Agency and Ownership in the Financial Services Industry

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No rational argument will have a rational effect on a man who does not want to adopt a rational attitude (Karl Popper, The Open Society and its Enemies).

1. Introduction

The 11th century was the century during which the seigniorial system was established all over Western Europe. The development of this feudal system already started in the 8th century as the kings gave benefices to men who swore loyalty to them and serve them as soldiers. Fighting was the chief function of the feudal males. They were conditioned to bear the weight of knightly armor and drilled rigorously. The raids of the Vikings during the 9th and 10th system and the civil wars kept large parts of Western Europe in a state of anarchy. Feudal wars were endemic and throughout their lives knights had the opportunity to spend most of their time practicing and fighting.

Landlords had to seek protection and obtained military support by becoming a vassal of the most powerful neighbor or even worse, become an un-free villager of a lord. Larger landlords with adequate resources chose the former system. Only a limited number could stay outside the feudal fief system. The system was refined as a hereditary fief system as long as the heir was competent.

By the 11th century the extension of the system took form as an institution in which most men that worked the land owed some rent and services to the landlord. The system had a pyramidal structure and the upper layer depended directly on the king. In France the Capetian king was the suzerain of the great lords. Next come a group of feudal potentates, called the "peers of France" of which the count of Flanders, the duke of Normandy, duke of Burgundy, the count of Champagne, the count of Toulouse and the duke of Aquitaine are the most important lay peers. These lords held directly of the king and had own vassals, the latter frequently counts. Down the line there are the knight's fiefs, the minimum unit to enable a man to support him.

The seigniorial system was an institution through which the landlords allowed the tenants to cultivate the land and part was cultivated for him. In addition the lord usually had additional extensive political rights. These rights depended on the organization of the seigniorial institution according to the custom of the land and the status of the lord. In France and western Germany the feudal hierarchy guaranteed the complete jurisdiction over the people and the freedom to discipline them. In England higher jurisdiction was firmly vested in the hands of the King.

The purpose of the feudal system was cooperation in case of war. The vassal owed military service to his lord and the lord was bound to protect the vassal. When the fief was in danger, the vassals were bound to stay in service as long as they were needed. Vassals had a duty to assist their lords especially for campaigns and in particular for the crusades, so worthy an enterprise. The system was refined and further developed in the 12^{th} and 13^{th} century, like the time the vassal had to serve for military duties, depending on the kind of campaigns of the lord, offensive or defensive campaigns. One kind of these offensive campaigns were the crusades.

In 1009 the Fatimid caliph of Cairo destroyed the Church of the Holy Sepulchre in Jerusalem. Notwithstanding the conditional permission of his successor to rebuild the church, stories started to be circulated in Western-Europe about the difficult circumstances in which the Christian community had to live in the Mid-Eastern region. The closing of the Church of the Holy Sepulchre in 1056, the papal blessing in 1063 to the Iberian Christians in their wars against the Muslim including an indulgence to those who are killed in battle, the disastrous defeat of the Byzantine empire at the Battle of Manzikert in 1071 further awakened the public interest in religious affairs in general and the idea that the territory in the Mid-East and other areas must be recovered. In 1085 Toledo was conquered and integrated in the Kingdom of Leon. When the first crusade was preached in 1095 the battle of Spain still continued.

Pope Urban II called upon all the Christians to join a war against the Seljuk Turks in 1095. His preaching followed a number of developments due to an outlet of an intense religious piety in the 11^{th} century and the fact that a class of warriors took every opportunity to start a new combat. Fighting was seen as an honorable profession. The crusades offered the opportunity to combine honor with piety and combat.

The scarce material of early medieval times suggests that the knights combined devotion with brutality. They accepted without question the teaching of the church, regularly confessed their sins, observed the rites of religion while slaughtering people and beating their own relatives.

While the knight was away from his home for several months or years, the question arises who ran his properties while the western armies were conquering Jerusalem. Women did not participate in any fighting activities and could govern the fief. However, women seemed to have an ambiguous position. Some sources deny a woman the right to hold a fief in her own hands or to do homage.[1] Others found an early example of a rich heir, Adela van Selnesse who was not married at the time her parents died.[2] She had to become the vassal of her uncle, the bishop of Terwaan to receive protection. Hence, women were capable to hold a fief. However, as the same source pointed out, the bishop married off Adela and her husband immediately replaced his wife as vassal. Married women were legally incompetent. Her husband performed the services for her. Unmarried women hired the services of a third party or performed the services themselves with the exception of military service where women were an absolute taboo.

The incompetence was not absolute but tied to the presence of the husband. This situation can be approached as an ineffective legal capacity. Recent history shows similar relationships. Between 1958 and 1976 a Belgian married woman had legal capacity. However, she continued to be incompetent in the system of universal community of property.

There was a bright side to this picture too. As soon as her husband was away, a woman enjoyed his status. It was by far the best alternative for the fief, her husband, the vassal and the lord the wife held the reins.
Wives became the mistresses of the fief and ruled her and his side of the household. It even seems that she was often equally harsh as her husband.

The situation where the fief was governed by the wife can be analysed as government by agency. There is very little material about the rules about agency in the Middle Ages. In one footnote in an article by de Gryse it is read: "*In the First Crusade, Robert II left his wife Clementia behind as regent; Diederik of Alsace twice left the regency in the hands of his wife Sibylla, twice in the hands of his son Philip, on the last occasion (1164) leaving Philip fully empowered as count*" and further "*the counts of Flanders had designated some one person,*

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1 M Baldwin (ed.), *The history of the Crusades – the first hundred years*, The history collection of the University of Wisconsin, 1969, p. 16, see http://digicoll.library.wisc.edu/cgi-bin/History/.

2 See for an analysis of the position of woman in the 11^{th} to the 13^{th} century seigniorial system, D. Heirbaut, *Over heren, vazallen en graven*, Brussel, Algemeen Rijksarchief, 1997, 90-94.

usually the ruling house, as regent or as count."[3] Detailed study of this kind of an agency relationship did not yet occur. This is strange.

Agency became one of the most important legal contracts in modern times. The next section will briefly describe the agency contract. Agency is of particular importance in organizations. Economic theory focused on the issue since the 1930's and since the 1970's agency contracts became embedded in economic theory. Section three discusses the economic approach of agency and the differences between the legal approach and the economic analysis. Section four assesses the position of the shareholder as principal in listed corporations and describes the determinants of the ownership structures. In section five the law and finance theory is addressed. The theory considers the legal framework as a major driver for the development of the internal organisation of the corporation as well as for the capital market of a country. The legal corporate and capital market framework developed at the speed of light in the European Union. The section will present evidence that the ownership structure did not keep pace with these legal developments, shedding doubt on the validity of the law and finance theory. Academics did not yet address in detail whether the general rules can be applied in the financial sector. Section five will also study how the law and finance theory can be applied in the financial services industry. Section six concludes.

[3] L. de Gryse, "Some observations on the origin of the Flemish bailiff (Bailli): the reign of Philip of Alsace", in *Viator*, Center for Medieval and Renaissance Studies University of California, Los Angeles 1976, 274, note 174.

2. Agency

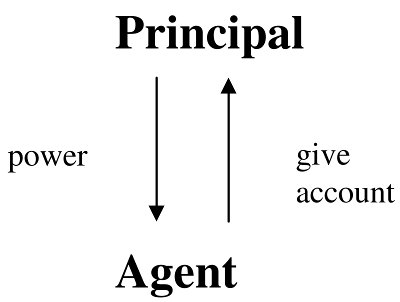
The American Restatement of the Law of Agency defines agency as "*the relationship which results from the manifestation of consent, by one person to another, that the other shall act on his behalf and subject to his control, and consent by the other so to act*."

This definition goes not without criticism as is not always necessary to base agency upon consent. It can be imposed by law, irrespective of the agreement. Fridman defines agency as "*a relationship that exists between two persons when one, called the agent, is considered in law to represent the other, called the principal, in such a way as to be able to affect the principal's legal position in respect of strangers to the relationships by the making of contracts or the disposition of property*".[4]

Generally, it is agreed that agency is a contract that comes into being with the consent of the parties. Article 1984 of the Belgian and French civil code state that an agency *contract* requires the consent of the agent. Article 7:414 of the Dutch civil code starts by saying that agency is a contract.

The contract of agency involves the delegation of the principal to the agent of some authority to act in the name of the principal and on his behalf. Under French and Belgian law the agent has to render account for his duties and to justify his conduct (figure 1).[5]

Figure 1: The principal agent relationship



[4] G. Fridman, *The Law of Agency*, London, Butterworths, 1990, 9.
[5] Article 1993 Civil Code.

However, the law leaves the internal organization of this relationship to the parties. Only the boundaries of the relationship have been determined by way of liability rules.

From an economic point of view, agency contracts are written – if written at all - in a world of information asymmetry, uncertainty and risk. Especially information asymmetry is studied in economics. It occurs when a party to a transaction has more or better information than another party. First described by Kenneth Arrow in his 1963 article on health care[6], the concept of information asymmetry became famous after the publication of Akerlof's article on the market for lemons.[7] Akerlof used the used car market as an example for his theory. There are good used cars and defective used cars, "lemons". The sellers know whether they offer a good or a defective used car. The buyer of a used car does not know beforehand whether the car is a good car or a "lemon". Hence the buyer's best assessment will be to consider a car of average quality for which he is willing to pay only the price of the car of known average quality. The owners of good cars will no longer be prepared to place their cars on the used car market. This withdrawal will further reduce the average quality of the used car market, causing buyers to reconsider the average price they want to offer for the used cars. It can cause owners of lower quality used cars to withdraw their cars from the market and finally end in the absence of a market. The market with asymmetrical information shows characteristics to those described in Gresham's law, stated as "bad money drives good money out of circulation". In the latter case money is considered to be a commodity.

There are numerous situations with information asymmetry. Typically a seller knows more about the product or service than the buyer. However the reverse may be true. For insurance products the buyer of the product generally will have an informational advantage as it is easier to assess his own behaviour.[8]

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6 K. Arrow, "Uncertainty and the Welfare Economics of Medical Care", *American Economic Review*, 53, 1963, 941-973.

7 G. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", *Quarterly Journal of Economics*, 84, 1970, 488-500.

8 Insurance companies more and more assess the risks of the buyer's behavior before they sell an insurance contract. A Belgian insurance company allows a discount for a life insurance if the clients have a body mass index – weight divided by the squared length (in meters) - between 19 and 25. In the Netherlands one insurance company gives a discount for its medical insurance if the insurance buyer consumes biological products, whereas another insurance company repays up to 40 euro when the insurance buyer uses cholesterol reducing products of a food giant with whom the insurance company has an agreement (S. Sinnaeve, "Moet u op dieet van uw verzekeraar", *Trends* 4 mei 2006, 54-59).

In the case of an agency relationship, the principal-agent problem treats the difficulties due to incomplete and asymmetric information when the principal hires the agent. The economic approach of agency is broader than what the law considers to be an agency contract. The economic approach includes cooperation between two persons where both parties cannot observe each other actions.

The services of the agent should be considered as useful for the principal – why else would he hire an agent? - but costly to the agent. It is unlikely that the agent always act in the best interests of the principal. It presupposes that the utility maximization functions of both are fully aligned. Diverging interests drive the agent to develop aberrant activities or, indeed, remain rather inactive. In fact, one of the basic elements in an agency relationship is the delegation of some authority to the agent. The more autonomy the agent enjoys and the greater the information asymmetry, the greater the probability of aberrant behaviour of the agent.

The contractual relationship will be designed to limit the “abnormal” behaviour of the agent. However, almost all contracts are incomplete. Ex ante it is impossible to draft contracts that take into account all future contingencies.

The principal will control the behaviour of the agent to limit the deviant behaviour of the agent through appropriate additional systems of monitoring, budgeting, compensating, stimulating, endorsing and enforcing etc. Briefly, the principal will incur costs whether he uses a stick or a carrot to align his interests with the interests of the agent. However, there will remain elements of the performance which are costly to observe.

The agent will expend resources too. The agent will try to comfort the principal that he will only act in the interest of the latter or at least show his willingness to reasonable satisfy the principal.

As hard as they will try, divergence between the interests of the principal and the agent will incur some additional loss.

Agency costs are the sum of:

- The monitoring expenditures of the principal;
- The bonding expenditures of the agent;
- The residual loss.

The agency problem is closely related to moral hazard. Moral hazard is used to describe the increased risk of immoral behaviour and a negative outcome (“hazard”) due to the fact that the person who committed this misbehaviour does not suffer all the consequences or even worse, benefits from this behaviour.

3. Agency in organizations

For a long time, organisations and firms in particular, like households, were not examined in any detail. The basic economic model describes how markets can produce an efficient outcome. Economic theory approached an organisation or a firm as a 'black box': a production function run by a selfless owner-manager who chooses the input and output levels that maximize profits and minimize costs (figure 2). Technology, economies of scale, non-separatibilities are the major determinants of the firm in this production approach.[9]

Since the nineteen twenties, economists have felt the need to go beyond the market approach and develop a theory to address the reasons for the existence of an organisation, its boundaries and its internal structure. In 1937, Coase reasoned that the cost of using the price mechanism explains the existence of organisations.[10] Especially in long-term relationships and in situations of uncertainty marketised contracts are unsatisfactory. The (neo-classical) market focuses on short term contracts and is instantaneous. Although not explicitly mentioned by Coase in his seminal article, the idea of transaction costs was born. Coase quotes the observation of D.H. Robertson that we find "*islands of conscious power in this ocean of unconscious cooperation [i.e., the market] like lumps of butter coagulating in a pail of butter-milk.*" In particular, organizations and firms serve as nexus for a set of agency relationships.

Alchian and Demsetz clarify the work of Coase. They introduce the team production view. Production is optimally undertaken by more than one individual, in particular due to gains from specialisation, in organisations. Moreover, its success depends on the ability to manage the team efficiently.

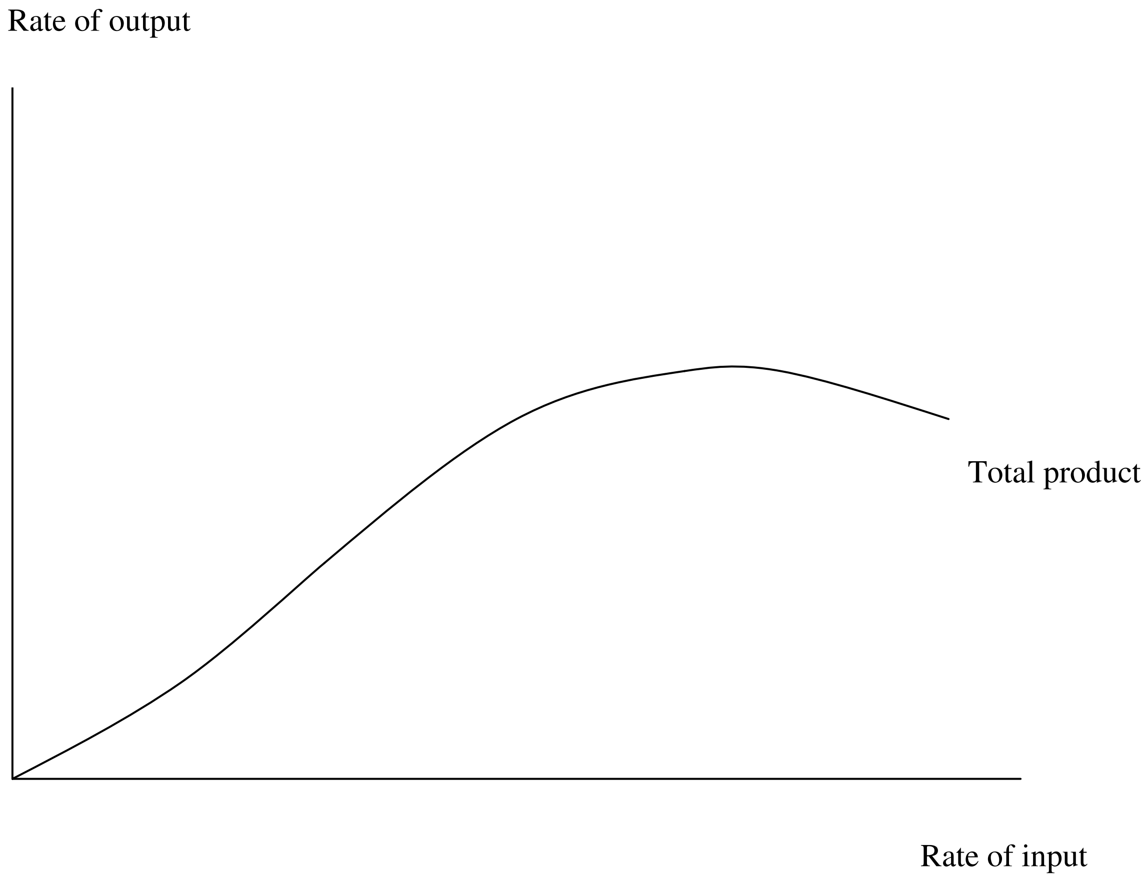
An organisation will be used if the costs of the market exceed the costs of an organisation, id est a non-price environment. Factors of the costs of the market include the solvability of the contracting party, discovering the relevant prices, the political risks, time limits, flexibility to revise contractual terms, enforcement problems and so on.

However, an organisation is not a free lunch. The use of organisations and corporations in particular are costly too. Factors of the costs of an organisation include the establishing of

9 O. Williamson, *The Mechanisms of Governance*, New York, Oxford University Press, 1999, 25.
10 R. Coase, "The Nature of the Firm", *Economica*, 4, 1937, 386-405.

organisations, monitoring the organisation, creating incentives, discovering contracting alternatives, and so forth.

Figure 2: The firm in a classic economic model



Total product function

Some theories of the firm study in detail the existence of firms and the different types of firms. Williamson studied the most important factors that influence the parties' choices. He discovered three main determinants[11]:

1. relationship specific assets
2. uncertainty and
3. frequency.

[11] O. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations", *Journal of Law and Economics* 1979, 233-261.

Or in a modern economic view:

Governance structure = f (asset specificity, uncertainty, frequency, other variables)

Williamson stressed the importance of the first determinant. Assets are specific and if they would be owned by different firms it would lead to costly protracted bargaining.

If a form of an organisation is used instead of the market, which kind of organisation will be used?

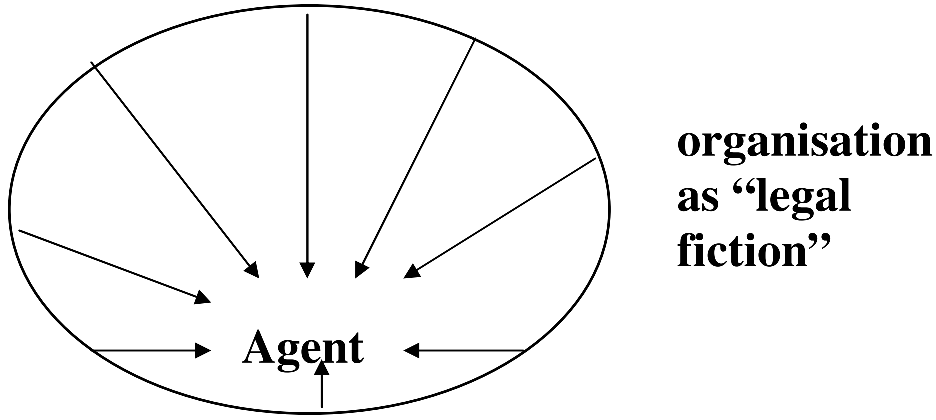
There are many different kinds of organizations and/or production. The introduction of the notion of transaction costs enables to elaborate a more general theory of economic organization. This new approach not only explains the existence of organisations, but also of different organisational forms like partnerships, franchising arrangements, joint ventures, networks, alliances, long-term contracts, corporations and so on. The theory explains how parties choose institutional arrangements that optimally mitigate the hazards.

Different intermediary forms combine to a different level some central coordination of the activities while retaining the incentives of the market. As an example we can refer to the franchise arrangements that allow to retain the price incentives of the market which the franchisee would lose in case of ownership hierarchy but mitigates the problem of asset specificity of brand-names.

The form of organisation that can survive in performing certain kinds of activities is the one that delivers the goods or services demanded by the market at the lowest price while covering the costs.

Organisations, which are distinct from the natural persons who promote and organise them, make the law of agency of particular importance. Especially if the organisation is a juristic personality – or call it a “legal fiction” - it is capable of acquiring rights and is subject to duties. Those kinds of organisations can only act by and through human beings. The organization can be considered as the principal and the human beings that act for the organisation as agents (figure 3).

Figure 3: The organisation and the agent



For different kinds of organisations the law offers a legal framework and internalises the agency relationship. The most common and by far the most important business organisation is the corporation. Companies are juristic personalities, distinct from natural persons who establish and organize them. The company can acquire rights and is subject to duties. Since it is an artificial entity it can only act by and through human beings. From that perspective it is clear that the company must be treated as the principal and those through whom it acts as the agents. Bainbridge characterizes the corporation by six attributes[12]:

- formal creation as prescribed by law;
- legal personality;
- separation of ownership and control;
- freely alienable ownership interests;
- indefinite duration and
- limited liability (and entity shielding[13]).

Others add to this list the delegated management with a board structure and investor ownership.[14] These attributes have been studied in numerous articles. Not all of these

12 S. Bainbridge, *Corporation law and economics*, New York, Foundation Press, 2002, 2.

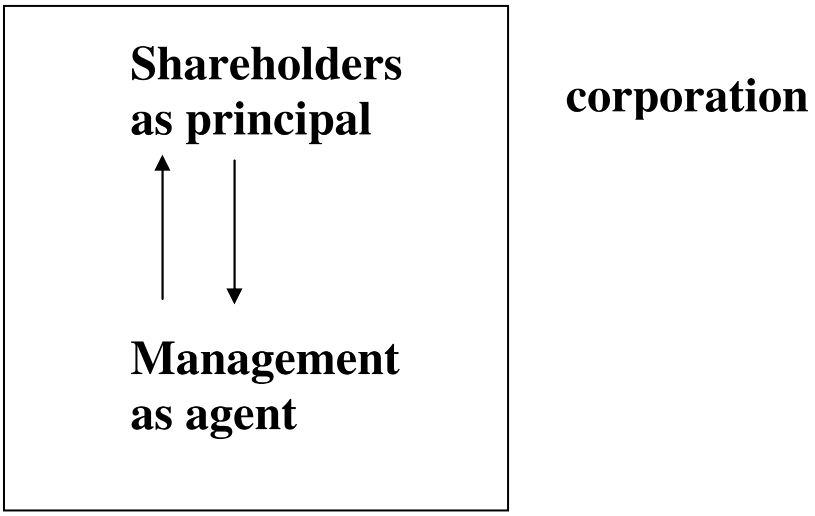
13 Bainbridge does not mention entity shielding separately. Entity shielding differs from limited liability. The latter insulates firm owners from business debt. The former indicates the protection of the business assets from the owners' personal creditors. For an analysis see, H. Hansmann, R. Kraakman and R. Squire, *Law and the Rise of the Firm*, January 2006, ECGI – Law Working Paper No. 57/2006, Available at SSRN http://ssrn.com/abstract=873507.

characteristics can be considered as a basic characteristic. Indefinite duration is not a prerequisite in some continental European countries. In some countries the law forbids indefinite duration.[15] Some characteristics have received considerably more attention than others.[16]

For the purpose of this lecture, we focus on one particular characteristic, the separation of ownership and control. First, the issue of the agency relationship in companies is addressed.

In its most elementary form the agency relationship in companies is seen as an agency conflict between management, acting as the shareholders' agents and the shareholders as principals. The management decides in which assets to invest and how to finance the investments. The model is depicted in figure 4.

Figure 4: The corporation in the agency model



The story goes as follows. "*The shareholders who owned the corporation controlled it. They elected a board of directors to whom they delegated management powers, but they retained residual control, uniting control and ownership.*"[17]

However, Berle and Means proved this story to be wrong.

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14 R. Kraakman, P. Davies, H. Hansmann, G. Hertig, K. Hopt, H. Kanda and E. Rock, *The anatomy of corporate law*, Oxford, Oxford University Press, 2003, 11-15.

15 In France the duration of the company cannot exceed 99 years (Article L 210-2 Commercial Code). Until 1984 the maximum duration of a Belgian company was 30 years. Continuation required a decision of the general meeting of shareholders.

16 Like limited liability.

17 W. Werner, "Corporation Law in Search of its Future", *Columbia Law Review* 1981, 1611.

Berle and Means' "Modern Corporation and Private Property" empirically documented the division of ownership from control in 200 large US corporations. The ultimate control appeared to be in hands of management in 44% of the corporations, only 11% were majority controlled. In the absence of a controlling shareholder, shareholders still retained the right to elect the directors but the management controls the election process. Also, other powers within the corporation flowed to the management.

The reduction of the organisation of corporation and the agency relationship to the agency conflict between shareholders and managers relied heavily on the assumptions that shareholders are principals, board and management are agents and both are not only formally distinct of each other. The work of Berle and Means illustrates inter alia that de facto the shareholders are deprived from a large part of the principal's rights. But there are several reasons to question the completeness of the model.

a) The principal

Large capital intensive industrial corporations were developed in the 19th century as no individuals or families could provide the required amounts of capital. The necessary funds were attracted from many investors.

An important feature of this corporation is the fact that all the assets the company acquires with the funds at its disposal is owned by the company and belongs only to the company. Hence and as it was already illustrated, the organisation called "corporation" is considered to be the principal, not the shareholders.

In most jurisdictions it is explicitly recognized that the directors owe their fiduciary duties and duties of care to the *company*. In a British company law textbook it can be read: "*traditionally this meant the members as a body to the exclusion of the interests of other stakeholders in the company, such as employees, creditors or individual stakeholders.*"[18]

[18] G. Morse, S Girvin, R. Morris, S. Frisby, A. Hudson, *Charlesworth Company Law*, 17ed., London, Sweet&Maxwell, 2005, 297. This view is confirmed in the Canadian Supreme Courts decision, People v. Wise. The duty of the officers and directors is to the corporation *per se* (R. Morck, *Corporations*, Harvard Institute of Economic Research discussion paper nr. 2101, January 2006, 4).

The company comes first. Exceptions occur, but only as exceptions. Different companies' acts and jurisdictions provide additional requirements or contain exceptions to the rule of the company as the principal:

> The UK companies act added in 1980 in section 309 that the directors must also have regard to the interests of the employees as a whole. This amendment does not comfort employees as they have not been offered any means to enforce this duty. Next it is not clear what directors ought to do if the interests of the members conflict with the interests of the employees as a whole.
>
> In cases of insolvency, the receiver has to act in the interests of the joint creditors.[19] Common law case law highlights the interests of the creditors in cases of doubtful solvency:
> "*In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise… But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending liquidation, return to solvency, or the imposition of some alternative administration.*"[20]
> The Belgian highest court has decided that the receiver is a judicial agent who has to act in the interest of the joint creditors and the debtor in bankruptcy.[21] Some jurisconsults even argue the receiver has to act in the collective interest.[22]

19 See the parliamentary documents to the Dutch insolvency act. This approach is criticized as the receiver has to act in the interest of the estate. He is not the agent of the joint creditors (N. Polak, *Faillissementsrecht*, Deventer, Kluwer, 1999, 148-149). Especially time constraints make an optimal assessment of all interests at stake extremely difficult. The receiver should take the collective interests into account (H. Haenen, "Curator waakt over maatschappelijk belang", *Financieele Dagblad* 4 mei 2006, 12).

20 Kinsela v Russell Kinsela Pty Ltd. (1986) 4 *N.S.W.L.R.* (722), 730.

21 Cass. 16 februari 1995, *Arr. Cass.* 1995, 181; *R.W.* 1995-96, 88.

22 E. Van Camp and G. Gijseghem, "Aansprakelijkheid van curatoren en vereffenaars" in Vlaamse Conferentie der Balie Gent (ed.), *Aansprakelijkheidsrecht*, Antwerpen, Maklu, 2004, 160.

In Germany the codetermination rules require the supervisory board to balance the interests of the shareholders, the interests of the employees and even the interests of the State[23]. The 1937 German stock corporation act contained a provision that the management board is responsible for the interests of the public good, the shareholders and the employees. The 1965 German stock corporation act no longer states ad verbatim an identical stakeholder approach as it was so obvious that it needed not to be mentioned in the law.[24] Legal scholars agree that it can be difficult to consider the interests of other parties but at the same time it is agreed that the shareholder value orientation must be combined with the expectations of other constituents inside and outside the corporation.[25]

Germany has developed a vigorous body of group law.[26] This law makes a distinction between contractual groups and de facto groups of companies. In contractual groups minority shareholders are protected by compensation rights, selling rights, dividend rights, and so on. These rights guarantee an adequate compensation for the ability of the parent company to induce the subsidiary to act against the subsidiaries interests. The interest of the group as a whole can or should be taken into account. However, there is evidence that many groups do not formalise their relationship and hence the parent has not the right to use its influence to induce the subsidiary to enter into disadvantageous transactions.[27]

Notwithstanding the relevance of these important exceptions, the general rule that the board of directors should act in the interest of the company can be maintained. In

23 R. Morck, *Corporations*, Harvard Institute of Economic Research discussion paper nr. 2101, January 2006, 4

24 For a brief overview of the history of the stakeholder philosophy in Germany, see K. Hopt, "The German Two-Tier Board: Experience, Theories, Reforms", in *Comparative Corporate Governance – The State of the Art and Emerging Research*, K. Hopt, H. Kanda, M. Roe, E. Wymeersch and S. Prigge (eds.), Oxford, Clarendon Press, 1998, 236-238.

25 For an overview of the literature see note 39 in K. Hopt, "The German Two-Tier Board: Experience, Theories, Reforms", in *Comparative Corporate Governance – The State of the Art and Emerging Research*, K. Hopt, H. Kanda, M. Roe, E. Wymeersch and S. Prigge (eds.), Oxford, Clarendon Press, 1998, 238.

26 Group law also exists in Brazil and Portugal. Other European Union countries – 15 member states - experienced with group law rules. The outcome was not positive. For an overview, see J. Embid Irujo, "Trends and Realities in the Law of Corporate Groups", *European Business Organisation Law Review* 2005, 65-91.

27 J. Dine, *The Governance of Corporate Groups*, Cambridge, Cambridge University Press, 2002, 57-58.

short, the principal is the company. What the interest of the company is, remains less clear.[28]

b) General meeting of shareholders

In an agency relationship the principal delegates some power to the agent. The contract will define which powers will be delegated. In most agency contracts the principal is in the position to determine the delegated powers.

As the company is the principal, it has no physical but only legal existence. The corporation needs assistance to express its will. “Organs” control the corporations, take corporate decisions and represent the company. The internal organisation of the company and the freedom to establish the agency relationships in companies are limited due to compulsory or at least default company rules.

The first important set of company rules relate to the organisation of the “owners” of the company. The shareholders are gathered in an “organ”, the general meeting of shareholders.

Individual shareholders cannot act individually, although different legal mechanisms are offered to shareholders to protect their interests. One of the most famous instruments is the American solicitation of proxies but also the Dutch “enquêterecht” and the Belgian individual shareholder right to request the commercial court to have the books and records of the company examined by an independent expert can be mentioned.

In general, shareholders meet in a general shareholders’ meeting which is in most European countries empowered to take different kinds of actions:

- ✓ the actions which relate to the proper functioning of the company. The agenda of the general meeting generally include:
    - o report of the board of directors;

[28] For an in-depth analysis see A. Francois, *Het Vennootschapsbelang*, Antwerpen, Intersentia, 1999, 795 p. An interesting recent illustration of the difficulties to define the interest of the company can be found in the UK Department of Trade and Industry’s white paper: “directors must promote the success of the company for the benefit of its shareholders, and this can only be achieved by taking due account of both the long-term and short-term, and wider factors such as employees, effects on the environment, suppliers and customers” (DTI, *Company Law Reform*, March 2005, London, 5)

- report of the external auditor;
- annual accounts;
- participation in the profit;
- discharge of the directors;
- discharge of the external auditor;
- (re)election/dismissal of directors;
- (re)election of the external auditor;
- other business.

✓ The actions which relate to the corporate structure of the company and those the law expressly reserved for the general meeting of shareholders. To take the Belgian companies act as an illustration the general meeting has the power to take decisions:

- on matters the articles of incorporation reserve to the shareholders' meeting;
- to continue the activities in case of serious loss of capital;
- on the acquisition (or pledge) of the companies' shares;[29]
- whether to grant third party rights, which influence the assets of the company (these rights depend on a takeover bid or a change of control);[30]
- whether to take decisions that significantly influence the assets or debts of the company or engage in obligations without consideration after the company has been informed of a takeover bid; and
- on other items for which the board decides to hear the shareholders;
- on the amendment of the articles of incorporation, including the modification of the corporate purpose.

De iure, the power to govern the company shifted to the board of directors. Most companies acts carved the separation of ownership and control into stone as the business and affairs and all residual power are managed by or under the direction of the board of directors.[31] The board is empowered to take all measures which are necessary or useful to accomplish the corporate purpose. The (general meeting of)

[29] In that case, the first general meeting requires a quorum of 50% of the subscribed capital, and the second meeting requires the attendance of one shareholder holding one share. Decisions require a majority of 80%.

[30] As above, but decisions require a majority of 75%.

[31] See Delaware General Corporation Law, § 141 (a).

shareholders has no power to initiate corporate action, cannot approve nor disapprove the overwhelming majority of corporate actions initiated by the board of directors. At most they can react. Shareholders have no right to manage the corporation: “Boards act and shareholders, at most, react”[32]. The general meeting of shareholders only has a right to elect the directors and dismiss and vote on the issues company law or directors submit for shareholder approval.

American and in particular Delaware corporate law limits the power of the general meeting of shareholders to control the board of directors. The powers of the shareholders “*are essentially limited to the election directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution*”[33]. Even for these powers the approval of the board of directors is needed, except for the election of directors and amendments of the bylaws. Due to other rules, the election and replacement of board members is not a free lunch for the shareholders.[34] Directors are elected by plurality and not by majority unless the bylaws or the charter provides otherwise. Opponents that want to stand up against the incumbent directors need to be prepared to bear the costs.

The general meeting of shareholders cannot give instructions to the board of directors. The Dutch Hoge Raad has already in 1955 decided in the Forumbank case that if the law or the articles of association of a company has empowered the board of directors to take certain decisions[35], the general meeting of shareholders has no right to usurp this right.[36] The agency relationship in a company could be better depicted as follows.

32 S. Bainbridge, *Corporation Law and Economics*, New York, Foundation Press, 2002, 193.

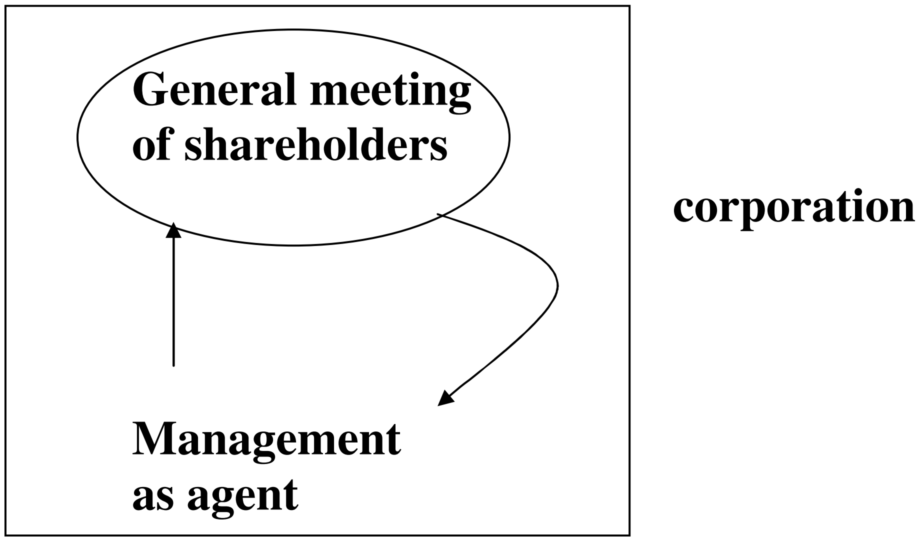
33 S. Bainbridge, “Director v. Shareholder Primacy in the Convergence Debate”, *Transnational Law* 2002, (45), 48.

34 For a detailed analysis of the rules see L. Bebchuk, *The myth of shareholder franchise*, working paper, October 2005, 39 p.

35 In the Forumbank case the board of directors was given the power to buy back shares of the company.

36 The discussion still remains whether the rule can be applied in a concern. For an analysis of this question see M.J.G.C. Raaijmakers, *Joint ventures*, Deventer, Kluwer, 1976, p. 84. For a brief overview of the different opinions, see W.J. Slagter, *Ondernemingsrecht*, Deventer, Kluwer, 2005, 623-624.

Figure 5: The corporation in the agency mode – modified view (1)



c) management and board of directors

The general agency model considers the management to be the agent of the company. Berle and Means found that in most large American corporations no one shareholder owns sufficient stock to control the corporation. Investors preferred to be passive holders of stock and avoided the involvement of the chaotic day-to-day decisionmaking and conflicts. The control vacuum that appeared in corporations was filled by management. The control shifted to management who took responsibility for running the company. This is how the story goes.

The story does not clearly distinguish between management and board of directors. In company law, the directors and not managers are considered the agents through whom the company acts. The American Model Business Corporation Act (MBCA) states: "*All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of its board of directors*."[37]

The management belongs to the board of the directors who should act bona fide for the interests of the company. The traditional board functions include:

[37] MBCA, § 8.01(b).

"(*1) establishing basic objectives, corporate strategies and broad policies;*
(2) asking discerning question; and
(3) selecting the president"[38]

Corporate boards exist as long as there are corporations.[39] To give an example: the in 1554 established "Russia company" was governed by four "sad, discreet and honest" consuls assisted by twenty-four members.[40] It is argued that early corporate boards were an imitation of town councils. These councils consisted of members and were related with merchant guilds.[41] In a guild decisions were taken by a combination of executive officers and the meeting of all the members that occurred at least each year. The latter elected the officers.[42]

The board of directors is in particular charged with managing the affairs of the corporation in the best interest of the corporation. However, company law typically does not express in detail what is expected from the board except that is must manage the company and take certain decisions.[43] In practice this is done so by delegating to the management the daily running of the business and authorise management to make operational decisions. The board of directors retains the power to hire and fire employees including the top management and to define the limits of their authority. Operational decisions are normally delegated to managers. This delegation resembles "legal" agency. The director's role is to supervise and control[44]. However in large American corporations these mid-20th century boards seemed to be not more than some kind of rubber-stamp.

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38 M. Mace, *Directors: Myth and Reality*, Boston, Harvard University 1971, 184.

39 Medieval organisations did not have boards. Those organisations were partnerships run by the family or a trused manager (F. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, working paper University of the Pacific, McGeorge School of Law, 2004, p. 32).

40 F. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, working paper University of the Pacific, McGeorge School of Law, 2004, p. 22.

41 F. Gevurtz, *The historical and political origins of the corporate boards of directors*, University of the Pacific, McGeorge School of Law, 2004, working paper, p. 41-58.

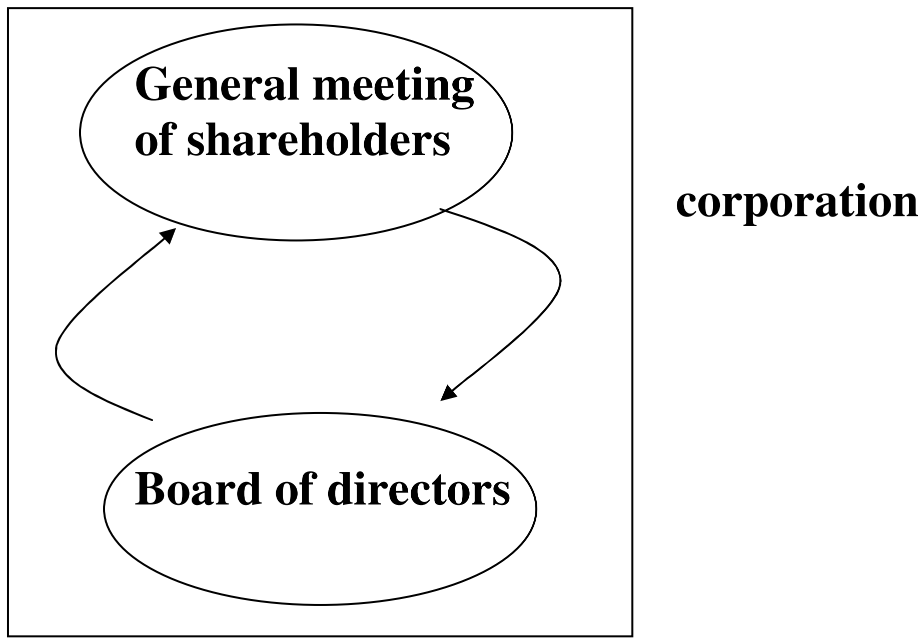
42 Reference is also made to the College of Cardinals which became the Pope's counsellors and in 1059 were granted the power to elect the Pope (decree of Nicholas II).

43 S. Dumoulin, "Board structures of the European Company", in *The European Company*, S. Dumoulin, C. Huiskes, E. Kemmeren and G. van der Sangen (eds.), Den Haag, Boom Juridische Uitgevers, 2005, 137.

44 Already confirmed by the Delaware Chancery Court in 1922 (*Cahall v. Lofland*, 114 A. 224, 229 (Del. Ch. 1921, aff. 118 A. 1. (del. 1922). In some countries the division of power into supervision and monitoring and operation is formalised in a two-tier board structure (cf. infra).

Besides, the accountability of the board of directors to the shareholders is limited. The requirement to disclose all information to the general meeting of shareholders is not absolute. The Dutch board of directors and the supervisory board do not have to provide information to the general meeting of shareholders if an important[45] interest of the company thereto exists.[46] The Belgian board of directors has a right to withhold information to the shareholders if it is established that the information could cause a serious disadvantage to the company, the shareholders or the employees.[47] Both examples are logic as the principal of the board of directors is the company. If it is in the interest of the company to remain silent, individual shareholders nor the general meeting can require information to be disclosed.

Figure 6: The corporation in the agency model – modified view (2)



Under German group law the parent company can instruct its subsidiaries. To do so, the group relationship must be formalized. In the absence of a formal relationship it is forbidden to use influence or undertake disadvantageous transactions. In case these transactions occur they not only have to be compensated but also the management board has to draft a report that only needs to be submitted to the supervisory board, not

[45] "zwaarwichtig".
[46] Dutch Civil Code Book 2:107 and 217, section 2.
[47] Article 540 Belgian Company Code.

to the general meeting.[48] Hence, the agency modeled corporation needs some further modification. This is depicted in figure 6.

d) Management and board of directors in a two tier system

In a number of European countries monitoring and managing is transferred to two bodies: the managing board and the supervisory board. The typical example of this type of companies can be found in the German “Aktiengesellschaft”, but also in the Dutch “structuurregime”. Also the Nordic countries and Eastern European countries are familiar with the two tier structure. Whether this organisational structure is efficient, remains difficult to assess. In countries were a two tier structure is not mandatory, its success is modest.[49] Anecdotic evidence indicates that monitoring management is a duty that has shifted towards other bodies or settings like preliminary meetings and committees, especially in Germany.[50]

Nonetheless, in the mean time, all European countries became familiar with the two tier board structure, due to the European company (SE). The SE can be established with a one or a two-tier board structure.[51] The legal separation of supervision and management complicates the general corporate agency model. The two tier model is depicted in figure 7.

e) The corporate form

Berle and Means believed that the limited interests the shareholders had in the large American corporation prevented the shareholders to materially affect the management. Moreover dispersed ownership was inherent to the corporate system. Technological developments, new mass production techniques and economies of scale require huge amounts of capital no entrepreneur or family could invest. Aggregating many smaller investments by selling shares to many investors helps to raise these enormous amounts.

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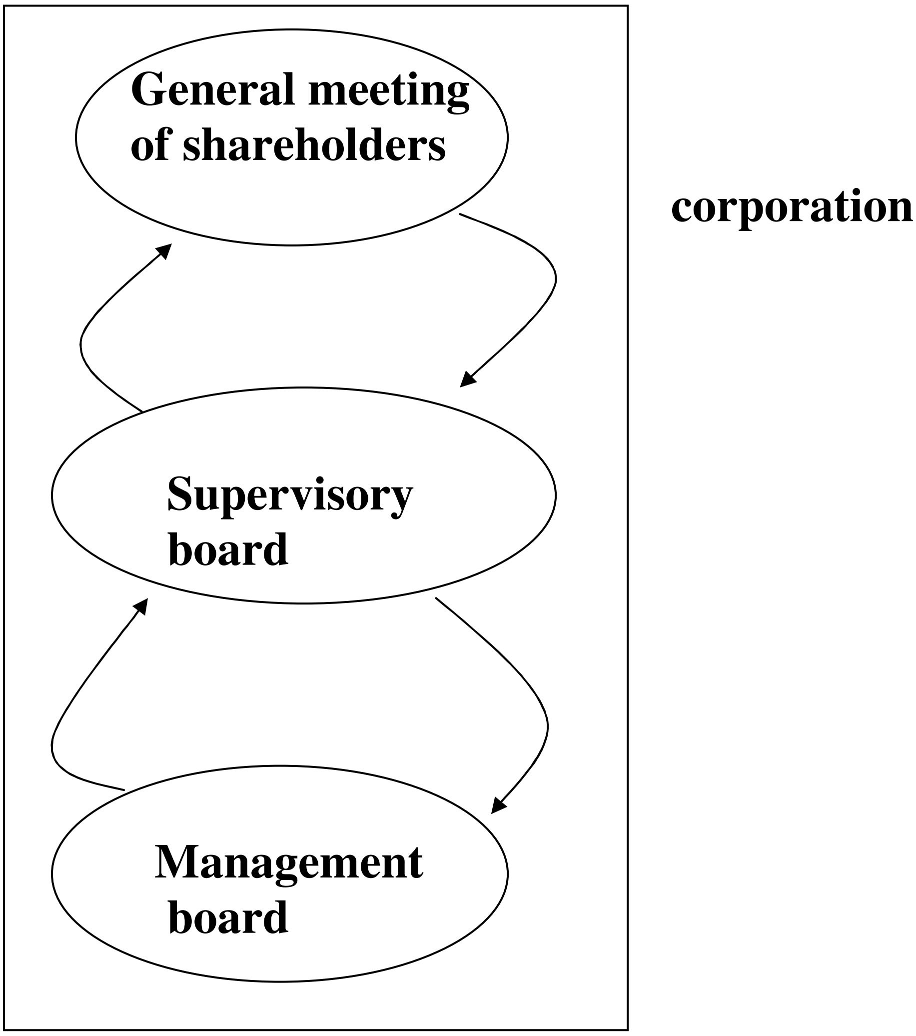
48 See the German Stock Corporation Act, section 312 to 314.

49 For Finland, see S. Helminen, “Finland”, in *European Corporate Law*, K. Van Hulle and H. Gesell (eds.), Baden-Baden, Nomos, 2006, 127.

50 This research question will not be further developed. For a discussion see M. Theisen, “Empirical evidence and economic comments on board structure in Germany”, in *Comparative Corporate Governance – The State of the Art and Emerging Research*, K. Hopt, H. Kanda, M. Roe, E. Wymeersch and S. Prigge (eds.), Oxford, Clarendon Press, 1998, 261-265.

51 The literature about the European company is overwhelming. For a discussion of the board structure, see for example S. Dumoulin, “Board structures of the European Company”, in *The European Company*, S. Dumoulin, C. Huiskes, E. Kemmeren and G. van der Sangen (eds.), Den Haag, Boom Juridische Uitgevers, 2005, 133-168.

Figure 7: The corporation in the agency model – modified view (3)



This idea of a widely dispersed ownership structure and the establishment of a shareholder democracy in the general meeting can still be found in some jurisdictions. French, Irish and Cyprian public limited liability companies need seven founders to establish the company. Portugal requires five shareholders for stock corporations. Until 1991 the Belgian Companies Act required that no shareholder could vote for more than 1/5 of the total number of votes and not more than 2/5 at any general meeting of shareholders. Voting caps are regularly found in corporate charters in

France and Belgium. The aim of the rule was the protection of minority shareholders and to guarantee the shareholder democracy in public limited liability companies.[52]

Besides, the idea of separation of ownership and control is not strange to corporate organizational law. Aforementioned it was illustrated that corporate law carved the separation of ownership into stone as the corporate decisions are assigned to the board of directors whereas shareholders have only limited power to initiate corporate actions.

However at the same time corporate law developed in other directions too. The private limited liability[53] company offers almost all of the aforementioned basic characteristics, though some of them in a slightly modified form: formal creation as prescribed by law, legal personality, limited liability, indefinite duration and some kind of alienable ownership interests. The ownership interests of private limited liability company are not easily alienable. In some countries, prior approval of the other shareholders is required to transfer the shares to third parties. In other countries, a share transfer needs a notarial deed. The freedom to transfer shares is limited though the transfer cannot be refused. The burdensome procedures that are in place to transfer the shares limit the liquidity and the value of the shares.

Separation of ownership and control is considered to be the missing prerequisite in those kinds of company types.

In wholly owned firms, the owners will probably make all operating decisions in order to maximize their utility. They will be the owners and the managers of the company and they can claim all the profits of the firm. In this kind of proprietorship, the decision agent holds the ownership of the residual claims. Single member companies can be seen as a typical example of this kind of organisation. In 1989 the Twelfth company law directive allows a single shareholder to hold all shares of the company.[54]

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52 For a discussion see H. Braeckmans, "Nieuwe regelen voor aandeelhouders en bestuurders: belangenconflict, minderheidsvordering, nieuwe regelen bij het houden van een algemene vergadering, deskundigenonderzoek", in *Het Gewijzigde Vennootschapsrecht*, H. Braeckmans and E. Wymeersch (eds.), Antwerpen, Maklu, 1991, 364-366.

53 The private limited liability company was introduced in 1971 in the Netherlands. By 2005 it is by far the most successful company type. There are approximately 633.000 private limited liability companies (BV's) registered in the Netherlands and only approximately 4.400 public limited liability companies (NV's) (figures from P. Riemer and H.A. Sijna, "The Netherlands", in *European Corporate Law*, K. Van Hulle and H. Gesell (eds.), Baden-Baden, Nomos, 2006, 271).

54 Twelfth Council Company Law Directive 89/667/EEC of 21 December 1989 on single-member private limited-liability companies, OJ L nr. 395, 30 December 1989, p. 40-42.

The directive is applicable to the private company limited by shares as the “Besloten vennootschap (met beperkte aansprakelijkheid)” in Belgium and the Netherlands, the “société à responsabilité limitée” and the German “Gesellschaft mit beschränkter Haftung”. How this company should be governed is not prescribed in this Directive. The national rules for the defined company types apply. Generally, this body will consist of the shareholder of that company, the director-shareholder. There are no reliable figures of the number of this kind of single shareholder private limited liability companies but since this company type is the most common in all European member states,[55] a considerable importance for the economy can be assumed.

However, the private limited liability company is managed by one or more salaried or unsalaried persons appointed by the articles of association or the statutes. This manager or management does not have to be a shareholder of the company.[56] Even if he is a shareholder, he will act as an “organ” of the company, not as a shareholder of the company. Hence, in a more technical legal way, there is separation of ownership and control and a specific kind of agency relationship.

Apart from the differences between the legal analysis of agency in corporate law and in economics, the question remains if public limited liability companies in other countries than the United States can be characterized in the way Berle and Means described the large American corporation. This is studied in the next section.

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[55] The estimated numbers for the private and public limited liability companies are

	Limited liability company	Stock corporation	Date
Austria	90000	2000	October 2003
Belgium	178600	82700	December 2003
Denmark	117000	39000	October 2005
Finland	188000	209	September 2005
France	985000	128000	January 2004
Germany	970000	16000	2004
Greece	24500	30000	2001
Ireland	138000	1100	December 2004
Italy	617000	41600	June 2005
The Netherlands	633000	4400	October 2005
Poland	109700	6000	2005
Portugal	471600	24200	2004
Spain	128717	2224	2004
Sweden	300000	1000	
U.K.	2100000	12500	October 2005

Source: Data collected from several contributions in K. Van Hulle and H. Gesell (eds.), *European Company Law*, Baden-Baden, Nomos, 2006, 390 p.

[56] In some countries it is a mandatory requirement for board members to be a shareholder of the company

4. *The position of the shareholder in large corporations*

In Europe and in the rest of the world facts and figures about the separation of ownership and control remained scarce until the 1990s. There were no major reasons to believe that the organisation of large corporations outside the US would be different from the general pattern found in American corporations and no research to corroborate/weaken the Berle and Means results was undertaken. However, this assumption proved to be wrong.

Until recently, little was known about the ownership structure of corporations outside the United States. One of the first studies that considered the concentration of ownership and the identity of the large shareholders in Europe was published by Franks and Mayer in the beginning the 1990's.[57] They observed that the pattern of ownership as described by Berle and Means is by no means universal. In most European countries, ownership is concentrated. In 1990, almost 85% of the German and 80% of the French large listed non-financial companies had at least one shareholder with 25% of the shares. The study of Franks and Mayer was extended by La Porta, Lopez-de-Silanes and Shleifer who identified the ultimate controlling shareholders of the 20 largest and 10 medium-sized firms in 1995 for 27 wealthy economies.[58] They classify a company as a controlled firm when a shareholder's direct and indirect voting rights exceed 20 per cent. Their study showed that less than 25% of the companies in Belgium, Italy, the Netherlands, Sweden and Spain have no major shareholder. Families, the state, or trusts in the Netherlands, are the most important shareholders. The number of German, French and Swiss companies having the same classes of major shareholders is also significant. The typical Berle and Means corporation can be found in the U.S., the U.K. and in Japan.

The European Corporate Governance Network (ECGN) studied the European ownership data. The network found that within Europe, the level of concentration of voting power is not uniform nor did it resemble the American structure.[59] The size of the voting block in different European countries and the U.S. can be found in table 1. In non-financial listed companies in Austria, Belgium, Germany and Italy a single shareholder or concerting group of shareholders

57 J. Franks and C. Mayer, "Corporate Ownership and Control in the U.K., Germany and France", *Journal of Applied Corporate Finance* 1997, reprinted in *Studies in International Corporate Finance and Governance Systems*, D. CHEW (ed.), Oxford, Oxford University Press, 1997, 281.

58 R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "Corporate Ownership Around the World", *Journal of Finance* 1999, 471-517.

59 F. Barca and M. Becht (eds.), *The Control of Corporate Europe*, Oxford, Oxford University Press, 2001.

controlled more than half of the companies in the mid-90's. The median voting block of the largest shareholder was between 52% and 57%. Sweden, the Netherlands and Spain are familiar with large minority shareholders holding a median stake of 34 to 43%. France seems to be the exception in continental Europe. The median ownership block of the largest shareholder is only 20%. The French sample differs substantially from all other samples. Only the 40 largest companies were analysed whereas in all other countries all or almost all listed entities were examined. In the United Kingdom and the United States, large shareholders are the exception. The median voting block remains beneath the 10% threshold.

Table 1: Size of the voting block by rank (mid-90's)

Country	No. of companies	Largest voting block:median	2nd largest voting block: median	3rd largest voting block: median
Austria	50	52,0	2,5	<5
Belgium	140	56,0	6,3	4,7
Germany	372	57,0	<5,0	<5
Spain	193	34,5	8,9	1,8
France	40	20,0	5,9	3,4
Italy	214	54,5	<5,0	2,7
Netherlands	137	43,5	7,7	<5
Sweden	304	34,9	8,7	4,8
UK	207	9,9	6,6	5,2
USA NYSE	1309	5,4	<5,0	<5
USA Nasdaq	2831	8,6	<5,0	<5

Source: M. Becht and C. Mayer, "Introduction", in *The Control of Corporate Europe*, Oxford, Oxford University Press, 2001, 19.

The voting blocks of other shareholders rapidly decrease. The largest voting blocks of the second largest shareholder can be found in Spain and Sweden and even in those countries the median block is less than 10%. There seems to be only one shareholder or group that controls the majority of the voting rights whereas all other shares are more or less widely dispersed.

Van der Elst confirmed the data for 1999.[60] The average voting block of the largest shareholders in Belgian, German and Italian companies exceeded 40%. In French companies and for a larger sample than in the ECGN study the largest shareholder had, on average, a majority block of more than 50%. The voting rights in hands of the largest shareholder of

60 C. Van der Elst, "The Equity Markets, Ownership Structures and Control: Towards an International Harmonization?", in *Capital Markets and Company Law*, K. Hopt and E. Wymeersch (eds.), Oxford, Oxford University Press 2003, 35-36.

British companies was with 18,3% much lower than in other European countries though much higher than the figures found by the ECGN research team.
Less than 25% of the companies in Belgium, Italy, France and Germany have no major shareholder. In the Netherlands, Spain and the UK the number is 43,8%, 57,9% and 67,5%.

The identity of the majority shareholders does not differ substantially between different European countries: founding family members or board members (especially after a buy-out) control the company either directly (U.K.) or indirectly through a pyramid of holding companies (like in Belgium, France and Italy). The situation of Germany was somewhat different: due to the absence of a mandatory take-over bid, the absence of a squeeze-out rule at the end of the 20th century and the well developed group law a large number of companies with a majority non-financial company as shareholder is stock exchange listed.

Except for Italy and Spain where some large banks control other banks the only other important class of investors who acquired majority stakes are foreign shareholders. Foreign investors control almost 1/3 of the majority controlled Belgian companies, more than 1/5 in Spain and one out of six in France (see table 2).

Van der Elst also studied the differences of the ownership concentration in different size classes. Demsetz and Lehn[61] proved that the size of the corporation influences the stake of the largest shareholder. Table 3 gives some detailed information on the average and median stake of the largest shareholder in four size classes. In all countries, the largest shareholder has on average the smallest voting block in large corporations. Nevertheless the average voting block of the largest shareholder substantially differs between different countries. Whereas large Italian corporations have a shareholder holding on average 40% of the votes, a U.K. corporation of the same size only has a shareholder owning on average 7.6% of the ordinary voting shares.

Large shareholders of large corporations in Spain, France and Germany seem to have a comparable voting block. However, when comparing means one can see large differences in the variance of the voting blocks between these countries. Half of the largest blocks in the

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61 H. Demsetz and K. Lehn, “The structure of corporate ownership: causes and consequences”, *Journal of Political Economy* 19, 1985, 1155-1177.

largest Spanish corporations do not exceed 11% whereas at least 50% of the largest shareholders of large German corporations hold a blocking minority stake of 25%.

In all other size classes, the largest shareholder has a significantly larger voting block. The differences between continental European countries and the U.K. are large for each size type. Notwithstanding the fact that the average voting block of the largest shareholder of micro caps in the U.K. is three times as large as these of the largest U.K. caps, it remains significantly smaller than the largest block in continental European corporations. In French small and microcaps, medium German corporations and Italian microcaps the largest shareholder has, on average, a majority stake. More than 50% of all French and Italian corporations, except the large caps, have one majority shareholder. The same conclusion can be drawn for medium and small German corporations.

Table 2: Number of controlled companies and identity of controlling shareholder

	Belgium 1999	Italy 1999	Spain 1999	Germany 1999	France 1999	UK 1994
Number of comp.	140	234	242	542	160	1333
Majority controlled	55	145	66	263	92	166
%	39,3%	62,0%	27,3%	48,5%	57,5%	12,5%
majority controlled by:						
individual/family		35,2%	30,3%	44,9%	43,5%	1,2%
board of directors						76,5%
non-fin. comp.	63,6%	29,0%	24,2%	34,6%	33,7%	8,4%
insurance comp.		3,4%	3,0%	2,7%		0,6%
bank	1,8%	11,0%	19,7%	3,8%	3,3%	2,4%
government	3,6%	7,6%		2,3%	2,2%	
foreign	30,9%	12,4%	21,2%	11,0%	17,4%	6,6%
foundation		1,4%	1,5%	0,8%		
other						4,2%
total	100%	100%	100%	100%	100%	100%
concerted exercise of voting > 50%	62,10%	69,50%				

Source: C. Van der Elst, "The Equity Markets, Ownership Structures and Control: Towards an International Harmonization?", in *Capital Markets and Company Law*, K. Hopt and E. Wymeersch (eds.), Oxford, Oxford University Press 2003, 40, table 16.

Another difference between the largest shareholder of a U.K. company and the largest shareholder of continental European companies concerns the ratio between the averages and median values. In the U.K., in each size class, a small number of companies have one shareholder with a significantly higher voting block. These blocks significantly influence the average. Therefore the median voting block is lower than the average in the U.K.. In all other countries at least one size class have more than 50% of the companies with a shareholder owning a block that is higher than the average.

Table 3: Concentration of the voting block of the largest shareholder (1999; UK 2001)

	Belgium	France	Germany	Italy	Spain	U.K.
average	41.71% (40.9%)	51.98% (54.9%)	46.13% (47.0%)	48.14% (51.5%)	37.91% (30.0%)	18.26% (14.1%)
st. dev.	21.72%	25.55%	26.60%	22.20%	26.95%	13.51%
maximum	88.99%	99.66%	100%	100%	100%	78.12%
minimum	<5%	<5%	<5%	<2%	<5%	<3%
Herfindahl	2430 (2557)	3518 (2856)	3062 (2856)	2973 (2794)	2409 (1366)	736 (418)
Comp. type						
Large	35.66% (34.8%)	30.13% (24.0%)	30.18% (25.0%)	40.30% (37.8%)	27.12% (10.8%)	7.65% (5.3%)
Medium	36.23% (33.3%)	53.09% (50.4%)	49.27% (56.7%)	46.38% (53.5%)	39.00% (36.0%)	12.85% (9.9%)
Small	44.21% (43.0%)	47.78% (57.9%)	59.86% (50.0%)	48.40% (52.3%)	47.56% (49.3%)	16.98% (13.0%)
Micro	42.76% (44.2%)	45.86% (67.8%)	64.55% (45.1%)	51.07% (51.1%)	35.06% (27.0%)	21.50% (16.7%)

Median values between brackets
Source: C. Van der Elst, "Industry-specificities and size of corporations: determinants of ownership structures", *International Review of Law and Economics* 2004, 432, table 2.

From all the data emerges the contrast between the traditional Berle and Means view of the corporation with a widely dispersed ownership structure, passive shareholders and controlling managers and the situation in continental Europe. The concentration of ownership is strikingly higher in continental European countries. Other shareholders do not have a countervailing power. The second, third and smaller shareholders only hold a fraction of the shares of the largest shareholder. The largest shareholders are in particular other non-financial companies or individuals. Foreign investors have acquired majority blocks in a large number of continental companies and the financial industry has large shareholdings in a significant number of Spanish and Italian companies.

What can cause these remarkable differences in ownership concentration?
A number of studies explain the different ownership patterns between different countries. From a legal perspective, La Porta, Lopez-de-Silanes, Shleifer and Vishny[62] hereafter LLSV

[62] La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., « Legal Determinants of External Finance", *Journal of Finance* 52, 1997, 1131-1150.

and La Porta, Lopez-de-Silanes and Shleifer[63] argue that the strength of investor protection rights and enforcement of these rights determine ownership concentration patterns. Roe's political analysis[64] suggests that in social democracies the government is forcing companies to stabilize employment and social welfare in general, rather than to allow companies to maximize profits for one particular class of constituents, id est the shareholders of the corporation. Further mechanisms to align the interests of managers and shareholders, like option schemes and disclosure and accountability, are harder to implement in European social democracies. This policy creates higher agency costs. To minimize these costs only large shareholders have sufficient power to supervise managers effectively and efficiently. Finally, Franks, Mayer and Rossi[65] assessed that the financing of acquisitions urged UK companies to open their ownership structure. Franks, Mayer and Wagner[66] found evidence that the German capital market developed in another way. The importance of internal financing of corporation and the acquisition of large ownership blocks is emphasized.

Within countries different ownership concentration patterns can be found due to industry-related or company-specific characteristics. Demsetz and Lehn[67] demonstrated that in the mid eighties ownership patterns depended on company size, the instability of the firm's operating environment, regulation of firms and some sector activities like sports and media. Further, the ownership structure is chosen so as to maximize performance[68]. Bebchuk[69] hypothesized that controlled corporations should be expected to be more common in countries in which private benefits of control are large and vice versa. In those countries a founder is unlikely to relinquish control after an IPO or a capital increase. Notwithstanding the fact that countries differ greatly in their incidences of controlled corporations and corporations with a dispersed ownership structure, in most countries some companies of each type can be found. Therefore, Bebchuk argues, even in countries with a high level of investor protection rights some

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63 La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., « Corporate Ownership around the World", *Journal of Finance* 54, 1999, 471-517.

64 M. Roe, *Political determinants of corporate governance*, Oxford University Press, Oxford, 2003.

65 J. Franks, C. Mayer and S. Rossi, *The Origination and Evolution of Ownership and Control*, ECGI Finance Working paper nr. 09/2003, 63 p.

66 J. Franks, C. Mayer, H. Wagner, H., *The Origins of the German Corporations – Finance, Ownership and Control*, ECGI Finance Working paper nr. 11/2005, 60 p.

67 H. Demsetz and K Lehn, "The structure of corporate ownership: causes and consequences", *Journal of Political Economy* 19, 1985, 1155-1177.

68 H. Demsetz and B. Villalonga, "Ownership Structure and Corporate Performance", *Journal of Corporate Finance* 7, 2001, 209-233.

69 L. Bebchuk, A *Rent-Protection Theory of Corporate Ownership and Control*, Cambridge, NBER Working paper nr. 7203, 1999, 37 p..

shareholders will gain private benefits out of control because there are company-specific and industry-specific parameters.
These parameters could be driven by opportunities to engage in self-dealing transactions, to take corporate opportunities or to profit from non-pecuniary benefits. At the company specific level Lamba and Stapledon[70] found a relationship between the level of related party transactions, a proxy for private benefits of control and the presence of a large shareholder.

In spite of all these additional studies, the seminal work of LLSV seems to be the most influential article that was published in the field of the corporate governance and economic analysis of corporate law. Therefore, it deserves further study.

[70] A. Lamba and G. Stapledon, *The Determinants of Corporate Ownership Structure: Australian Evidence*, University of Melbourne, Public Lax and Legal Theory working paper nr. 20, 2001, 28 p.

5. Agency, law and finance and ownership developments in and outside the financial services industry

a. Agency and ownership in the "law and finance" theory

When management is separated from ownership, the recipients of the profit differ from the agent whose decisions determine the firm's profit level. The agents do not bear a substantial share of the wealth effects of their decisions. Berle and Means recognized that the separation of ownership and control in the large American corporations created a risk that the interests of the shareholders and the management diverge. The shareholders, as residual claimants, are entitled to the corporation's profits. Management is empowered to decide how to manage the company, how the resources of the company will be used and how the earning will be spent. The company's earnings can be used to buy new private jets and nice corner offices or be distributed among all shareholders. Corporate law can respond to the potential divergence of the shareholder and the managerial interests. It can do so in a number of ways. It can give shareholders more control over the firm. It can offer instruments to discipline managers in case they put their own interests before the interests of the shareholders. Law can also offer mechanisms to align the interests of the shareholders and the managers.

Law and finance theories study the strength of corporate law and securities law to protect the investment community and shareholders. The differences in legal protection of investors can help to explain the differences in the separation of ownership from control. How can shareholders cope with poor laws denying the interests of the shareholders and allow managers to shirk the shareholders? The lack of legal protection of shareholders can result in higher concentration of ownership. Shareholders and investors in countries that offer poor protection for their investments respond with acquiring or holding large stakes in the company to improve their control position. The company law offers more rights to shareholders which have more ownership rights.

In the 1990s La Porta, Lopez-de–Silanes, Shleifer, and Vishny (LLSV) explored in their seminal paper of "law and finance" the determinants of ownership concentration.[71] LLSV and

[71] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, R. Vishny, « Legal Determinants of External Finance", *Journal of Finance* 52, 1997, 1131-1150.

La Porta, Lopez-de-Silanes and Shleifer[72] argue that the strength of investor protection rights and enforcement of these rights determine ownership concentration patterns.

LLSV define the one share-one vote rule and an index of six shareholder rights as the determinants of financial market development and ownership concentration. The criteria in the "anti-director index" are:

- The company or commercial code requires the ordinary shares to carry one vote per share. Multiple voting or non-voting ordinary shares are not allowed and firms cannot set a maximum number of votes per shareholder;
- the country allows shareholders to mail their proxy votes to the firm;
- the shareholders are not required to deposit their shares prior to the general shareholders' meeting;
- cumulative voting (id est to cast all the votes for one candidate standing for election to the board of directors) is allowed or proportional representation in the board is allowed;
- an oppressed minorities mechanism is in place. This mechanism ensures minority shareholders – a shareholder who owns 10% or less of the shares - a judicial venue to challenge decisions of management or of the general meeting or a right to be sold out of the company when they object certain fundamental changes;
- the company or commercial code grants shareholders the first opportunity to buy new issues of stock – preemptive rights – that can only be waived by the general meeting of shareholders;
- a share stake of 10% or less entitles a shareholder to call for an extra-ordinary shareholders' meeting

More recently, La Porta, Lopez-de-Silanes and Shleifer examined the effect of securities laws on stock market development. Stock market development was measured as the value of the shares, other than those owned by the three largest shareholders. The stock market development can be considered as a proxy of ownership concentration. Extensive disclosure

[72] R. La Porta, F. Lopez-de-Silanes and A. Shleifer, "Corporate Ownership Around the World", *Journal of Finance* 1999, 471-517.

requirements and an accessible procedure to recover investor losses are positively related with larger stock markets.[73]

The Djankov, La Porta, Lopez-de-Silanes and Shleifer team reshuffled the anti-director index for an even larger number of countries in an "anti-self dealing index". This index is used to asses the risks of self-dealing in companies with large shareholders. The paper argues that full disclosure of this type of transactions and the requirement of approval of disinterested shareholders offers the most effective regulatory strategy.[74]

Law and finance theory developed at the speed of light. To name but a few: Demirgüç-Kunt and Levine found that civil law countries have an underdeveloped financial market system whereas common law countries create incentives to develop a market based system which has a positive influence on the creation of wealth.[75] Rajan and Zingales and Mayer and Carlin emphasized the importance of a developed financial market for those industries with a larger need of external finance.[76] Demirgüc-Kunt and Maksimovic added legal variables to assess the influence of these variables on growth.[77]

Legal systems that offer investors a large bundle of these rights tend to have shareholders who acquire smaller stakes in large listed corporations. Hence, ownership concentration is used as a substitute for poor legal protection.

This line of research with its emphasis on the development of an appropriate corporate and securities regulatory framework needs further analysis. There are at least three fields in which further research is required.

First LLSV analysed a limited number of shareholder rights. The relationship between the most important constituents of the company, the shareholders, the board of directors and the

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73 R. La Porta, F. Lopez de Silanes. and A. Shleifer, *What Works in Securities Laws?,* Tuck School of Business Working Paper No. 03-22, July 2003, 40 p.

74 S. Djankov, R. La Porta, F. Lopez-de-Silanes, A. Shleifer, *The Law and Economics of Self-Dealing*, working paper, December 2005, 39 p.

75 A. Demirgüç-Kunt and R. Levine, *Bank-based and market based financial systems: Cross country comparisons*, World Bank Working Paper nr 2143, 1999.

76 R. Rajan and L. Zingales, "Financial dependence and growth", *American Economic Review* 1998, 559-586 and W. Carlin and C. Mayer, *Finance, Investment and Growth*, working paper presented at the Conference "Convergence and Diversity in Corporate Governance Regimes and Capital Markets", Eindhoven, 4-5 november 1999, 42 p.

77 A. Demirgüc-Kunt and V. Maksimovic, "Law, Finance, and Firm Growth", *Journal of Finance* 1998, 2107-2137.

management is composed of many other elements. Cools addresses this issue. Cools emphasizes the importance of the differences in the distribution of powers.[78] In the United States the board of directors and even more the management has the necessary power to run the corporation. The shareholders and the other constituents of the corporations do not have equal possibilities to intervene. She illustrates these differences referring to the differences in the allocation of decision-making power, the agenda-setting power, the default versus mandatory corporate law rules and in particular the removal of directors. In the United States, and in particular in Delaware, the board of directors is the holder of the primary management power, whereas the shareholders' meeting in many European countries has considerable broader powers, in particular to amend the company's constitutional documents. In the United States filing a proposal for the agenda of the general meetings of shareholders is prohibitively expensive for shareholders. In European countries, the shareholders who have a stake granting the right to convene a general meeting, can generally also set the agenda. The American corporate law has a more flexible approach to reallocate rights than European law. In Europe, it is impossible to assign the board of directors with powers that are statutorily reserved to the shareholders' meeting. In particular it is relatively easy to dismiss directors in European companies than it is in the United States. European directors can be removed without a cause.[79] Another line of research should be to study the liability regimes of the directors: are the duties of care or of loyalty and the limits of the fiduciary obligations different in different countries?[80]

Related to the former issue, Rose critically assesses the methodology of the LLSV law and finance reports.[81] He concludes that the knowledge of the relative importance of the various formal investor rights is limited. Using dummy-variables to indicate the presence of a right is too general and does not reflect the underlying powerful forces. He suggests that the level of investor protection should be measured as the ratio of actual minority votes cast at the general meeting to the total number of minority shares.

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78 S. Cools, "The real difference in corporate law between the United States and continental Europe: Distribution of powers", *Delaware Journal of Corporate Law* 30, 2005, 697-766.

79 Especially L. Bebchuk recently addressed this issue in L. Bebchuk, "The case for increasing shareholder power", *Harvard Law Review* 2005, 833-917 and L. Bebchuk, *Letting shareholders set the rules*, Harvard Law and Economics Discussion Paper nr. 548, March 2006, 31 p.

80 For an analysis of this issue, see H. De Wulf, *Taak en loyauteitsplicht van het bestuur in de naamloze vennootschap*, Antwerpen, Intersentia, 2002, 910 p.. For an analysis of the risks independent directors encounter, see B. Black, B. Cheffins and M. Klausner, "Liability risk for outside directors: A cross-border analysis", *European Financial Management Journal*, 2005, 153-171.

81 C. Rose, *The challenges of quantifying investor protection in a comparative context*, working paper Copenhagen Business School, 2006, 46 p.

Second, the thesis of LLSV is based on one-year data. In their Law and Finance paper the authors analysed different dependent variables, like ownership concentration, initial public offering activity, size of the stock market, etc. for 1994. For the "anti-self dealing index" the authors used an aggregate index of five years for initial public offerings and stock market capitalizations and listed entities. However for ownership data they continued to use the ownership concentration at one particular point in time.
If corporate and securities law in a particular country improves, the ownership concentration of listed entities in that country should decrease.

Third, the law and finance approach of LLSV assesses the influence of corporate, commercial and securities law on ownership concentration of non-financial companies. They did not address the issue to what extent different industries are confronted with different rules and markets that could influence their ownership structure, nor did they take into account the different interests that different kinds of large shareholders might have. The recent Dutch experience with a number of hedge funds illustrates the different behavior of different classes of shareholders.

A number of these issues will be addressed more in detail in the next paragraphs. First, the development of the legal framework will be discussed. Next the evolution of ownership structure over the last ten years will be drawn. Finally the specificities of the financial services industry will be assessed and the ownership developments of this industry will be examined.

b. Recent legal and ownership developments

Since the collapse of Enron and revelations of corporate misconduct the corporate and auditing world has changed. Corporations have introduced new internal control procedures and have reported their new governance structures. Large audit firms have been reorganized. The "Big Four" have sold (parts of) their consultancy networks and these audit firms no longer offer a wide range of non audit services to controlled firms.

These business and ethical reflections have not prevented the regulators from diagnosing the causes and issuing new laws and rules to restore or enhance confidence in corporate behavior, financial reports and audits. To name but a few of the recent reforms: the American Sarbanes-Oxley Act (SOA), (parts of) the German Corporate Governance Code – Kromme-Codex[82] – and the "TransPuG" Act[83], the Vorstandsvergütungs-Offenlegungsgesetz, the Irish Companies (Accounting and Auditing) Act 2003, draft clauses and reports to reform the UK Companies Act[84] and the Companies (Audit, Investigations and Community Enterprise) Act 2004, the Italian "Riforma organica della disciplina delle società di capitali"[85], the Belgian "corporate governance" Act[86] and the law of 16 January 2006 requiring to report the important risks and uncertainties the company has to deal with[87], The French Acts to enhance the "financial security" and for new economic rules[88], The Dutch Tabaksblat Code and the law of 5 July 2004 to amend the Dutch Civil Code with respect to the structure regime[89].

Most of these acts, bills, reports and best-practice guidelines emphasize the importance of the well-functioning of the board, the importance of a balanced composition of the board of directors with a sufficient number of non-executive and independent board members, committees to study particular issues and problems like the internal and external audit and remuneration of directors[90] and executive managers, and the internal control procedures of the company. Also, a number of these reforms contain new rules on auditor supervision and auditor independence.

Further, the European Union restarted its activities in the field of corporate law after a period of approximately ten years of standstill.

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82 The final version of the Code has been published in *Aktiengesellschaft* 2002, 236. The Code was amended in 2003. The final version can be downloaded, free of charge: www.corporate-governance-code.de.

83 *Bundesgesetzblatt* 25 July 2002, p. 2681.

84 See the Combined Code of July 2003. Other examples are the British Modernising Company Law – draft clauses and the review of the regulation regime of the accountancy profession, The Final Report to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer by the Co-ordinating Group on Audit and Accounting Issues, January 2003; The Audit Committee Combined Code Guidance (Smith report), January 2003, The Higgs report, January 2003, etc.

85 Law of 17 January 2003, Official Italian Gazette, 22 January 2003, S.O. nr. 8.

86 Law of 2 August 2002, Official Belgian Gazette, 22 August 2002, p. 36555.

87 Law of 16 januari 2006, Official Belgian Gazette, 20 January 2006, p. 3118. See in particular the articles 96 and 119 of the Companies Code.

88 *Loi n° 2003-706 sur la sécurité financière*, August 1, 2003, *Official Journal*, n° 177, August 2, 2003, p. 13220 and *Loi n° 2001-420 sur les Nouvelles régulations économiques*, May 15, 2001, *Official Journal*, May 16, 2001, p. 7776.

89 The latter empowers the general meeting of shareholders to appoint the supervisory board members and grants new powers to vote on important decisions, like the remuneration policy.

90 Like the British Directors' Remuneration Report Regulations 2002.

In a recommendation of December 2004 the European Commission emphasized the importance of the disclosure of the remuneration policy of the directors and information of the amount and form of the individual remuneration packages.[91]

The Recommendation of February 2005 on independent directors ensures the presence and role of independent non-executive directors on listed companies' boards.[92] They are considered the countervailing power against the executive and powerful executive board members.

The European internal market will be strengthened due to the new 10th Company Law directive on cross-border mergers. The directive will curtail the prohibitive cross border merger costs.[93]

The 4th and 7th Accounting Company Law directives will be revised. The proposed amendments of October 2004 to the accounting directives confirm the collective responsibility of board members for financial statements and key non-financial information, increase the transparency of transactions with related parties, improve the provision of information about off-balance sheet arrangements and require listed companies to disclose a corporate governance statement.[94]

The auditing profession will be reformed and the convergence of auditing standards is endorsed in the modernized 8th company law directive.[95] The capital market must be provided with and independent assurance of reliable corporate reports. The directive will require the use of international standards on auditing, strengthen the public oversight of auditors, require the compliance with ethical and independence standards, endorse the responsibility of group auditors.

The modernized 8th company law directive requires of the listed entities to establish an audit committee or assign the duties of this committee to the administrative or supervisory body. This audit committee must perform:

- The monitoring of the financial reporting process;

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91 Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 25 February 2005, nr. 52, 51.

92 Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies, OJ L 29 December 2004, nr. 385, 55.

93 Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies, OJ L 25 November 2005, nr. 310, 1.

94 Proposal for a Directive of the European Parliament and the Council amending Council Directive 78/660/EEC and 83/349/EEC concerning the annual accounts of certain types of companies and consolidated accounts, COM (2004) 725 Final.

95 Directive 2006/43/EC of the European Parliament and the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 9 June 2006, nr. 157, 87.

- The monitoring of the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- The monitoring of the statutory audit of the accounts;
- The monitoring and assessing of the independence of the auditor, in particular when he provides additional services to the audited entity.[96]

The transparency directive requires listed entities to report on the principal risks and uncertainties that group of companies face.[97]

Directors and other persons discharged with managerial responsibilities of an issuer shall disclose transactions in financial instruments of the issuer to the competent authority and the market must be informed about the transaction as soon as possible.[98]

A particular line of reforms addresses the issue of active shareholder engagement. The investment chain of intermediaries disconnects the ultimate owners with their investments in the company. The European Commission issued in January 2006 a proposal for a directive on the exercise of voting rights by shareholders of member states.[99] The objectives of this proposal are to abolish the share blocking rules – one of the LLSV anti-director rights – in order to enhance the possibilities to electronically participate in the general meeting, to be able to vote without attending the meeting and to ensure the timely convening of the meeting and the timely distribution of the documents.

Other actions that the European Commission announced or the European Union has decided and that can facilitate a broader and more efficient capital market with value-creating enterprises are:

- The requirement to apply International Accounting Standards/International Financial Reporting Standards;

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96 Detailed rules with respect to the provision of additional services can be found in the Commission Recommendation of 16 may 2002 Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, OJ L of 19 July 2002, nr. 191, 22.

97 Article 4 of the Directive 2004/109/EC of 15 December 2004 of the European Parliament and of the Council on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L nr. 390, 31 December 2004, 38.

98 Article 6 of the Directive 2003/6/EC of 28 January 2003 of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), OJ L nr. 96, 12 April 2003, 16.

99 Proposal for a Directive of the European Parliament and the Council on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted tot trading on a regulated market and amending Directive 2004/109/EC, COM(2005) 685 final.

- The proposal for a directive to simplify the rules with respect to the formation of the company and the maintenance of capital[100]
- The establishment of a European Corporate Governance Forum and an Advisory Group on Corporate Governance and Company Law.

A comparative legal analysis of all new rules and measures must address the improvements of the corporate organisation and the reduction of agency problems within the corporation. The first studies on the improvements of all these new measures are started but much more research is needed. A large number of new rules still need to be transposed in the individual member states and the influence on the market and corporate organisation only starts to emerge.

Martynova and Renneboog developed several corporate governance indices for 30 European countries and the US over the period of 1990 and 2005.[101] The index contains variables on one-share-one vote, non-voting shares, multiple voting shares, the use of proxy votes, the equal treatment principle, the protection of minority shareholders, pre-emptive rights, the requirements to call an extra-ordinary general meeting, voting caps, minority claims, etc. A large number of these variables will be strengthened in the near future due to the new European requirements. Notwithstanding the European developments, the first results already indicate the improvement of regulatory provisions to protect shareholders. Figure 8 depicts the development of the availability of these rights in different groups of countries in Europe. The shareholder protection index of Lele and Siems shows a similar pattern for a large number of protective shareholder measures in a limited number of countries over a period of 35 years.[102]

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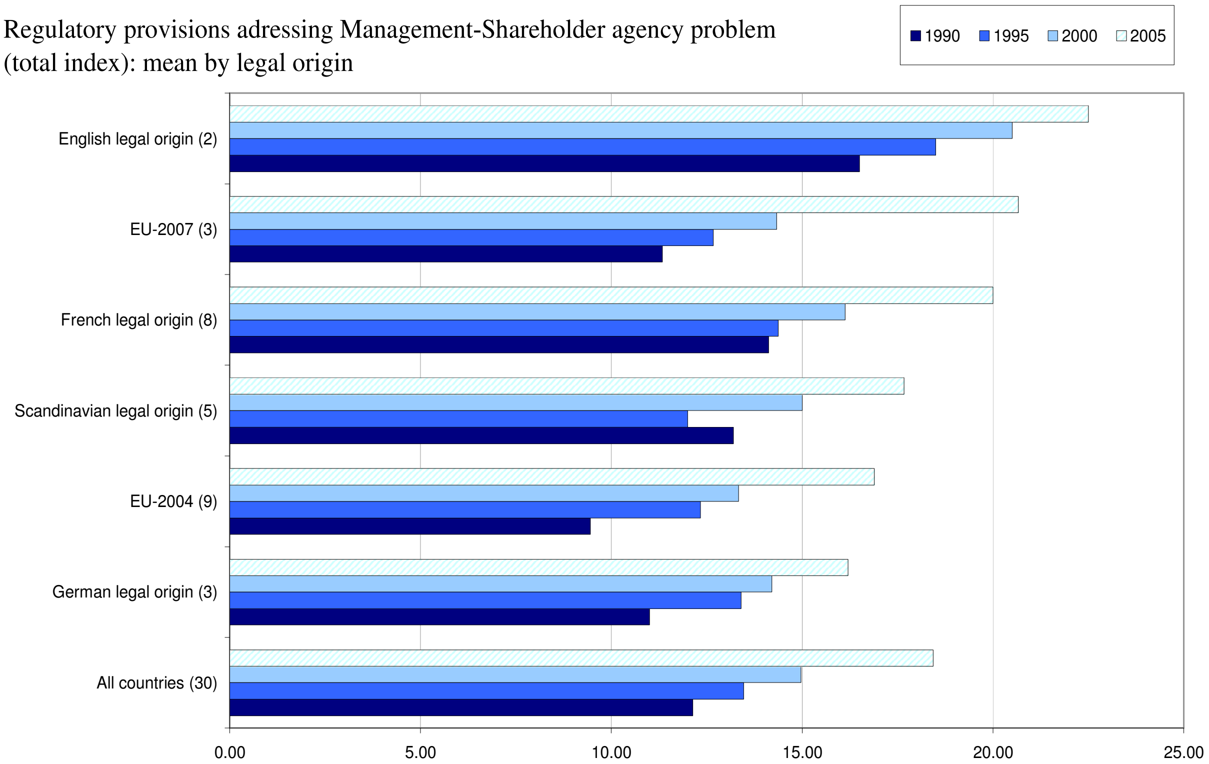
[100] Proposal for a directive of the European Parliament and the Council amending Council Directive 77/91/EEC, as regards the formation of public limited liability companies and the maintenance and alteration of their capital, COM(2004) 730.

[101] M. Martynova and L. Renneboog, *Corporate governance indices: convergence and diversity of national corporate governance regulations*, Discussion paper CentER, Tilburg University, 2005.

[102] P. Lele and M. Siems, *Shareholder Protection: A Leximetric Approach*, Working Paper Centre for Business Research, University of Cambridge, May 2006, 35 p.

Figure 8:



Source: L. Renneboog, *Does Corporate Governance Matter?*, background paper to the inaugural lecture, Tilburg University, 9 December 2005, p. 45.

If there is causation or at least correlation between the legal framework and ownership concentration, long term developments of the ownership structures should reflect the improvements in legislation. In light of the law and finance theory, the enforcement and endorsement of investor protection rights will lower ownership concentration. This hypothesis has not been tested so far for the medium/long term. Given the disclosure requirements the European Union introduced at the beginning of the 90's, it is possible to study the development of the ownership structure of a large number of companies in several European countries. Figure 9 summarizes the developments in ownership concentration over a period of ten years in five European countries: Belgium, France, Germany, Italy and the UK. The Netherlands is not part of this analysis due to the disconnection between voting rights and control of large corporations. Companies that were stock exchange listed in 1995, in 1999 as well as in 2005 are part of the sample.[103] This requirement reduces the sample significantly[104]

[103] For Belgium 1996 data are used, for the UK 1994 and 2001 data. In 1995 capital rights in French companies are used, instead of voting rights. The availability of both the data for voting and for capital rights for other years indicate that the capital block of the largest shareholder is on average smaller than the voting block, due to the existence of double voting rights for "stable" shareholders.

but it has the advantage that it reduces noise in the sample due to the elimination of the influence of the particular ownership structures of initial public offerings and of companies in a delisting procedure.[105]

The data confirm the larger dispersion of ownership in British companies than in continental European companies. The largest shareholder of British companies has on average a voting block of less than 20%, less than half of the average voting block of the largest shareholder in continental European companies. French and Belgian companies have large shareholders with a voting block of approximately 40%. The size of the stake of the largest shareholder of German and Italian companies resembles one another. A voting block of 50% is common in both countries.

The development of the ownership concentration in these countries only partly support the Law and Finance theory that the improvement of investor protection rights correlates with lower ownership concentration levels. The introduction of the Cadbury code as a listing requirement in the mid-nineties could be the explanation of the decrease of the average voting block of the largest shareholder from 20,5% to 15,9%. However, later improvements of the position of minority shareholders of British companies, like the requirement to approve the remuneration report seem to have no effect on the ownership concentration levels. Ownership concentration soared from 15,9% to 17%.

A similar development can be found in Belgium. The 1995 company law changes can be an explanatory variable for the decreasing ownership concentration. The 1995 amendments introduced a squeeze-out procedure, restructured the rules for shareholder agreements and share buy-backs and sharpened the rules to apply in case of a conflict of interest.[106] The average size of the largest voting block fell with almost 6% from 44,1% to 38,5%. The decline did not continue in the beginning of the 21st century. The ownership concentration soared. The largest voting block was in 2005 40,8% on average, notwithstanding the 2002 company law amendments. In 2002 a requirement to install a committee of three independent directors to assess conflicts of interests and rules for corporate opportunities were introduced,

104 58 Belgian, 65 French, 155 German, 95 Italian and 162 British companies were listed over the period of ten years and are in this sample.

105 For an analysis of the development of the ownership structure of initial public offerings, see M. Goergen and L. Renneboog, "Prediction of control concentration in German and UK IPOs", in *Convergence and Diversity of Corporate Governance Regimes and Capital Markets*, J. Mc Cahery et al. (eds.), Oxford, Oxford University Press, 2002, 251-267.

106 For a detailed analysis of the changes see E. Wymeersch and H. Braeckmans (eds.), *Het Gewijzigde Vennootschapsrecht 1995*, Antwerpen, Maklu, 1996, 507 p.

as well as new requirements to guarantee the independence of auditors. It is puzzling that these improvements seem to have no positive influence on ownership concentration.

The French 1995 Vienot Corporate Governance Code seems to have no negative influence on ownership concentration.[107] Hard law – the 2001 NRE law and the 2003 LSF law – does have an effect. The voting block of the largest shareholder decreased from 43,9% in 1999 to 40,4% in 2005. It might be that the influence of the new rules is not yet fully reflected in the figures, due to time lags.

The significant German legislative reforms – at least ten major new securities and companies acts were published between 1994 and 2004[108] – caused, if anything, an increase in the ownership concentration. Since 2005 the largest shareholder controls the corporation with a voting block of more than 50%, up from 47% in 1995.

Finally, the Italian developments of the ownership concentration are not in conflict with the Law and Finance hypothesis but they do not support the theory. The stake of the largest shareholder of Italian companies decreased from 51,4% in 1995 to 47,8% in 2005 but the major legal amendments of corporate and securities acts were enacted after 1999, whereas the decline in concentration took place in the second half of the 90's. As the most important legal reforms came into force in 2003, it might be that ownership concentration did not yet respond to the new legal framework.

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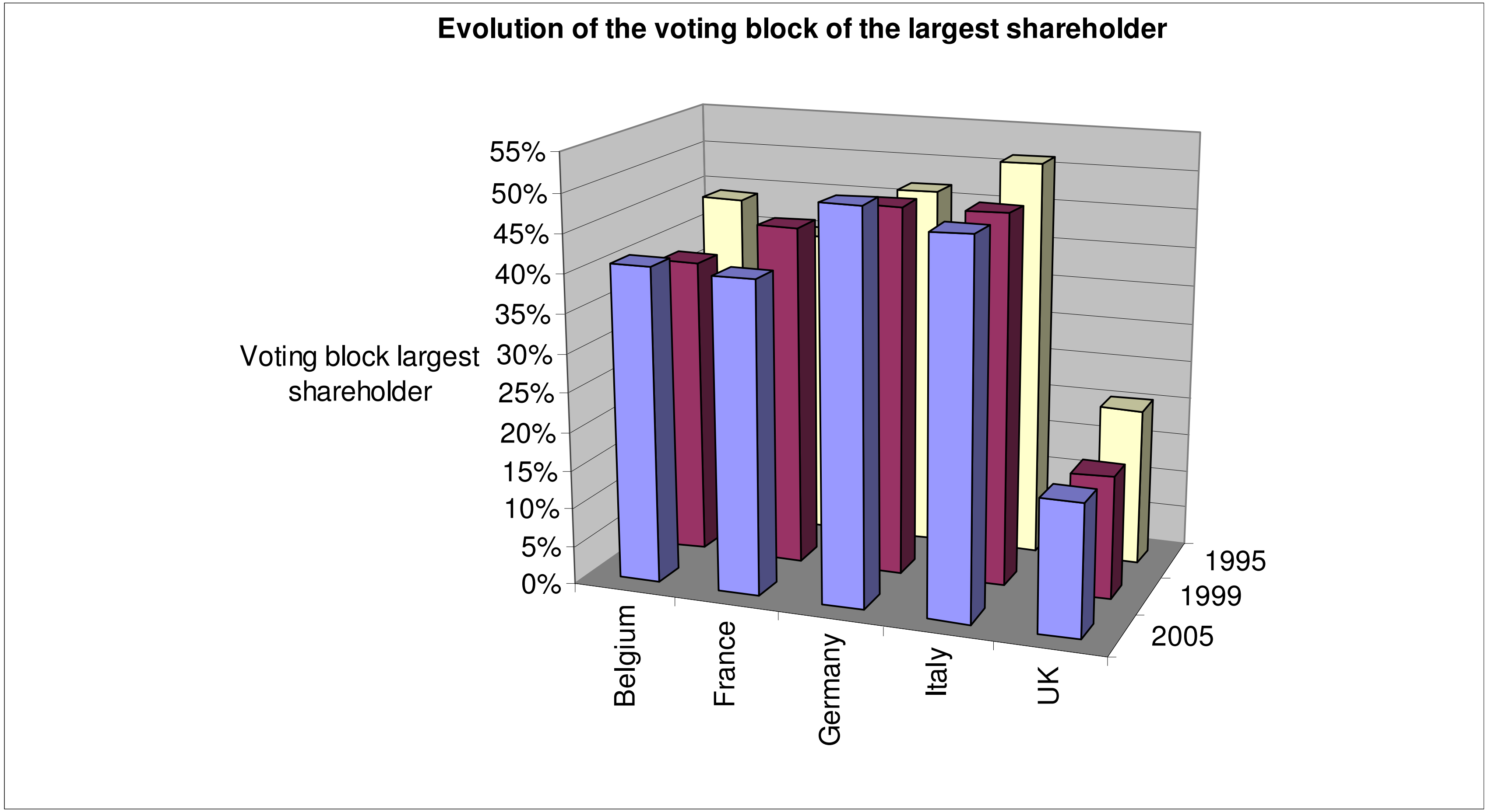
107 The development of the ownership concentration from 1995 to 1999 should be read with caution due to the different concentration ratio which was used: capital rights concentration figures for 1995, voting rights concentration figures for 1999.

108 Including better protection of shareholder rights. In particular minority shareholders have better access to company information and can easier cast their votes. For an analysis of the major German reforms, see U. Noack and D. Zetzsche, *Corporate Governance Reform in Germany: The Second Decade*, Working paper Center for Business and Corporate Law, Heinrich-Heine-Universität Düsseldorf, June 2005, 49 p.

Figure 9: Evolution of the voting block of the largest shareholder



The data for Belgian are for 1996, 1999 and 2005; the data for the UK are for 1994, 2001 and 2005; the 1995 French data are capital rights.
Source: own research

Ownership structures can be studied in a number of ways: identity of the identified shareholders, the identified versus non identified stakes, majority versus minority shareholders, herfindahl-indices, etc. The distribution of the voting block of the largest shareholders illustrates the importance of certain voting thresholds. If shareholders acquire more shareholder rights or the rights attached to certain voting thresholds changes, law and finance theory predicts that ownership concentration will be redirected to new and lower equilibria.

The figure for the UK shows that majority shareholders are uncommon in British listed company. In 2001 and 2005, less than 5% of the companies had a shareholder who controls the British corporation. In 1994 this ownership pattern was found in more than 10% of the British corporations. This is due to the 1994 consolidated approach of the ownership of shares by the board of directors. In 1994, all but one controlled company had as a majority shareholder the board of directors. The British takeover rules which were introduced in the late sixties can be considered as the major catalyst of the widely dispersed ownership pattern of listed companies. It requires shareholders who acquire a voting block of more than 30% of the votes, to take over all other shares. Hence, listed entities with a major shareholder are the exceptions in the United Kingdom.

The distribution of the relative importance of the voting block of the largest shareholder of continental European companies differs significantly from the British model. The threshold of 30% is of less importance and the companies with a widely dispersed ownership structure are uncommon. Less than 10% of the companies in Belgium, in Italy and in Germany have only shareholders with less than 10% of the votes.

The threshold of 50% of the votes is of high importance in France, in Germany and in Italy. More than 20% of all French and Italian companies have a shareholder with a voting block between 50% and 60%. In approximately 10% of the German corporations the largest shareholder owns 50% to 52% of the votes. Another important threshold is 25% in German corporations and 33% in French corporations. It allows the blocking of important decisions to be taken by the general meeting of shareholders.

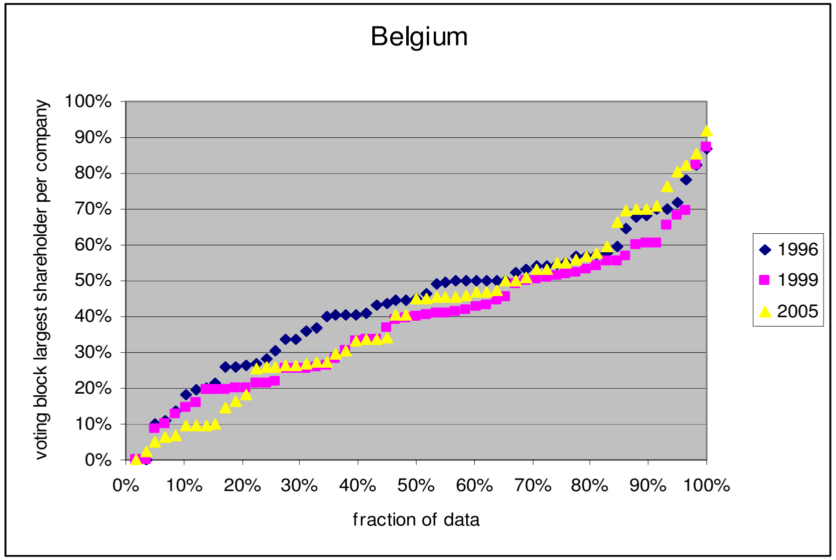
In Belgium, the thresholds of 25% and 50% are considered to be relevant though less outspoken.

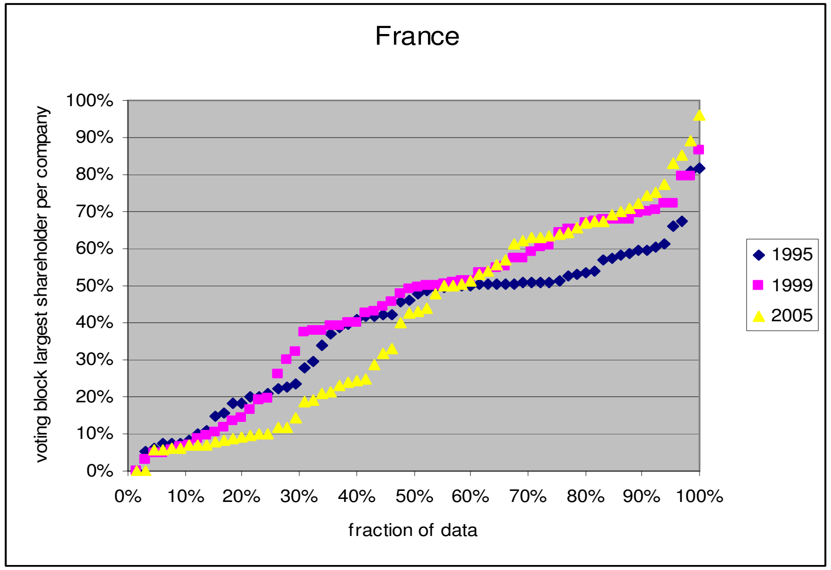
When the evolution of the distribution within countries is assessed, the number of significant differences is limited.[109] This was expected given the differences in the average voting block of the largest shareholder. Large Italian shareholders diminished their holdings over the period of 10 years. Voting blocks of 55% to 65% are more common in 2005 whereas blocks of 65% to 80% were frequently found in 1995. Non controlling voting blocks up to 35% are found in around 1/3 of the Italian companies in 2005 against 22% of the companies in 1995. In the UK, France and Germany there are no major changes to be reported. In Belgium the modest decline of the largest voting block cannot be contributed to one particular size class. All shareholders of Belgian firms have sold a small part of their holdings.

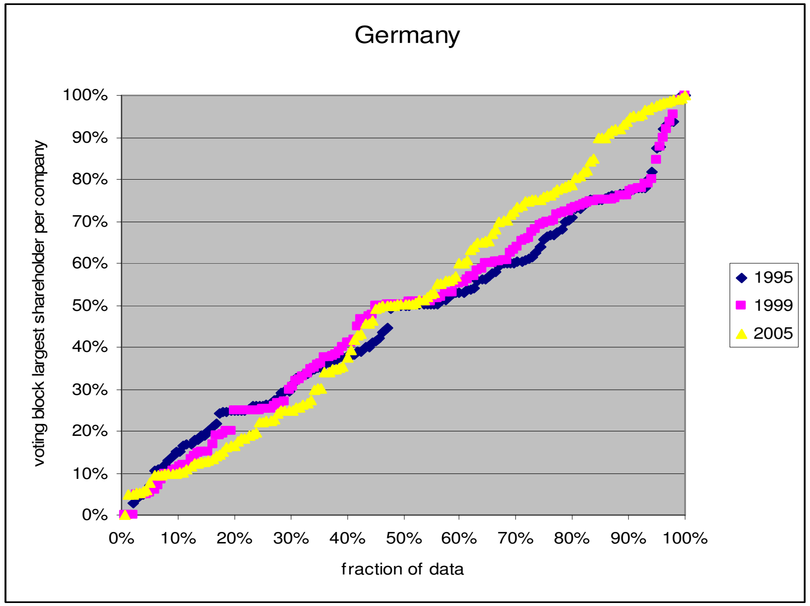
As for the results of the average voting block of the largest shareholder, the figures for the distribution of the ownership concentration are not in conflict with but do not strongly support the theory of the correlation between investor protection rights and ownership concentration.
It might be that industry differences can explain why the aggregate data are unconvincing. One of the industries that is vital to the well-functioning of the economy is the financial services industry. The available data allow to further study these specific industries.

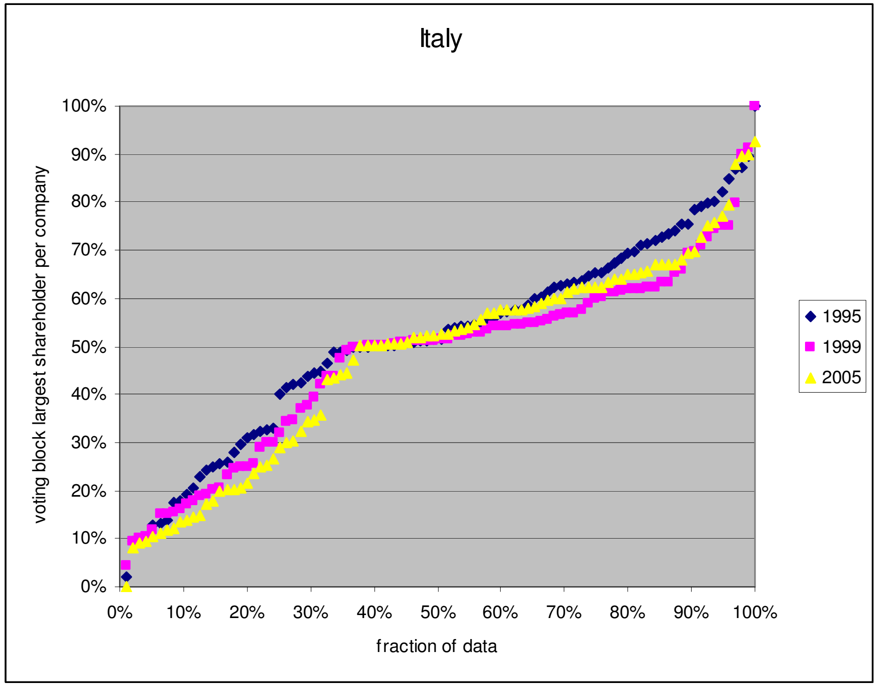
[109] Taking into account the differences in capital rights in 1995 and voting rights in 1999 and 2005 for France and the consolidation of the ownership of shares of board members for UK companies in 1994.

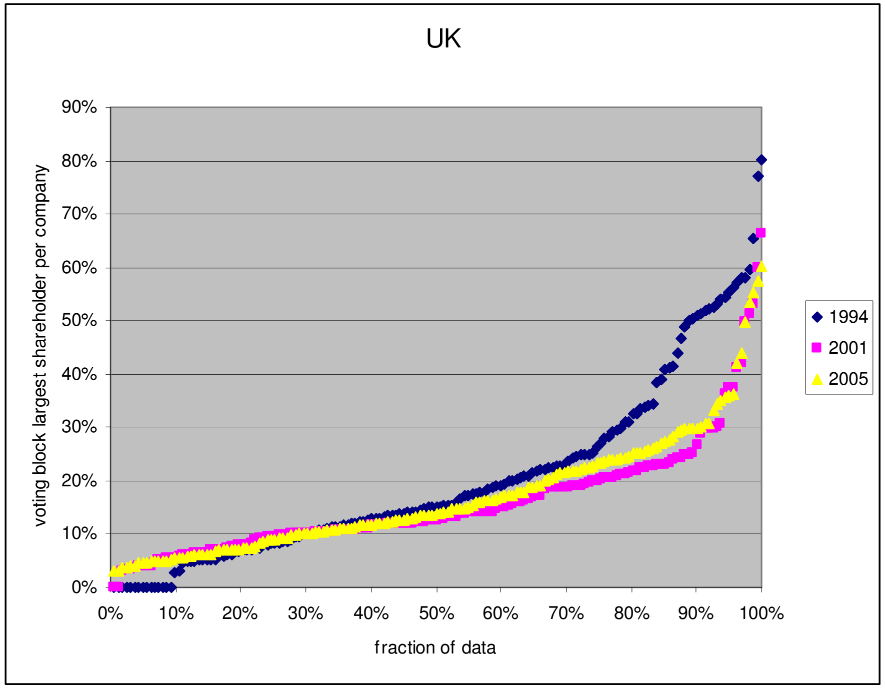
Figure 10: Percentile plot of largest voting block











Source: own research

c. Agency theory and ownership in the financial services industry

LLSV and other "Law and Finance" studies analyse ownership structures of industrial and commercial companies and the size of the capital market. The financial industry is mostly excluded, probably due to the specific legal framework within which financial institutions work. However the financial industry is of vital importance for industrial expansion, growth, capital allocation and the governance of firms.[110] This makes this industry of particular interests to be studied in order to further enhance efficiency. The governance of the financial industry assumes a central role. Most financial companies have shareholders, creditors, board of directors, managers, etc. This suggests that it must be possible to study the agency theory in a similar way as in the non-financial industry.

However the financial industry has two related characteristics that are specific and require an additional analysis.
First, the financial industry has more information asymmetries. Notwithstanding the fact that information asymmetries exist in all agency relationships and in all industries, Furfine has shown that these asymmetries are larger in banks.[111] The same can be said about other types of financial industry companies: insurance companies, investment funds and companies and pension funds. Next the financial services industry is heavily regulated. Management of companies in the financial services industry have less degrees of freedom to manage the company (and shirk the shareholders).

A. Information asymmetries

1. Information asymmetries in banks

Large information asymmetries can exist for several reasons. For shareholders it is extremely difficult to assess the loan policy. Allocating capital can be organized outside the supervision of the shareholders. Loans that are granted to borrowers in trouble can enhance the financial

[110] R. Levine, "Financial development and economic growth: Views and agenda", *Journal of Economic Literature*, 1997, 35, 688-726.
[111] C. Furfine, "Banks as monitors of other banks: Evidence from the Overnight Federal Funds Markets", *Journal of Business* 2001, 74, 33-57.

results in the short run – boosting the interest income – but it is detrimental for the long-run health of the bank.

Next, it is harder to design optimal incentive contracts in the banking sector due to the fact that it is harder to align the managers' interests with the shareholders' interests. Managers can find it easier to shirk the shareholders. In particular, managers can design compensation packages that take into accounts those elements that managers can manipulate.

Connected lending seems to be a major problem in many banks. These loans are granted at lower interest rates than the market average, have longer maturities, have a lower pay-back ratio and lower recovery rates and are less frequently guaranteed by collateral.[112]

Banks have a different capital structure than non-financial companies, mainly due to the little equity basis and large debts. The liabilities are mainly in the form of deposits. A deposit insurance system protects the depositors. This protective mechanism enhances the free rider problem.

The take over barriers are common in the banking industry. Barth, Caprio and Levine studied the legal barriers to acquire a bank. In a large majority of the 107 countries in the database regulatory approvals are necessary to acquire a 50% or 25% stake.[113]

In a survey of the European Commission a number of specific impediments for cross-border merger and acquisitions were identified.[114] Some of them are due to information asymmetry, all of them hamper the optimal functioning of the markets. The most important impediments are:

- non-overlapping fixed costs;
- difficulties to sell the same products across countries;
- political interference;
- multiple reporting requirements;
- divergence of supervisory practices;
- complexity of supervisory approval processes.

The study of the European Commission found that due to these impediments, the relative number of cross-border deals in the banking industry is lagging behind vis-à-vis the number

112 R. La Porta, F. Lopez-de-Silanes and G. Zamarripa, « Related Lending », *Quarterly Journal of Economics*, 2003, 231-268.

113 J. Barth, G. Caprio and R. Levine, *Bank regulation and supervision: what works best*, Working paper, August 2001, 65 p. and J. Barth, G. Caprio and R. Levine, *The regulation and supervision of banks around the world*, Working paper, February 2001, 88 p.

114 European Commission, *Commission Staff Working Document: Cross-boarder consolidation in the EU financial sector*, Brussels, 26 October 2005, SEC (2005) 1398, 32 p.

for other industries and the cross border deal size is smaller in the financial sector than the domestic deal size while the opposite is true in the other industries.
Finally, the banking activities changed significantly. The reliance of the banking industry on non-interest income soared significantly from 28,3% in 1992 to 42,5% in 2001.[115] It aggravates the difficulties for shareholders to familiarize with the activities of banks.

2. Information asymmetries in other types of financial organizations

The aforementioned survey of the European Commission highlighted that the impediments for cross-border consolidation in the banking industry are largely relevant for the whole financial sector. Opaqueness or information asymmetries are common in the insurance, pension fund and UCITS-industries.

Law and economic textbooks illustrate the difficulties insurance companies are confronted with. In Wikipedia "adverse selection" starts with the following example: "*The term adverse selection was originally used in insurance. It describes a situation where, as a result of private information, the insured are more likely to suffer a loss than the uninsured. For example, suppose that there are two groups among the population, smokers and non-smokers. An insurer selling life policies can't tell which is which, so they each pay the same premiums. Non-smokers are likely to die older than average, while smokers are likely to die younger than average. So the life policy is a better buy for the smokers' beneficiaries. The insurance company anticipates or learns that the mortality rate of the policy holders exceeds that of the general population, and sets the premiums accordingly. The result is that non smokers tend to go uninsured though if they could buy a policy on terms that are actuarially fair given their characteristics, they would do so. So market failure is involved. Whether examples of this sort apply in reality is an open question. Smokers may tend to reckless behaviour in general, so be relatively disinclined to insure. Or they may be in denial and not want to recognise their enhanced mortality. When the insured are less at risk than the uninsured this is known as advantageous selection.* "[116]

115 Expert Group on Banking, *Financial Services Action Plan: Progress and Prospects*, May 2004, p. 6 (see http://ec.europa.eu/internal_market/finances/docs/actionplan/stocktaking/report-bank_en.pdf)

116 http://en.wikipedia.org/wiki/Adverse_selection, consulted the last time on May 22, 2006.

The expert group on insurance and pensions pointed at the consumer resistance to buy insurance from "unknown, foreign based insurers". The need for the customer to feel comfortable with the insurance supplier is particularly strong. Further, at the supplier level the expert group discovered complicated consumer protection rules and conduct of business rules.[117] Last, but not least, the complexity of a lot of insurance products is known to all shareholders and investors.

Beneficiaries of undertakings in collective investment in transferable securities – UCITS – and pension funds cannot easily monitor trading with affiliates or investments in securities issued by affiliates, selection of custodians and depositaries, negotiations with distributors, etc. Pooling and master-feeder structures, allocation of trades, front running or trading ahead of customers and late trading are some of the many practices that can be easily abused to shirk the beneficiaries. Besides investment funds are compared using different disclosure standards, performance indicators, risk characteristics etc. which result in approximately every fund being the number 1 in one or more classes of funds.

B. Regulations

The second distinguishing feature of the financial services industry is the heavy regulations. The importance of the financial services industry intensifies the idea of the necessity of government intervention. Especially bank failures are considered to have large externalities and they should be prevented at any cost. At the same time banks enhance economic growth. Regulation must make sure both components are taken into account.

A detailed analysis of all different rules and regulations in the financial services industry goes beyond the scope of this lecture. However, there are some distinguishing features which can be considered as of high importance for the discussion of the agency relationships in the financial services industry. In particular, banks and other financial institutions have to take into account rules about their ownership structure, their management structure and their investment policy. Other industries do not have to adhere to these kinds of rules.

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117 Expert Group on Insurance and Pensions, *Financial Services Action Plan: Progress and Prospects*, May 2004, p. 17-18 (see http://www.jura.uni-augsburg.de/prof/moellers/materialien/5_kapitalmarktrecht/100_aktionsplan_finanzdienstleistungen/aktionsplan_pdfs/fsap_ueberpruefung_insurance_pensions.pdf).

1. Regulation of the European banking industry

Before a bank can start its operational activities, the competent authority must be informed of "*the identities of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings, and of the amounts of those holdings*". The authorities have to refuse this authorisation "*if, taking into account the need to ensure the sound and prudent management of a credit institution, they are not satisfied as to the suitability of the abovementioned shareholders or members.*" After granting the authorisation, shareholders who wish to acquire or dispose of a qualified holding must inform the competent authority about their plans. *"Such a person must likewise inform the competent authorities if he proposes to increase his qualifying holding so that the proportion of the voting rights or of the capital held by him would reach or exceed 20 %, 33 % or 50 % or so that the credit institution would become his subsidiary."* The competent authority has the power to oppose the plan "*if, in view of the need to ensure sound and prudent management of the credit institution, they are not satisfied as to the suitability of the person."* Besides the competent authority has the right "*where the influence exercised by the persons is likely to operate to the detriment of the prudent and sound management of the institution*" to "*take appropriate measures to put an end to that situation. Such measures may consist for example in injunctions, sanctions against directors and managers, or the suspension of the exercise of the voting rights attaching to the shares held by the shareholders or members in question.*"[118] The assessment of the suitability of shareholders is considered as an important element in the prudential framework, especially when there is a change in control at the bank.

The Member States define the criteria to be used when assessing the suitability of the qualifying shareholders. In 2005 the European Commission consulted The Committee of European Banking Supervisors (CEBS) to develop common criteria to be used in the assessment procedure. Its advice considers the introduction of a two step procedure.[119] First, a general suitability analysis of the fitness and properness of the intended qualified shareholder is required. The assessment can make use of a number of negative criteria like "negative criminal records". Second, a refined analysis is needed in cases the shareholder will be the

118 See the articles 7 and 16 of the Directive 2000/12/EC of the European Parliament and Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L nr. 126, 26 May 2000, p. 1-59.

119 Committee of European Banking Supervisors, Technical advice to the European Commission on a review of Article 16 of Directive 2000/12/EC, CEBS/05/76, 31 May 2005, 10 p.

"controller of the target institution". In these cases the minimum criteria to be fulfilled should be:

a. *"The qualifying shareholder should have "appropriate financial strength" in relation to the characteristics of the target institution, including the complexity of its business;*
b. *The qualifying shareholder should have a sound business plan and strategy for the target institution;*
c. *The proposed acquirer must have adequate and appropriate proposals for the corporate governance arrangements to be implemented at the target institution and, if appropriate, any wider group, after the proposed acquisition;*
d. *If new managers are appointed to the target institution as a result of the cross-border merger or acquisition they should be fit and proper, in the sense of Article 6 of the CBD: this includes both integrity and professional competency;*
e. *The group structure should be transparent enough to allow appropriate supervision according to Article 7.3 (close links);*
f. *The qualifying shareholder must have appropriate and adequate arrangements for the management of conflicts of interest between the qualifying shareholder, existing shareholders of the target institution, and the target institution itself, including where appropriate, measures to remove the source of the conflict."*

CEBS referred to the fitness and properness of the management of the bank. Article 6 of Directive 2000/12/EC requires at least two persons who effectively direct the business of the bank of "*sufficiently good repute or lack sufficient experience to perform such duties*." Besides the credit institution must supply "*a programme of operations setting out, inter alia, the types of business envisaged and the structural organisation of the institution*"[120].

Finally, banks cannot acquire qualified holdings in other industries that exceed 15% of its own funds. The total amount of the acquired qualified holding may not exceed 60% of its own funds.[121]

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120 Article 8 of the Directive 2000/12/EC of the European Parliament and Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L nr. 126, 26 May 2000, p. 1-59.

121 Article 51 of the Directive 2000/12/EC of the European Parliament and Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, OJ L nr. 126, 26 May 2000, p. 1-59.

2. Regulation of other types of financial organizations

Other types of entities in the financial services industry, like insurance companies and investment companies are confronted with similar to identical requirements as those banks are confronted with. With respect to the information of qualified holdings and the assurance of the competent authority of the sound and prudent management before the start of the insurance activities, article 8 of the third non-life insurance directive[122], article 7 of the life assurance directive[123] and article 6 and 12 of the reinsurance directive[124] resemble article 7 of the Banking Directive 2000/12/EC.

Article 15 of the third non-life insurance directive, article 15 of the life assurance directive and article 19 of the reinsurance directive are similar to article 16 of the Banking Directive 2000/12/EC with regard to the acquisition of a qualified holding in an insurance company[125] and the power of the competent authority to end the detrimental influence on the prudent and sound management of the institution.[126]

Investments outside the financial services industry are limited in similar ways as in the banking industry. Insurance companies must ensure the assets covering the technical provisions to be diversified and adequately spread. Non-life insurance companies and life

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122 Article 8 of the Directive 92/49/EEC of the European Council of 18 June 1992 on the co-ordination of laws, regulations and administrative provisions relating to insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC, OJ L nr. 228, 11 August 1992, p. 1-23.

123 Article 8 of the Directive 2002/983/EC of the European Parliament and Council of 5 November 2002 concerning life assurance, OJ L nr. 345, 19 December 2002, p. 1-51.

124 Article 6 and 12 of the Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directive 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC, OJ L nr. 323, 9 December 2005, p. 1-50.

125 As for the banking industry, the insurance and investment firm industry studies the approval process for qualified holdings (see European Insurance and Occupational Pensions Committee, Update – Cross border consolidation in the financial services sector: Revision of the supervisory approval process in the banking, insurance and securities' field, March 2006, MARKT/2509/06, 3 p).

126 In most cases these requirements are considered to be too burdensome. The Expert Group on Insurance and Pensions illustrates it as follows: "*Other routine administrative burdens should be reduced and preferable eliminated, especially in the context of the approval of the acquisition of "qualifying holdings". A cascade holding structure could produce situations where a party is subject to extensive reporting obligations, but has no material influence over the entity reported. Similar burdens arise in relation to "fit and proper requirements". One of the largest, recent, cross-sectoral acquisitions almost had to be abandoned because of the length of time required to obtain the necessary approvals for individuals who already satisfied EU "fit and proper" requirements, albeit under differing national supervisors. A sole approval by the lead supervisor should suffice. Situations where several supervisory authorities, exercising supervision over different local subsidiaries which are all part of the same insurance group, each require reporting of common risk exposures outside their home jurisdiction should be avoided…. Another example is the application of the data protection rules which block different subsidiaries in the same financial services group using each others' client data…*" (The Expert Group on Insurance and Pensions, *Financial Services Action Plan: Progress and Prospects – Final Report*, may 2004, 14).

assurance companies are allowed to invest up to 5% of the total gross technical provisions in shares and other financial instruments of the same undertaking. The limit may be raised to 10% of the gross technical provisions if the total investments of the insurance company in undertakings in which more than 5% of the gross technical provisions is invested do not exceed 40% of the gross technical provisions. For all investments in undertakings which are not listed in a regulated market the limitation is 10% of the gross technical provisions.[127] Member States are allowed to introduce similar rules for reinsurance companies.[128]

For investment firms the articles 9 and 10 of the Mifid directive require sound and prudent management and suitability of the shareholders with qualifying holdings.[129] Investments firms also have to comply with a significant number of organizational requirements: rules governing personal transactions of management, rules to prevent conflicts of interests and affecting the interests of clients, rules to avoid undue additional operational risks when relying on a third party for performance of investment services and activities, etc.[130]
UCITS need management companies directed by persons of sufficiently good repute and sufficiently experienced, provide a programme of activities[131], suitable shareholders with qualifying holdings[132], adequate internal control mechanisms[133], must employ a risk management process[134], etc. UCITS are not allowed to invest more than 5% of the assets in the same undertaking. This threshold can be raised to 10% under the condition that the total value of this kind of investments does not exceed 40% of the assets[135]. Besides it is forbidden

[127] Article 22 of the Directive 92/49/EEC of the European Council of 18 June 1992 on the co-ordination of laws, regulations and administrative provisions relating to insurance other than life assurance and amending Directives 73/239/EEC and 88/357/EEC, OJ L nr. 228, 11 August 1992, p. 1-23; article 24 of the Directive 2002/983/EC of the European Parliament and Council of 5 November 2002 concerning life assurance, OJ L nr. 345, 19 December 2002, p. 1-51.

[128] Article 34 of the Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directive 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC, OJ L nr. 323, 9 December 2005, p. 1-50.

[129] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6 and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ L nr. 145, 30 April 2004, 1.

[130] Article 13 of the aforementioned Mifid Directive.

[131] Article 5a of the Directive 85/611/EEC of the Council on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L nr. 375, 31 December 1985, p. 3.

[132] Article 5b of the aforementioned UCITS Directive.

[133] Article 5f of the aforementioned UCITS Directive.

[134] Article 21 of the aforementioned UCITS Directive.

[135] Article 22 of the aforementioned UCITS Directive.

for the investment company to exercise significant influence over the management of an entity in which it invests.[136]

Pension fund must be governed by persons of good repute and appropriate professional qualifications and experience or must, at least, employ advisers with these attributes,[137] need a written statement of the investment policy principles[138], must apply the prudent person rule which include inter alia to limit investments in securities of the sponsoring undertaking to 5% and no more than 10% of the portfolio in the sponsoring group[139]. The same thresholds apply in case of investments in other entities and groups.

3. Soft law recommendations in the financial services industry

Besides the heavy regulations, the financial services industry is more familiar with soft law recommendations than other industries. The Basel Committee on Banking Supervisions issued a corporate governance code addressing the specificities for bank governance in 1999 called "Enhancing Corporate Governance for Banking Organisations". An updated edition was issued in February 2006. Especially internal control and internal audit functions were already developed in these corporate governance guidelines for the banking industry, long before the Sarbanes-Oxley Act and other Transparency Directives required reporting on risk management. More detailed guidelines to assess compliance and supervision of operational risks can be found in the Basel Committee on Banking Supervision's "Sound practices for the management and supervision of operational risk"[140] and "Compliance and the compliance function in banks"[141].

The Organisation for Economic Cooperation and Development issued specific guidelines for the insurance business and the pension fund industry in April 2005. These guidelines take into account the specific instruments and constituents that can enhance insurers and pension funds

136 Article 25 of the aforementioned UCITS Directive.
137 Article 8 of the Directive 2003/41/EC of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision of 3 June 2003, OJ L nr. 235, 23 September 2003, 10.
138 Article 12 of the aforementioned pension fund directive.
139 Article 18 of the aforementioned pension fund directive.
140 First published in February 2003.
141 First published in April 2005. The impact seems to be considerable. Recently it was announced that the demand for compliance officers is higher than the supply (P. Battes, "Vijver compliance officers is bijna leeg", Het Financieele Dagblad 4 maart 2006, 1).

organisation, such as the position of actuaries, custodians and policyholders, and facilities to statutory redress. Besides, being important institutional investors, pension funds, investment funds and insurance companies also have to address corporate governance issues as shareholders of listed entities.[142]

These international developments coexist with national recommendations. In Belgium, the Banking, Finance and Insurance Commission issued a consultation document to issue corporate governance guidelines for financial services companies.[143]

Though not compulsory, the importance of all these requirements cannot be underestimated. More and more the investors' community requires corporations to take into account sound corporate governance practices in their investment decisions. Evidence is found that corporate governance can enhance corporate performance and even for contradictory evidence it goes that corporate governance is a self-fulfilling prophecy.[144]

4. Government supervision

Government or government agencies monitor companies in the financial services industry. Due to the detailed regulatory framework these types of companies have to apply, government intervention is necessary. With prudential regulation public regulators and supervisors monitor the activities as well as the organisation of the financial services industry. Anecdotic evidence suggests that government frequently assesses the stability of financial services entities. Some recent examples illustrate the government activities:

- The Australian Securities and Investment Commission initiated court action against Citigroup for insider trading and unconscionable conduct[145];
- The Dutch Autoriteit Financiele Markten gave ING a fine for shortcomings in its internal organisation[146];

142 See for an example "The Responsibilities of Institutional Shareholders and Agents – Statement of Principles" of the Institutional Shareholders' Committee (September 2005, first published in 1991), http://www.ivis.co.uk.

143 For more information, see http://www.cbfa.be/nl/press/html/2006-05-15_bedrijfspensioen.asp (last consulted 29 May 2006).

144 For an overview of the academic literature on this topic, see L. Brown and M. Caylor, *Corporate Governance and Firm Operating Performance*, Working paper Georgia State University, March 2006, 37 p.

145 V. Marsh, "Australian watchdog attacks Citigroup", Financial Times 1 April, 8.

146 G. van der Marel, "ING voert controle sterk op", Het Financieel Dagblad 3 maart 2006, 1 and 11.

- The Dutch Nederlandse Bank instructed the Dutch private bank Van der Hoop during a number of years and several bank crises[147];
- An Italian court suspended the Chairman of Capitalia, a large Italian bank after investigations discovered that the chairman was involved in the Parmalat-case;[148]
- Etc.

Government supervision cannot prevent all failures in the financial services industry. In the mid-1980s more than 700 savings and loans banks and 300 banks failed in the United States. More recently, the Austrian Bawag bank was able to conceal over 1.3 bn euro losses for over five years. This failure was announced shortly after discovering the involvement of the bank with Refco, the insolvent futures broker.[149] The supervision authorities could not prevent the Dutch private Bank Van der Hoop bankruptcy filing in 2005.[150] And who can forget Barings and Nick Leeson?

C. Ownership structure in the financial services industry vis-à-vis the non-financial industry

Better and more detailed regulation and government monitoring reduces the need for shareholders to acquire large ownership blocks to protect their rights. Shareholder can free ride. The government monitors. Thus, the "Law and finance" theory predicts a more widely dispersed ownership structure in the financial services industry compared to the other industries. This development continued and even accelerated due to the more sophisticated and detailed regulatory framework that is established in the financial services industry in most countries in the last decade. Regulation and supervision reduces the incentives of shareholders to monitor the financial services companies. Smaller stakes enhance liquidity and facilitates the use of the "wall street rule".

However the financial services industry is also characterized by its information asymmetries. The opaqueness requires more shareholder involvement to protect their rights. Blockholders

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147 X., "Van der Hoop al tien jaart scherp in vizier", Het Financieel Dagblad 3 februari 2006, 15. However, Van der Hoop was declared bankrupt in 2005.

148 I. Limbach, "Capitalia's chairman suspended", Financial Times 23 February 2006; see also http://www.forbes.com/business/feeds/afx/2006/02/23/afx2547707.html. However, the shareholders voted for his return.

149 H. Simonian, "Bawag concealed € 1.3bn losses for five years", Financial Times 25 March 2006, 8.

150 I. Bickerton, " Van der Hoop bankrupt as clients move money", Financial Times 19 December 2005, 6.

are more powerful and have more incentives to monitor the management of financial services companies. This hypothesis results in higher ownership concentration in the financial services industry.

Whether one of both hypotheses can be supported is a question that deserves a lot of study. New data are available to address the questions. A first assessment can be found in figure 11. The figure summarizes the data of the evolution of the voting blocks of the largest shareholders in different industries. The general pattern for the non-financial industries has been discussed in section 5 b. The evolution of the ownership concentration in the financial sector partly resembles but also partly diverges from the developments in the other industries.

First, the major difference between the concentration of ownership in continental Europe and the United Kingdom is also found in the different industries. The dispersion of ownership is much larger in the British financial industry than it is in the financial industry in continental Europe.

Second, the financial services industry cannot be characterized by its homogeneous ownership structure. In all countries insurance companies have a more concentrated ownership structure than banks. Notwithstanding the extensive and detailed rules the insurance companies have to apply, the ownership structure is not more dispersed than in other industries. Conversely, the banking industry is less concentrated and more banks have a more widely dispersed ownership structure than other industries.

Third, the development of the ownership concentration is not similar in the financial services industry as in the other industries. Only for British and Italian banks and Italian insurance companies the pattern in the financial services industry is identical to the pattern in the other industries. In all other countries and industries the development differs and in a number of cases the differences are striking.
In some countries opposite trends can be discovered. In Germany the ownership in the banking industry became more concentrated, whereas the opposite trend is visible in the other industries, as well, although less significant in the German insurance industry. As in the other industries, the ownership in the British banking industry is in 2005 more dispersed than it was in 1995 though the concentration in the insurance business remained unchanged.

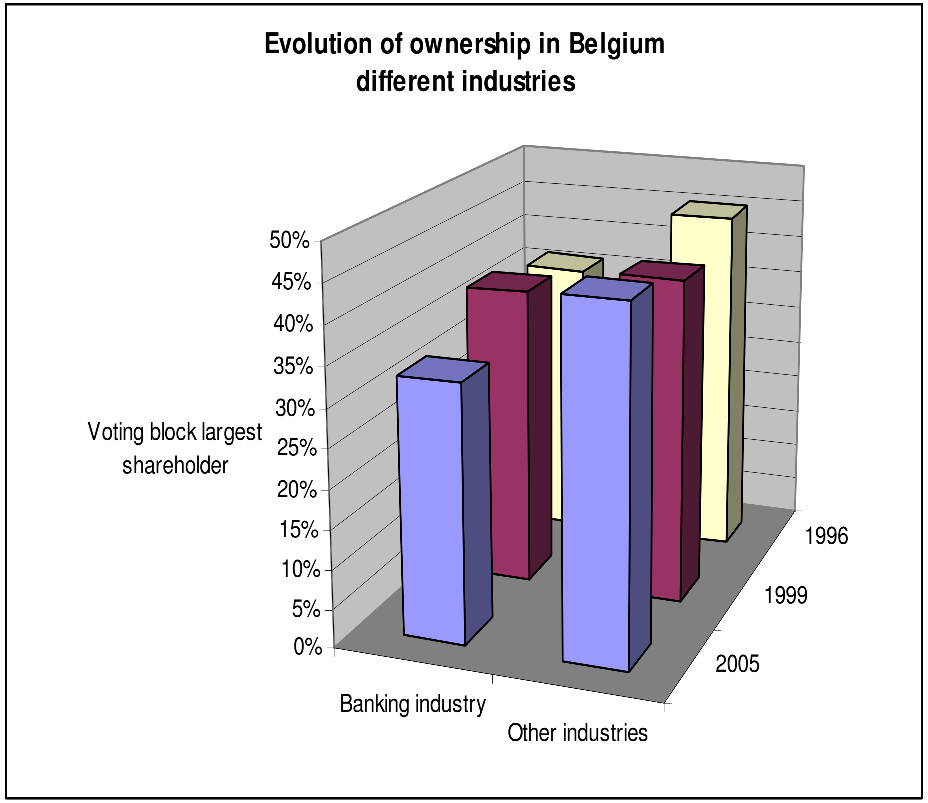
Fourth, the ownership concentration within the same industry did not developed in similar ways, notwithstanding the harmonization of the rules and procedures through European and international legislation. The German banking industry has a more concentrated ownership structure in 2005 than in 1995 whereas the British banks are characterized by a widely dispersed ownership structure

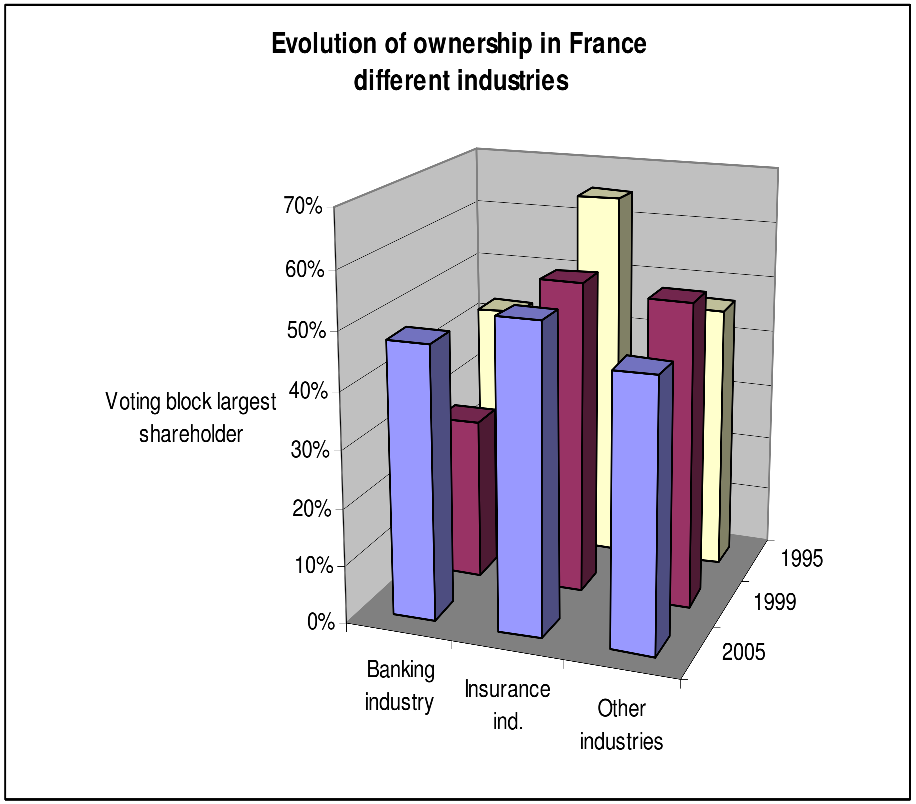
A more detailed analysis of the data reveals much more complex ownership patterns than would have been expected from the law and finance theory. The ownership development in the British banking industry fits with the idea that the improvement of shareholder rights causes a more dispersed ownership structure. The average voting block of the largest shareholder in de British banking industry diminished from 12,6% in 1994 to less than 6% in 2005. This decrease is considerably higher than the decrease in other industries in the UK from 22,8% to 18,4%. It suggests that the improved regulation in the banking industry underpins the beliefs of minority shareholders that a smaller stake in a bank is sufficient to claim all their rights. A similar evolution can be found in Italy. The average voting block of the largest shareholder in Italian banks diminished from a majority stake of 51,9% to less than 30%. Less convincing evidence can be found in the Belgian banking industry. The average voting block in listed Belgian banks diminished from 36,3% to 32,9%, though in 1999 the largest shareholder had a stake that exceeded the 1995 level.

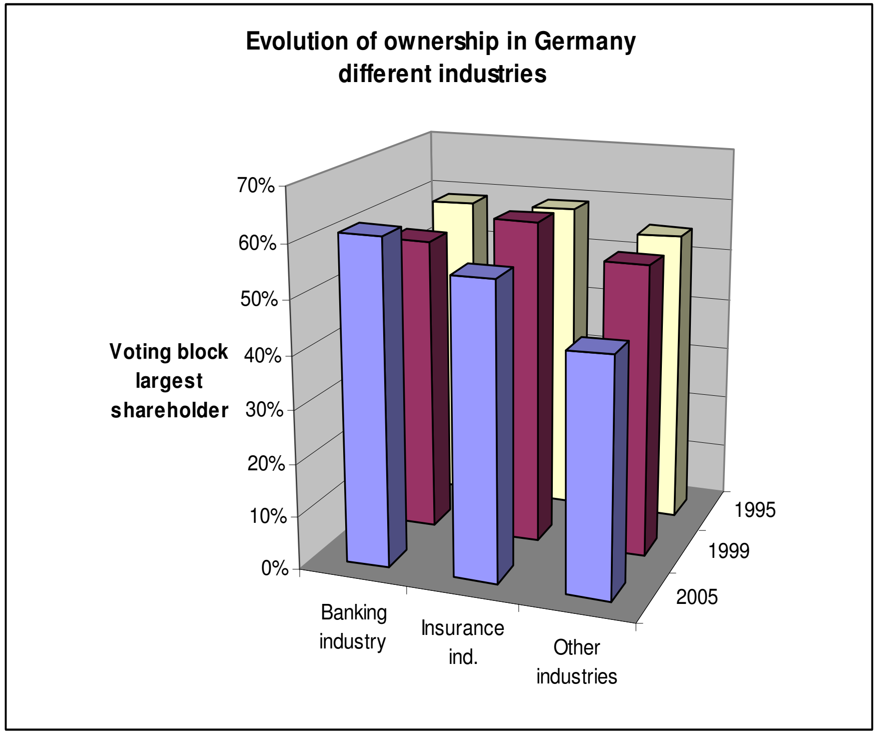
The supporting evidence of the hypothesis of a correlation between better minority rights regulation and lower ownership concentration is conflicting with the development of the ownership structure in the British insurance industry. The ownership concentration remained unchanged during a period of 10 years. One explanation might be that despite the improved regulation, the information asymmetries in the insurance industry worsened. The positive influence of the regulation is undone by the increased complexity of this industry. A similar pattern can be found in the German insurance industry where the average voting block of the largest shareholder remained approximately unchanged between 55% and 60% over a period of ten years.

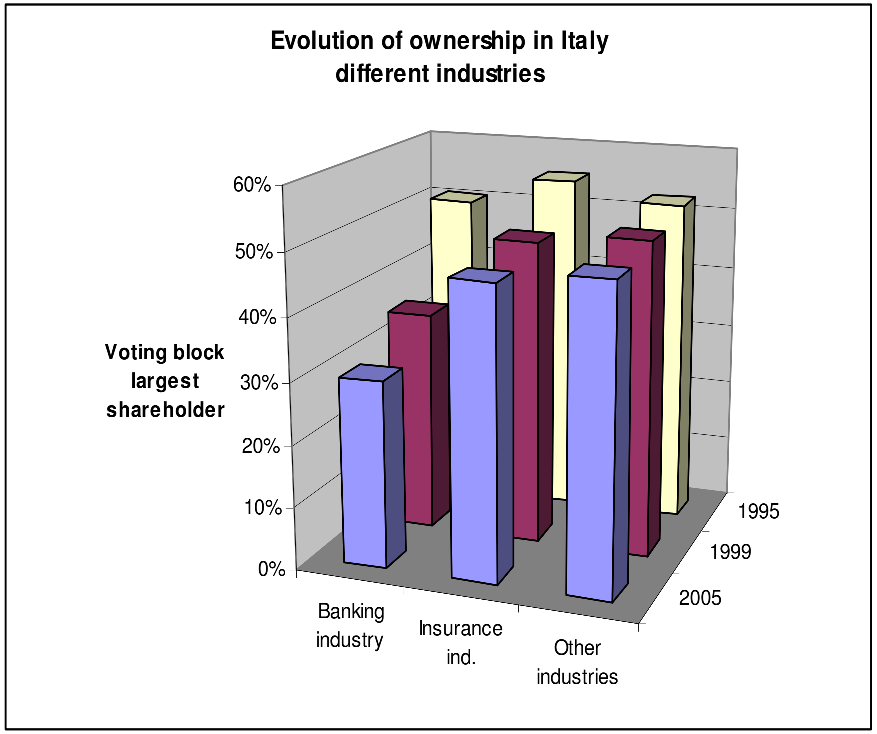
The argument that the improved regulation causes a lower ownership concentration does not convince in this international comparison. The Italian insurance industry developed in an opposite way. In 1995 the average Italian insurance company had one controlling shareholder with an average voting block of more than 55%. In 2005, this industry is still familiar with large shareholders though they do no longer control, on average, a majority block. The decrease of ownership concentration in the Italian insurance industry is larger than in other industries, suggesting that the improved regulation reduced the requirement for shareholders to hold a majority stake. Finally, in French insurance companies, the largest shareholders sold part of their large majority blocks. The average voting block of the largest shareholder of a French insurance company decreased from 65% to 53%, whereas the voting concentration remained unchanged in other industries.

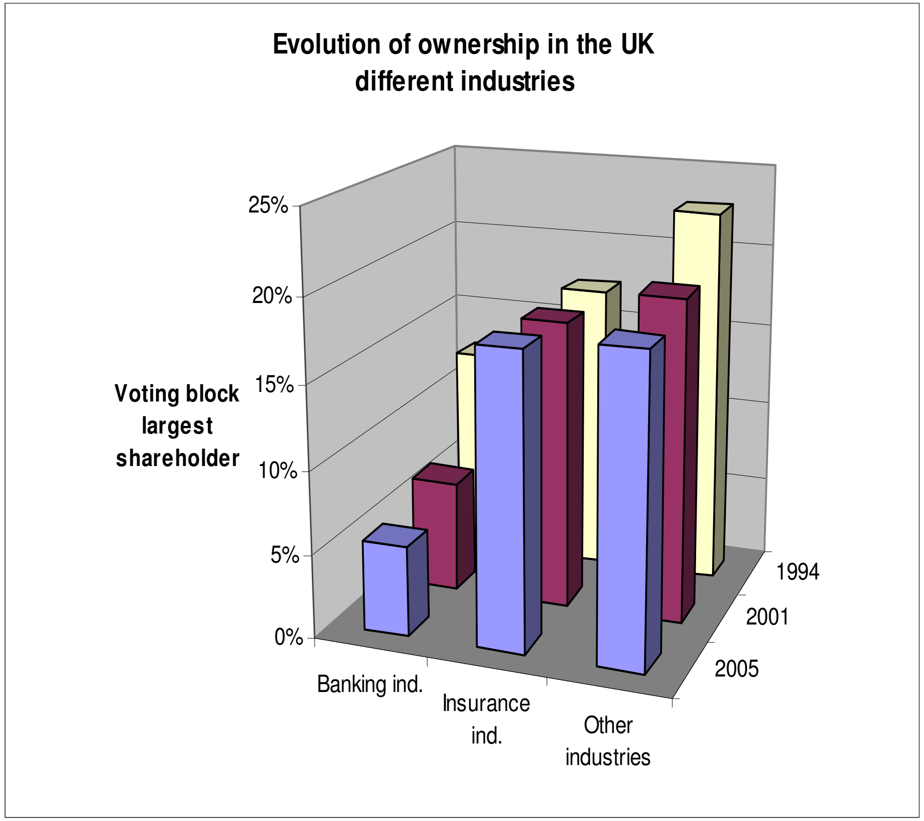
Conflicting evidence becomes even more puzzling when taking into account the development of the German and French banking industry. The overwhelming number of new banking rules could not prevent that in Germany and France the largest shareholder increased his voting block from 58,8% to 61,1% in Germany and from 42,9% to 47,7% in France.
Further, the patterns between industries differ. The German case illustrates opposite developments. The German capital market became more liquid as the average majority voting block of the largest shareholder in this sample was converted in a large minority block whereas no major changes occurred in the insurance industry and the concentration increased in the ownership of German banks.


Evolution of ownership in Belgium
different industries
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
Voting block largest shareholder
1996
1999
2005
Banking industry
Other industries


Evolution of ownership in France
different industries
70%
60%
50%
40%
30%
20%
10%
0%
Voting block largest shareholder
1995
1999
2005
Banking industry
Insurance ind.
Other industries


Evolution of ownership in Germany
different industries
Voting block
largest
shareholder
70%
60%
50%
40%
30%
20%
10%
0%
Banking
industry
Insurance
ind.
Other
industries
1995
1999
2005


Evolution of ownership in Italy
different industries
Voting block
largest
shareholder
60%
50%
40%
30%
20%
10%
0%
Banking
industry
Insurance
ind.
Other
industries
1995
1999
2005



Source: own research

The voting block of the largest shareholder is not the only determinant of ownership structures. Many others exist. Another proxy for ownership structure is the number of controlled companies in different industries. Table 4 summarizes the data of the relative number of companies with a majority shareholder and the additional number of companies with a minority shareholder owning more than 25% of the votes.[151] The data confirm the aforementioned findings. British banks have a widely dispersed ownership structure, whereas European shareholders are reluctant to relinquish control to the market. In particular in the insurance industry, even large listed insurance companies have one controlling shareholder or at least a large minority blockholder. 90% of the Italian, 85% of the French and 75% of the German insurance companies belonged to this class in 2005.

Table 4: Relative number of companies with a controlling shareholder or a shareholder with a voting block of 25% to 50%

		Belgium	Germany	France	Italy	UK
Banks	1995	44%/22%	64%/10%	56%/12%	65%/13%	0%/14%
	1999	43%/14%	62%/14%	14%/29%	49%/5%	0%/0%
	2005	33%/33%	64%/8%	40%/0%	38%/8%	0%/0%
Insurance comp.	1995		65%/26%	67%/12%	70%/20%	9%/11%
	1999		73%/20%	50%/50%	54%/31%	3%/18%
	2005		67%/8%	57%/29%	56%/33%	5%/15%
other industries	1995	42%/39%	63%/23%	52%/29%	65%/20%	13%/20%
	1999	39%/37%	47%/27%	62%/23%	65%/20%	6%/16%
	2005	43%/37%	42%/26%	53%/14%	62%/20%	5%/16%

Source: own research

Although other criteria, like the herfindahl index, the voting power of the largest shareholder vis-à-vis the power of other large shareholders, etc. should be studied to increase the robustness of the results, all findings are similar: the law and finance theory can only partly explain the development of ownership as a substitute for poor investor protection rights.
Other, especially company-specific parameters should be taken into account. Table 5 shows some preliminary evidence that the identity of the largest shareholder is of importance to explain the ownership structure. The identity must be studied in combination with the country

151 It should be taken into account that in some countries the relevance of an voting block of 25% is modest. In France the blocking minority is 33,33%.

of incorporation.[152] French individuals hold large blocking minority stakes in French listed entities, whereas Belgian individual investors seem to consider their relationship as a genuine investment.[153] Non-financial corporations acquire minority controlling positions in listed entities but a majority block in Germany. This type of shareholder is by far the most important kind of large shareholders in continental European companies. Insurance companies have small investments in British and Belgian companies though acquired controlling blocks in Italian companies. Similarly, Italian and Spanish banks want to control the companies in which they acquired the largest stake, whereas Belgian and British banks have no major interest in a large minority block. The government is still involved in privatization processes in a number of companies in continental Europe.

The differences found in table 5 encourage more detailed research. Together with the different types of companies listed on the different stock exchanges and in combination with the different legal framework, I am convinced that this law and economics approach has more power to explain a significant part of the behaviour of the capital markets.

Table 5: Average largest voting block of the different types of shareholders

	Belgium		France		Germany		Italy		Spain		UK	
	2005	N	2005	N	2005	N	2005	N	2005	N	2005	N
Individual/Family	10,64%	3	41,77%	16	38,90%	167	49,75%	55	21,89%	9	16,30%	21
Non-financial corporations	38,28%	61	48,70%	63	54,77%	107	47,62%	52	31,52%	74	21,63%	86
Insurance company	8,37%	2	18,83%	2	26,45%	20	36,79%	2	34,14%	4	12,44%	22
Banks	9,14%	3	28,04%	5	39,88%	22	48,28%	12	49,95%	16	14,66%	11
Government	43,14%	3	27,19%	4	53,26%	9	46,46%	11		0		0
Foreign	42,60%	31	29,18%	16	55,72%	65	49,31%	21	21,33%	18	13,91%	103
Other		0	10,12%	5	35,05%	9	36,90%	3	22,87%	2	19,02%	294
No major shareholders	0%	2	0%	1	0%	5	0%	6	0%	1	0%	9
Total		105		112		404		162		124		546

Source: own research

[152] And the industry in which the corporation operates.

[153] Although a large number of Belgian companies are controlled by wealthy individuals or families but they make use of pyramidal structures.

6. Conclusion

For the first time, data of the medium term developments of European ownership structures of listed companies are available. The data allow a detailed and in-depth analysis of the position of the "principals" of limited liability companies. A corner of the veil has been lifted. The evolution of the ownership structure of listed European companies differs from country to country, within different industries and between different time periods. The ownership structure of British listed companies is dispersed and remains dispersed. The ownership concentration in continental Europe is high and remains high. Ownership concentration changed but at a moderate pace. Within industries, ownership patterns adjust but all in all disruptions have not been discovered. Besides, ownership developments within the same industry can differ from country to country. Differences according to the size of the corporation, the identity of the shareholder and the activities of the corporations are considerable.

In the mean time, the European Union developed a complete new regulatory framework for the capital market. The European institutions issued the new standards for a broader and more efficient capital market with value-creating enterprises. An efficient framework to facilitate the financing of companies, create a deep and liquid capital market and enhance competitiveness was the reason behind the "Financial services action program" and "The company law and corporate governance action plan". Most rules have been enacted and a number of them have already been transposed in national law. The law and finance theory predicts that these developments will foster the capital market and strengthen the position of minority shareholders. The size of the shareholdings is considered to be a substitute for investor protection. The better the protection the less there is a need for shareholders to acquire large stakes to protect their investments against shirking by the "agents" of the company, i.e. the management. The theory is straightforward. The addition of variables like the size of the information asymmetries in some industries – for which the financial services industry can be used as an example - does not compel this relationship between law and ownership to be modified. However, the hypothesis that the differences between ownership concentration will decrease due to the development of better rules in "legally underdeveloped" continental European countries, the integration of the financial markets and the improvement of corporate governance, is not supported. Do shareholders react in the way the theory predicts? The results challenge this conventional wisdom. All the findings are hard to match with the theory that ownership concentration is negatively correlated with investor protection.

This answer encourages more detailed research. One path has been explored. Information asymmetry and detailed regulation are important characteristics of the economically crucial financial services industry. The first characteristic requires additional monitoring of the management. Due to the detailed regulatory framework government (agencies) bear the costs of this monitoring. Shareholders of financial services companies can free ride. Hence relatively small shareholdings are more efficient as the liquidity is higher. Data of the development of the ownership structures of the financial services industry over the last decade do not confirm unequivocal the hypothesis. Ownership structures differ and patterns of convergence are hard to find. Is the regulatory framework unsatisfactory or does the theory needs modification?

I hope the aforementioned preliminary conclusions are wrong. If there is no relationship between ownership and shareholder protection, it can be questioned whether investor protection legislation is of any use. The position of the shareholder is an important field of research for corporate lawyers. Abolishing this part of legislation makes the position of corporate lawyers unstable.

Fortunately, there are good reasons to believe the preliminary results are too incomplete to conclude investor protection and ownership concentration are no substitutes at all.

The data in the paper only gave an incomplete picture of the ownership structure of listed entities in a number of European countries over the decade 1995-2005. Only a few elements of the position of the "principal" have been assessed. There remain lots of other factors of the position of the shareholder to be studied. It was already indicated that the identity of the shareholder must be considered as one of the important components. Besides, the complexity of the agency relationship requires at least an extensive analysis of the position of the agent and the interaction between both parties. This research must take into account psychology, sociology, history, criminology and other behavioural sciences. Truly interdisciplinary research is under construction. There is a long road ahead. It is encouraging that more and more necessary data are available to construct that road.