. We point to the trade-off between efficiency of information (which presupposes heterogeneity) and decision-making efficiency (which requires homogeneity). Boards must be characterised by trust and cooperation based on shared experiences and values. Heterogeneous boards might delay or even block the decision-making process in important matters. Many companies have found themselves in crisis not

because of a lack of discipline in the way the board has worked but because of individual board members who have been confident they knew best or because of conflicts between board members, which have weakened the work of management.

As long as legislators – for good reason – continue to give controlling shareholders a decisive influence over the composition of the board, it is difficult to envisage any major changes in companies controlled by owners. It would be naïve to imagine that the choice of direction or strategic decisions could be significantly affected by "reinforcing" or supplementing the board by the addition of one or two new names. Odd men out will either leave the board (at their own initiative or that of others) or turn into good team players who share the consensus of the rest of the board. In practice, everyone on the board is hostage to the controlling owner. The majority of the board is generally replaced when it has committed serious strategic mistakes and the company has therefore acquired new owners. In between there may be good reason to have a harmonious and decisive board as a sounding board for the managing director.

Better systems of remuneration for corporate managers?

It has sometimes been said that the most important task of the board of directors is to appoint and dismiss the managing director. Present trends in corporate governance allocate a considerably broader role to the board, in terms of strategy, supervision and control. But far too often, a responsibility that ought to be one of the most important tasks of the board as a whole is still neglected: to ensure that the managing director and other senior executives in the company have a system of remuneration that gives them incentives to act in the interest of the owners.

In practice, the management has a monopoly on strategically relevant information regarding conditions in the compa-

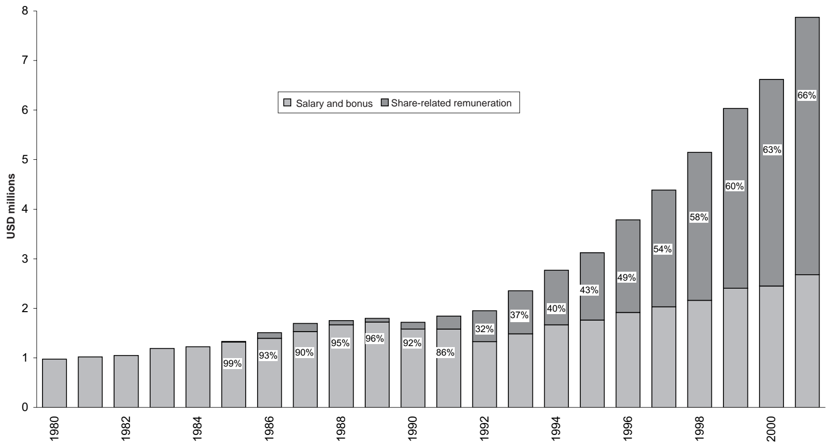
ny and outside it. By concealing information or being selective in revealing it, the management can induce the board – including the controlling owner – to take the decisions it desires. Such behaviour is normally rooted not in ill will, but merely in an honest attempt to limit the information available to the board to what is relevant for its decisions. The problem, however, is that the management of a company has a – conscious or unconscious – agenda of its own, which generally differs from the agenda of the owners. An enterprising managing director has a natural ambition to control more resources and test his powers in new markets and areas of activity. He (generally speaking, it is a he) is loath to admit failure and protects his colleagues from the criticism of the board.

For these reasons, very strong financial incentives may be needed to induce the managing director (and other senior executives) to curb their natural instincts and instead provide the board with evidence for decisions that may entail the discontinuation of unsuccessful ventures, selling off of operations and returning of resources to the owners – all in the interest of the owners. This applies particularly to companies that lack a controlling owner.

We are as astounded as most of the general public at the levels attained by the remuneration paid to senior executives. We note that they are matched by the market-based incomes earned by megastars in such fields as sports, music and the cinema. As economists, however, our interest is bound to focus on whether the market works and whether remuneration corresponds to performance.

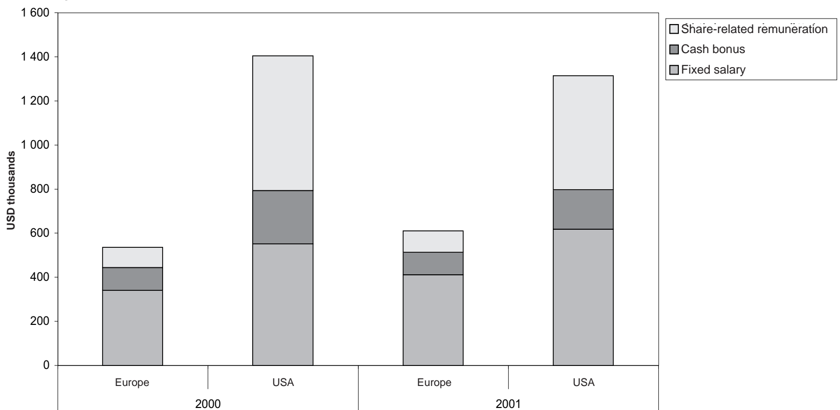
It turns out on examination that the rapid growth in the remuneration of CEOs in the United States is mainly attributable to a sharp rise in the options allocated to them (figure 4). The extremely high remuneration noted at the top of the income league has generally been due to the outstanding results achieved by a few of these options programmes one year or another, but in recent years there have also been a number of cases of gross abuse of power and/or negligence by boards of directors.

Figure 4. *Median CEO remuneration (level and composition), USA 1980–2001, in million dollars, 2001 prices*



Source: Brian I. Hall, "Incentive Strategy II: Executive Compensation and Ownership Structure", Teaching Note N9–902–134, 2002, Harvard Business School.

Figure 5. *CEO remuneration in Europe and USA, level and composition in 2000 and 2001, in thousand dollars*



Note: Data refer to manufacturing companies with a turnover of about USD 500 million.
Source: Brian I. Hall, "Incentive Strategy II: Executive Compensation and Ownership Structure", Teaching Note N9–902–134, 2002, Harvard Business School.

In Europe, including Sweden, the remuneration paid to managing directors has risen more or less as steeply as in the United States, but without the sharp rise in the options component (figure 5).

Even so, levels of remuneration in Europe remain well below those in the US and levels in Sweden are among the lower rates found in Europe. That said, as a result of the recent trend, the CEO of a medium-sized Swedish company will normally earn more than ten manufacturing employees put together (table 3).

Table 3. *CEO remuneration in Europe 1984–2000, in multiple of manufacturing worker's pay*

	1984	*1988*	*1992*	*1996*	*1997*	*1998*	*1999*	*2000*	*2000 ($ 1 000)*	*Increase (%)*
Netherlands	8	9	10	9	14	13	17	22	621	177
UK	10	13	16	17	18	23	24	25	720	148
Italy	9	12	14	16	16	17	20	22	568	143
Belgium	9	9	12	12	13	14	18	19	655	114
Sweden	**7**	**6**	**8**	**7**	**11**	**11**	**13**	**13**	**440**	**90**
Spain	11	13	17	16	14	15	17	17	399	58
France	10	12	17	15	15	15	15	15	540	54
Germany	9	8	10	8	11	10	13	11	422	27
Switzerland	9	9	11	12	10	10	11	11	448	21
Average	9	10	13	12	14	14	16	17	534	93

Note: CEO remuneration is made up of basic salary plus bonus, compulsory and voluntary social insurance contributions, benefits in kind and options and other incentive programmes for the CEO of a company with a turnover of USD 500 million. The manufacturing worker's pay includes social insurance contributions. All wages and salaries are converted at the current dollar rate of exchange.

Source: The data are from the international consultancy company Towers Perrin and a study by Martin Conyon and Graham Sadler, University of Warwick, 1999. They are reproduced from the Swedish Trade Union Confederation's publication Eliterna flyger högre (The elites are flying higher), 2001.

In the face of the major demands for restructuring that European business is encountering, we consider it would be a mistake to restrict the element of share-related remuneration, in-

cluding options, given to corporate managers here. On the contrary, we believe it may need to grow. We doubt that necessary structural measures will be taken unless corporate managers are given forceful financial incentives to propose and implement measures affecting their companies' operations that will sometimes be painful – for example, refraining from fighting a bid for the company that, though hostile, will raise its value. Options have proved to be a means of giving managers cost-effective incentives to act in the owners' interest in such connections.

Having said that, we see great scope for improvement in existing options programmes. Options lose their effect as an incentive when share prices suffer major setbacks and programmes may therefore need to be adjusted after the event if the stock market turns downwards. Options programmes have also created incentives for managers to attempt to manipulate share prices to peak at the time options are due to be sold. Both problems can be countered by extending the duration of options, cutting the redemption price (not raising it, as is sometimes advocated) and requiring a longer binding period for the shares received. There may sometimes be an argument for allocating shares directly (i.e. options with a zero redemption price) on condition that they must not be sold for a certain period. Gains and losses due to general share price movements on the stock exchange should also be limited. This can be done by indexing the redemption price of the underlying share or – a simpler and probably more cost-effective measure – by allocating smaller quantities of options more frequently.

It goes without saying that the share market must be given full information about the design of options programmes and what they cost the company. Admittedly, increased transparency has raised managers' income levels by both reasonable and unreasonable benchmarking. But increased transparency is necessary to promote the emergence of more cost-effective incentives and to limit abuses. There is no reason not to give an unambiguous account of how much corporate managers

and board members are paid each year, including clearly specified information about the value of the different types of compensation (at the time allocated). We can also envisage a more active role for major owners in developing and monitoring generally accepted standards and reasonable levels for compensation.

The power of owners must be open to challenge ...

This brings us back to the crucial role of the owner's function in all corporate governance. Ultimately, corporate governance is about solving two fundamental problems: to make capital available to the right managers and to ensure that they put it to good use. Since the conditions for economic activity are constantly changing, the system must also be able to guarantee that control is transferred from less suitable owners to people who are better fitted to take on the ownership role.

To a great extent, this is a matter of giving the right incentives to those who now control assets to transfer them to new owners and managers who value them more highly. The tax regulations, for example, must allow old owners to dispose of their controlling holdings without suffering greater costs than they would have incurred if they had retained them. From this point of view, abolishing capital gains tax on controlling blocks would probably make good business sense for the national economy.

An efficient system of corporate governance, however, must also enable shifts of control in listed companies, against the wishes, at times, of the existing controlling minority owners (table 4). The various possible means of challenging present controlling owners and managers are summed up in the concept of *contestability*. This option is also crucial for putting pressure on those who currently control assets to manage them properly.

Table 4. *Company acquisitions in different regions*

Year	*Austra-lia*	*Canada*	*USA*	*EU 15* *Total*	*UK*	*Excl. UK*	*Others*
Number of non-hostile* acquisitions							
1989	81	184	1 188	550	316	234	114
1990	69	193	834	597	290	307	188
1991	107	269	790	817	252	565	363
1992	46	194	746	824	181	643	296
1993	100	215	789	803	196	607	456
1994	124	224	1 015	816	221	595	614
1995	162	296	1 106	806	219	587	753
1996	142	277	1 115	676	195	481	745
1997	107	258	1 150	574	201	373	726
1998	103	231	1 203	653	234	419	893
1999	100	289	1 236	801	271	530	1 180

Year	*Austra-lia*	*Canada*	*USA*	*EU 15* *Total*	*UK*	*Excl. UK*	*Others*
Number of hostile** acquisitions							
1989	3	6	45	36	32	4	10
1990	2	0	12	24	22	2	5
1991	8	1	7	34	31	3	2
1992	10	2	7	20	15	5	4
1993	10	1	11	15	11	4	5
1994	8	11	33	11	8	3	4
1995	18	19	59	22	14	8	7
1996	22	8	45	20	13	7	11
1997	12	17	27	23	11	12	5
1998	12	14	19	14	12	2	5
1999	15	6	19	42	21	21	6

Note: *The board of the target company recommended the shareholders to accept the bid. ** The board of the target company recommended the shareholders to reject the original bid.

Source: Marco Becht, Patrick Bolton and Ailsa Röell, "Corporate Governance and Control", Finance Working Paper No. 02/2002, European Corporate Governance Institute, Brussels.

In European efforts to promote harmonisation, the attempt has been made to increase contestability by weakening the ability of present controlling owners to strengthen and defend their power as owners.

One obvious example of this is the proposal in the Winter Report for a "break-through" rule that in practice would entail

a substantial erosion of the potential returns on controlling ownership. We take a sceptical view of such radical changes, as in the longer term they would lead to a systemic shift from a controlling owner system to an Anglo-Saxon system of corporate governance, without the necessary foundation for a shift of this kind being in place.

Nor do we wish to propose regulations abolishing the present possibility of differentiating the voting value of shares by a factor of 1:10. Compared with the systems of control in other European countries it constitutes a relatively transparent means of retaining a control-oriented corporate governance system without large private fortunes. It also allows new companies to turn to the stock exchange to meet their needs for new capital without the entrepreneur having to relinquish control. We observe, however, that the market may be on the way to solving the "problem" of differentiated voting rights. Many international investors steer clear of companies that have shares with special voting rights. To increase their valuation, some owners have begun to remark these shares to reflect equal voting entitlements.

The system of regulations on the corporate control market – i.e. trade in controlling blocks, bidding and mandatory bidding, permissible defence mechanisms – therefore plays an important role. But there are other ways of challenging the power of owners as well. The increased media alertness to the ways in which controlling owners use and abuse their companies, and the growing element of investigative journalism in this coverage, helps to put pressure on controlling owners. It has also helped to bring greater transparency to controlling ownership and actual power relations. Digital technology has the potential to improve opportunities for smaller shareholders to join forces and mobilise votes in preparation for shareholders' meetings. Finally, the courts should be able to play more of a role than at present where opportunities for the minority to assert its rights are concerned, not least by means of the option of class actions that entered into force at the turn of the year.

... but we need more controlling owners

There must therefore be scope for new owners and owner groupings who have plans to enhance the value of the company to challenge the controlling power in Swedish listed companies. But this can only happen if there are financially strong individuals and institutions that are willing and able to shoulder the responsibility of ownership. Here we face a problem in Sweden. There are too few private individuals and families with sufficient resources to control medium-sized and large companies. The funds that manage the Swedish people's savings are neither willing nor suitable corporate owners. The public pension funds that control growing fortunes are in practice barred from assuming ownership responsibilities. The new private equity companies play an important role in the corporate control market, but do no more than take on temporary ownership responsibilities in low-yield corporate units and steer them towards new long-term owners. As a result, more and more companies that do not fit in with existing ownership structures are being sold to foreign owners. This can lead to welcome revitalisation, but we can see no disadvantage in giving Swedish owners the chance to compete on equal terms.

When we advocate increased competition and mobility on the corporate control market, what we have in mind, then, is not so much a weakening of existing owners' control as a chance for new potential owners to challenge the power of the owners in existing companies. These new owners must obtain a reasonable return on the work and risk involved in analysing the target company, developing plans for its future, and seeking financing for a takeover. Protection for the minority in the form of rules requiring mandatory bids, equal treatment, etc., must not be designed so as to allow all shareholders without restriction to hitch a free ride on this work. It must be possible to trade controlling blocks at an adequate premium on the share price and a potential owner mounting a challenge must be able to build up an adequate position of

ownership in an undervalued company before being obliged to make a public bid. Otherwise the will to financial entrepreneurship will be undermined, as will the returns on assuming a controlling responsibility. This would not be in the interests of small shareholders either.

Risk of over-regulation

There is a risk at present that the excesses and business scandals that have occurred on both sides of the Atlantic will give rise to over-regulation. Irregularities in the business sector are leading to demands for action by the politicians. And the politicians have not been slow to demonstrate their capacity to act. However, legislation and regulation can cause substantial costs to the economy. In their aspiration to prevent repeat cases, laws and rules can also have the effect of hindering future development and innovations.

For similar reasons, there is a danger in introducing common rules imposing central regulations on corporate governance systems in the EU. To be sure, there is much to be gained from consistent rules that establish a level playing field. We believe the potential gains are particularly great where attempts are concerned to create increased disclosure regarding the often very complex control structures in Europe (table 5). We are also of the opinion that common legislation may be desirable in specific areas, for example, the right of shareholders to decide themselves on any defensive measures to be taken following a hostile bid for a company.

However, ownership structures, institutions and traditions differ in the different EU states and the same rules can have widely varying consequences in different countries (table 6). The strict mandatory bid regulation included in the Commission's proposed takeover directive and the Winter group's original break-through rule targeting companies with differentiated voting values are examples of regulations that can have a wide range of impacts. In such areas we consider that lively institutional competition between countries and regulatory

Table 5. *Use of instruments for separating ownership and control*

Country	Number of companies	Sole controlling owner (%)	Pyramid ownership (%)	Cross-ownership (%)	Ownership using several instruments (%)	Company managed by owning family (%)
Belgium	104	71.15	25.00	0.00	2.38	80.00
Finland	92	41.30	7.46	0.00	1.49	69.23
France	522	64.75	15.67	0.00	2.87	62.20
Germany	631	59.90	22.89	2.69	7.22	61.46
Ireland	26	42.31	9.09	0.00	0.00	77.78
Italy	181	58.76	20.27	1.13	8.78	70.00
Norway	98	38.78	33.90	2.04	20.34	66.67
Portugal	68	60.29	10.91	0.00	0.00	50.00
Switzerland	155	68.39	10.91	0.00	0.91	70.00
Spain	465	44.30	16.00	0.22	5.43	62.50
Sweden	149	48.32	15.91	0.67	0.00	73.47
UK	721	43.00	21.13	0.00	4.93	75.85
Austria	88	81.82	20.78	1.14	6.49	80.00
Total	**3 300**	**53.99**	**19.13**	**0.73**	**5.52**	**68.45**

Note: The table is based on 3 300 companies with controlling owners whose holdings exceed 20 per cent of the votes. The column *Sole controlling owner* shows proportion of companies controlled by a *single* owner. *Pyramid ownership* shows the proportion of companies whose largest controlling shareholder uses pyramid ownership as an instrument of control. *Cross-ownership* shows the proportion of companies whose largest controlling shareholder uses cross-ownership as an instrument of control. *Ownership using several instruments* shows the proportion of companies whose largest controlling shareholder exercises at least 5 per cent of his ownership via more than one instrument. Company managed by owning family shows the number of companies whose management is supplied by the family of the largest shareholder.

Source: Mara Faccio and Larry H. P. Lang "The Ultimate Ownership of Western European Corporations", *Journal of Financial Economics*, Vol. 65, No. 3, pp. 365–395.

systems can be a more economically efficient method for achieving, in the longer term, a common European market for ownership and corporate control.

Table 6. *Ultimate controlling owner in listed companies (category of owner)*

Country	Number of companies	Diversified ownership	Family	State	Non-financial company with diversified ownership	Financial institution with diversified ownership	Others
Belgium	130	20.00	51.54	2.31	0.77	12.69	12.69
Finland	129	28.68	48.84	15.76	1.55	0.65	4.52
France	607	14.00	64.82	5.11	3.79	11.37	0.91
Germany	704	10.37	64.62	6.30	3.65	9.07	3.37
Ireland	69	62.32	24.63	1.45	2.17	4.35	5.07
Italy	208	12.98	59.61	10.34	2.88	12.26	1.20
Norway	155	36.77	38.55	13.09	0.32	4.46	4.54
Portugal	87	21.84	60.34	5.75	0.57	4.60	6.90
Switzerland	214	27.57	48.13	7.32	1.09	9.35	6.31
Spain	632	26.42	55.79	4.11	1.64	11.51	0.47
Sweden	245	39.18	46.94	4.90	0.00	2.86	5.71
UK	1 953	63.08	23.68	0.08	0.76	8.94	3.46
Austria	99	11.11	52.86	15.32	0.00	8.59	11.11
Total	**5 232**	**36.93**	**44.29**	**4.14**	**1.68**	**9.03**	**3.43**

Note: The table is based on 5 232 listed companies and shows the proportion of companies controlled by different categories of controlling shareholder with more than 20 per cent of the votes. Because of cross-ownership the figures for the different ownership categories do not add up to 100 for some countries.

Source: Faccio and Lang (2002).

Freedom of contract and self-regulation

The point of departure for any discussion of corporate governance has to be freedom of contract. Interventions on the part of the political authorities, such as restrictions of the right to differentiate between the voting value of shares, must be implemented with great care and with clear reference to specific shortcomings deriving from freedom of contract. The burden of proof must rest with those who claim there is a need for regulation. This applies in particular to changes affecting contracts that have already been entered into.

We perceive two main problem areas where legislators have reason to intervene: (1) when shortcomings in individual contracts risk having major knock-on effects on entire markets, and (2) when contracts are incomplete and require interpretation. Enron and WorldCom are obvious examples of the first type of problem. The effects extended far beyond the individual companies and influenced public perceptions of the entire American business sector. There were strong reasons for Congress to act to make it clear that no repetition of these cases was to be possible. An example in Sweden might be the recent new issue of shares by Ericsson, when owners of shares with little voting power – who had advanced by far the largest part of the risk capital – were obliged to see their ownership watered down by the controlling minority owners who pushed through the new share issue. In order to salvage the international credibility of the system of differentiated voting rights (and hence the credibility of the Swedish stock market), legislation may be needed giving each type of share a separate voting entitlement in such connections.

One alternative to supranational or national legislation or regulation is self-regulation, with the power to regulate being delegated to industry organisations, bodies representing certain parties or stock exchanges. The advantage of self-regulation is that the actors have reason to weigh the benefits of the regulations against the costs. The disadvantage is that it has to be expected that the parties involved will seek to create a regulatory framework that favours their own interests above all, at the expense of utility to the economy as a whole. Self-regulation should therefore mainly be tried in areas where the stakeholders have no opportunity to shift the costs to outsiders. In addition, the authorities must monitor developments to ensure that this body of regulations does not fall into the hands of any individual player or group of players.

In many respects, we regard the marketplace/stock exchange as the ideal level for regulating many of the transactions on the market for ownership control that are currently regulated at national or supranational level. Those issuing se-

curities have the option of choosing the stock exchange on which they want their securities to be listed and thus which regulatory framework they wish to comply with. Traders and investors, similarly, will choose their marketplace with reference to transaction costs, disclosure and regulations. The competition between stock exchanges, in turn, gives them strong incentives to balance the interests of issuers, intermediaries and investors so as to make themselves attractive to all parties.

For this to work, however, certain conditions have to be fulfilled. Firstly, the stock exchanges must be run commercially, so that they do actually have strong incentives to attract as much profitable trade as possible. Secondly, the stock exchanges and their stakeholders must ultimately bear all the receipts and costs deriving from their regulatory systems (no external effects). Thirdly, the stock exchanges must have a genuine opportunity to monitor compliance with their regulations and impose stiff sanctions on anyone who infringes against the rules. Fourthly, no single group of stakeholders or owners must be allowed to dominate the way the exchange is run so as to be able to satisfy their own interests. Where this final point is concerned, we are sceptical about the long-term prospects of the Stockholm stock exchange establishing international credibility under its present ownership.

Iron triangles

When all is said and done, for important areas of the markets' regulatory systems legislation and regulation at national or supranational level is the most appropriate solution. But here too there is a risk of individual parties acquiring undue influence over the system. The specifically Swedish model of corporate ownership and control has emerged out of a close interaction between high finance, the political authorities and the trade union movement – the "iron triangle", as it is sometimes called. The mutual purpose has been stable, long-term ownership in exchange for looking after certain interests that

are of importance to the economy and the trade unions when making decisions.

For a quarter of a century following the Second World War, this model appeared to function well. It delivered a high rate of growth combined with a high, stable level of employment. In the closing decades of the twentieth century, the down sides of the model became apparent. They lie in the difficulty faced by new entrepreneurs and owners in asserting their interests under the present regulatory framework, so as to be able to challenge the existing owners' control over companies and markets. This has undermined the regenerative power of the business sector.

There is thus an inherent danger in the consensus between the political authorities, the owners of capital and the trade union movement. In its policy for growth, the government must not just listen to today's voters; it must also take unborn generations into account. Similarly, in its industrial policy, the government must not just listen to current owners; it must also take into account all the potential (and perhaps better) owners who may challenge them. If it proves too difficult for the government, when shaping its policies, to break free of the present very strong national ownership interests, this becomes an argument for regulating certain ownership issues in an arena above the national level.

Ownership power – driving and undergoing change

It may perhaps seem odd that we have taken as the point of departure for our argument in this report the proposition that the Swedish (and European) system of corporate ownership and governance needs reform so as to enable an increased rate of change in the business sector. Mergers, hive-offs, company closures, switches of production or relocation, after all, often place a great strain on workers and their families. Much of the present debate in society accordingly has to do with the pace of change being too high even now, and the huge human and social problems this creates.

Shouldn't the perception of all the economic, social and human costs associated with a rapid pace of industrial change lead to recommendations aimed at *slowing* the rate of change, rather than speeding it up? As has become clear, this is not the view we espouse. There are two reasons why this is so.

Firstly, Sweden today is an integral part not only of the EU but of the whole global economy – an economy currently undergoing very rapid change as a result of several different factors: technological development, deregulation, trade liberalisation and aspirations for integration. Our prosperity depends on full participation in this process and we are consequently exposed to constant demands for adaptation and renewal. Our report has discussed how to make one particular aspect of this adaptation as smooth and efficient as possible.

Secondly, we believe it may be possible to distribute the burdens of change slightly differently in society. Companies that fail to adapt to new production and market conditions are obliged to lay off labour and perhaps go out of operation. A more far-sighted and dynamic management might perhaps have been able to avoid the crisis by initiating changes in the company at an earlier stage. Hence, changing the management may be an alternative to laying off staff. If the existing owners don't have the sense to change the management team in time, a purchase giving the company new owners might perhaps have been the best solution.

Changing the management, board or principal owner of a company is not an end in itself and too frequent switches can cause problems for the company concerned. But *if* a change of management or owner is capable of putting a company on a better footing to face the future, then from the point of view of the wider economy, there is naturally no reason to wait and see. Our report has argued that Swedish ownership in part sits entrenched behind walls that – in the worst case – can generate high costs to the economy. As economists and social scientists, we advocate increased mobility on the market for controlling ownership for the same reasons that we issue similar recommendations for the labour market, the housing market,

and so on. In our opinion, this would be the best way of utilising the total resources possessed by society and a development that would be to the advantage of public prosperity.