

# The One-Share-One-Vote Controversy in the EU

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# The One-Share-One-Vote Controversy in the EU

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## Abstract

The proposal by the European Commission (EC) to establish shareholder democracy and mandate the one-share-one-vote (1S1V) rule has drawn much attention and controversy. In the pursuit of enhancing the rule's popular appeal, EC policy-makers have tried to make equiproportional representation nearly an aphorism tied to corporate egalitarian sentiments underscoring justice, fairness and ethics.

Against this background, the question of who could be against or oppose shareholder democracy and the 1S1V principle has both positive and normative implications. Based on a review of law, finance and economics literature, this paper evaluates the economic underpinnings and efficiency of the 1S1V rule and concludes that it is generally a suboptimal corporate voting mechanism that compromises economic efficiency and distorts the incentives of corporate constituencies. Moreover, it is submitted that any attempt to mandate the 1S1V rule in the EU may induce companies to either move to pyramidal structures, or worse yet, to use complex derivative instruments to decompose 1S1V. While pyramidal holdings may further facilitate the expropriation of private benefits of control as compared with the status-quo, the decomposition of 1S1V can i) advance the heterogeneity of shareholders' preferences, ii) create incentives for negative voting arbitrage and iii) encourage the approval of value-reducing transactions, or more detrimentally, become a takeover defence. Hence, even if the EC could hypothetically move corporate Europe from controlled ownership structures to minority ownership ones, the 1S1V rule is clearly worse than the status quo, and paradoxically, instead of advancing the rights of 'disadvantaged shareholders', 1S1V can further demote shareholder rights in the EU. As a result, 1S1V cannot promote a value-enhancing corporate governance regime in the EU in general or meet the policy objectives of the intervention in particular in terms of strengthening the rights of shareholders, enhancing third-party protection or fostering the efficiency and competitiveness of businesses in the EU.

On the normative side, the issue is how corporate law can efficiently police the ability of controlling shareholders to expropriate rights from minority shareholders in general and extract private benefits in particular. Generally, it is asserted that if a corporate law regime is adequately structured, there is less need to worry about the voting rule and non-proportionate votes would not be a serious concern. In this light, this paper concludes by outlining some policy alternatives. First, it is proposed that EC policy-makers refrain from taking any measure at the level of the Community and instead strengthen disclosure rules and their enforcement. Furthermore, some standards of review governing significant conflict-of-interest transactions can be introduced. Second, it is submitted that EC policy-makers can also provide for opt-in and opt-out provisions for the member states. Such menus should once again be complemented by rigorous disclosure rules and their enforcement.

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## Introduction

For a few years now, European Commission (EC) policy-makers have been trying to establish a new form of democracy in the EU – namely corporate democracy. As a result, corporate Europe has long been subjected to a hefty dose of inconsistency stemming from the EC's Communication on Modernising Company Law and Enhancing Corporate Governance in the EU, launched in 2003.<sup>1</sup> The Communication, as the argument goes, pursues three key policy objectives, to: i) strengthen the rights of shareholders, ii) enhance third-parties' protection and iii) foster the efficiency and competitiveness of business.<sup>2</sup>

Critics of the EU's agenda for the reform of corporate governance have questioned whether the reform agenda and policy measures as proposed can create a value-enhancing corporate governance regime in the EU. The proposals to establish shareholder democracy and enforce the one-share-one-vote (1S1V) rule across the board in the EU have been among the most controversial. Whereas the political marketability of shareholder democracy and the 1S1V system has dominated the agenda of EC policy-makers, the economic justification for 1S1V as a value-enhancing technique of corporate governance in terms of fostering efficiency and competitiveness has been stunningly absent.

The conclusion this paper draws from a wider finance, economics and law scholarship is that the 1S1V rule is simply one corporate decision-making rule among many, and not necessarily the best one. The conditions for 1S1V being the optimal choice are highly contestable, and depending on the circumstances and the nature of corporate actions, 1S1V may be value-decreasing. Moreover, 1S1V can lead to changes involving organisational engineering and the applications of different derivative techniques capable of further disenfranchising minority shareholders in the EU. Hence, tying the 1S1V system to shareholder democracy in the pursuit of protecting minority shareholders is both misperceived and misguided.

The rest of this paper is organised as follows. Section 1 briefly reviews the concept and evolution of shareholder democracy in the comparative paradigm of EU and US debate. Section 2 presents a brief overview of the economics of corporate voting. Section 3 examines the optimality of the 1S1V rule in the context of complete contracting, incomplete contracting, takeovers, ownership pyramids and derivative instruments. It also discusses the justification and empirical support for 1S1V as a preferred vehicle of shareholder democracy in the EU. The paper concludes with summary remarks outlining key priorities and principles for revamping shareholder empowerment in the EU.

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<sup>1</sup> See European Commission (2003).

<sup>2</sup> Ibid.

## 1. Shareholder democracy

Proponents of shareholder democracy in the EU have long been inspired by the principles of political democracy. Political democracy has evolved both conceptually and procedurally around two fundamental dimensions. Conceptually, the substantive view of democracy stipulates that an electoral system should be devised in such a way that the principles of democratic faith, fairness, objectivity and morals are met. Procedurally, the conception of democracy, as incorporating articles of conceptual substance, should provide for meaningful and non-discriminatory participation of the electorate in political processes through a right to vote. The one-person-one-vote principle and majority rule have emerged in the context of electoral systems in political democracies as embodying substantive and procedural dimensions of democracy.<sup>3</sup>

The recent corporate fallouts across the both sides of the Atlantic have prompted unprecedented regulatory response aimed at reinforcing political democracy in terms of its conceptual and procedural principles at the level of corporations. A regulatory response with the goal of establishing shareholder democracy, arguments go, seeks the protection of shareholder rights, the reduction of fraud, enhanced financial transparency and strong public confidence in the markets. This section briefly sketches the concept of corporate/shareholder democracy as it has emerged and evolved in the US and the EU, both conceptually and procedurally.

### *Shareholder democracy in the US*

Shareholder democracy in the US has been traditionally associated with shareholder representation and empowerment, aimed at boosting shareholder activism and managerial accountability. The concept of shareholder democracy in the US has been shaped by the Supreme Court of Delaware, which intermediated two seminal standards of review, namely the *Blasius Standard* and the *Unocal Standard*. Under the *Blasius Standard* the Court held that “the shareholder franchise is the ideological underpinning upon which the legitimacy of the directorial power rests”.<sup>4</sup> Under the *Unocal Standard*, the Court redefined the fiduciary duties of board members in the context of hostile takeovers by recognising that “because of the omnipresent specter that a board may be acting primarily in its own interest’s, rather than those of the corporation and its shareholders”, a board of directors may attempt to thwart a takeover bid for self-interested reasons in order to protect or entrench themselves instead of fairly assessing the pros and cons of a bid.<sup>5</sup> Hence, a board’s response should be “reasonable” and “proportionate” and any defensive measure taken should be necessarily in the best interests of the company’s shareholders.<sup>6</sup> Consequently, to the extent that a board’s response is disproportionate to the threat posed, and defensive measures taken create a “preclusive or coercive” effect upon shareholders, the shareholders should decide whether the board can

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<sup>3</sup> For the origin of the one-person-one-vote principle in the US, see e.g. *Gray v. Sanders*, US 368, 381 (1963), in which Justice Douglas argues that “The conception of political equality from the Declaration of Independence, to Lincoln’s Gettysburg Address, to the Fifteenth, Seventeenth Amendments can mean only one thing – one person, one vote.” See also Elstner (1998), who argues that “[political democracy is a] simple majority rule, based on the principle, ‘One person one vote’.” Additionally, see Issacharoff & Lichtman (1993), who argue that the one-person-one-vote principle is a fair, objective and easy standard of review to measure and remedy for any deviation from equiproportional representation in the political system.

<sup>4</sup> See *Blasius Industries, Inc. v. Atlas Corp.*, 564, A.2d 651, 659 (Delaware, 1988).

<sup>5</sup> See *Unocal Corp. v. Mesa Petroleum Co.*, 493, A.2d 946 (Del. 1985).

<sup>6</sup> *Ibid.*

effectively continue exercising its fiduciary duties.<sup>7</sup> In the context of hostile takeovers, shareholder democracy in the US thus becomes tantamount to the ability of shareholders to replace the board.

More recently, the concept of shareholder democracy in the US has witnessed dramatic changes and proposals in terms of shareholder approvals, nominations, voting criteria and corporate actions. The US Securities and Exchange Commission (SEC), for example, has proposed a new director nomination rule in an effort to make the process for nominating board candidates less expensive and less cumbersome for shareholders and make boards more responsive and accountable.<sup>8</sup> This rule, if implemented, will allow shareholders (under some qualifying circumstances) to nominate directors and have their nominees listed in the company's proxy materials after a 'triggering event' as compared with the current situation, which allows shareholders to nominate board candidates through incurring the costs of printing and distributing their own proxy materials.

The next important ramification of the recent corporate governance debate in the US in terms of shareholder democracy has been emergent calls to move from a pluralistic vote to a majority vote.<sup>9</sup> Some have argued that corporate charters should mandate a majority vote for directorial elections, while others, such as institutional investors, have proposed that a majority vote should be mandatory for all aspects of corporate life.<sup>10</sup>

In this context, while some scholars have strongly advocated for more corporate democracy in terms of shareholders being able to initiate and vote on the company's basic corporate governance arrangements and "housekeeping rules of corporate law",<sup>11</sup> others have posited fundamental concerns and doubt as to whether more shareholder empowerment is the right way to reform corporate and securities law in the US.<sup>12</sup>

### *Shareholder democracy in the EU*

The first such concept of shareholder democracy at the EU level was introduced by the recommendations of the High Level Group of Company Law Experts (HLG) on takeover regulation in the EU in 2002.<sup>13</sup> Their report stated that shareholders are the owners of the company and they should take the ultimate decision as to whether or not to sell the company.<sup>14</sup> Unreservedly, it was implied that shareholder democracy will be achieved through the principle of proportionality between the risk-bearing capital (non-voting stock) and decision-making on the one hand and the break-through rule on the other (by imposing 1S1V).<sup>15</sup>

The implications of these recommendations have been widely analysed in law, economic and finance literature. The consensus that has emerged out of that research is that the HLG's recommendations on revamping the takeover market in the EU were a mixed bag of tools and

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<sup>7</sup> Ibid.

<sup>8</sup> See Proposed Rule 14a-11: Security Holder Director Nominations, Exchange Act Release Nos. 34-48626; IC-26206; File No. S7-19-03 (14 October 2003) (Proposing Release). See also Press Release 2003-133 (8 October 2003).

<sup>9</sup> See Borrus (2006).

<sup>10</sup> Ibid.

<sup>11</sup> See for example Hansmann & Kraakman (2001) and Bebchuk (2005).

<sup>12</sup> See for instance Romano (2004) and Bainbridge (2003).

<sup>13</sup> See European Commission (2002a).

<sup>14</sup> Ibid.

<sup>15</sup> Ibid; however, it would have been more correct to use equiproportional instead of proportionality.

instruments unable to promote more active and efficient takeover markets across the EU.<sup>16</sup> Most strikingly, however, in an attempt to promote shareholder democracy and decision-making in the EU, these recommendations could at best demote and at worst oppress real ownership rights and hence shareholder democracy, since they effectively redefine the concept of ownership, shifting it to non-owners (i.e. those with cash-flow rights) and giving them the power to decide whether or not to sell the company.<sup>17</sup>

The idea of shareholder democracy in the EU surfaced again in 2002 following the second report of the HLG on company law reform in the EU<sup>18</sup> and in 2003 following the EC's Communication.<sup>19</sup> While corporate Europe has tried to puzzle out just how representative shareholder democracy should become in the EU, for EC policy-makers, corporate governance in general and shareholder democracy in particular have seemed to be a foregone conclusion *alla* Mead (1922): "corporate governance is associated with representative government and is aimed at mirroring social, economic and political institutions of a wider society into the level of corporations". To implement 'democratic representation' at the level of corporations EC policy-makers opted for the 1S1V rule as an instrumental choice.

Against this background, the next section briefly discusses the economic theory of ownership and corporate voting.

## 2. The economics of ownership and corporate voting: A brief overview

The economic theory of ownership and ownership structure unequivocally states that ownership matters.<sup>20</sup> Not only does ownership matter, but its distribution and exercise also matter insofar

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<sup>16</sup> See for example Bebchuk & Hart (2002), who claim that instead of promoting economic efficiency, the break-through rule will push companies towards substituting dual-class capitalisation by other structures of control such as pyramids. These structures can further exacerbate problems related to monitoring, incentives and liquidity. See also McCahery & Renneboog (2003), who argue that the costs of the break-through rule exceed its benefits. The board neutrality and break-through rules are neither necessary nor sufficient conditions for ensuring a level playing field. Each rule should be assessed on its own merits and efficiency implications. In addition, see Coates (2003), who effectively asserts that the break-through rule is not any better politically or economically than the status quo.

<sup>17</sup> There are two fundamental and self-contradicting principles on which the recommendations are based. The first is that shareholders are the owners of the company and any decision on whether or not to sell the company belongs to them. Hence, managers should be banned from taking any takeover defence measures (the board neutrality rule). The second principle is that there should be proportionality between risk-bearing capital and control in connection with the pre-bid structures and mechanisms of the target company, so that the bidder can break through the barriers for exercising control in the target company and exert control in proportion to his/her holdings (the break-through rule).

The concept of risk-bearing capital has been previously unknown to economics although economic logic would associate it with cash flow rights. The HLG proposed that upon the acquisition of 75% of risk-bearing capital, the bidder can break through any mechanisms and structures that deviate from 1S1V. Hence, in the context of takeover the claimants of residual cash flow rights acquire residual voting rights based on the arguments that the former bears the ultimate effects of their decisions, whereas holders of control rights part with some of their control rights. Paradoxically, in the takeover context this would mean that in the pursuit of promoting shareholder democracy in the EU, i) ownership rights are shifted from the real owners to the non-owners; and ii) the decision of whether or not to sell the company is not in the hands of the owners but in the hands of the non-owners.

<sup>18</sup> See European Commission (2002b).

<sup>19</sup> See European Commission (2003).

<sup>20</sup> See for example Jensen & Smith (1984), who extend the basic framework of Modigliani & Miller (1958) to include variables such as taxes, bankruptcy costs and agency costs, and who argue that

as it is generally argued that the degree of distribution of ownership is an equilibrium response to the company's operating conditions,<sup>21</sup> and hence these features affect the performance of the company and the value thereof.<sup>22</sup> Moreover, it is submitted that managerial performance and incentives depend on the degree of concentration of ownership and managers' stake of ownership in the firm.<sup>23</sup>

Consequently, corporate voting mechanisms are critical in the context of exercising ownership over a wide range of corporate affairs. The 1S1V rule is a corporate voting mechanism that makes control exactly proportionate or equiproportional to the capital invested by tying cash flow rights to the voting rights for these shares. It is based on the assumption that shares entail i) economic ownership (cash flow rights) and voting power (voting rights) and ii) cash flow rights should be exactly proportionate to voting rights since shareholders are interested in higher share value and thus equally will vote to promote that interest so as to maximise the value of the company.<sup>24</sup> Moreover, to Easterbrook & Fischel (1983), the 1S1V rule would be a "mechanism by which stocks are valued [so that] the price reflects the terms of governance and operation".

The 1S1V principle is also generally designed as a legal counterbalance to managerial power along the lines of the central concept of a modern corporation, namely the separation of ownership and control.<sup>25</sup> Since minority shareholder-owners inherently suffer from collective action problems when attempting to monitor manager-shareholders in dispersed ownership structures (e.g. in the US), the argument goes that the 1S1V rule is one of the instruments that can be used to reduce the divergence between the interests of managers and shareholders and discipline wayward managers through the threat of replacement or the exercise thereof.<sup>26</sup>

In the US, the 1S1V rule was introduced by the New York Stock Exchange (NYSE) in 1926 as a self-regulatory rule, which subsequently became a statutory regulation further to the Securities Exchange Acts of 1933 and 1934. In 1986, demutualization and competitive forces made the NYSE refuse to enforce 1S1V.<sup>27</sup> Later, in 1990, the SEC's imposition of 1S1V on self-regulatory organisations was invalidated by the Court of Appeals for the DC Circuit, which held that it was beyond the scope and power of the SEC to regulate the internal corporate governance of listed companies.<sup>28</sup>

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the mix of financial claims (including debt and equity) affects the value of the firm since any changes in the mix change the firm's total cash flows. See also Mayers & Smith (1986) and Masulis (1987).

<sup>21</sup> See for instance Demsetz (1983) as well as Demsetz & Lehn (1983).

<sup>22</sup> See for example Wruck (1989), Hertzels & Smith (1993), Smith (1986), Grossman & Hart (1986), Jensen, & Warner (2000), Grossman & Hart (1986) and finally, Grullon & Kanatas (2001).

<sup>23</sup> See for example Jensen & Meckling (1976) and Jensen (1986).

<sup>24</sup> For more details, see for example Easterbrook & Fischel (1983), who argue that "it is not possible to separate the voting right from the equity interest and that someone who wants to buy a vote must buy stock too". See also Easterbrook & Fischel (1991) along with Black & Kraakman (1996) – the latter asserting that "The case for the one share one vote rule turns primarily on its ability to match economic incentives with voting power."

<sup>25</sup> For more details on separation of ownership and control, see Berle & Means (1932).

<sup>26</sup> See Black & Kraakman (1996), in which the authors argue that "The case for the one share one vote rule turns primarily on its ability...to preserve the market for corporate control as a check on bad management." See also Jensen & Warner (2000).

<sup>27</sup> See Rule 19c-4 "Governing Certain Listing or Authorization Determinations by National Securities Exchanges and Associations", Securities Exchange Act 1934. For a comprehensive history of the 1S1V rule in the US, see for example Seligman (1986).

<sup>28</sup> See *The Business Roundtable v. SEC*, 905 F.2d 406 (DC Cir. 1990).



In the EU, 1S1V is already a statutory rule in some member states. The recent study by Deminor (2005), for example, which examines the FTSE–Eurofirst 300 companies, highlights that:

- The 1S1V rule is already applied by 65% of all companies analysed. Deviations occur in most markets but are widespread in France, the Netherlands and Sweden (see Figure A1 in the Appendix for more details).
- There is variety of exceptions to the 1S1V rule. Multiple voting rights are used by 20% of the analysed companies and are again extensively used in France, Sweden and the Netherlands (see Figure A2 in the Appendix for more details on multiple voting rights and Figure A3 for all types of deviations by the frequency of each type).<sup>29</sup>

In this light, the following section evaluates how the 1S1V principle can influence shareholder value and whether it can be an optimal choice for shareholder empowerment.

### 3. Is the 1S1V rule optimal?

The link between the 1S1V rule and shareholder welfare is a critical one, since the extent to which 1S1V can be an optimal economic arrangement in terms of best promoting shareholder value predetermines whether 1S1V can be the right policy instrument for EU intervention in the pursuit of shareholder democracy in the EU. The efficiency implications of 1S1V have been broadly discussed in law, finance and economic literature. At best there are conflicting views as to whether deviations from 1S1V increase or reduce corporate value.<sup>30</sup>

Is the 1S1V rule the best policy instrument to achieve shareholder democracy in the EU? To answer this question, the following subsections present an in-depth analysis of 1S1V in the context of complete contracts, incomplete contracts, takeovers, pyramidal holdings and derivative instruments.

#### 3.1 1S1V and complete contracts

Corporate voting structures in general and the 1S1V rule in particular are irrelevant in the world of complete contracting, costless enforcement and homogenous shareholders. If all contracts are complete, then the corporate players are capable of: i) fully foreseeing all the future contingencies; ii) stating the course of action with respect to each contingency; and iii) writing comprehensive contracts at zero cost.<sup>31</sup> Moreover, if knowledge of the states of nature is common among shareholders – i.e. the states are dependent upon observable and verifiable variables – third parties can easily observe and enforce contracts. This means that there are no principle–agent problems of moral hazard and/or adverse selection. *Ex ante* complete contracting leaves no room for *ex post* residual decision-making, opportunism or divergent/heterogeneous preferences. Hence, all shareholders have identical tastes or preferences. Costless enforceability of contracts eliminates incentive and coordination problems, and thus invalidates the very necessity of ownership in general and the 1S1V rule in

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<sup>29</sup> See Deminor (2005).

<sup>30</sup> See for example Jarrel & Poulsen (1988) along with Partch (1987).

<sup>31</sup> See for example Coase (1937). Contractual completeness refers to the fact that parties can specify their rights and obligations with respect to all current and future states of the world.

particular. The initial distribution of ownership and the 1S1V rule do not matter in this context since resources will eventually end up at their highest-value utilisation and economic efficiency will be maximised.<sup>32</sup>

### 3.2 1S1V and incomplete contracts

As soon as the assumption of contractual completeness is abandoned, the incomplete contracting paradigm implies that shareholders are rational maximisers of their welfare but only boundedly so. Moreover, there are agency costs of contracting, monitoring and opportunism that give a rise to divergent incentives. Consequently, incomplete contracts validate the necessity of ownership. Not only does ownership become relevant in this context, but its distribution does as well. If ownership and its distribution matter, then instruments of exercising ownership in general and the 1S1V rule do too. The issue then becomes how 1S1V influences shareholder value! There might be two areas in which explanations of its influence in the incomplete contracting paradigm can be derived: transaction costs and the concentration of ownership, both of which are driven by heterogeneous preferences.

#### *Transaction costs*

In the transaction costs paradigm, the optimality of 1S1V can be explored based on the relationships between the nature of the investment, the degree of its specificity (re-deployability/liquidity) and the cost of finance.<sup>33</sup> It can be generally argued that since different modes of finance have different costs, in this framework the level of asset specificity determines preferences for different modes of finance. Moreover, the degree of specificity of investment determines different incentives and divergent preferences, and hence, undermines the very basis of the 1S1V principle, namely that of “similar if not identical shareholders”.<sup>34</sup>

Low asset-specific (more liquid) investments can be easily financed by debt, since they are associated with lower transaction costs of finance, while high asset-specific investments (less liquid) ought to be financed by equity, since this entails lower transaction costs. This logic is very simple. As the degree of asset specificity of the investment increases, the degree of its liquidity shrinks and the transaction costs of its monitoring rise. As the liquidity shrinks, the value of pre-emptive rights decreases so the cost of debt finance increases. Thus, higher (lower) costs of debt finance induce the firm to choose lower (higher) cost equity finance for investment projects. More importantly, ownership and *ex post* residual decision-making should be allocated in such a way that information asymmetries and high agency costs of monitoring (post-contractual costs) could be minimised. This can be achieved through extending adequate incentives to the party(ies) making the most particular, relationship-specific investment through conferring controlling residual voting power to such a party(ies).

In this context, the 1S1V rule implies that high and low agency-cost shareholders, or alternatively shareholders with divergent preferences, obtain the same *ex post* decision-making power (voting rights). This increases information asymmetries and the agency costs of

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<sup>32</sup> This implies three types of efficiency: productive, allocative and distributive. Productive efficiency refers to the costs of goods and services produced in the economy. Allocative efficiency refers to the allocation of resources to the production of the goods and services consistent with societal preferences. Distributive efficiency refers to the efficiency with which the output and services produced are delivered to the society at given disposable incomes and market prices.

<sup>33</sup> For more information, see for example Demsetz (1983), Grossman & Hart (1986), Hart (1995) and Hart & Moore (1990).

<sup>34</sup> See for example Easterbrook & Fischel (1983).

monitoring while reducing the incentives surrounding the high agency cost factor(s), thus inducing further costs for the company and impacting its value. Hence, 1S1V becomes a suboptimal voting mechanism in the world of incomplete contracts and heterogeneous shareholders as defined by the degree of specificity of their investments.

In view of these considerations, economic optimality would suggest that in order to maximise shareholder value, there should be complete separation between voting rights and cash flow rights. The party(ies) embarking on the most particular, relationship-specific investment should have the full non-fragmented menu of residual *ex post* decision-making power in the company.

### *Ownership concentration*

Another framework that can shape the optimality debate concerning 1S1V is the concentration of ownership, once again driven by non-identical shareholders in terms of their preferences for control. Since 1S1V is an instrument of the distribution and exercise of power within a corporation, its efficiency implications vary with the degree of concentration of ownership.

The degree of ownership concentration varies across the world's advanced economies. There are different ownership structures, e.g. across the both sides of the Atlantic, with the most important difference being the wide presence of a controlling shareholder(s) in the EU.<sup>35</sup> The latter signifies the fact that unlike the US, ownership and control are not fully separated in most of continental Europe.

Not only is there a striking difference between ownership concentration in the EU and the US, but the main categories of owners and the instruments of ownership vary significantly as well. Unlike the US, ownership in continental Europe has been generally highly concentrated through such instruments as pyramidal holdings, ownership cascades, disproportionate classes of shares, voting trusts and voting caps (see Tables A1 and A2 in the Appendix for more details).<sup>36</sup>

Corporate voting instruments, be it in the US or EU, have evolved historically as a result of different preferences for control and liquidity as well as the wider set of institutions of ownership and historical market structures. Dispersed ownership structures, for instance, inherently suffer from a problem that is generally known in the economic literature as a 'free rider problem'. The essence of the problem is that in dispersed ownership structures, there will generally be lack of monitoring since the costs and benefits of monitoring will be shared disproportionately: the costs of monitoring will be incurred by an individual shareholder willing to do so, while the rest of the shareholders and stockholders will only benefit from any such monitoring without any contribution. The lack of monitoring will further exacerbate the conflict of interest between minority shareholders and the board by effectively allowing managers to benefit from diverting corporate resources by, for example, engaging in related-party transactions (see Gilson & Gordon, 2003), undertaking projects targeted to their needs and ends (see Demsetz & Lehn, 1983), pursuing visionary projects (see Jensen, 1993) or enhancing their human capital (see Shleifer & Vishny, 1989).

Hence, in the context of dispersed ownership structures, the 1S1V rule is designed as an instrument among the broader set of core and supporting institutions of corporate governance to mitigate the agency costs of monitoring and the effects of divergent incentives between minority shareholders and managers – more specifically, to reinforce shareholder primacy through monitoring and disciplining corporate boards.

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<sup>35</sup> For more details, see for example Barca & Becht (2001).

<sup>36</sup> See for example Bennedsen & Nielsen (2002), along with Faccio & Lang (2002).

Although concentrated ownership structures effectively overcome the free rider problem between small shareholders and managers by giving controlling shareholders the power and benefits of control, they introduce another type of agency problem, i.e. one between controlling and non-controlling shareholders. Through different instruments of exercising control, like those employed in the EU, controlling shareholder(s) can effectively curb managerial power. Thus, by promoting their own interests through general oversight, majority shareholders also promote those of the minority. Yet, structures such as ownership cascades, pyramids and voting trusts allow controlling shareholders to unilaterally and disproportionately benefit from their holdings through related-party transactions, to control premia and to freeze-out transactions to the detriment of non-controlling shareholders (see Gilson & Gordon, 2003).

The latter point has two important ramifications for the optimality of 1S1V. First, the degree of concentration of ownership determines different incentives and divergent preferences, and as a result, undermines the very basis of efficiency of the 1S1V principle, namely that of “similar if not identical shareholders”.<sup>37</sup>

Second, in the context of controlling structures in general and in the EU in particular, the 1S1V rule as designed to discipline self-interested managers is not a suitable policy instrument since in most of continental Europe the nature and magnitude of agency problems is not between minority shareholders and wayward managers, but between minority and majority shareholders. Therefore, it would be a more viable and efficient step forward if EC policy-makers could introduce measures that could effectively constrain the private benefits of control for controlling shareholders on the one hand and ensure an efficient redress mechanism for minority shareholders on the other.

In any case, a proper disclosure regime for such transactions is key to limiting the amount of control benefits accrued by controlling shareholders. As an example, the International Accounting Standard (IAS) 24 Related Party Disclosures already defines how information should be disclosed about the transfer of resources, services or obligations between related parties (regardless of whether a price is charged), the nature of related-party transactions and outstanding balances to enable an understanding of their potential effects.<sup>38</sup> Moreover, IAS 24.16 mandates disclosure of management compensation and thus constrains the ability of majority shareholders to compensate themselves as, for instance, board members of the company.<sup>39</sup> Furthermore, IAS 1.96 (97) requires the company to present a statement of changes in equity as a separate component of the financial statements, which makes equity change transactions more transparent and hence reduces the need for extensive legislating in this area.<sup>40</sup>

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<sup>37</sup> See Easterbrook & Fischel (1983).

<sup>38</sup> See IAS 24 for more details.

<sup>39</sup> See IAS 24.16, which mandates the disclosure of compensation for key management personnel in total along with each of the other following categories: i) short-term employee benefits; ii) post-employment benefits; iii) other long-term benefits; iv) termination benefits; and v) equity compensation benefits. Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including all directors (whether executive or otherwise).

<sup>40</sup> See IAS 1.96, which requires that an entity shows: i) profit or loss for the period; ii) each item of income and expense for the period that is recognised directly in equity and the total of those items; iii) total income and expenses for the period (calculated as the sum of (i) and (ii)), separately itemising the total amounts attributable to equity holders of the parent and to minority interests; and iv) for each component of equity, the effects of changes in accounting policies and corrections of errors.

Moreover, according to IAS 1.97, the following amounts may be additionally presented in IAS 1.96 or they may be presented in the notes: i) capital transactions with owners; ii) the balance of accumulated profits at the beginning and at the end of the period, and the movements for the period; and iii) a

Taking these considerations into account, the EU could, for example, better concentrate on strictly reinforcing accounting and standards, which might be further complemented by the introduction of rigorous standards of judicial review.<sup>41</sup>

### 3.3 1S1V and takeovers

The implications of voting mechanisms in general have been widely analysed in the context of proxy contests for corporate control.<sup>42</sup> In particular, a rigorous analytical framework of the (non)optimality conditions of the 1S1V rule in the takeover context have been developed by the pioneering works of Grossman & Hart (1988) and Harris & Raviv (1988). Despite the fact that the proposed settings differ in certain respects,<sup>43</sup> the authors' general conclusion is that the distribution of voting rights affects the value of the firm and under qualifying conditions (which almost never occurs), the 1S1V is Pareto-optimal.<sup>44</sup>

Based on the concepts of private and public benefits of control that accrue to the board and shareholders respectively, Grossman & Hart (1988) argue that 1S1V maximises the value of the firm as compared with dual-class capitalisation, since dual-class capitalisation coupled with the following qualifying conditions might allow for control to be transferred to a potentially inefficient bidder who enjoys private benefits of control:

- i) shareholders have the same preferences;
- ii) control is concentrated through a dual-class structure with a 50:50 split between the voting and non-voting shares that have equal cash flow rights;
- iii) the incumbent management does not enjoy private benefits;
- iv) there is only one party in the control contest obtaining significant private benefits; and
- v) the bidder bids only for the voting stock, while the holders of non-voting stock incur the costs of inefficient management without benefiting from any control premium.

Under these qualifying assumptions, however, the 1S1V rule would eliminate the possibility of inefficient management taking control. Any bidder should be able to acquire all the outstanding

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reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and at the end of the period, disclosing each movement.

<sup>41</sup> Gilson & Gordon (2003) argue that subjecting any transaction between the controlling shareholder and the company to standards of business judgement and intrinsic fairness can effectively mitigate the degree of extraction of private benefits of control.

<sup>42</sup> See for instance Edelman & Randall (2003), Gilson & Schwartz (2001), Bebchuk & Hart (2001) and Easterbrook & Fischel (1991). Gilson (1987) argues that only companies with weak corporate governance voting structures employ takeover defences in general and multiple classes of shares in particular.

<sup>43</sup> Grossman & Hart (1988) concentrate on the maximisation of the economic value and assume that the subjective probability of small shareholders being pivotal in the takeover context is zero. By contrast, Harris & Raviv (1988) also analyse maximisation of the social value and assume that small shareholders can be pivotal in the takeover context.

<sup>44</sup> This refers to the criterion associated with the name of Vilfredo Pareto. The underlying premise of the Pareto criterion is individual welfare. It holds that a group is better off if: a) every individual is better off, or b) at least one member of the group is better off without anyone else being worse off.

shares of the company at a share price trading under the incumbent management. Hence, 1S1V outperforms any dual-class structure by maximising the public (economic) value of the firm.<sup>45</sup>

The second seminal contribution, made by Harris & Raviv (1988), presents a trade-off between social and economic optimalities and argues that this trade-off determines the optimality of 1S1V. Social optimality is achieved when the sum of the private and public benefits is maximised. The 1S1V principle in combination with the simple majority rule becomes socially optimal because it is capable of replacing wayward management. The party capable of running the company more efficiently obtains the control. Yet, social optimality generally is achieved to the detriment of economic optimality. The authors show that any dual-class structure with a full separation of voting rights and cash flow rights maximises the public value of the firm. Nevertheless, although economic efficiency endows shareholders with more benefits, it does not necessarily ensure the victory of the best management team. Consequently, efficiency might suffer as a result of the 1S1V rule.

Under qualifying conditions, not having such a voting rule leads to inefficient acquisitions from the non-voting shareholders' perspective in a Grossman & Hart-type setting. But as the magnitude of the inefficiency essentially turns on whether private benefits for bidders are very large, one wonders how relevant such an assumption is. The assumption of there only being one party in the control contest is not realistic. As the number of contestants increase, concentrated voting power allows for 'squeezing out' more public benefits from private benefits. The party in the control contest that can enjoy the greatest control benefits is also that which can run the company more efficiently (see also the previous arguments concerning transaction costs and incomplete contracts). Accordingly, as a result of a more efficient party taking control of the company, holders of non-voting stock can be better off.

Moreover, the fundamental presumption of shareholders being homogenous value-maximisers is indefensible. The literature has long emphasised the role of behavioural and cognitive psychology in price performance and price behaviour over time, and hence the heterogeneity of preferences of corporate players.<sup>46</sup> They are not identical insofar as their preferences are concerned since they have limited, non-identical cognitive capacities to store, process and interpret information.<sup>47</sup> Different corporate players also have different perceptions or biases about the market and its trends. They use behavioural and judgmental faculties such as biases related to i) motivated reasoning, ii) self-confidence and iii) flawed statistics to seek out and discover valuable information in the face of informational incompleteness.<sup>48</sup> Consequently, the way in which corporate players make judgements on stock performance, for example, and how they determine and express their respective preferences define the way in which they are different from each other in their preferences and how such differences are reflected in stock returns and volatility.<sup>49</sup>

In this light, the existence of value-increasing deviations from 1S1V is further supported by various authors. For instance, Shleifer & Vishny (1986 and 1988), Hirshleifer & Thakor (1994) and Hirshleifer (1995) claim that deviations from 1S1V are necessary to extract the highest value from the bidder. Zingales (1994 and 1995) and Gromb (1997) further argue that dual-class

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<sup>45</sup> A point should be made here that any rational bidder will incorporate foreseen costs associated with the 1S1V rule into his/her bid price, which might imply that the public value of the firm is not necessarily maximised under the 1S1V rule in this context.

<sup>46</sup> For more details, see for example Kahneman & Mark (1988) and Choi & Pritchard (2003).

<sup>47</sup> See Simon (1955).

<sup>48</sup> See Hirshleifer (2001) and Tversky & Kahneman (1974).

<sup>49</sup> See Goldstein & Hogarth (1977).

capitalisations with complete separation between voting and non-voting stock increases the efficiency of the bid. Burkart, Gromb & Panuzzi (1998) additionally contend that deviations from the 1S1V rule might be desirable to mitigate post-takeover agency problems in the absence of the mandatory bid rule.

Jensen & Warner (2000) advance the non-optimality debate of 1S1V by concluding that deviations from the 1S1V rule can create more shareholder wealth since they allow for capturing more benefits of control from the successful bidder. Coates (2001) further claims that it is largely misleading to believe that 1S1V promotes takeovers while any dual class is a takeover defence. Even if dual-class shares can be seen as a takeover defence, Bebchuk, Coates & Subramanian (2002) conclude that takeover defences in general have little or no impact on the bid outcome.

Martin & Partnoy (2005) further undermine the feasibility of 1S1V in the context of takeovers, arguing that voting arbitrage can effectively make 1S1V a suboptimal corporate voting mechanism and demote shareholder value. Arbitrageurs, the argument goes, can destroy the shareholder value in the takeover context, if their net holding position of shares as defined by the difference between pure holdings and the short positions is negative. The destruction can take two forms. First, shareholders with a net negative position can block value-enhancing takeovers since any value-enhancing takeover will result in a net negative cash flow for these shareholders and hence losses from short positions. Second, arbitrageurs can vote for suboptimal tender offers in order to maximise payoffs associated with net short positions. Accordingly, the company can be taken over by inefficient management, which will be consequently reflected by sliding stock prices and allow profiting from short positions. In both cases, the more shareholder value is destroyed, the more profits arbitrageurs make.

The authors At, Burkart & Lee (2006) explore how voting structure, asymmetric information and private benefits determine the takeover outcome. They conclude that generally, 1S1V is not optimal in terms of promoting more value-increasing bids.

Consequently, as a voting mechanism, the 1S1V rule cannot promote a more active and value-enhancing corporate takeover market in the EU. Paradoxically, it can promote incentives linked to self-interest and takeovers that are value-destroying – or even worse a takeover defence.

### 3.4 1S1V and pyramids

Pyramidal holdings are designed as hierarchically intermediated chains of affiliated companies through a top-down chain of control as a vehicle to achieve a desired degree of trade-off between liquidity and control.<sup>50</sup> Through such structures the ultimate owner(s) retain most of the voting power of the chain and mostly externalise financial, risk-bearing or liquidity costs. These structures give an opportunity or ‘default options’ to the ultimate owner(s) to diversify risks and allocate resources across a portfolio of companies and contracts while ensuring necessary voting control is retained over the chain. Moreover, for a given value of the company, it is cheaper to establish and manage a pyramidal holding instead of a group of horizontally structured companies, since the latter requires significantly higher equity investment, lower leverage and as a result higher costs of management *vis-à-vis* pyramidal holdings.

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<sup>50</sup> See for example Wolfenzon (1999). For the trade-off between liquidity and control, see Coffee (1991); however, Aghion, Bolton & Tirole (2004) contend that highly speculative liquid markets necessitate more not less monitoring. See also Becht (1999).

Although some authors document that pyramidal holdings can create value through “internal capital markets”,<sup>51</sup> it is also submitted that such structures allow for maximum extraction of private benefits by the ultimate owner(s).<sup>52</sup> Moreover, as compared with the negative effect that dual-class capitalisation has on liquidity and incentives, pyramidal holdings have a much larger negative impact on these variables.<sup>53</sup> Shleifer & Vishny (1997) argue that “large owners gain nearly full control of the company and are wealthy enough to prefer to use firms, to generate private benefits of control that are not shared by minority shareholders”.<sup>54</sup> La Porta et al. (2002) further posit that weak minority protection rules induce expropriation of outside shareholders, which is an increasing function of the controlling shareholders owning fewer cash flow rights. Nevertheless, Becht (1999) argues that the imposition of legal rules/voting mechanisms aimed at strengthening minority rights can indeed have negative effects on corporate performance insofar as they can reduce monitoring incentives and shrink liquidity.

Against this background, the imposition of 1S1V can induce companies valuing more control through non-equiproportional capitalisation to switch to pyramidal structures.<sup>55</sup> Particularly in the EU, which is characterised by majority ownership and a wide variety of non-equiproportional capitalisation, this is a plausible scenario. Hence, even if 1S1V is mandated in the EU, instead of meeting its policy objectives, it might indeed affect minority rights and lead to minority abuse as compared with, for example, dual-class capitalisation. From a policy perspective, it might sound prescriptive to ban pyramidal holdings. Yet that could be insurmountable task, as such a move would be tantamount to i) prohibiting industrial groups, most of which take the form of pyramidal holdings in the EU, and ii) or identifying pyramids and prescribing limitations on their use.<sup>56</sup>

Even if EC policy-makers somehow manage to ban pyramidal structures, derivative instruments may effectively allow the achievement of the same economic effect of separation of cash flow rights from voting rights of the same shares but at much higher costs, as is discussed below.

### 3.5 1S1V and the market for votes

Political, legal and economic scholarship has long dealt with the issue of the market of votes in terms of vote-trading in the political markets and the equilibrium conditions thereof.<sup>57</sup> Vote-trading and political logrolling have long been part and parcel of the market for votes and political dynamics in many advanced democracies.<sup>58</sup> Moreover, scholarship on the issues of public and social choice has extensively concentrated on the political bargains and vote-trading outcomes as well as the stability and optimality properties thereof.<sup>59</sup>

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<sup>51</sup> On the value creation of pyramidal holdings, see for example Williamson (1975), as well as Stein (1997) and Billet & Mauer (1999).

<sup>52</sup> See for example Bebchuck, Kraakman & Triantis (2000).

<sup>53</sup> Ibid.

<sup>54</sup> See Shleifer & Vishny (1997).

<sup>55</sup> See Becht (1999); see also Berglof & Burkart (2003), who further extend this argument in the context of takeover regulation.

<sup>56</sup> For a similar argument, see also Ferrarini (2002).

<sup>57</sup> See for example Buchanan & Tullock (1962), Stigler (1972), Schwartz (1977) and Pelzman (1990).

<sup>58</sup> For more details on logrolling, see for example Buchanan & Tullock (1962), Mueller, Philpotts & Vaneket (1972) and Bernholz (1973).

<sup>59</sup> See for example Becker (1983 and 1985) as well as Bernholz (1973).



There is an important analogy that can be drawn from the choice of the decision and legal rules in the political market for votes with regard to the choice of decision and legal rules in the corporate market for votes. Borrowing from Karlan (1999), it can be argued that on the one hand, shareholders' rights to vote and voting rules have powerful, expressive individual and collective choice functions insofar as they reveal individual and collective choices.<sup>60</sup> On the other hand, if individual, rational value-maximising shareholders think of their votes as simply something to be auctioned to the highest bidder, they are likely to see the sole purpose of the corporate governance process as the maximisation of their own short-term self-interest.<sup>61</sup>

In this light, the advance of capital markets and derivative instruments has introduced many exchange mechanisms in the market for corporate votes. These techniques permit wholesale and retail vote-trading in the market for corporate votes conducive to different preferences in terms of control. In particular, derivative techniques allow for de facto decomposition of the 1S1V rule, i.e. the separation of cash flow rights from voting rights to those shares. These instruments also de facto endow the ability, in consonance with all legal requirements, to possess greater or fewer voting rights as compared with the cash flow rights of those shares, depending on the need and the nature of a derivative transaction.

There are many decomposing derivative techniques such as stock lending, equity swaps, direct and indirect hedges and the like, which enable corporate actors to retain formal control while outsourcing some or most of the cash flow rights.<sup>62</sup> For example, stock lending allows for separating cash flow rights from voting power so that the borrower ends up with enough voting power to push through desired decisions during a general meeting of shareholders while the lender retains cash flow rights in exchange for some fee. This is a relatively easy technique in the US, where stocks amounting to 99% of market capitalisation can be lent and borrowed.<sup>63</sup>

Another technique to decompose 1S1V is the use of collars, in which corporate insiders hedge by taking put and call positions simultaneously to limit their possible risk through fixing the downside and upside. Any such operation effectively decomposes 1S1V by allowing the retention of voting powers while reducing cash flow exposure. Bettis, Bizjak & Lemmon (2001) argue that in the US, senior executives of listed companies use collars for 36% of their holdings, which allows them to outsource 25% of their cash flow exposure.

Shareholders can also combine pure shareholdings with a short position shareholding to decompose 1S1V. Martin & Partnoy (2005) hold that this combination makes such shareholders at best indifferent to the shareholder value (when the net cash flow position is zero as a result of holding exactly the same number of shares and a short position in that share) and at worst interested in the destruction of shareholder value (when the net cash flow position is positive as a result of holding more shares in the short position as compared with traditional holding).

Hu & Black (2006a and 2006b) further analyse the taxonomy and implications of security derivatives that allow for 'decoupling' cash flow rights from voting rights attached to the same share and conclude that such separation is indeed value-destroying, and worse yet, as compared with dual-class recapitalisation, does not require a shareholder vote.

The possibility and opportunity for corporate vote-trading and de facto decomposition of 1S1V changes shareholder preferences and the degree to which these are reflected in the decision-making process. In this context, the 1S1V rule simply becomes a starting point or an initial

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<sup>60</sup> For a basic taxonomy in the political context, see Karlan (1999).

<sup>61</sup> Ibid.

<sup>62</sup> For insider hedging and collars, see for example Bettis, Bizjak & Lemmon (2001).

<sup>63</sup> See D'Avolio (2001).

entitlement in the market for corporate votes. The decomposition of 1S1V emerges as an exchange mechanism through which individual shareholders express or reveal the relative strength and intensity of their preferences or alternatively shareholders acquire more votes on issues that are more valuable to them in exchange for weak preferences on others. Any such vote-trading would occur until the marginal benefit of acquiring one more vote on a given issue is equal to its marginal cost.

Thus, the unequivocal finding from corporate finance literature is that even if 1S1V is a mandatory rule, that does not preclude the application of different derivative techniques to decompose and de facto separate cash flow rights from voting rights attached to the same share. Moreover, any such decomposition may distort incentives and advance the destruction of shareholder value instead of promote it. This may be further exacerbated by the fact that decomposition does not require any kind of formal shareholder vote.

At the same time, borrowing from Buchanan & Tullock (1962), it can be contended that permitting those shareholders who feel strongly about an issue to compensate in some ways those whose opinion is feebly held can result in a great increase in the well-being of both groups, and the prohibition of such transactions will serve to prevent movement towards the conceptual boundary of shareholder optimality under almost any definition of this term. “With all side payments prohibited, there is no assurance that collective [shareholder] action will be taken in the most productive way.”<sup>64</sup>

## Summary and concluding remarks

Generally, EC policy-makers have not satisfied the burden of proof that establishing shareholder democracy and enforcing the 1S1V rule will rebuild investor confidence, protect shareholders and third parties as well as foster business competitiveness and efficiency across the EU. While opting for harmonised, mandatory 1S1V across the EU, EC policy-makers do not adequately substantiate why this measure is justified at the level of the Union in light of standards of subsidiarity and proportionality (i.e. by proving that member states are not able to implement this measure as efficiently as could be done at the EU level), with the argument 1S1V is proportional to the objective pursued. This approach has shown the ubiquitous characteristic of EU law-making: mandatory harmonisation has once again overshadowed the economic rationale of intervention.

When trying to make the case for the 1S1V rule, a very important open question if not disregarded remains as to the diversity of the core and supporting institutions of corporate governance in the EU, such as traditionally-concentrated ownership structures, multiple classes of votes, and complex mechanisms of retaining control and balancing the liquidity of shares. If the 1S1V principle was so value-enhancing, one would expect to widely observe that in the absence of a top-down imposition of the rule there would have been a bottom-up evolution, i.e. through i) companies going public with provisions for the 1S1V rule in their charters in the pursuit of increased ability to raise capital; and/or ii) intensive lobbying on the part of member states’ legislatures to provide for 1S1V in their respective jurisdictions and at the level of the EU. Since none of these has been a dominant phenomenon in the EU, one can argue that at the least 1S1V is not as valuable as presumed.

Furthermore, if the absence of a mandatory 1S1V rule was so disempowering for shareholders in the EU, and if controlling shareholders have expropriated the rights of minority shareholders, one would expect to see a highly dysfunctional system of corporate governance in the EU in

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<sup>64</sup> See Buchanan & Tullock (1962).

general, and capital flowing to less productive use in the EU in particular. Yet empirical evidence shows just the opposite. On average, the stock markets in the EU have performed relatively well since 1982, with returns comparable to US levels (see Table A3 in the Appendix). In terms of macroeconomic performance the indicators also look quite good. From 1970 to 2000, the EU's real income was almost constant at approximately 70% of that of the US (see Table A4 in the Appendix). Meanwhile, the EU's level of productivity increased over the same period from 65 to 90% of that of the US. On average, the EU's total factor productivity was even higher in comparison with the US over the period of 1980 to 2000 (see Table A5 in the Appendix).

Against this background, the conclusion this paper draws from the literature on law, economics and finance is that 1S1V is neither a sufficient nor a necessary condition for shareholder democracy in general or shareholder empowerment in the EU in particular. Despite the fact that the 1S1V rule is more politically attractive, it is suboptimal in terms of its economic efficiency. Even if the EU hypothetically manages to disperse ownership in the Union – which, in the light of the EU Takeover Directive, is an insurmountable task – at best 1S1V is clearly not a value-enhancing mechanism in itself and at worst is associated with deadweight social losses. Most striking, however, is the fact that even in traditional 1S1V jurisdictions like the US, the advance of capital markets and corporate derivative securities effectively allow for the decomposition of the 1S1V system. Paradoxically, any such decomposition can distort incentives and lead to the destruction of shareholder value. Consequently, while trying to promote shareholder wealth, EC policy-makers might instead promote its destruction through the 1S1V rule.

Moreover, there are already ample lessons to draw from 60 years of US corporate history, which provide a clear example with regard to policy intervention. Growing recognition of the fact that, as an ideological underpinning of 1S1V, a “long-standing commitment to encourage high standards of corporate democracy” as reflected by individual standards of “corporate responsibility, integrity and accountability to shareholders” is not adequate led to the abolition of the 1S1V mandatory rule in the US.<sup>65</sup>

This conclusion leaves a nagging question as to what is next? There might be two policy alternatives for EC policy-makers. The first alternative is to refrain from taking any action at the EU level. Instead, in view of the concentrated ownership structures in the EU, shareholder empowerment can be achieved through reinforcing the role of non-executive directors in the areas of potential conflict of interest between majority and minority shareholders, rigorously enforcing the IAS disclosure rules and disclosure-triggering standards, and possibly introducing some standards of review governing significant conflict-of-interest transactions.

The second alternative could be the introduction of an opt-in or opt-out provision in the member states with respect to the rule. The opt-in member states would allow companies to opt into the statutory 1S1V provision. The opt-out member states would allow companies to opt out of the 1S1V rule by either charter or bylaw amendments. In light of the exemptions from the breakthrough rule of the EU Takeover Directive, this approach is also consistent with the body of EU law. A self-regulatory approach can be further complemented by rigorous, harmonised transparency requirements and their enforcement. As soon as companies make their corporate governance arrangements in general – as well as their voting, economic ownership structures and decision-making rules in particular – publicly available during the initial public offering (IPO) and the post-IPO stages through periodic disclosures to allow investors to make informed decisions, there is no reason to believe that constraining investors' and issuers' choice with respect to voting and decision-making rules by law is the right option to pursue.<sup>66</sup> It also might

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<sup>65</sup> These quotations are derived from Loss & Seligman (1989-, 3<sup>rd</sup> ed., 2003).

<sup>66</sup> For a choice of law debate, see for example Guzman (2000) and Choi & Guzman (2001).

be beneficial to require US-style disclosure schedules such as those concerning rights attached to securities, directors and officers, compensation, long and short positions, articles of incorporation and bylaws.<sup>67</sup>

In the IPO stage, rational investors could discount the price of securities with voting and decision-making rules that disenfranchise shareholder rights and hence increase the company's cost of capital. Alternatively, rational investors could pay the fair value and thus decrease the firm's cost of capital if the firm offers more shareholder-friendly voting and decision-making rules. Accordingly, rational managers or controlling shareholders who recognise that the 1S1V rule matters, for instance in terms of reducing the cost of capital, would adopt such a mechanism even if it is not a mandatory rule. In the post-IPO stage, disclosures of any changes of voting and decision-making rules through proxy statements or through quarterly, semi-annual or annual reporting can have a similar effect as those of the IPO stage.

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<sup>67</sup> For US disclosure schedules, see for example: Item 9 of Form S-1 with respect to the corporate governance rights of the securities being sold, Item 11(k) of Form S-1 with respect to directors and officers, Item 11(l) with respect to executive compensation and Item 16(a) with respect to the articles of incorporation, bylaws and other documents or contracts specifying the rights of security holders.

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## Appendix Tables and Figures

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*Table A1. Instruments of separation of ownership and control in the EU*

<b>Member states</b>	<b>Sample</b>	<b>Controlling owner (%)</b>	<b>Pyramid ownership (%)</b>	<b>Cross-ownership (%)</b>	<b>Owning family (%)</b>
AT	88	81.82	20.78	1.14	80.00
BE	104	71.15	25.00	0.00	80.00
FI	92	41.30	7.46	0.00	69.23
FR	522	64.75	15.67	0.00	62.20
DE	631	59.90	22.89	2.69	61.46
IE	26	42.31	9.09	0.00	77.78
ES	465	44.30	16.00	0.22	62.50
IT	181	58.76	20.27	1.13	70.00
NO	98	38.78	33.90	2.04	66.67
PT	68	60.29	10.91	0.00	50.00
SE	149	48.32	15.91	0.67	73.47
UK	721	43.00	21.13	0.00	75.85

*Source:* Faccio & Lang (2002).

*Table A2. Differentiated voting rights in Europe*

<b>Country</b>	<b>Number of companies</b>	<b>Proportion of companies with differentiated voting rights (%)</b>
Sweden	334	0.55
Italy	208	0.41
Finland	129	0.36
Denmark	210	0.33
UK	1,953	0.24
Ireland	69	0.23
Austria	99	0.23
Germany	704	0.18
France	607	0.03
Spain	632	0.00
Portugal	87	0.00
Belgium	130	0.00

*Source:* Bennedsen & Nielsen (2002).

*Table A3. Stock market performance – The EU vs. the US (%)\**

	US	EU
From 1982	1,222	1,145
From 1987	436	426
From 1992	164	113
From 1997	28	13
From 2001	-32	-34

\* From 1 January of the given year through the end of December 2002.

Source: Holmstrom & Kaplan (2003).

*Table A4. PPP GDP per person, PPP GDP per hour and hours per person, 1970 and 2000 – The US, the EU and France (US = 100)*

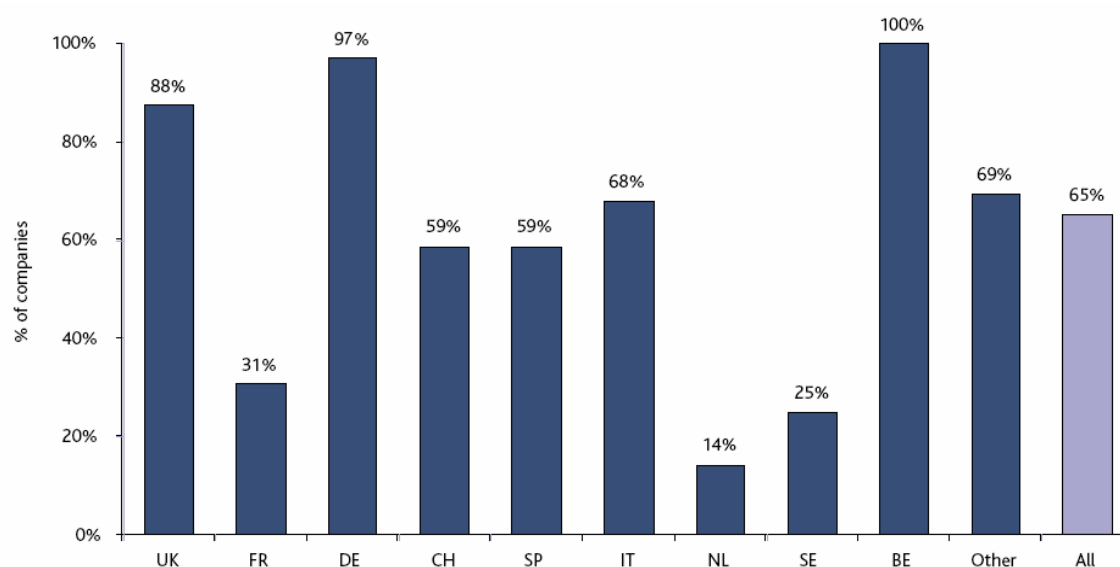
	GDP per person		GDP per hour		Hours per person	
US	100	100	100	100	100	100
Europe	69	70	65	91	101	77

Source: Blanchard (2004).

*Table A5. Total factor productivity growth – The US, the EU and France, 1980-2000 (percent per year)*

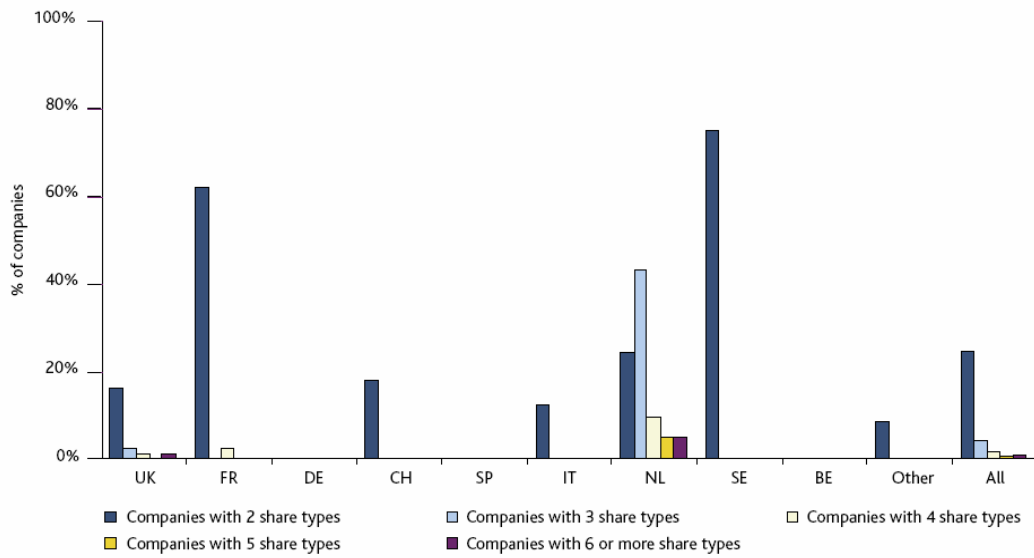
	1980s	1990s	1990-95	1995-2000
US	0.91	1.06	0.74	1.39
EU	1.45	1.04	1.36	0.72

Source: Blanchard (2004).

*Figure A1. Companies applying the ISIV principle in the EU*

Source: Deminor (2005).

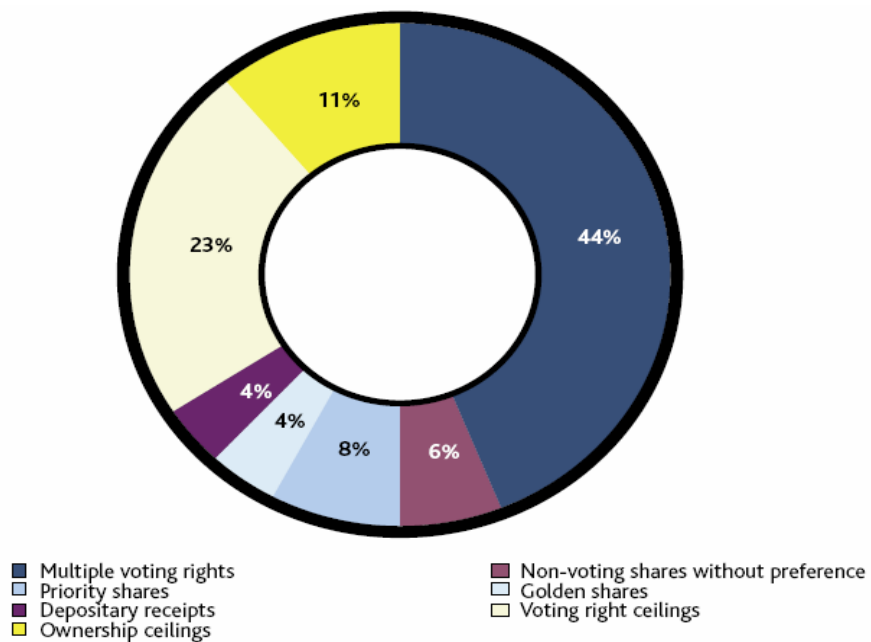
Figure A2. Number of share types in European companies



\*Non-voting preference shares are not taken into account.

Source: Deminor (2005).

Figure A3. Exceptions to the 1S1V principle in the EU by the frequency of each type



Source: Deminor (2005).

## About ECMI

The European Capital Markets Institute (ECMI) was established as an independent non-profit organisation in October 1993, in a collaborative effort by the European Federation of Financial Analysts Societies (EFFAS), the Federation of European Securities Exchanges (FESE) and the International Securities Market Association (ISMA), now the International Capital Market Association (ICMA). ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, regulatory authorities and university institutes.

European capital markets have experienced rapid growth in recent years, corresponding to the gradual shift away from relationship banking as a source of funding and at the same time, have had to absorb and implement the massive output of EU-level regulation required to create a single market for financial services. These developments, combined with the immense challenges presented European financial institutions by the globalisation of financial markets, highlight the importance of an independent entity to undertake and disseminate research on European capital markets,.

The principal objective of ECMI is therefore to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.



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