

Deutsch, Klaus Günter; Stichnoth, Holger

Working Paper

Corporate Governance in Germany – Perspectives from Economics and Finance. A Conference Report

Research Notes, No. 02-3e

Provided in Cooperation with:

Deutsche Bank Research, Frankfurt am Main

Suggested Citation: Deutsch, Klaus Günter; Stichnoth, Holger (2002) : Corporate Governance in Germany – Perspectives from Economics and Finance. A Conference Report, Research Notes, No. 02-3e, Deutsche Bank Research, Frankfurt a. M.

This Version is available at:

<https://hdl.handle.net/10419/149027>

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July 3, 2002

No. 02-3

Research Notes

in Economics & Statistics

Corporate Governance in Germany – Perspectives from Economics and Finance

A Conference Report

- The German system involving the financing, management and supervision of companies, known for short as Corporate Governance, is in the process of changing radically. The most important causes for this are to be found in the internationalisation of investment capital, regulatory reform and enhanced transparency of entrepreneurial activities.
- By now, the regulations applying to corporate governance go far beyond the rules codified in stock-corporation law in the narrower sense. The German Corporate Governance Code has instituted new minimum standards for private-sector companies. A law dealing with transparency and disclosure requirements will come effect into in due course. Institutional investors are also exerting pressure with catalogues of demands of their own. Furthermore, internationally operating corporations are going to elaborate their own sets of rules.
- The German system, under which supervisory functions have traditionally been assumed by major shareholders and creditors, is now becoming more closely geared to the capital market. There is considerable crisis potential in the transitional phase. The system can only be prevented from slipping if both law-makers and the companies themselves act quickly.
- The items on the agenda are: complete transparency of ownership and supervisory structures; comprehensive, timely disclosure requirements; robust rights for minority shareholders; and a reform of three key corporate organs, the shareholders' general meeting, the supervisory board and the board of management. Transparency, robust rights for shareholders and efficiently functioning institutions translate into low capital costs, and vice versa!
- Direct control by major shareholders and controversial changes in ownership on the basis of transactions involving blocks of shares will continue to play a larger role in the foreseeable future than the disciplining of management by means of corporate takeovers involving public bids to shareholders. This is not necessarily a shortcoming. While concentrated share ownership, on average, has a positive impact on the economic performance of companies, there is not yet any empirical evidence that this holds true for the market for mergers and acquisitions.
- The future should see the influence of institutional investors on corporate governance growing and that of creditors waning. The concomitant reduction in goal conflicts is to be welcomed.

Editor

Ulrich Schröder
+49 69 910-31704
ulrich.schroeder@db.com

Deutsche Bank Research

Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Directors

Axel Siedenberg
Norbert Walter

Dr. Klaus Günter Deutsch, DB Research – Berlin Office
+49 30/3407-3682 (klaus.deutsch@db.com)
in collaboration with Holger Stichnoth

Preliminary remark about the symposium

In collaboration with the European Corporate Governance Institute (ECGI), Deutsche Bank Research conducted a symposium on the theme 'Corporate Governance in Deutschland – Perspektiven der Wissenschaft' ('Corporate Governance in Germany – Perspectives from Economics and Finance') on 1st March 2002 on Deutsche Bank's premises in Berlin. The European Corporate Governance Institute (ECGI) organised the session on 'A comparative look at Corporate Governance – the Anglo-Saxon model versus the Continental European model'. The contributions have been selected by the ECGI.

The purpose of this symposium was to present the results of recent research on corporate governance in Germany as well as in Europe in general and thus to fructify the debate about economic research and economic policy in government, parliament and media circles in the Federal Republic. Links to current research on legislative and regulatory activities have been established.

This conference report constitutes a summary of the key insights generated by the experts who were invited to participate. Many of the speakers have provided condensed versions of their lectures, abstracts of the studies presented as well as support materials. We would like to take this opportunity of once again extending our cordial thanks to all speakers for their willingness to cooperate. Contact addresses for those who presented papers are to be found at the end of the text. Information on secondary literature and sources has likewise been appended.

The programme, the majority of the presentations, studies written by the speakers and pertinent support materials are also available via the Internet at the following addresses:

- www.dbresearch.com, rubric: Economic policy, 'Window to academia'
- [www.ecgi.org/past events](http://www.ecgi.org/past%20events).

Introduction and Synopsis

For some years now in Germany, the rules and institutions governing the internal and external control and monitoring of incorporated companies ('Kapitalgesellschaften') – designated in the following pages as corporate governance (CG) – have been the subject of a debate involving both legal and economic experts. A number of problematic cases centering on the actual or supposed failure of control mechanisms within companies, structural weaknesses when it comes to the monitoring function exercised by the capital market on stock corporations, and the persistent and highly vociferous criticisms levelled at the principle according to which the board of management is supervised and monitored by the supervisory board have led public opinion (in the Federal Republic but – above all – in the Anglo-Saxon countries) to draw the conclusion that German corporate governance is in a state of crisis and in urgent need of being reformed.

By now, the government, the parliament and the administrative organs of many major companies are as busy subjecting German CG to a 'reform' as are shareholder representatives, investment funds and trade unions. The proposals generated by the government commission headed by Professor Theodor Baums have been available for some

Symposium on March 1, 2002

Conducted in collaboration with the European Corporate Governance Institute

Research is of great importance for the capital market

Conference report

Documentation available via the Internet

The German system of corporate governance is coming in for criticism

There is a consensus about the need for reform, but not about the concrete details

The proposals made by the Baums Commission are central

time now (Baums 2001) and have led inter alia to the promulgation of the German Corporate Governance Code (Deutscher CG Kodex 2002), which was elaborated by a commission headed by Dr. Gerhard Cromme of Thyssen-Krupp AG. What is more, the CG 'construction site' will probably take on further contours with the advent of a law on transparency and disclosure requirements, which will come into effect in a few weeks and as a result of further legislative measures that can be expected to materialise in the next legislative period. At the same time, political decisions in other spheres have far-reaching implications for CG: these include (among many others) the tax and pension reform, and the takeover law (WpÜG).

It is not a matter of denying the need for a well-conceived reform; but this is the place to raise questions which logically come first, i.e. how German CG can be aptly characterised, which deficiencies are in evidence, and in what time-frame an improvement can be implemented. These particular questions were discussed at the symposium from a multitude of academic economic perspectives, which are documented in the report that follows. The lectures were long on content, and it is not our aim to establish an implicit consensus. Indeed, such a consensus does not exist on many points. Nevertheless, five central topics and possible messages (from the point of view of the author) can be singled out:

1. CG as a system: CG is shaped by rules of conduct, institutions, markets (for the financing of companies) and organised industrial relations, which need to be looked at in the round from a systemic perspective. As well as the legal and regulatory framework conditions, the concrete nature of governance practices at the company level plays an important role. The efficiency of the capital market in terms of processing information about companies, especially concerning the quality of their administrative organs and management teams, is likewise a decisive factor. Moreover, corporate governance cannot be decoupled from corporate financing. The systemic character of corporate governance can also be gauged from the goal conflicts which must be taken into account when instruments come to be deployed. Solving various agency and governance problems is tantamount to an optimisation problem.

2. Uncertain, non-linear causal chains: The current state of knowledge about the structure and efficiency of German CG is not necessarily optimal. The economic impact of such central determinants as the ownership structure or the monitoring role played by the market in the case of takeovers either cannot be interpreted in an unambiguously positive or negative manner or else is actually unknown. What is more, the impact of certain determinants is non-linear. Account must be taken of these aspects when it comes to framing regulatory rules.

3. Systemic change: The German system of CG is already in an ongoing process of transformation. The three central developments in German CG during the past decade are as follows: the maturation of the German equity market; the continual strengthening of the regulatory environment for the stock market (although this has partly happened in a roundabout manner); and the behavioural changes which have taken place at stock corporations with respect to supplying the capital market and the general public with information about their economic performance and prospects. The capital market is gradually replacing the supervisory board as the dominant control mechanism. Although the transformation in German CG may only extend to parts of the system in the first instance, it is also bound to have repercussions on the entire system

The German Corporate Governance Code

A law on transparency and disclosure requirements is being elaborated

The tax and pension reforms are significant, as is the takeover law

The German system is not easy to understand

The following contributions do not add up to a consensus; they are messages from scientific community

Corporate governance must be regarded as a system

Financing, control and information are core problems

Goal conflicts require optimisation rather than maximisation

Causal connections are often non-linear or ambivalent

Market developments are exposing the system to stress

Change is already taking place

Signs that the capital market is gradually playing a bigger role

and thus on the overall quality of corporate governance in the Federal Republic. The big question is whether the transition which is discernible at the moment to an open and public system geared more closely to investors than creditors can take place without isolated crises, functional slippages and problematic developments in individual cases. Whether or not the transition works out well will depend on the conduct of management teams, the regulatory environment, and the behaviour of capital-market participants. Given the systemic dimension, a gradualistic approach may even lead to a crisis.

4. Recommendations for reform: Many researchers take the line that reform measures should concentrate on strengthening the control mechanism constituted by the information and valuation function of equity markets. Most progress can probably be achieved by engineering a higher degree of transparency in terms of performance, shareholder structures, and the conduct of companies and their administrative organs. A reinforcement of the role of the shareholders' general meeting, of shareholder rights and of investor protection is also called for. The Baums Commission has made numerous proposals on this score (Baums 2001: chapter 3 & chapter 5) which should be taken on board as soon as possible. A good example here is the ruling, entailed in the government's law on transparency and disclosure requirements, which would allow companies running investment funds to authorise a proxy (who is free to cast his vote independently of the company as well as of banks) to exercise the voting and creditor rights associated with the capital share in question not just on an ad hoc basis but permanently.¹ In this way, institutional investors could play a more prominent role in the medium term.

The rights of outside – i.e. minority – shareholders relative to major shareholders also need to be strengthened to a substantial extent, with the aim of limiting the problematic effects (special advantages, asymmetric information, and so on) emanating from the typical shareholder structure at large quoted corporations. The takeover law, which came into effect at the beginning of the year, marks a considerable step forward at least as far as the legal situation of minority shareholders and the protection of their interests in the case of a takeover are concerned, although the criticisms levelled at the problematic rulings relating to the code of conduct for administrative organs are warranted (Deutsch 2001, Schmidt, Prigge 2002 as well as a flood of legal literature).

On balance, the declining influence of creditors and major shareholders which is likely to derive from the tax reform and other sources (cf. Deutsch, Quitzau, Nassauer 2001) can be expected to have a positive impact inasmuch as the agency conflicts between major and minor shareholders and between creditors and equity investors should be reduced (cf. also Heinrich 2001). Nonetheless, there is not a linear relationship between concentrated share ownership and economic efficiency. A very high and very low concentration of share ownership appear to be problematic, whereas one or two key minority shareholders can have a highly beneficial effect on corporate governance. The identify of the major shareholders is also significant (Gugler 2001). Very many of today's large companies became global

Minor stimuli, major effects

The big question: can systemic change take place without triggering a crisis?

Investors need information in order to evaluate companies

The shareholders' general meeting need to play a more significant role

The rights of institutional investors have to be extended

Minority shareholders need greater protection ...

... in order to limit the special advantages secured by major shareholders

The takeover law is a step forward

A lower degree of concentration in ownership structure

It would be wrong to draw premature conclusions

¹ Article 3, paragraph 2 of the law on transparency and disclosure requirements (amendment to article 10, paragraph 1, sentence 4 KAGG). We are referring in this context to the 'Allgemeine Begründung' (Overall Legislative Intent), p.76 (German federal government 2001).

names while remaining in the hands of a particular family, although they have rarely managed to maintain that status without a shift in governance structure.

It is not possible to argue unambiguously that the corporate-governance market is strengthened by 'hostile takeovers'. For one thing, these are rare; and, for another, it has not been proved that they eliminate efficiency deficits. By contrast, a 'normal' takeover very definitely makes a contribution towards improving CG and certainly has a disciplinary dimension. At the end of the day, the potential threat of being taken over in the event of a persistently poor performance counts for more than an actual concrete takeover.

It is true that an improvement in institutional arrangements is frequently recommended, but it is not easy in practice to clearly link this with corporate performance. This does not mean that the functioning of – and cooperation between – two institutions, the board of management and the supervisory board, could not and should not be strengthened. Admittedly, the Baums Commission has generated numerous proposals concerning this point; this is the main focus of the German Corporate Governance Code; and further related topics are scheduled to be dealt with. Nonetheless, it must be pointed out that researchers have not yet found much in the way of empirical evidence that the structures of administrative organs have a particularly big impact on performance.

5. No role model is available: A look beyond Germany's borders generates the insight that national differences continue to be very pronounced with respect to CG systems and corporate-financing practices. Furthermore, a uniform Anglo-Saxon role model cannot be discerned. In many ways, the United Kingdom constitutes a special case, differing appreciably from the United States. It would be all the harder to put forward a substantiated case that Germany should take its bearings by one country or another. For example, distortions in voting rights are particularly unpronounced in the Federal Republic (DWS 2001).

It is important to explicitly warn against the notion that adapting elements of foreign systems will invariably lead to a strengthening of the German system. All the same, the yield demands made by retail investors on equity investments in OECD member countries are probably going to rise. This would result in a 'gentle' convergence with a high degree of transparency and public information about facts which are relevant for valuation purposes in various countries.

The report which follows will summarise the central statements made by speakers at the symposium.

Session I: Corporate Governance in Germany –Ownership, control and changes in control

Dr. habil. Eckehart Böhmer (Director of Research, New York Stock Exchange)² introduced the symposium and presented some key research findings concerning CG in Germany. More specifically, he made the following clarifications. In the CG debate, analysis centres on the relationship between the management team and the owners of relatively large stock corporations (AGs). This relationship only plays a subordinate role in the case of smaller AGs and companies with a different

Exaggerated expectations concerning the market for corporate control would be misplaced

The mere threat of a takeover has a disciplinary effect

Institutional reform of administrative organs is desirable ...

... but it would be wrong to expect too much

No role model from other countries

Share of Euro STOXX 50 companies where there are distortions in voting rights*

- Germany	18
- France	69
- Italy	75
- Netherlands	88
- Spain	100

* Non-voting stock, multiple voting rights, maximum voting rights, golden shares, preferred stock

Source: DWS

The capital market is likely to induce 'gentle' convergence of information standards

The starting-point is a separation of ownership and control

² The opinions expressed in this lecture are those of the author and do not necessarily represent those of the New York Stock Exchange or of its management. The essays underlying this lecture are available at www.ssrn.com. Precise details can be obtained from the references at the end of the text.

organisational form, the reason being that ownership and governance are not as a rule in separate hands in such cases and that the ownership group is composed of a limited circle of investors. By contrast, large AGs have a broad spectrum of investors, meaning that ownership and governance are largely separate: owners are obliged to delegate control over their holding to a management team whose interests are not always identical with theirs.

Furthermore, the debate is concentrated on shareholders, given that the claims of other parties with an interest in a given company are settled by contract and can easily be examined. While it is often unclear whether a particular decision is in the interests of the owners, it is easy to establish whether, say, an interest payment or wage payment has not been made.

Transparency: The transparency of the economic performance, as well as of the monitoring and shareholder structures of an AG, is of paramount importance when it comes to judging the impact of corporate decisions on the vested interests of shareholders. Transparency makes it possible for investors to arrive at a better estimate of the value of the company in question and to judge to what extent the incentives driving major shareholders overlap with their own. As a result, a higher degree of transparency reduces uncertainty regarding future returns. According to the generally accepted principles governing the financial valuation of securities, an investor demands a higher yield if there is a lower level of transparency. The corollary, which is of considerable significance for the competitiveness of German companies, is that an increase in transparency can reduce the capital costs of quoted corporations, thus enhancing their ability to compete. To this extent, the transparency issue has far-reaching macroeconomic consequences.

Special features of the German market: The German corporate landscape exhibits special features which increase the importance of transparency. Typical features of German AGs are the heavy influence exercised by commercial banks due to the high share of bank loans in outside capital, direct equity holdings, proxy voting, and personal tie-ups. Furthermore, the control exercised by means of voting rights is highly concentrated by international standards: more than 75 percent of the voting rights at every second AG with an official listing ('Amtlicher Handel') are controlled by major shareholders. In principle, this is unproblematic; but, on account of their ability to influence the company in question directly, large shareholders have certain incentives to transfer wealth away from their smaller counterparts. As a result, effective investor protection is all the more important.

A significant question is the extent to which the prevailing monitoring structure is optimal. It is to be assumed that the high level of concentration was in the interests of value maximisation at least prior to the acceleration in the development of the German capital market. However, not only the role of capital markets has altered drastically over the past decade but also the legal and institutional environment, which means that a high level of concentration is not necessarily desirable any longer. As a result, law-makers should create the underlying conditions for a functional, transparent market for corporate control, which provides major shareholders with an opportunity to dispose of holdings. The security-trading law (WpHG) and this year's abolition of the taxation of capital gains were initial steps in this direction.

Stakeholder claims are secured by firm contracts while shareholders have to carry the control risk

Transparency is the precondition for company valuation

The higher the level of transparency, the lower the capital costs

German control structures exhibit a low level of transparency and a high level of concentration

Effective investor protection is particularly important

The control structure is no longer optimal in today's capital-market environment

Regulation versus enforcement: Another highly important area concerns the relationship between regulation and its actual enforcement. The tenor of the fast-growing secondary literature on this topic is that it is not the quality of regulatory rules which influences the behaviour of market participants but rather how effective enforcement is and whether violations are sanctioned (cf. for example Bhattachara, Daouk 2001). Two arguments which have a significant bearing on this debate follow from this. Firstly, the choice of the means used to ensure transparency is only of secondary importance. On the accounting front, for example, the selection of the standard to be employed (German Commercial Code (HGB), IAS or GAAP) probably only plays a subordinate role; what is more significant is stringent monitoring and the sanctioning of violations. Secondly, a similar line of argument applies to the current tendency to deal with various areas of enormous importance to companies and investors (such as takeovers and corporate governance) by recourse to codes. Such codes do not have any legal force, do not provide for effective sanctions in the case of violations, and do not create any mechanism to monitor infringements. This approach is therefore of dubious value.

The way ahead: The importance of the German capital market has increased appreciably in recent years. Furthermore, there have been significant shifts in the legal and institutional environment which have a bearing on the debate concerning corporate governance in the Federal Republic. We are talking here, among other things, of rulings which enhance transparency (the security-trading law) and institutions which can be relied on to focus the gaze of investors more firmly on the equity market (pension funds). These developments provide an excellent basis on which to build (in the wake of initial experiments with codes) a concrete foundation for more efficient corporate governance, thus offering German AGs better prerequisites for competing in the international marketplace.

Dr. Jens Köke (University of Mannheim) has analysed changes in ownership structures at a large number of quoted and unquoted German corporations ('Kapitalgesellschaften') in the period from 1986 to 1997. The frequency of transactions involving blocks of shares is comparable to that in other countries, with most of these leading to a change in ownership. Such changes occur relatively often in the case of companies with a high degree of leverage and are rarer at larger corporations or at enterprises where ownership is highly concentrated. Weak performance only results relatively frequently in a change in ownership in the case of quoted companies. Changes of ownership entail greater management fluctuation and tend to lead, in the case of quoted corporations, to the disposal of assets and the dismissal of employees (Köke 2001).

In a different study, Köke has investigated the causes of takeovers and market-exits (bankruptcies, insolvencies) at German corporations, looking separately at stock corporations and limited-liability companies. In both categories, the likelihood of a takeover or market-exit is higher if the earnings situation is weak and the debt ratio high and when the company in question is relatively small. Furthermore, the concentration of ownership and the governance structure have a decisive bearing on the likelihood of takeovers in the case of stock corporations (AGs); the likelihood of a market-exit is closely correlated with the restructuring measures undertaken. The results of this investigation are not generally dependent on whether the takeover or market-exit takes place in the near or the more distant future (Köke 2002a).

Regulation is only effective if enforced by sanction

The effectiveness of codices is questionable

The capital market is gaining in importance

The legal underpinnings need to be strengthened

Share-block transactions are as common as in other countries

A change in control structures normally take place

Small, heavily-indebted companies run a higher risk of being taken over

The degree of ownership concentration and the identity of the owners are important

In a third publication, Köke has looked into the implications of CG and market discipline for productivity growth. He comes to the conclusion that companies with concentrated ownership structures tend to register considerably higher productivity increases. Financial pressure on the part of creditors has a positive impact on productivity growth especially in the case of companies which are contending with economic difficulties. As to market discipline, he draws the conclusion that productivity growth is higher if there is a high degree of competition on goods markets. However, this rule only applies if shareholder structures exhibit a high degree of concentration. The results of this analysis do not imply that the shareholder structure, the complexity of ownership structures or the size of the supervisory board have a decisive influence on productivity growth (Köke 2002b).

Dr. Tim Jenkinson (Saïd Business School, Oxford University) presented the results of a study prepared together with A. Ljungqvist (Jenkinson, Ljungqvist 2001) on the role of controversial share-block transactions, with special reference to seventeen selected cases in Germany (from the 1988-1996 period). It is argued that controversial changes of ownership are an important element in the CG system which has operated up to now. The authors discovered heavily fragmented control structures in companies without a majority shareholder. Changes of ownership happen far more frequently than is commonly assumed at such companies and may (via the acquisition of blocks of shares) take place against the will of the management of the target company. In the vast majority of the cases investigated, a change of ownership took place (on 12 out of 17 occasions) or else there was a cooperative solution (on 3 occasions). Bids to minority shareholders only occurred in five cases, and even then only on disadvantageous conditions (with price mark-downs ranging from 15 percent to 64 percent). Another finding is that banks frequently played a beneficial role when it comes to accumulating holdings. Such changes of ownership were facilitated by lax disclosure requirements for shareholdings and for joint action. Prominent defensive measures were alliances (12 instances) and white knights (6 instances).

Dr. Stefan Prigge (Economics Faculty, University of Hamburg) presented a new study relating to the takeover law (WpÜG) (Schmidt, Prigge 2002a; Schmidt, Prigge 2002b). Prigge reported that researchers have not yet come up with any unequivocal results.

One problem area, which is also part of the public debate going on at the moment, is the distribution of competences between the board of management, the supervisory board and the shareholders in a takeover situation. There is a prevalent model in the academic literature on this score: in such situations, it becomes increasingly likely that the interests of the board of management and the supervisory board (on the one hand) and those of the shareholders (on the other) will diverge. As a result, shareholders should be given a stronger position in such cases. The German federal government started deviating more and more from this line last summer, strengthening the position of the board of management and the supervisory board while playing a crucial role in thwarting the EU takeover directive. This development is to be regretted.

The second problem area has not so far attracted as much attention: changes of ownership at companies with a controlling shareholder. One of the great strengths of the WpÜG is that it renders those takeovers unattractive which the bidder wishes to implement above all in order to subsequently realise special advantages at the expense of minority shareholders. The decisive factor in the new law is the

Companies with major shareholders record higher productivity growth

Competition on good markets is beneficial for such companies

Controversial changes in control are a central element of the existing CG system

Minority shareholders come off badly

Banks are frequently the driving force behind a change in ownership

Investor protection is writ small

Defensive strategies are typical but rarely successful

A neutral stance on the part of the administrative organs is advisable in the case of takeovers

The existing takeover law does not meet this requirement

The share-price ruling is a two-edged sword:

- **Companies marked by widespread shareholdings can be taken over in an efficient manner**

requirement that an offer be made to all shareholders at a given minimum share price. This strength is relevant both for companies with widespread shareholdings and for those with a controlling shareholder. In the case of companies with widespread shareholdings, there is only a slight probability of the WpÜG impeding changes of ownership which enhance efficiency. However, the WpÜG could prove an obstacle which should not be underestimated to changes of ownership which enhance efficiency in the case of companies with a controlling shareholder. The combination of the obligation to make an offer to all parties and of a minimum share price may lead to a situation in which a bidder is compelled to offer all shareholders a price which reflects the remuneration he has paid to the old controlling shareholder in exchange for special advantages. As a result, a change of ownership which could enhance efficiency may never happen. In view of the shareholder structure in Germany, where the majority of companies have a controlling shareholder, this problem should not be underestimated. The most elegant remedy would be a systematic improvement in the protection of minority shareholders.

Discussion

Q: One participant made the point that the abolition of proxy voting suggested by Böhmer would probably reduce the already very low attendance levels at shareholders' meetings, thus compounding the risk of 'accidental majorities'. It was important to ask how attendance levels can be increased. If this is not practicable, he continued, it is perhaps better to keep the present proxy-voting system.

A: Böhmer replied that accidental majorities are not encountered at shareholders' meetings. The ideal solution, in his eyes, would be for shareholders to be able to follow the shareholders' general meeting live via the Internet and then be able to vote online.

A: A different participant drew attention to a number of legal innovations: it was now also possible to transfer voting rights to a proxy by e-mail. Apart from the right of banks to vote deposited shares at shareholders' meetings, there was now the option of proxy voting, although only (to date) in the case of registered shares. The participant in question went on to argue that Germany is more advanced than other countries in these respects. The importance of shareholders' general meetings was often exaggerated; after all, controlling shareholders are predominantly in the ascendant in Germany.

Q: According to one person participating in the discussion, the German Corporate Governance Code is not as harmless as Böhmer had argued. Böhmer had taken the line that rules without sanctions are ineffective. He, by contrast, was confident that the capital market would monitor whether or not the code was being observed; analysts would punish companies which failed to play by the rules.

A: Böhmer conceded that analysts could influence the opinion of individual investors, but argued that the loss of reputation suffered by companies which violated the code was a less effective disciplinary instrument than stringent enforcement. By way of example, he referred to a study which had appeared shortly beforehand in the 'Journal of Finance' (Bhattachara, Daouk 2001), which demonstrates that rules against insider trading only have an effect if they are strictly enforced.

A: Jenkinson objected that there is a fundamental distinction between rules against insider trading and CG rules: while the regulations governing insider trading are fairly simple and clear both in terms of

- **However, efficient takeovers of companies with a controlling shareholder can be prevented**

Stronger protection for minority shareholders would have been preferable

What is the future of proxy voting?

The Internet opens up new avenues

New legal options are already available

Has the German Code got teeth?

It is of great importance that the norms are actually enforced

Flexibility in the application of CG norms is important

goals and legal implementation, CG is allegedly a 'softer' theme. Jenkinson added that it is difficult to come up with rules which fit all companies, arguing that there are good reasons for almost every company to deviate from individual provisions. He was therefore of the opinion that it is wise for this very reason to leave the monitoring of CG to the capital market; experiences in the United Kingdom showed that stringent enforcement was not necessary as long as companies are obliged to justify any deviations from the code ('comply or explain').

Q: In this connection, one participant illustrated the vicious circle in which certain badly-managed companies get themselves trapped: if the capital market punishes the poor quality of the management in the form of a lower share price, there is then a risk that the company will curl itself up into even more of a ball for fear of a takeover, leading to a further mark-down in the share price, and so on. This participant also asked provocatively whether the endeavours of the Europeans in the field of CG were in fact pointless. That, he added, is at any rate the way that many Americans see it; capital markets, after all, are characterised to a great extent by economies of scale, with the net result that all market participants will end up on Wall Street.

A: Böhmer answered that he would strongly welcome such a development. However, he went on, participants on the New York Stock Exchange take their competitors very seriously and need to actively solicit listings. As to the disciplinary impact of the capital market, he made the point that such an influence can only be exercised by the bond market in the case of unquoted companies.

Q: One participant perceived a contradiction between Prigge's and Jenkinson's presentations: the latter had argued that the weak protection enjoyed by minority shareholders in Germany makes a hostile takeover profitable. This was not efficient. In his remarks concerning the takeover law (WpÜG), Prigge had pointed to the danger that efficient changes of ownership at AGs with a controlling shareholder (the normal state of affairs in Germany) could be blocked on account of the combination of the obligation to make an offer to all parties and of the obligation to set a floor below the share price in this connection which is stipulated in the WpÜG, meaning that stronger protection for minority shareholders could lead to less efficiency.

A: In his answer, Jenkinson drew attention to the trade-off between more – potentially efficiency-augmenting – changes of ownership, on the one hand, and the protection of minority shareholders from exploitation, on the other. Due to the free-rider problem, there are, in Jenkinson's view, too few changes of ownership because all shareholders may well profit from a takeover, whether or not they have borne part of the cost. In his view, a decision has to be reached on the extent to which one is prepared to restrict the ownership rights of minority shareholders in an attempt to cope with this problem. Jenkinson concluded that this is ultimately also an empirical question.

A: Prigge did not detect a contradiction between the two lectures. In his view, the exploitation of minority shareholders is *one* motive for a takeover. He argued that the WpÜG is a good thing because it allegedly restricts 'bad' takeovers driven by the pursuit of special advantages; elsewhere, however, it allegedly goes too far, the reason being that stronger protection of minority shareholders does indeed make changes of ownership which will enhance efficiency more difficult.

Q: All members of the panel were asked whether they thought that CG was really as poor as it is reputed to be. If it is true that inferior CG raises the capital costs of companies, how can it be that capital costs in Germany are so low?

Monitoring of CG by the capital market could prove a successful strategy

The 'comply or explain' rule has a disciplinary effect

Unfortunate incentives for undervalued companies?

Wall Street dominance?

Wall Street also takes its rivals seriously

The effect of the takeover law:

More or less efficiency?

Trade off:

- **protection of minority rights**
- **versus low hurdles for takeover**

The WpÜG shield shareholders from unfavourable takeovers, but also from favourable ones ...

Is CG as bad as its reputation?

A: Böhmer replied that capital costs in Germany are indeed low but that they could be lower still if CG were to be improved. Jenkinson pointed out that cases are to be found in every country where the CG system has failed. The question, in Jenkinson's view, is how these cases were reacted to, and – in particular – whether the systemic weaknesses were quickly rectified.

Session II: Corporate Governance: In balance or in a state of disequilibrium?

In his lecture, **Professor Reinhard H. Schmidt** (Economics Faculty, University of Frankfurt am Main) presented the cardinal results of several studies (Schmidt, Hackethal 2000, Schmidt, Hackethal, Tyrell 2001) concerning national systems of corporate financing and corporate governance. His core thesis is that the United Kingdom and the Federal Republic have two equally consistent systems which are markedly different from one another, and which would run the risk of becoming destabilised and dysfunctional precisely if gradual alterations were to be made to parts of the system.

In the cooperative CG 'insider system' in Germany, based on a high degree of information and long-term implicit contracts between owners, managers, employees and creditors, the diverse demands of the groups in question are harmonised, rather than being strictly geared to a maximisation of shareholder value as in the United States and in other countries with 'outsider systems'. The objective of entrepreneurial activity is allegedly not even clearly defined in German company law.

The monitoring functions of shareholders are based on a dominantly internal model: major shareholders exercise control through the size of their shareholding and through the supervisory board while minor shareholders have comparatively feeble rights; capital-market regulation is lax, and 'hostile takeovers' are decidedly rare. The control exercised by creditors is likewise internal (via long-lasting lending relationships, protections, and scope for intervention) and geared to ensuring stability and liquidity. After all, the influence of employees is secured by the German principle of codetermination ('Mitbestimmung'), by internal promotion systems flanked by dismissal protection, as well as by attractive overall remuneration packages; this model serves the goal of accumulating company-specific human capital in the long term. In all three dimensions, market solutions with clear alternative options only come into play on a complementary basis. Nevertheless, various market-oriented and political processes are causing elements which are not typical of the system (control via markets) to bulk considerably larger.

Schmidt discussed three hypotheses concerning possible development scenarios. We could see: first, an optimal combination of the best elements from the market-oriented and relationship-oriented systems; second, the coexistence of the two systems, without the efficiency differential being too pronounced; and third, a systemic crisis, triggered by the fact that a gradual change-over is not feasible. Schmidt argued that a convergence of the two systems is not to be expected. Although it has not been proved that Anglo-Saxon systems are superior, a mixed system could only be incoherent and would be impossible to maintain. As a result, he saw a possibility that the German CG system and Germany's social free-market economy in general could enter a state of crisis as a result of innovation and globalisation. Schmidt took the line that the German system is too cumbersome and entails disadvantages for German companies when it comes to raising funds

Better CG = Lower capital costs

Crisis management is a key element in any system

To date, Germany has exhibited a consistent CG system

An insider system is based on bank financing, industrial relationships and the legal framework

The system is geared to major shareholders, creditors and employees

Long-term harmonisation of interest is on the front burner

External markets play only a supplementary role

Scenarios for systemic change:

- **combination**
- **coexistence**
- **crisis**

It is conceivable that the German system could enter a crisis

due to its lack of transparency in the eyes of outside investors. This implies the need for radical change, if a coherent system is indeed to be arrived at again. He predicted that the Anglo-Saxon model would assert itself under the pressure of circumstances. In that event, CG could be weakened, at least during the transitional period. Schmidt raised the questions of how exactly the competition between the systems would look like in practice and of whether various CG systems could coexist within a particular country.

Dr. Max Steiger (Capital Markets Policy, Deutsche Bank AG) discussed the role played by institutional investors (Steiger 2000). The institutionalisation of saving activity is one of the most remarkable developments on international capital markets in recent years. The upshot is that private savings are increasingly being administered by professional investors (private-sector insurance companies, capital-investment companies, pension schemes and pension funds). This

Radical reform is called for

Can a variety of systems coexist in one country?

The institutionalisation of investment capital ...

... has many causes

Significance of institutional investors

	Assets under management as a percentage of GDP		Equity investments as a percentage of assets under management	
	1992	2000	1992	1999
United States	127,2	195,2	30	51
United Kingdom	131,3	226,7	68	68
France	61,9	133,3	19	42
Germany	34	79,7	10	28
Japan	78	100,5	22	19
Netherlands	131,5	209,6	16	43
Total of all OECD-countries*	c. USD 16 trn	c. USD 36 trn		

Source: OECD, * 1999 figures

process of institutionalisation is also reflected in the long-term shift in shareholder structures: as the proportion of equities which private households hold directly falls, so the ratio for institutional investors increases. The causation here is complicated. For one thing, Anglo-Saxon pension funds and unit trusts (mutual funds) have been increasing the weighting of European shares in their portfolios in order to optimise their risk-return profiles. For another, investment companies based in Germany have been able (in view of the public debate about the foreseeable problems which the state system of old-age provision is going to encounter) to increasingly convince retail investors of the long-term superiority of investment funds to direct investments. As a consequence of this trend, equity holdings are now concentrated in the portfolios of a – by comparison with the number of private investors – small number of institutional investors. At least in the United States and the United Kingdom, this has led to institutional investors becoming more closely involved in the field of CG.

All the same, individual institutional investors (in their capacity as minority shareholders) do not as a rule possess enough voting rights to be in a position to exercise a direct influence at shareholders' general meetings. They are endeavouring to make up for this supposed weakness with the help of their comparative advantage when it comes

Diversification by Anglo-Saxon investment funds

Investment in old-age provision

Funds only have insignificant direct influence ...

to processing information and keeping tabs on corporations. The instruments with which investment companies can enforce their interests range from threats to dispose of substantial blocks of shares (which would have a predictable knock-on effect on a corporation's share price) to the numerous personal conversations which take place between the management of the investment companies and members of the board of management of the corporations in question. The likely implications for corporations and institutional investors of this trend, which can be expected to become increasingly pronounced in the Federal Republic as well, are: increasing investor-relations activities on the part of corporations; company-specific CG regulations; and the exercising of voting rights at shareholders' general meetings by investment companies as well as vote-pooling by these companies.

Dr. Frank Nassauer (Capital Markets Policy, Deutsche Bank AG) advanced the argument that the globalisation of companies and – above all – of investors has led to a situation in which the respective corporate-governance systems are being put under the microscope. Efforts are afoot, on the part of both the corporate sector and law-makers, in virtually all industrialised economies, but also in numerous developing countries as well as at the supranational level, to make CG more efficient (cf. Nassauer 2000).

Given the variety of CG systems, three lines of development are possible:

1. Convergence takes place, on account of the fact that globalisation is increasingly blurring the differences between political, historical and cultural influences, causing the country-specific determinants of GC to lose a great deal of their importance. However, it remains to be seen whether a 'golden mean' will emerge in practice.
2. The system which is superior will become established. The fact that the German system is taking its bearings to an increasing extent by its US counterpart can be viewed as an indication of the superiority of market-based CG to the mode of CG which is based on stable relationships between stakeholders at a particular company in a world where economic activity is increasingly global and dynamic.
3. A specific mode of CG emerges for companies with a global reach, with institutional investors playing a central role. Under this scenario, institutional investors would have a disciplinary effect on companies as a result of market forces and also due to their use of the instruments laid down in company law.

Nassauer concluded that it is not possible at the present point in time to tell which of these three potential trends will assert itself in the longer term. In his view, it is quite possible in view of the increasing dynamism of the corporate environment that a dynamic mode of CG will emerge which is capable of adjusting flexibly to new developments.

Dr. Klaus Günter Deutsch (DB Research) pointed to a study (Deutsche Bank Research 2001) written in collaboration with **Dr. Jörn Quitzau** (Deutsche Bank Research) and **Dr. Frank Nassauer** on the consequences of the 2000 tax reform on the structure of equity holdings in the Federal Republic. The central theses are as follows. Within the framework of the tax reform, capital gains realised by corporations became exempt from taxation on 1st January 2002. Previously, the hidden reserves frequently realised when shares in stock corporations were divested had been subject to a high corporation-tax burden. The tax burden in question used to have a considerable retarding influence

... but process information and ...

... participate in the monitoring function

They have an indirect influence by shaping public opinion and by disposing of positions

Their influence is set to increase

Globalisation is leading to heightened interest in CG

Three scenarios:

- **Convergence**
- **The US system will assert itself**
- **A special system for major companies**

We may see a move to a flexible 'dynamic' CG system

The exemption of capital gains from taxation has implications for GC

on the disposal of equity holdings. In view of modern benchmarks for the return on investment and of the premise that shareholder value has to be increased in a sustainable fashion, many large equity holdings are probably no longer attractive and will probably therefore be unwound or realigned.

The landmark tax-policy decision constituted by the 2000 tax reform is likely to have far-reaching implications for German industrial and financial companies' equity holdings in domestic stock corporations. In the medium term, the high degree of concentration evident in present-day shareholder structures at large German stock corporations (AGs) will probably decrease to a marked extent. At the same time, the importance of institutional investors and minority shareholders could well rise. Nonetheless, it is not likely that the shareholder structure is going to develop in a straightforward way into a structure dominated by widespread shareholdings. Above all industrial companies can be expected to exercise control as major shareholders in future too, whereas financial institutions should gradually withdraw from this role. It is an open question whether there will, in individual cases, be gaps and deficits in CG.

All things considered, the reduction in equity holdings held by industrial companies and financial institutions which is likely to materialise in the course of the coming years will promote structural change in the economy, open up traditional relationship structures to the winds of competition, and pave the way for the capital market to play a more prominent role in CG.

Discussion

Q: Referring to Schmidt's lecture, one person participating in the discussion argued that the existence of complementarities cannot surely justify advocating the preservation of the status quo. He asked Schmidt whether he welcomed the ruling exempting capital gains from taxation and the new takeover law in spite of the complementarities in question, and how the principle of codetermination ('Mitbestimmung') is to be viewed in spite of the complementarity it entails.

Q: Another participant also raised a question in connection with Schmidt's presentation: how are the two 'pure' CG systems, i.e. the German and the Anglo-Saxon ones, to be regarded against a backdrop of changing framework conditions? Points mentioned in this connection were the internationalisation of business activity, the growing importance of institutional investors, and the trend towards greater equity financing.

A: Replying to the first two questions, Schmidt noted that he had not wished to advocate the preservation of the status quo. On the other hand, he tended to regard the takeover law as an example of the inertia inherent in the German system: the principle of codetermination only codified what had already existed in de facto terms in any case. By contrast, the exemption of capital gains from taxation could indeed undermine the system. He once again clarified that there was plenty of scope for changes within the system even from his own systemic perspective. One example here, in his view, involves the recommendations put forward by the Baums Commission. As to the implications of his argument for law-makers, he suggested that laws ought to take the systemic context into account. Thus, law-makers should not aim to steer a middle course in the field of CG. He added the pointed formulation: 'In Gefahr und großer Not führt der Mittelweg zum Tod.' (roughly: 'When things are really dangerous, the risky thing is the middle course.')

Changes in the pattern of equity holdings at German companies

We may see shifts in shareholder structures

Gaps in the control chain?

The exemption of capital gains from taxation will promote structural change

What is the relationship between reform policy and systemic stability?

How are the 'pure' models to be viewed in periods of change?

The tax reform constituted a radical departure

There is much scope for systemic reform

Radical action may be required

Q: One participant made the point that shareholders are exposed to greater risks than other stakeholders, whose claims on the company are clearly defined in contractual form and asked whether it did not follow from this that companies should commit themselves to maximising shareholder value.

A: Schmidt answered that nobody would contest the meaningfulness of a moderate orientation towards shareholder value. He had not asserted that all stakeholders are equal; it is just that it is not only the interests of shareholders which count in the real world. In his view, demands that the respective board of management should take its bearings in principle by the 'company's interest' are not practicable. Schmidt pointed out that maximisation of a multi-dimensional goal function such as a 'company's interest' is only possible if the relationships – and possible goal conflicts – between the individual interests feeding into this function are clearly defined. He argued that this weighting of interests is ultimately carried out by the board of management – which is why it is so important that the actions of the board of management are monitored.

A: Nassauer agreed that the German takeover law tended to be viewed in other countries as an attempt to cement the status quo. For example, the practical impact of authorisations given by German shareholders' general meetings to empower the board of management to take decisions eighteen months hence ('Vorratsbeschlüsse') is dubious in his view; at any rate, the company in question should expect to see its shares marked down on the capital market.

Q: In connection with Steiger's lecture, Böhmer remarked that he did not find the exit option for investors all that bad at all. The exit option, like the voice option, can serve to discipline the management of a company: if dissatisfied shareholders dispose of their holdings, the share price will decline, with the result that the next capital increase will prove less profitable for the company concerned.

A: Steiger answered that he did not intend to belittle the exit option. On the other hand, index trackers are largely barred from employing this option, and must endeavour to exercise an influence on the company's policy (voice option).

Session III: Systems of Corporate Governance compared – the Anglo-Saxon model versus the Continental European model

Prof. Colin Mayer (Said Business School, Oxford University) described the collective research effort on corporate control in Europe (Barca, Becht 2001). The study is based on ownership data in nine European countries from the EC Large Shareholdings Directive. It reports remarkable variations across countries.

Firstly, there are very much higher levels of concentration of ownership in Continental Europe than in the UK and US. The chart on the right shows the percentage of companies in eight European countries and the US (NASDAQ and NYSE) where there is a majority shareblock. Two-thirds of companies in Austria, Belgium and Germany are under majority control and one-third of Dutch and Spanish companies. In contrast approximately two percent of UK and US firms are under majority control.

What of the relationship between stakeholders and shareholders?

A moderate shareholder-value orientation is appropriate

It is the board of management which weights the different interests involved

It is of particular importance that the board of management be adequately monitored

The takeover law has codified the status quo in terms of interests

Institutional investors have a disciplinary influence by exercising exit and voice options



The contrast is even more striking in relation to blocking minorities, which exist in more than 90 percent of Belgian, 80 percent of German and only eight per cent of US firms (see chart).

Secondly, it is not just the size of shareholdings that matters, but also their nature. It is much more family and intercorporate holdings that predominate on the Continent as against financial institution and individual shareholdings in the UK and US.

Thirdly, there is widespread use of pyramids, cross-shareholdings and dual-class shares to leverage voting over cash flow rights in Continental Europe and amplify control by large shareholders. Examples are Porsche, where the Porsche and Piech families have 100 percent voting control but with a small percentage of cash flow rights (see chart), and ING in the Netherlands where shares are held by a trust (the Administratie Kantoor) which in turn issues non-voting certificates.

Fourthly, even where there is no voting control, there may be impediments to external control through anti-takeover devices, and restrictions on nominations to and replacements of members of the board.

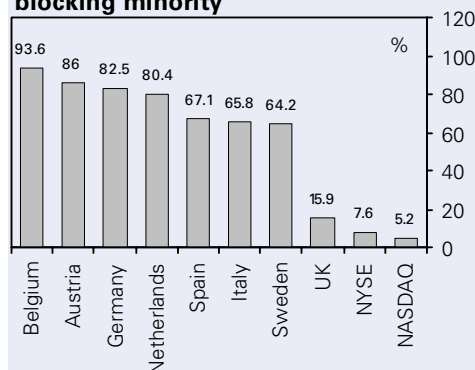
The question that these observations raise is: so what? What is the significance of these features of ownership and control for CG and corporate performance. The prevailing view is that (i) the Anglo-American system represents the superior form of CG, (ii) share blocks are associated with the exploitation of private benefits, (iii) it is of critical importance that minority investor protection is strengthened and a market for corporate control is created and (iv) the Continental system is breaking down and giving way to market systems.

Mayer argues that CG is much more complex than these stylised descriptions would suggest. Firstly, no such thing as an Anglo-American or Continental system exists. There are marked differences between the UK and US and there are stronger similarities in some respects between the US and Continental Europe. Secondly, empirical evidence on the relation between ownership and performance is unclear (Gugler 2001). In a study of the UK, Julian Franks, Luc Renneboog and Colin Mayer found that there was no relation between concentration of ownership and the disciplining of bad management. Board turnover in poorly performing firms is not related to either the concentration or the nature of the ownership of the firms. Repeating this on Germany, the authors find exactly the same thing. Despite the much higher level of concentration of ownership in Germany, ownership concentration neither enhances nor detracts from the disciplining of bad management.

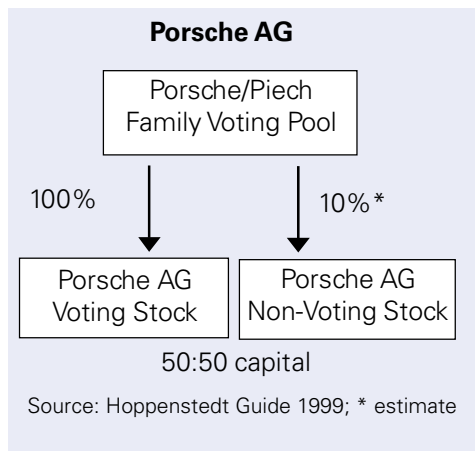
The large share blocks are a source of neither good nor bad CG. In a different study, the authors find that the takeover market, the market for corporate control, is not associated with the disciplining of bad management. The targets of hostile takeovers are not particularly poorly performing companies. It is therefore important to appreciate that the ownership and control differences are not primarily concerned with good or bad CG.

Does this make them irrelevant? Not a bit of it. What they do appear to be related to are the activities of companies rather than their governance. The real difference between systems concerns their degree of flexibility to be able to respond to new developments and opportunities as the growth of venture capital in the UK and US illustrates. But, the converse of flexibility is commitment. What the dispersed ownership systems achieve in flexibility, they lose in an absence of commitment. This manifests itself in the commonly ascribed

Share of quoted companies with shareholders possessing a blocking minority



Source: Country Chapters in Barca and Becht (2001)



Source: Hoppenstedt Guide 1999; * estimate



Source: Form 20-F

Differences have an important bearing on economic activities

- flexibility vs. commitment

problem of short-termism. For some activities, most notably large-scale manufacturing, long-term commitments by several parties are critical. For others, in particular high technology activities, the flexibility of being able to respond to changing technologies is more important. The complex webs of ownership that the book details in Continental Europe are part of the creation of long-term relations between several different stakeholders.

Different systems are therefore suited to different activities. They are also suited to different periods of time. While concentrated ownership may have been suited to the development of European manufacturing in the second half of the twentieth century, it might be much less suited to the technological innovations of the more highly developed 21st century European economies. This is the central issue that European policy makers need to be addressing in the context of, for example, debates on the takeover directive.

“The key point is not that takeovers are better forms of CG than share blocks. I read that the British government recently lectured the Japanese on the merits of the British CG systems. Preaching the virtues of particular CG systems has become the modern day equivalent of the religious and political crusades of the past.

Instead, the central question is whether the ownership and control structures of Continental Europe have outlived their useful life. If they have, then there may be much merit in the Winter³ proposals to allow acquirors to steam roll through existing takeover impediments by putting different classes of shares on an equal footing.

On the other hand, if the technological revolutions are short lived and we will return to more traditional activities then the superiority of existing structures may re-emerge. Or, and this is perhaps the most likely, picking winners is extremely difficult and we should let individual member states choose and not try to pick winners.”

Professor Marco Becht (ULB, Brussels, Director at ECGI) presented the results of his investigation into CG in the United States (Becht 2001). He started by asserting that corporate control by major shareholders is the exception. Shareholders with more than five percent of the voting rights to quoted stock corporations are to be found at less than half of the US companies listed on the NASDAQ and the NYSE. What is more, 92 percent of the companies with a listing on the NYSE have no shareholder who possesses more than 25 percent of overall voting rights. Although blocks of shares are frequently held by investment funds, these are not normally actively involved on the CG front. That said, the influence of significant minority shareholders as well as of major shareholders is certainly noticeable in individual cases.

Becht explained that the control function embodied by ‘hostile takeovers’ has decreased sharply in importance since the late 1980s. The reason for this is that numerous barriers have been erected against public takeovers thanks to alterations in the legal parameters (defensive legislation at the state level) and due to active measures taken by the administrative organs. ‘Poison pills’ prescribed in company charters, staggered contracts for board members (which make it more difficult to replace a management team in the wake of a takeover), the issuing

³ Mayer referred to the recommendations of the „High Level Group of Company Law Experts“ chaired by Jaap Winter (Unilever) in its report of January 10, 2002, which was requested by the European Commission in preparation for its second proposal for a directive on takeover bids.

- industrialisation vs. innovation

The CG debate is ideological

The expedience of ownership structures is relevant

Member states should be able to choose a model themselves

Major shareholders do not usually exercise an insignificant degree of control on companies

The capital market only exercises an insignificant degree of control on companies

of preferred stock and many other measures play a significant role. The efficacy of takeovers in the United States (in the sense that they enhance the efficiency of the company which has been taken over) has already been called in question elsewhere (Gugler 2001: 40). As a result, CG in the United States principally relies on the disciplinary influence of information, transparency and disclosure, i.e. it relies directly on the capital market.

Dr. Marc Goergen (UMIST, Manchester) gave a paper on the connection between the activities of UK pension funds and CG (on the basis of various research projects, inter alia Goergen 2002). He draws the conclusion that ownership and governance structures in the United Kingdom are characterised by a high degree of fragmentation – albeit to a somewhat less pronounced extent than in the United States. The largest shareholder is faced with a second shareholder who also owns a comparatively large block of equity. This system differs from that encountered in Continental Europe. In the case of quoted UK companies, institutional investors (mostly unit trusts and pension funds) are the largest (minority) shareholders. The second-biggest shareholdings are in the hands of board members.

At first glance, the British system appears to exhibit strong parallels with that operating in the United States. However, there turn out to be significant differences. There is a larger market for mergers and acquisitions in the United Kingdom than there is on the other side of the Atlantic. This is attributable to the fact that obstacles to takeovers such as non-voting stock and ‘poison pill’ paragraphs in company charters are thin on the ground. Furthermore, there are only few factors impeding the replacement of a whole board of management.

Institutional investors, the main group of major shareholders in the United Kingdom, have been criticised for adopting a passive investment stance. What could be the reason for such passivity? First, the trustees of pension funds do not have sufficient experience. Second, the voting procedure is complex, the reason being that voting proxies are in the hands of intermediaries rather than of fund managers or trustees. However, there are indications that institutional investors are becoming increasingly active on this score. There is also a certain amount of evidence that institutional investors are beginning to cooperate with one another. All the same, there is no proof as yet that they augment shareholder value.

Dr. Klaus Gugler (Economics Department, University of Vienna) presented the central findings of a research project carried out by a team of authors on the correlation between CG and corporate performance (Gugler 2001). The system of corporate governance in Continental Europe and Japan is markedly different from its Anglo-Saxon counterpart. In Germany, Austria and Italy, major shareholders exercise strategic control. The ownership structure is concentrated, and widespread shareholdings accounting for more than half of aggregate shares in circulation are more the exception than the rule even in the case of large companies. Markets, especially equity markets, play a subordinate role, both as far as the control function and as far as investment financing are concerned. In the event of bankruptcy, creditors have far-reaching rights while minor shareholders find themselves in a worse position.

The study ascertained that a higher degree of concentration in terms of ownership structures leads, on average, to an improvement in corporate performance. However, this statement does need to be qualified to take account of the fact that, first, there are country-specific

A multitude of barriers to takeovers

Control by means of information

Shareholder structures are not so fragmented in the UK

Institutional investors are the biggest shareholders

Hostile takeovers are frequent in the UK ...

... but it is rare for investment funds to exercise control

Major shareholders and creditors are influential in Continental Europe

Concentrated shareholder structures lead, on average, to better performance ...

divergencies, second, the identity of the major shareholder plays a role, and third, the conflict between major shareholders and those with a small equity interest is particularly pronounced in Continental Europe. The majority of studies demonstrate that untransparent processes at companies and legal discrimination against minor shareholders (by comparison with the US system, for example) prevent those with small stakes from being able to assume that they will get their fair share of the respective company's performance. This, in turn, leads to a lower propensity to invest in shares and to a low proportion of minor shareholders at companies as well as to illiquid equity and financial markets. Accordingly, it would seem to be an important prerequisite for the reform of European equity and financial markets that corporate decisions become more transparent and that minor shareholders are given a better legal deal.

Discussion

Q: The first question concerned the degree of concentration in ownership structures. 'What does the correlation between concentration and private special advantages look like?' asked one participant.

A: Mayer replied that it is commonly assumed that a high degree of concentration in ownership structures leads to special advantages and is thus to be seen negatively. In his opinion, however, this does not apply without reservation. He mentioned the examples of Siemens and the British companies Boots and Unilever, where, in his view, special advantages have ultimately accrued to all shareholders.

He was also sceptical whether such a positive view should really be taken of a market for corporate control, which is after all the focus of many current efforts to engineer an improvement in CG. He added that research findings are far from unambiguous; the defence mechanisms illustrated in Becht's lecture, with which many US companies are now attempting to protect themselves against hostile takeovers, should also be seen against this background. The corporate-control market only functions to a limited extent in the United States too.

A: Gugler took the line that the connection between the degree of concentration in ownership structures and corporate performance is not linear; the negative correlation in evidence in the case of a high degree of concentration is due to the exploitation of special advantages.

Q: One participant asked which actors were active in the equity market if even institutional investors adopted a passive stance, as had become clear from Goergen's lecture. In his opinion, it is the hedge funds which drive the market. Despite the growth rates recorded recently, these are still very much on the small side, but allegedly exercise a disproportionate influence on price movements: because they do not act as index trackers and are interested not in relative but in absolute performance, they allegedly make greater efforts to gain information about companies. He went on to argue that other market participants were aware that hedge funds had higher-quality information and that they followed in their footsteps, thus reinforcing the influence of the hedge funds in the market.

A: Mayer agreed, adding that this mechanism does not only hold for hedge funds but also for so-called vulture funds. Both types of company hold only few voting rights but have, in his view, a significant influence on price formation.

... but countries and major shareholders are different ...

... and the conflict with minor shareholders is an important aspect

The consequences are limited investment in equities and illiquid markets

Enhancing transparency and protecting shareholders' rights are decisive factors

Do concentrated shareholder structures lead to special advantages?

Only a problem in certain cases

The effectiveness of the control exercised by takeovers is open to doubt

There is not a linear correlation between the degree of concentration and the degree of control

Are hedge funds the force driving the market?

A driving force without internal influence

Q: Finally, the question was raised as to whether the decidedly large influence of the board in the United States, in the example used by Becht in his presentation, is the rule.

A: Becht replied that the example he had chosen is indeed typical. However, there is a certain diversity: not all companies are based in Delaware. He pointed out that pension funds in the United States are obliged to exercise their voting rights. Whether such a regulation is meaningful is a question which is also relevant for Germany now that it is embarking on a system of old-age provision which is 'fully-funded' to a greater extent.

Q&A: A question was asked about the importance of friendly takeovers, which account after all for the vast majority of acquisitions. Mayer answered that, even in the case of a consensual takeover designed to exploit economies of scale, roughly half of the members of the board of management of the company taken over leave what has by then become the amalgamated board within the space of two years; in the case of a hostile takeover, only a shade under 90 percent of the board members have been dismissed by the end of the same period. To that extent, it is no coincidence that the board of management should take such pains to protect itself from a (hostile) takeover. Mayer once again made the general point that the market for mergers and acquisitions, according to research, only exerts limited control, the reason being that target companies are not typically poorly-run outfits but rather firms whose performance is average.

Session IV: Economic forces and regulatory trends

Hilmar Kopper (Chairman of the Supervisory Board, Deutsche Bank AG) argued at the beginning of the symposium that the debate concerning the reform of the administrative organs of stock corporations (AGs) cannot be shelved even after the publication of the German Corporate Governance Code.⁴ In his view, the institutions continue to be in need of reform.

Kopper stressed that timely, comprehensive and confidential exchanges of ideas between the Managing Director (or Spokesman of the Board of Management) and the Chairman of the respective supervisory board had a critical bearing on the functioning of CG in Germany. In his opinion, the importance of this information flow was not sufficiently appreciated by those participating in the political debate.

As to the board of management, Kopper argued that the collective responsibility laid down in law for this administrative organ was hard to flesh out in the case of internationally operating companies: in view of the increasing complexity of operations, only the board member in charge of the area in question could understand – and thus take responsibility for – the specialised issues involved in their full depth and breadth. Contrary to the common conception, however, German board members are not excessively bound to consensus rules;

Many US companies are protected through their charters and through institutional arrangements

Consensual takeovers also trigger staff fluctuation at the management-board level

Institutional reform is desirable

Strategic dialogue between the board of management and the supervisory board

It is hard to put flesh on the principle of collective responsibility

⁴ See in this connection the following press reports: 'Kopper warnt vor Scheinheiligkeit bei der Debatte um Unternehmenskontrolle', Handelsblatt 4.3.2002, 'Kopper: Vorstand und AR schlecht konstruiert', Börsen-Zeitung 2.3.2002, and 'Cromme allein zu Haus', Financial Times Deutschland 5.3.2002.

controversial votes certainly take place on controversial matters. With reference to the discussion concerning the disparities between US and German stock-corporation law, Kopper drew attention to the fact that the German law in question does not allow for a CEO with authority to give instructions and that the streamlining of decision-making structures which is regarded as being imperative must therefore take place through another channel. Deutsche Bank has reacted to this necessity by creating a Group Executive Committee. He added, however, that leadership responsibility for Deutsche Bank AG was obviously still in the sole hands of the group's board of management.

Kopper accentuated that the German-style supervisory board, constructed on the principle of 50:50 codetermination by shareholders' and employees' representatives, amounted to an even more special institution by international standards. In his opinion, a characteristic feature of this particular body in Germany is the excessive number of participants: reducing the number of supervisory-board members to eight or ten would be necessary in the interests of purposeful debate. What is more, the specialist qualifications of supervisory-board members on both the employees' and the shareholders' side are frequently inadequate at the moment. Kopper took the line that there are simply not enough suitably qualified supervisory-board members who are in a position to fill the very many available seats in a competent manner. The fact that experienced supervisory-board members often sit on a number of different boards is a consequence of this situation. A remedy would be to scale down the size of supervisory boards.

Although the German Corporate Governance Code is unable to solve these particular problems, it is nevertheless valuable in Kopper's eyes: it makes the German system of administrative organs transparent, for example for foreigners, and at the same time contains meaningful recommendations especially – but not exclusively – for quoted corporations. Companies will compete to achieve the most exemplary implementation of the recommendations, a development which is very much to be welcomed. This is being meaningfully supported by the legal requirement to either 'comply' or 'explain'.

Professor Ulrich Seibert (Head of the Company-Law Department, Federal Justice Ministry) argued that the German law-maker had already put in place a milestone on the road to better CG in the thirteenth legislative period (i.e. during the last four years of Helmut Kohl's chancellorship) in the form of the law on control and transparency in the corporate field (KonTraG). Further progress had been made in the fourteenth legislative period, under the auspices of the SPD-Green government, in the form of the law on registered shares, the 2000 tax reform (in particular the decision to make capital gains exempt from taxation), and the endeavours of the Baums and Cromme commissions to give CG a stronger legal basis.

Seibert continued that the Baums Commission had submitted some 150 proposals, which are now being implemented, partly through legislation and partly via the German Corporate Governance Code. In his view, the Code is a clear and concise reflection of existing law. This performs a most important service because foreign investors do not always find German legal regulations easy to hunt down and easy to interpret. Moreover, the Code contains 50 proposals for better entrepreneurial conduct. He added that legal sanctions for entrepreneurial conduct had deliberately not been included; the verdict should be reached on the capital market.

Streamlining decision-making structures

German supervisory boards have too many members

Competent supervisory-board members are thin on the ground

It would be appropriate to downsize supervisory boards

The German Corporate Governance Code is valuable

Companies are going to compete in an effort to be the most exemplary

The legal framework for CG is being improved

The German Corporate Governance Code also plays an explanatory role for foreign investors

The implementation of the recommendations for conduct should be monitored by the capital market

Some of the suggestions made by the Baums Commission were taken up by the law-maker and the federal government before the end of the current (fourteenth) legislative period within the framework of the legislative procedure involving the law on transparency and disclosure requirements. The next legislative period should see the tackling of such topics as the right of appeal at shareholders' general meetings, the adaption of the law governing the liability of legal persons for their executive organs to international standards, and maybe also the 'Virtual Shareholders' General Meeting' and a central register of companies.

Dr. Anne d'Arcy (Corporate Center Controlling, Deutsche Bank AG) presented the activities of Deutsche Bank AG in this domain, emphasising that this company was currently playing a pioneering role by setting standards of its own (Deutsche Bank 2001). There is not only a group board of management with overall responsibility but also numerous implementation procedures within the company. It has become apparent in this connection that it is essential to take account of conflicts of interest and disclosure requirements, as well as to ensure a greater amount of external transparency. The company's listing in the United States constitutes a further step towards strengthening the corporate governance of Deutsche Bank AG.

In the final contribution, **Dr. Rainer Geiger** (Deputy Director for Financial, Taxation and Corporate Issues at the OECD) filled in the international dimensions of the theme. Against the background of the internationalisation of investment capital, the global privatisation wave and the increasing trend towards regulation in the international system, the OECD adopted a multi-lateral, non-binding, cooperative and evolutionary approach to standard-setting when issuing its CG principles in 1999 (OECD 1999). Apart from the fundamental rights of shareholders and the protection of minority shareholders, these principles cover the role played by companies' equity holdings, questions relating to transparency and disclosure, as well as the responsibility of administrative organs.

In his conclusion concerning the central tasks which await us in the coming years, Geiger pointed to the emergence of regional CG networks, to company-law reforms and to the implementation of the principles in threshold and transition countries. In his view, particular difficulties are posed by the optimisation of accounting and audit principles (as the case of Enron had shown), by the need to take measures against the abuse of offshore centres, by the elaboration of fair rules for corporate takeovers, and by the need to ensure that members of administrative organs at companies world-wide have the proper specialist and ethical qualifications.

Discussion

Professor Norbert Walter (Management, DB Research) drew inferences from the day's discussion. He remarked that 'pure' CG systems are (in Professor Schmidt's eyes) preferable to mixed forms but that it is not evident which of the two 'pure' systems, i.e. the Anglo-Saxon or the German one, was superior in general. However, it had become apparent in the course of the symposium, especially at the session organised by ECGI, that it was only in the United Kingdom that CG was unambiguously geared to the capital market. In other words, if there is indeed a model for Continental Europe, it is the United Kingdom and not the United States.

Further statutory regulations are in the pipeline:

- **The law on transparency and disclosure requirements**
- **Further topics are due to be tackled in the next legislative period**

Deutsche Bank is in the process of implementing its own standards

The OECD has shown the way

Much remains to be accomplished

- **Reforms of company law**
- **Implementation in threshold countries**
- **Accounting principles**
- **Takeover law**

The special role of the United Kingdom: CG via the capital market

A role model for other countries?

A further conclusion to be drawn, in his view, is that it is incumbent on the law-maker to stop the predominance of private interests which come into play once a certain critical degree of concentration in ownership structures has been reached. Walter took the line that this also applies to family-owned corporations: these too must submit to the rules of the capital market as soon as they seek access to it. As to the question of a fully-funded system of old-age provision and thus of the likelihood that institutional investors are going to be of greater importance in future, he observed that the (in any case, considerable) risks inherent in this form of old-age provision would be further magnified if these investors were to hold excessively large stakes in individual companies. The point is that CG is only one of several objectives. He does not regard the frequently deficient competence of today's pension-fund trustees as a fundamental problem; after all, they too have their teams of advisers.

Q&A: Böhmer came back to the question of how effective a code is which lacks the legal power to impose sanctions. In crisis situations, he speculated, some companies could feel it was worthwhile to infringe the code. Earlier cases of insider trading in the Federal Republic had demonstrated that such wrong-doing could not be prevented if the guilty party had no need to fear punishment in the form of personal liability.

Q&A: One participant expressed the opinion that it would in general be mistaken to expect too much of public opinion; only a few well-known DAX companies are taken any notice of at all, and other firms, even some represented in the DAX but especially ones listed in the MDAX or SMAX, attract scarcely any – or no - attention. He asked why the stock exchange could not directly admonish a company which had violated the code.

Q&A: Seibert pointed out that a liability ruling already existed in the case of deliberate lying or false declarations in connection with the code. The question was rather what reaction is appropriate in the case of negligence. In his view, it is wrongheaded always to call for the law-maker to come to the rescue; a flexible solution would be preferable. The cases of a number of US companies which had to concede that there had been accounting irregularities showed that the capital market can punish miscreants in a brutal manner. As to the smaller companies which had been mentioned, he remarked that the code could spell relief for these in particular: in future, they will no longer be compelled to keep responding to individual questions but will instead have the option of using a 'scorecard' once a year to inform all interested parties of how the company in question is dealing with the regulations contained in the CG code.

Q&A: Becht confirmed that a code is useful. Experience in other European countries has demonstrated that it takes the existence of such a code to stimulate companies to come to terms with questions relating to CG. In such a situation, he added, analysts would no longer just concentrate on cash flows but would take note that companies also have managers.

Q: Another participant asked whether negative repercussions would not derive from the fact that not a single company will be able to make a 'comply or explain' declaration in 2002 in view of the fact that the code has only been in existence since February 2002.

Is regulation of ownership structures necessary?

Large blocks of shares in the hands of institutional investors is not unproblematic

Has the Code got no teeth?

Public opinion is only of relevance in the case of major companies

Monitoring by the capital market rather than via legal sanction

'Comply or explain' makes the task of monitoring easier

CG codices stimulate monitoring activities

A: Seibert agreed that this could be problematic. However, the problem could perhaps be remedied with the help of a transitional arrangement, according to which the initial declaration is only valid for the future, with a 'full' declaration only following from 2003 onwards.

Q: One participant asked how the German Corporate Governance Code shaped up against the OECD principles presented by Geiger and whether an EU-wide set of regulations was being worked on.

A: Seibert responded that the OECD's principles are designed above all for law-makers, especially for those in developing and transition countries, and only to a lesser extent for companies or investors. In his opinion, however, it would not be worthwhile to elaborate a comparable pan-European code of best practice.

Q&A: Some remarks were made in connection with Deutsche Bank's CG principles. Deutsche was one of the frontrunners in CG in the Federal Republic not least because of the takeover of the US company Bankers Trust and of its listing on the NYSE; criticism from the SEC had also been beneficial. There can be no question, it was argued, that Deutsche Bank is acting as a role model in Germany; but companies with a purely national alignment would not take their bearings by it.

Q&A: Another participant was not prepared to go along with the notion that Deutsche acts as a role model, arguing that it is actually typical of the German system of CG. And was not the 'quartet' ('Vierklang') advocated by Deutsche Bank, viz. the company's intention to cater for the interests not only of shareholders but also of employees, customers and the company itself, also typical of the Federal Republic? He warned at the same time against designating everything as CG: some things which get subsumed under the title CG are simply aspects of either public relations or investor relations.

A: d'Arcy replied that the 'quartet' ('Vierklang') continued to be of importance and that the listing in the United States had exercised an influence on the evolution of Deutsche Bank's CG principles; on the other hand, Deutsche had already planned to implement the SEC's demands before they were made. It was therefore a matter of the idle question as to what had come first, the chicken or the egg. In her view, not the least significant reason why Deutsche Bank has a great interest in CG is that it is an important investment bank which has to - and is eager to - compete with its rivals.

Dr. Klaus Günter Deutsch, DB Research - Berlin Office
+49 30/3407-3682 (klaus.deutsch@db.com)
in collaboration with Holger Stichnoth

Deutsche Bank's CG principles

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Internet:

Publications by Ekkehart Böhmer on the topic of corporate governance are available (largely in a complete version) under: http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=38106.

Contact Addresses

Dr. Anne Christine d'Arcy

Deutsche Bank AG
Corporate Center Controlling
Head of European Accounting and Disclosure Regulation
Taunusanlage 12
60325 Frankfurt am Main
Tel: +49 69 910-43035
Fax: +49 69 910-47532
E-mail: anne.darcy@db.com

Dr. Ekkehart Böhmer

Director of Research
New York Stock Exchange, Inc.
11, Wall Street
New York, NY 10005
USA
E-mail: eboehmer@nyse.com

Dr. Marc Goergen

Manchester School of Management
UMIST
PO Box 88
Manchester MB0 1QD
United Kingdom
Tel: +44 161 200-3456
E-mail: marc.g.goergen@umist.ac.uk

Dr. Tim Jenkinson

Professorial Fellow
Said Business School
Park End Street
Oxford OX1 1HP
United Kingdom
Tel: +44 0 1865-2889-16
E-mail: tim.jenkinson@sbs.ox.ac.uk

Hilmar Kopper

Deutsche Bank AG
Taunusanlage 12
60325 Frankfurt am Main

Prof. Marco Becht

Solvay Business School and Law Faculty
Université Libre de Bruxelles
Avenue Franklin D. Roosevelt 50
CP 114
1050 Brussels
Belgium
Tel: +32 2 650-4466
Fax: +32 2 650-4466
E-mail: mbecht@ulb.ac.be

Dr. Klaus Günter Deutsch

Deutsche Bank Research
Berlin Office
Unter den Linden 13/15,
10117 Berlin
Tel: +49 30 3407-3682
Fax: +49 30 3407-3680
E-mail: klaus.deutsch@db.com

Dr. Rainer Geiger

Deputy Director
Directorate for Financial, Taxation and Corporate Issues,
OECD,
2, rue André Pascal
75775 Paris Cedex 16
France
E-mail : rainer.geiger@oecd.org

Dr. Klaus Gugler

Department of Economics
Center for Business Studies
University of Vienna
Room II/237 (AE 15)
Brünner Straße 72
1210 Vienna
Austria
Tel: +43 1 4277-37467
Fax: +43 1 4277-37498
E-mail: klaus.gugler@univie.ac.at

Dr. Jens Köke

Mannheim Research Institute for the Economics of Aging
University of Mannheim
L 13, 17
68131 Mannheim
Tel: +49 621 1235-190
Fax: +49 621 1235-223
E-mail: koeke@zew.de

Dr. Frank Nassauer

Deutsche Bank AG
Capital Markets Policy
Taunusanlage 12
60325 Frankfurt am Main
Tel: +49 69 910-38164
Fax: +49 69 910-39238
E-mail: frank.nassauer@db.com

Prof. Dr. Reinhard H. Schmidt

Wilhelm Merton Professor of Business Administration,
with special
reference to International Banking and Finance
Johann Wolfgang Goethe-Universität Frankfurt am Main
Mertonstr. 17
Room 319B
60054 Frankfurt am Main
Tel: +49 69 798-28269,
Fax: +49 69 798-28272
E-mail: rschmidt@wiwi.uni-frankfurt.de

Dr. Max Steiger

Deutsche Bank AG
Capital Markets Policy
Taunusanlage 12
60325 Frankfurt am Main
Tel: +49 69 910-38941
Fax: +49 69 910-39238
E-mail: max.steiger@db.com

Prof. Dr. Norbert Walter

Member of the Board of Management
Deutsche Bank Research
Große Gallusstraße 10-14
60311 Frankfurt am Main
Tel: +49 69 910-31810
Fax: +49 69 910-31826
E-mail: norbert.walter@db.com

Prof. Colin Mayer

Saïd Business School
Park End Street
Oxford OX1 1HP
United Kingdom
Tel: +44 0 1865-2-88919
E-mail: colin.mayer@sbs.ox.ac.uk

Dr. Stefan Prigge

Wissenschaftlicher Assistent (Lecturer)
University of Hamburg
Economics Faculty
Institut für Geld- und Kapitalverkehr (Institute for
Monetary and Capital Transactions)
- Arbeitsbereich Kapitalmärkte –
(Segment: Capital Markets)
Von-Melle-Park 5
20146 Hamburg
Tel: +49 40 42838-2763
E-mail: prigge@bigfoot.com

Prof. Dr. Ulrich Seibert

Head of Department, Company-Law Department,
Bundesministerium der Justiz (Federal
Justice Ministry)
Mohrenstr. 37
10117 Berlin
E-mail: seibert-ul@bmj.bund.de

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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg.

Print: ISSN 1615-956X / Elektr.: ISSN 1615-9683 / Internet: ISSN 1616-0428