Corporate Governance and the Role of Investment Funds

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A. Reform of the German Stock Corporation Law between the 13th and 15th Legislative Period (1998-2002) *

[1] Since the mid-90\'s Germany has seen a whole range of laws on corporate governance: first and foremost the KonTraG, i.e. the law on control and transparency (1) , followed by the NaStraG, i.e. the law on registered shares and the facilitating of proxy voting (2) , then, more recently, the TransPuG, i.e. the law on transparency and disclosure (3) , and - finally - the German Corporate Governance Codex issued by the Cromme Commission (4) -- and there is probably more to come during the next legislative period. What are the reasons for this striking increase in activity? What are the driving forces and is there a master plan behind these efforts?

B. The Need for Reforming the German Corporate Governance System

[2] The German set of rules on corporate governance is a system in itself (5) . It must be kept in mind that any amendment of one component potentially impacts all other components. For simplification purposes, the German system is often referred to as one of \"internal\" corporate governance, versus the \"external\" corporate governance system in the Anglo-American environment . In any case, our system has produced good results in the past, in particular during the period of the so called *Wirtschaftswunder* in the 1950\'s and 1960\'s, although the control exercised by banks and insurance companies and the existence of cross-holdings have given rise to increasing criticisms in recent years.

I. The Components of the System

[3] The German system essentially consists of the following known components, or players (7) :

Board of management, supervisory board (8) , labour representatives in the co-determined supervisory board (9) , auditors, shareholders at the general meeting, major shareholders, small shareholders, custodial banks, associations of shareholders, institutional investors (mutual funds, asset managers) (10) , analysts, rating agencies, and of course the economic and financial press.

II. The Causes

[4] It must be borne in mind that the German corporate governance system has developed and grown on the basis of very specific economic and social conditions (11) . As the external conditions of a system change, the system needs continuous adaptation and reform. Regardless of short-term bull or bear markets and the burst of the internet bubbles, we see the following long-term changes of the external conditions (12) :

- *The globalisation of the world economy and the internationalisation of the financial markets is likely to increase.*

- *We observe a slow shift away from borrowing and internal financing, as well as a shift from the principal banker relationship towards more equity financing*
through the stock exchanges. The discussions on the Basel II Accord suggest that this trend will continue.

- *Conversely, these developments also change investor behaviour; the share of venture capital assets in the portfolios has increased and in the field of retirement provision, we see a growing trend towards funded systems.*

- *Most German companies have so far been controlled by major shareholders (families, banks, insurance companies, cross-holdings) (13) . In recent years we have observed a gradual break-up of the so-called Deutschland-AG (\"Germany Inc.\"), possibly also a withdrawal of banks from industrial holdings, a change in shareholder structure towards more free float, more IPOs, an increase in the number of shareholders, and, in particular, a substantial increase in foreign shareholders, especially institutional investors.*

III. The Effects

[5] These developments do not necessarily create a recognition of the need to step up legislative action. As we all know, the political debate on corporate governance is usually not driven by theoretical considerations - but by scandals. This also explains why this discussion has moved in waves. However, these scandals and corporate crises are only the external factors; the actual prime movers of the continuous reform process are the on-going changes of the economic conditions of our system, as described earlier (14) . So this is not a radical upheaval, but rather a

gradual shift. This shift has impacted the discussions on legislative action as follows:

[6] Growing globalisation of the world economy tends to strengthen the influence of mobile production factors such as capital and technology at the expense of labour, which is considered an immobile factor. As international free float replaces conventional control mechanisms (major shareholders, banks), the principal-agent problem is aggravated, and a control vacuum emerges.

[7] Because of the international structure of the financial markets, German companies compete with global investment alternatives seeking venture capital. Nowadays, they must even compete for the money of German investors who have become used to diversifying much more broadly and internationally than in the past.

[8] Foreign investors expect company earnings to match internationally used benchmarks, and they expect German company law to be consistent with international standards or particular patterns of thought - whereby the question of which standards are better does not really matter.

[9] On the whole, we see a growing influence of the capital markets on stock corporation law . (15)

[10] In particular, we see that the corporate governance discussion follows the example of other countries, especially American patterns of thought . (16)

[11] The traditional shareholder meeting where shareholders are actually present is becoming more and more parochial because the shareholders physically present at the meeting no longer reflect in any way the actual structure of globally dispersed shareholders.

[12] Internationally operating groups which employ most of their staff abroad are raising the issue of making the composition of the boards more international - including the labour representation in the German supervisory board.

[13] In view of the dramatic increase of shareholders in large companies (up to two to three million in some cases) and the fact that they are dispersed throughout the world and in view of the massive volumes of securities transactions there is growing pressure to use modern communication media in the field of company law (17) .

IV. The Programme

[14] These influential factors have charted the course for our legislative projects in the course of the last ten years and will also be the driving forces behind the projects planned for the next legislative period (18) . They dictate the long-term reform programme – as follows:

[15] The responsibility and control of the *board of management* as well as its focus on profitability and competitiveness must be strengthened (19) .

[16] The *supervisory board* must be revitalised and given a new impetus as an efficient and qualified control body (20) . This can and must be achieved even within the framework of the German co-determination system (21) . This implies a shift of power from the board of management to the supervisory board. The supervisory board\'s independence, in particular vis-à-vis the board of management must be assured. By the same token it is necessary to safeguard the *auditor\'s* independence from the board of management; auditors should be tied in more closely with the supervisory board and act as its auxiliary . (22)

[17] The *shareholder meeting* as a physical assembly must be given a new mission. Its role must be redefined. (23)

[18] Rather than expanding the decision making rights of the shareholders at the meeting or of shareholder minorities, it would be preferable to increase the *liability* of the company\'s officers and directors . (24)

[19] Existing shareholder rights - in particular information and *voting rights* - must be available to all shareholders, including foreigners . (25)

[20] The *financial information* provided by companies must be improved and made available internationally . (26)

[21] *Conflicts of interest* of all players - from the members of the board of management to the analysts - must be disclosed and minimised, and violations against insider rules must be countered effectively . (27)

[22] Company and accounting laws must be geared to a lesser degree towards company creditors and more towards the capital markets. Internationally used financial instruments and international *accounting standards* must be

integrated into the German laws .(28)

[23] Wherever possible, red tape should be reduced and costly rules deregulated.

[24] So this is the programme. Virtually all amendments of the stock corporation law in recent years, as well as most of the measures planned for the future, fall into this programme. A great deal has already been achieved! (29)

V. The Shareholder Value Doctrine(30)

[25] The shareholder value doctrine propagated in the 90s was also of a programmatic nature. The German KonTraG (law on control and transparency) (31) was strongly influenced by this doctrine. However, the law itself was not aimed at increasing shareholder prosperity as an end in itself. Instead the focus of corporate policy and the officers and directors on shareholder value, or rather on \"value-added\", was used to make companies better performers and more competitive for the benefit of all. The intention was to put the continuous quest for added value once again in focus as the driving force of entrepreneurial action and thinking. Even if the term \"shareholder value\" has fallen out of fashion, the policy objectives for which the term was used are still valid. The Holzmann case, I think, has demonstrated in exemplary fashion that management-policies such as \"Fill the books, what matters is turnover\" have led to situations where large-scale projects were started even though it was clear from the beginning that they would not be profitable. Similarly, excessive takeovers for the purpose of turnover at the expense of returns often lead in the wrong direction. On the other hand, the massive pressure from the capital markets on companies to show higher and higher earnings has created misleading incentives in favour of \"accounting for growth\" and some rather creative accounting practices. Therefore it is important that we not lean too far in the other direction.

VI. The Aim

[26] It is the objective of all legislative action to shape the terms and conditions for management and control of large corporations in a way to enable them to generate income and to operate competitively. That is easier said than done. Corporate governance has to do with people, as all key positions of our corporate governance system are occupied by people. These people are not necessarily committed to the values of \"truth and justice\". They are primarily interested in their own benefit, in \"quick money\" and only as a second thought do they perhaps attend to the interests of their client or employer. This applies not only to managers, supervisory board members and small shareholders, but also to analysts, financial journalists, auditors and, with all due respect, presumably also to fund managers - in other words, to all the players in this complex corporate governance system (32) . Whether the scandals we have seen in the last time, especially in the United States, show symptoms of a drop in standards and a loss of professional ethics , or whether this is merely due to eternal human nature is a question we cannot yet answer definitively. At any rate, this is one of the problems which makes our task so difficult and the reason why the quest for good corporate governance requires our ongoing efforts and continuous countermeasures.

C. The Role of Mutual Funds(35)

[27] The legislator can only create the legal framework. It is up to the economic actors themselves to fill this framework. Mutual funds belong to these economic players. How is their role changing with the change of the external conditions?

[28] As the role of major shareholders declines and more companies become widely held, small shareholders can no longer act as free riders relying on others to perform control functions - they must themselves also exercise control.

[29] Small private shareholder are not always able to assume this role, though. In recent years, they have started to invest increasingly in equities - this was a positive trend although they sometimes followed blind euphoria. Now they will become more cautious and will leave this turf to the professionals, in other words to mutual funds.

[30] In this environment the investment fund managers will in the future assume the role of exercising ownership control in stock corporations (36) . If mutual funds simply invest along the index they obviously give companies extremely negative incentives to improve their corporate governance. The so-called Wall Street rule, i.e. voting with one\'s feet, appears quite convincing on first sight but it also has its shortcomings in that its effects often come too late. For management - which is not subject to ongoing control by the shareholders - it is apparently quite easy to develop strategies by which it can mislead the listless markets over a longer period of time. Once the swindle is exposed, share prices suffer extreme erosion, and the macroeconomic damage is considerable.

[31] Until now, corporate governance was only an issue when a company was in trouble. Shares which looked successful were sought after and bought without paying much attention to corporate governance. This is wrong. Corporate governance must also be given attention in good times.

[32] For this reason, the control function of mutual funds must start at an earlier stage. Of course, they can not scrutinise in detail every company they hold in their portfolios. Neither will it be possible for them - at least not at reasonable cost - to understand the complexity of all legal and corporate systems. But what they can do is assess corporate governance on the basis of comparative standards. For this purpose, corporate governance codices, which formulate best practice rules tailored to the legal environment in each country, can be quite helpful . Many countries have such a codex. Germany issued its codex, the so-called \"Cromme Codex\", only recently . It provides an excellent overview of our legal system and formulates sensible and internationally recognised best practice rules. By means of a \"comply or explain\" mechanism, companies must state which of these practices they comply with and which they don\'t. This is stipulated in the law . (39)
Mutual funds can use such national codices for the purpose of better screening and comparing companies within a given legal system.

[33] Investment funds will also have to accept the fact that they will have to scrutinise company accounts more thoroughly. The gradual reduction of the great number of different accounting systems worldwide to US-GAAP and IAS, as well as the cautious rapprochement between these two major systems, should make this task somewhat easier in the future.

[34] Investment funds hold the voting rights of the equities in their portfolios. It is their duty and responsibility to monitor shareholder meetings to ensure that the shareholders do not unwittingly allow decisions to pass to the shareholders\' own detriment. I am referring for instance to stock option programmes, the main features of which are adopted under German law by the AGM, that is to say, under the eyes of the shareholding public.

[35] It makes no sense to demand more shareholder rights if these rights are not exercised or exercised only by randomly knit small majorities.

[36] For all these reasons the investment fund managers should also consider developing mechanisms for cross-border voting and should urge Governments, including the German Government to ease the legal conditions for it. Obviously, it will not be possible or desirable for every investment fund to create the manpower needed to compile the necessary know-how for all legal systems. But funds could create national voting right representations which could represent the votes of many funds and thus benefit from economies of scale. The German *\"Viertes Finanzmarktförderungsgesetz\"* (Fourth Financial Markets Development Act) (40) has recently opened up the possibility for investment funds to give a permanent power of attorney to independent third parties such as associations of shareholders.

[37] We also support the Brussels efforts to develop principles for cross-border voting in Europe. But in view of the worldwide distribution of shares, we must look beyond Europe, cross border voting must become worldwide, simple and low-cost, and that means that it must become possible to vote on the internet . (41) By the same token, information about shareholder meetings, agendas etc. must become available worldwide, fast and inexpensive - and here again, the answer is the internet . (42)

[38] We have no intention of making it compulsory by law for investment funds to exercise their voting rights. All we can do is to appeal to the funds to do it - in their own interest and the interest of their investors who have entrusted their money to them . (43)

[39] Of course, we must look further into the future: In a system which is based on private ownership of the means of production, it is understood that the owner is in the best place to make the right decisions on the allocation of the scarce capital resources. However, funds are not the economical owners; they are trustees. Neither are associations of shareholders or professional voting right representatives of the real owners. This means that we will once again come across the principal-agent or conflict of interest problem at a second level, so that the classical question arises: who controls the controllers?

[40] Fund managers, after all, are also human beings - therefore it is important that they too adhere to best practice rules including ethical and professional best practice standards. The International Investment Fund Association as well as the European Federation of Investment Funds and Companies (FEFSI) (44) have developed such standards - this is a good thing and a far-sighted move.

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(1) Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG) v. 30.4.1998, BGBl. I S. 786.

(2) Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung - Namensaktiengesetz (NaStraG) v. 18.1.2001, BGBl. I S. 125.

(3) Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität (TransPuG) v. 19.7.2002, BGBl. I S. 2681.

(4) English version available at www.corporate-governance-code.de

(5) For a recent account see Oquendo, *Breaking on through the other side: Understanding Continental European Corporate Governance*, 22 U. Pa. J. Int\'l Econ. L. 975 -1027 (2001) (discussing US-perspectives on German Corporate Governance); Hopt, *Gemeinsame Grundsätze der Corporate Governance in Europa?* , ZGR 2000, 817 (Common principles of Corporate Governance in Europe?); *see also* COMPARATIVE CORPORATE GOVERNANCE - THE STATE OF THE ART AND EMERGING RESEARCH (Hopt et al. eds., 1998).

(6) *See, e.g.,* Teichmann, *Corporate Governance in Europa*, ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 2001, 645, 647-648 (reporting on the \"First European Conference on Corporate Governance\"). In abstract terms this distinction may be of heuristic value. However in day-to-day practice the systems are not as clearly defined and they are not independent of their external environment. This reminds me of an essay by Immanuel Kant from the year 1793 titled: \"Thoughts on the adage: This may be the case in theory but is of no use in practice\".

(7) For a detailed analysis see HOPT/KANDA/ROE/WYMEERSCH/PRIGGE, *supra* note 6 at 223-841.

(8) *See* Hopt, *The German Two-Tier Board (Aufsichtsrat): A German view on Corporate Governance, in Comparative Corporate Governance,* 4-30 (Hopt/Wymeersch eds., 1997).

(9) For a recent account see du Plessis, *Some thoughts on the German System of Supervisory Codetermination by Employees,* in FESTSCHRIFT FÜR BERNHARD GROßFELD AT 875-888 (Hübner/Ebke eds., 1999).

(10) *See* Schneider, *Mitbestimmte Pensionsfonds - eine ordnungspolitische Herausforderung?* EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (EuZW) 2002, 225 (Co-determined pension funds - a regulatory challenge?).

(11) *See* ROE, STRONG MANAGERS - WEAK OWNERS, 1994, 210-216; *see also* Hopt, *Corporate Governance: Aufsichtsrat oder Markt?* (Supervisory Council or Market?), in MAX HACHENBURG DRITTE GEDÄCHTNISLESUNG (Third Commemorative Lecture) (Hommelhoff/Rowedder/Ulmer eds., 2000)at 9, 18.

(12) Cf. Wymeersch, *Gesellschaftsrecht im Wandel: Ursache und Entwicklungslinien* (The changing of Corporate Law: Causes and Perspectives), ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 2001, 294, 294-302.

(13) *See* La Porta/Lopez-de-Silvanes/Shleifer, *Corporate Ownership around the World,* 54 J. Fin. 471, 498-500 (1999).

(14) *See also* Hertig, *Western Europe\'s Corporate Governance Dilemma*, in CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW - LIBER AMICORUM RICHARD M. BUXBAUM (Baums et al. eds., 2000), pp. 265 - 282.

(15) *Cf.* Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 663-682 (1999).

(16) Strenger, *Corporate Governance: Entwicklung in Deutschland und internationale Konvergenz* (Corporate Governance: The Development in Germany and International Convergence), DEUTSCHES STEUERRECHT (DStR) 2002, 2225.

(17) Seibert, *Stimmrecht und Hauptversammlung - eine rechtspolitische Sicht* (Voting Rights and AGM - a Legal View) BB 1998, 2536.

(18) For a detailed discussion of potential fields for legislative action *see* BERICHT DER REGIERUNGSKOMMISSION CORPORATE GOVERNANCE (Report of the Government Commission \"Corporate

Governance\") (Baums ed., 2001) [hereinafter BERICHT]; see also the opinion of the \"Group of German Experts on Corporate Law\" pertaining to the questions for consultation issued by the European Union\'s \"High Level Group of Experts on Corporate Law (HLG)\", ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2002, 1310-1324 [Hereinafter GERMAN EXPERTS].

(19) *Cf.* BERICHT, *supra* note 19 at 65-91.

(20) *Cf. id.* at 91-105.

(21) *Cf.* Oquendo, *supra* note 6, at 994.

(22) *Cf.* BERICHT, *supra* note 19 at 316-331.

(23) *Cf. id.* at. 117-159.

(24) *Cf. id* at 107-116. *See also* FLEISCHER, EMPFIEHLT ES SICH, IM INTERESSE DES ANLEGERSCHUTZES UND ZUR FÖRDERUNG DES FINANZPLATZES DEUTSCHLAND DAS KAPITALMARKT- UND BÖRSENRECHT NEU ZU REGELN? Gutachten F für den 64. Deutschen Juristentag (Is it recommendable to reform the law of securities regulation in order to enhance investor protection and to promote Germany as a financial market-place? Expert opinion for the 64. German Lawyer\'s Conference) at 101-103 (2002).

(25) *See* GERMAN EXPERTS, *supra* note 19 at 1315; *see also* BERICHT, *supra* note 19 at 125-126, 150-155.

(26) *Cf.* BERICHT, *supra* at 281-292. *See also* FLEISCHER, *supra* note 25 at 41-51, 90-91.

(27) *Cf.* BERICHT, *supra* at. 96-97; FLEISCHER, *supra* note 25 at 23-24, 79, 122-141.

(28) *Cf.* Ebke, *Accounting, Auditing and Global Capital Markets,* in CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW, *supra* note 11 at 113-136.

(29) Ehrhardt/Nowak, *Die Durchsetzung von Corporate-Governance Regeln* (Enforcing Corporate Governance Rules, DIE AKTIENGESELLSCHAFT (AG), 2002, 336, 345.

(30) *Cf.* Mülbert, *Shareholder value aus rechtlicher Sicht* (shareholder value from a legal perspective), ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 1997, 129; von Werder, *Der Shareholder Value-Ansatz als (einzige) Richtschnur des Vorstandshandelns?* (Shareholder Value approach as (sole) guideline of Management Action?), ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 1998, 69; Küller, *Das Shareholder Value-Konzept aus Gewerkschaftssicht* (The shareholder value concept as seen by the trade unions), BETRIEBSWIRTSCHAFTLICHE FORSCHUNG UND PRAXIS (BFuP) 1997, 517; Schmidt/Spindler, *Shareholder Value zwischen Ökonomie und Recht* (Shareholder Value between Economy and Law), in WIRTSCHAFTS- UND MEDIENRECHT IN DER OFFENEN DEMOKRATIE: FREUNDESGABE FÜR FRIEDRICH KÜBLER (Assmann ed, 1997), at 515.

(31) *See supra* note 2.

(32) *Cf.* TERRY SMITH, STRIPPING THE CAMOUFLAGE FROM COMPANY ACCOUNTS, , 2nd edition, 1996.

(33) *Cf.* FLEISCHER, *supra* note 25 at 23-24.

(34) *See Sittenverfall - Manager ohne Moral* (Moral decline - Managers without Morals), MANAGER MAGAZIN 6/2002, at 138 et seq.

(35) *See generally* INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE (Baums et al. eds., 1994).

(36) *Cf.* Schneider, *Auf dem Weg in den Pensionskassenkorporatismus?* (Towards Pension-fund-corporatism?), DIE AKTIENGESELLSCHAFT (AG) 1990, 317, 322-323; Monks, *\"Schlafende Riesen\"* (\"Sleeping Giants\"), *in* CORPORATE GOVERNANCE 331-339 (Feddersen et al. eds., 1996); Gilson/Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MISC in the Corporate Governance Debate,* 45 Stan. L. Rev. 985 (1993).

(37) Schneider, *Kapitalmarktorientierte Corporate Governance-Grundsätze* (capital market oriented corporate governance principles), DER BETRIEB (DB) 2000, 2413-2417.

(38) *See supra* note 4.

(39) *See* Seibt, Deutscher Corporate Governance Kodex und Entsprechenserklärung (§ 161 AktG-E) (German Corporate Governance Kodex and Compliance-Statement), DIE AKTIENGESELLSCHAFT (AG) 2002, 249.

(40) Viertes Finanzmarktförderungsgesetz (4. FMFG) v. 21.6.2002, BGBl. I S. 2010.

(41) *Cf.* GERMAN EXPERTS, supra note 19 at 1315

(42) *Cf. id.*

(43) *See* GERMAN EXPERTS, *supra* note 19 at 1316; BERICHT, *supra* note 18 at 158.

(44) *See* www.fefsi.org.