

A History of Corporate Governance and of the oddity of the British

Randall Morck

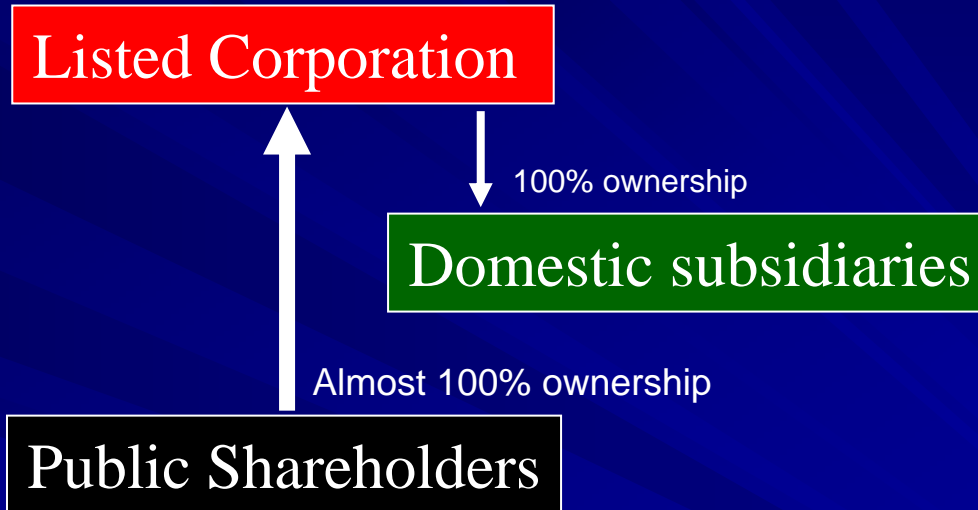
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Large US or UK Corporations

- Large firms are free standing; most are widely held



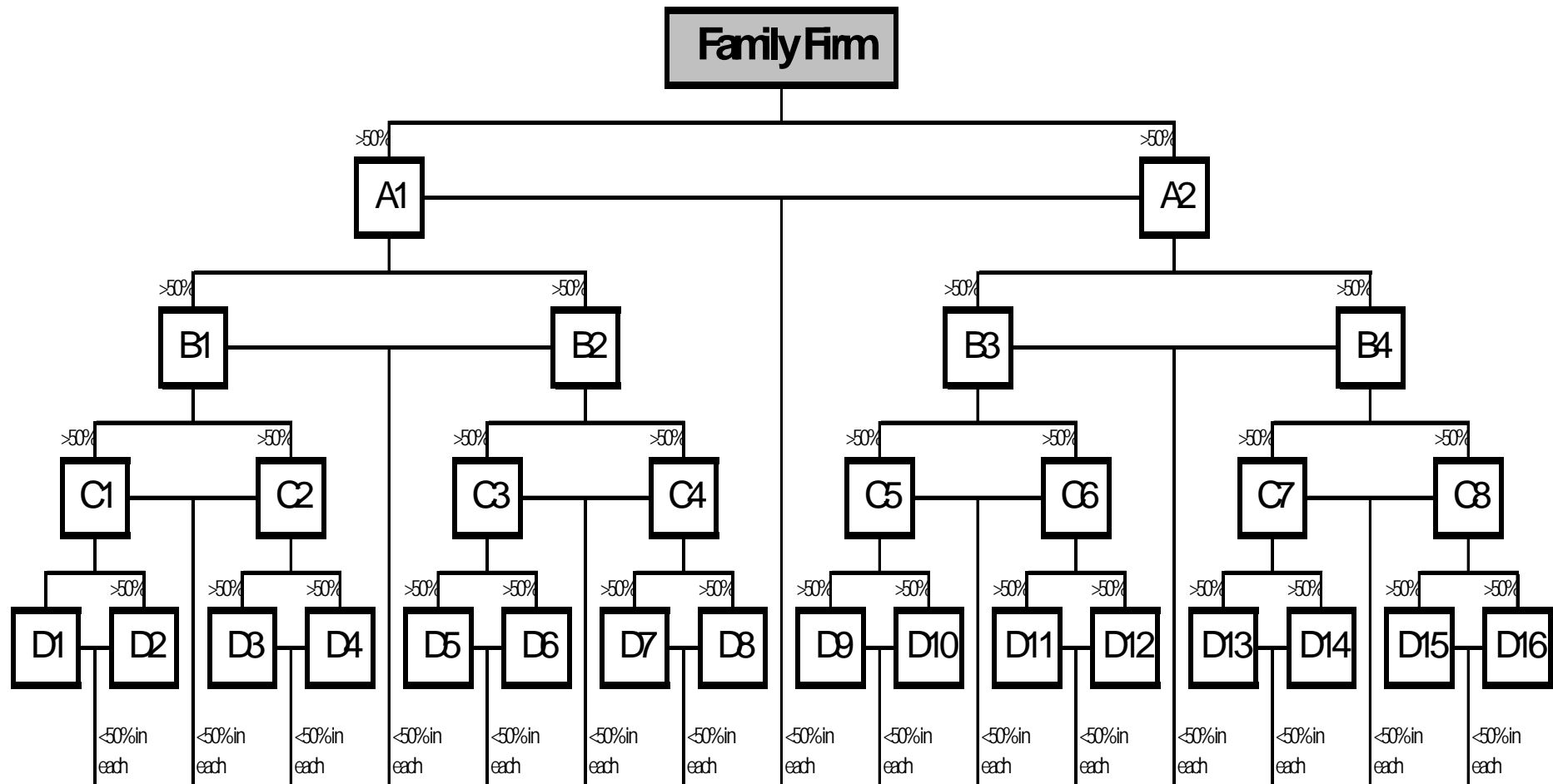
Freestanding

- Listed corporations neither control nor are controlled by other listed companies controls no publicly traded US company
- Any domestic subsidiaries are 100% owned

Widely held

- Managers usually own less than 1%
- Large shareholders are institutional investors with e.g. 5%
- “Controlling” shareholders hold eg. 5% to 20%
- Founders (or heirs) quickly sell shares to diversify

Elsewhere ... Wealthy Old Families & Pyramids



Public Shareholders – Individuals or Institutional Investors

Roosevelt's New Deal

'35	<ul style="list-style-type: none">■ Securities and Exchange Act enforces transparency, making makes tunneling harder to conceal
'36	<ul style="list-style-type: none">■ Intercorproate dividend tax at 10% of regular rate■ No capital gains tax on property from complete liquidation of a controlled subsidiary■ Public Utilities Holding Co. Act “Death Sentence Clause” bans pyramids > 2 layers high in public utilities industries
'37	<ul style="list-style-type: none">■ Intercorproate dividends tax at 15% of regular rate■ No capital gains tax on any assets from complete liquidation of subsidiary
'40	<ul style="list-style-type: none">■ Investment Companies Act regulates listed companies with extensive shareholdings in other listed companies as investment companies

Source: Morck (2005).

**Table 3. The Elimination of US Holding Company Structures:
Important US Companies Listed in 1937 as recently Eliminating One or More Holding Company Structures**

Company	Role of Intercorporate Dividend Tax
A.G. Spalding & Brothers	Apparent tax saving, but not explicit mention
Acme Steel Company	Apparent tax saving, but not explicit mention
Air Reduction Company Inc.	Apparent tax saving, but not explicit mention
Associated Gas & Electric Company	Apparent tax saving, but not explicit mention
Atlas Corporation	Apparent tax saving, but not explicit mention
Atlas Powder Company	Apparent tax saving, but not explicit mention
Bethlehem Steel Corporation	Explicitly cited as justification
Blackstone Valley Gas & Electric Company	Apparent tax saving, but not explicit mention
Borden Company	Explicitly cited as justification
Central Main Power Company.	Apparent tax saving, but not explicit mention
Central Power & Light Company	Apparent tax saving, but not explicit mention
Consolidated Oil Corporation	Apparent tax saving, but not explicit mention
Diamond Match Company	Explicitly cited as justification
E.I. de Pont de Nemours & Co.	Explicitly cited as justification
Eastern Gas & Fuel Associates	Apparent tax saving, but not explicit mention
Eastman Kodak Company	Apparent tax saving, but not explicit mention
Electric Bond & Share Company	Apparent tax saving, but not explicit mention
Electric Power and Light	Apparent tax saving, but not explicit mention
General Foods	Apparent tax saving, but not explicit mention
International Harvester Company	Apparent tax saving, but not explicit mention
International Hydro-Electric System Company	Explicitly cited as justification
McKesson and Robbins Incorporated	Apparent tax saving, but not explicit mention
Nevada-California Electric Corporation	Apparent tax saving, but not explicit mention
Northern New York Utilities	Apparent tax saving, but not explicit mention
Pacific Gas & Electric Company	Apparent tax saving, but not explicit mention
Pillsbury Flour Mills Company	Apparent tax saving, but not explicit mention
Safeway Stores	Apparent tax saving, but not explicit mention
Southern Pacific Company	Apparent tax saving, but not explicit mention
Union Pacific Railroad	Apparent tax saving, but not explicit mention
United States Rubber Company	Explicitly cited as justification

Germany is Also Odd

■ Hitler's Problem

- The National Socialist (Nazi) party wants to control the entire economy, but can't seem 'communist'

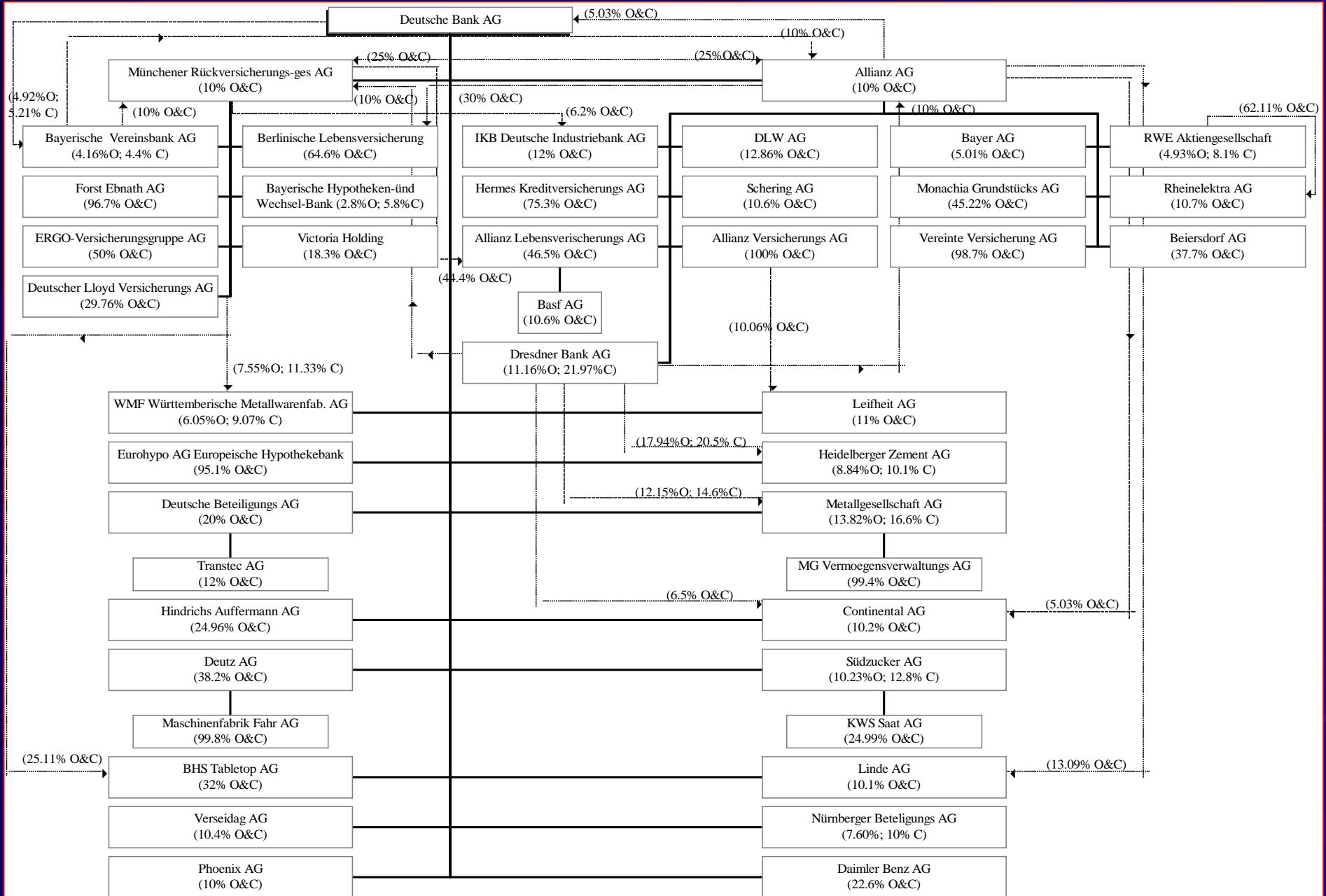
■ Hjalmar Schacht's solution

- "Entrust" banks with public shareholders' votes
- "Aryanization" puts Nazi's in charge of the banks & unions
- "Führeprinzip" transfers fiduciary duty to stakeholders – employees, banks, and (most importantly) the Reich

German Corporate Governance

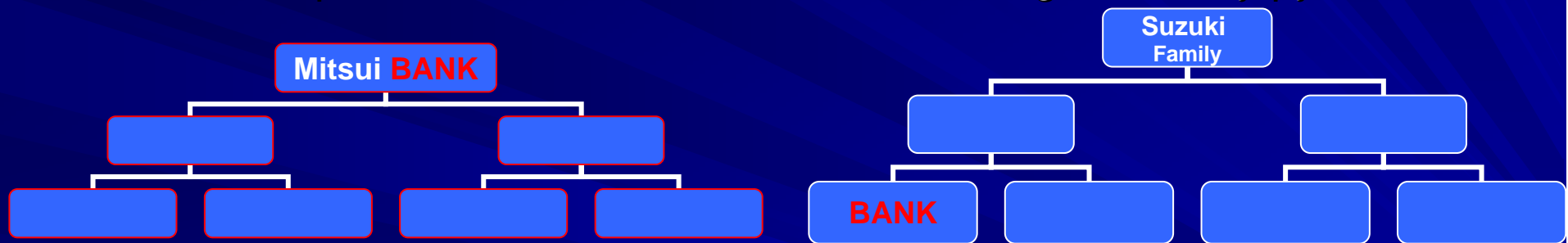
<i>industrial</i>	<i>bank voted proxies</i>	<i>bank via subsidiaries</i>	<i>bank's direct stake</i>	<i>total</i>
Siemens	0%	9.87%	85.81%	95.48%
Volkswagen	0	8.89	35.16	44.05
Hoechst	0	10.74	87.72	98.46
BASF	0.09	13.81	81.01	94.71
Bayer	0	11.23	80.09	91.32
Thyssen	6.77	3.82	34.98	45.37
VEBA	0	12.82	78.23	90.85
Mannesmann	0	7.78	90.35	98.11
MAN	8.67	12.69	28.84	48.20
Preussag	40.65	4.51	54.30	99.48
VIAG	10.92	7.43	30.75	49.10
Degussa	13.65	8.65	38.35	60.65
AGIV	61.19	15.80	22.10	99.09
Linde	33.29	14.68	51.10	99.07
Deutsche Babcock	3.22	11.27	76.09	90.58
Schering	0	19.71	74.79	94.50
KHD	59.56	3.37	35.03	97.96
Bremer Vulkan	0	4.43	57.10	61.53
Strabag	74.45	3.62	21.21	99.28

The Deutsche Bank pyramid



Japan is Odd Too ...

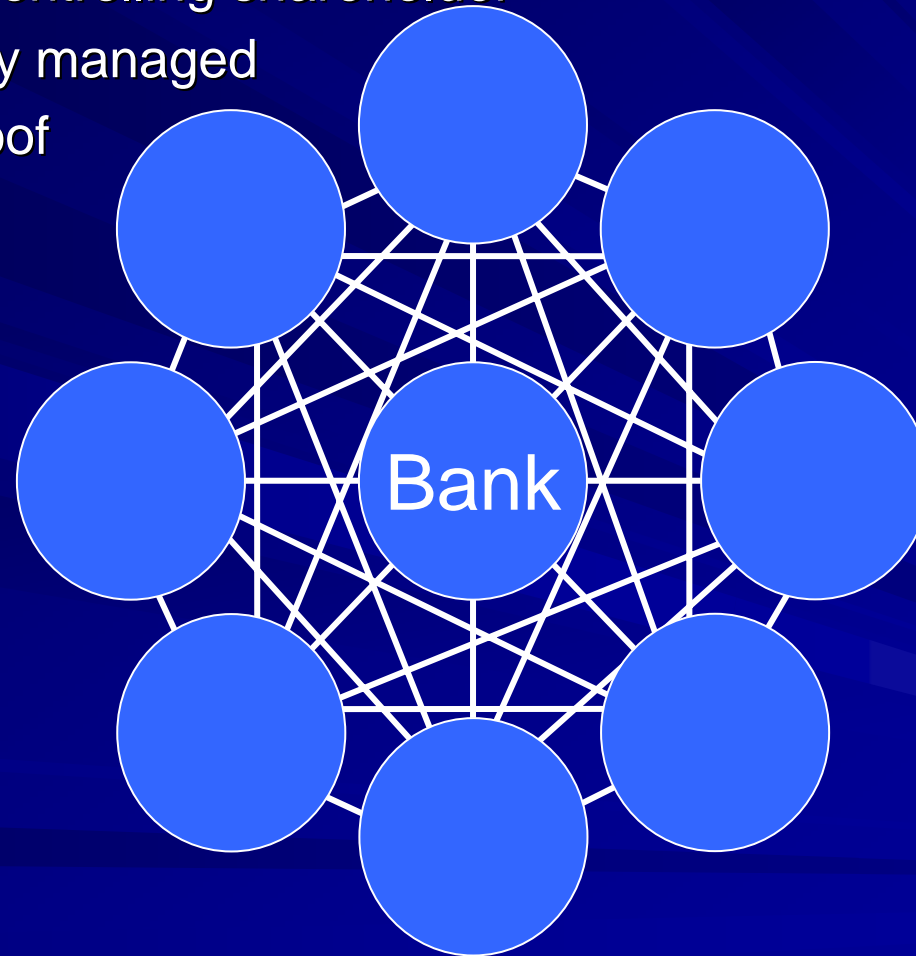
- Meiji Restoration and the great zaibatsu family pyramids
 - Mitsubishi, Sumitomo, Mitsui lever large family fortunes into control over corporate assets of vastly greater assets
- The Great Depressions of the 1920s and 1930s
 - The collapse of the Suzuki zaibatsu and other great family pyramids



- Wartime economy run by Soviet-trained planners
- The American Occupation & *de facto* mass privatization
- The widely held economy leads to hostile raids and greenmail
- The keiretsu that characterize modern Japan emerged in the 1960s and 1970s as networks of white squires to protect each other against hostile takeovers



- Each group firm owns a small stake in every other group firm
- Collectively, other group firms control every group firm
- Group firms are
 - Free of any controlling shareholder
 - Professionally managed
 - Takeover-proof
 - Banks fading



A stylized Japanese *keiretsu* group

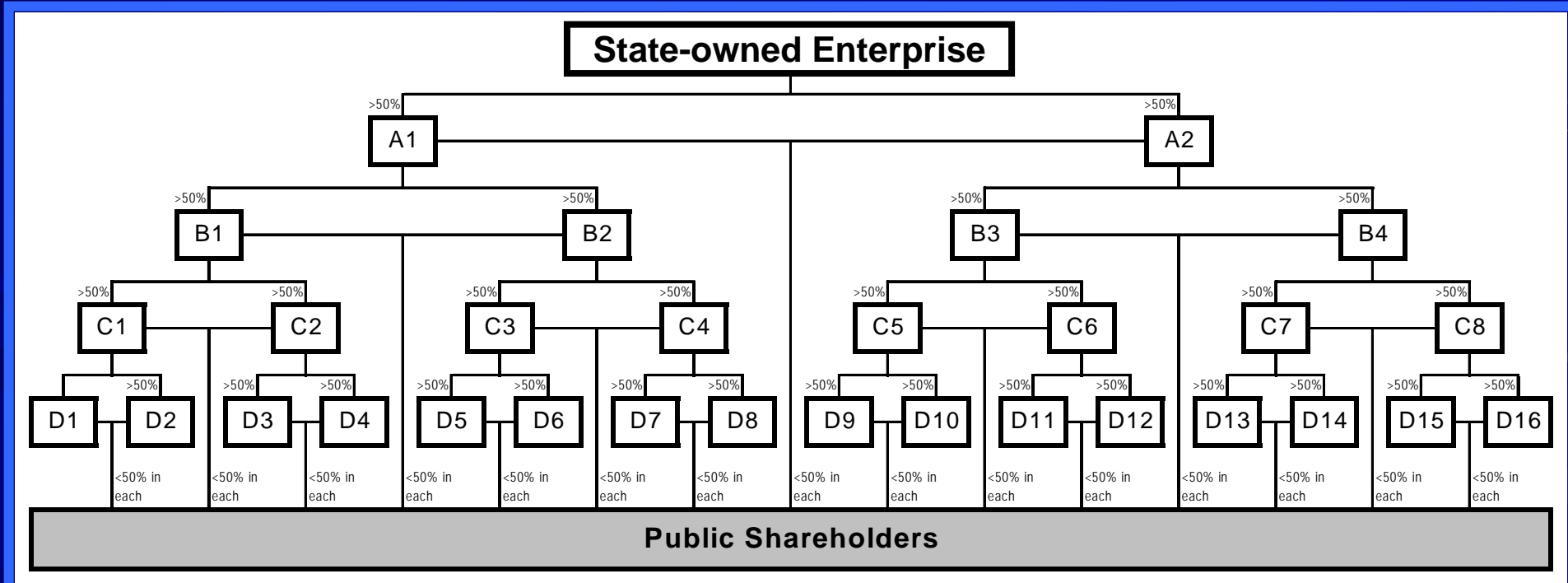
Italy's State Controlled Pyramids

Mussolini's Problem

- How to control the economy but not seem communist

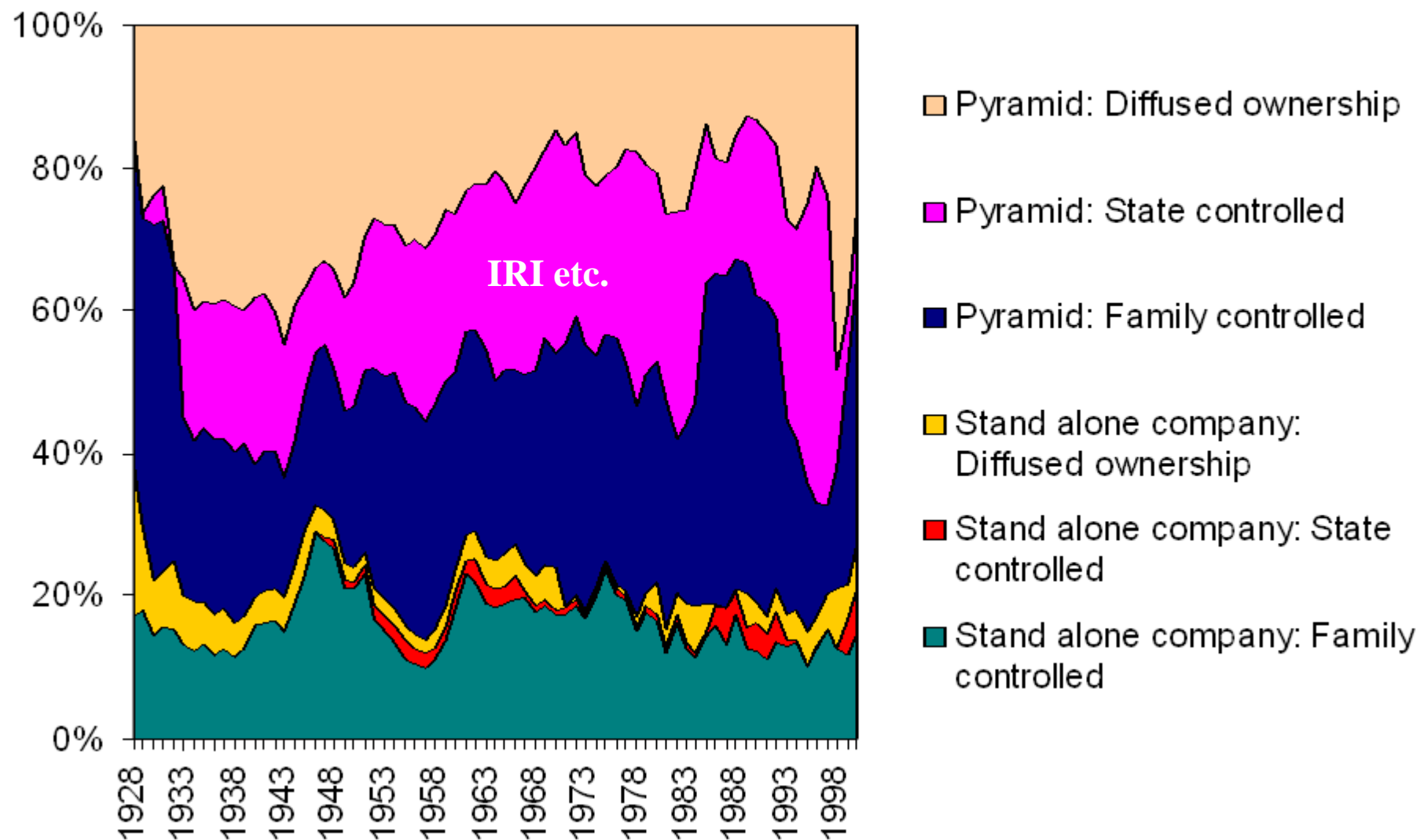
Mussolini's solution

- Fascist run sovereign wealth funds at apexes of huge pyramidal business groups of listed firms



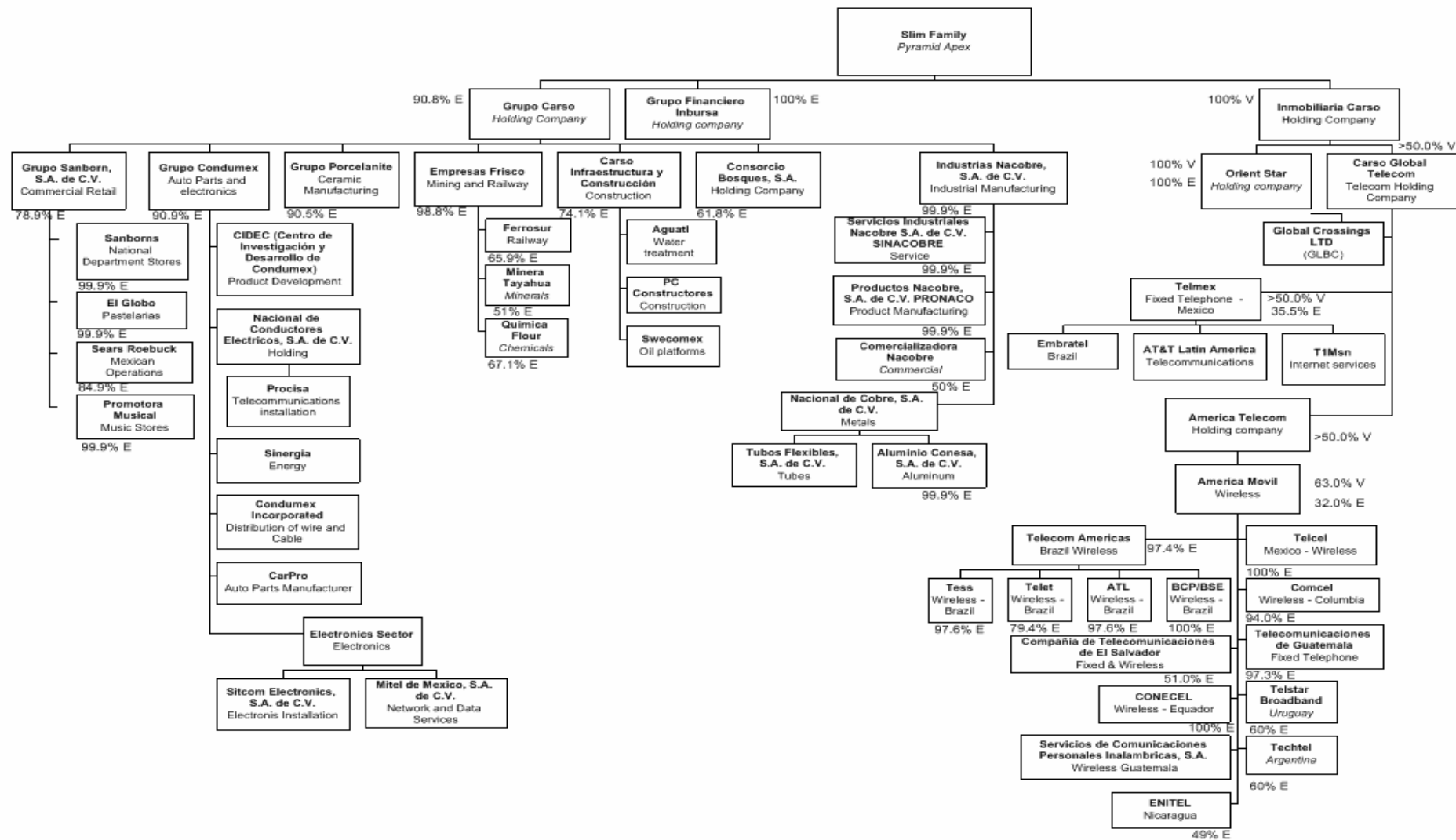
Aganin, Alexander and Paolo Volpin. 2005. The History of Corporate Ownership in Italy

Control Composition of Traded Companies (Market Value)

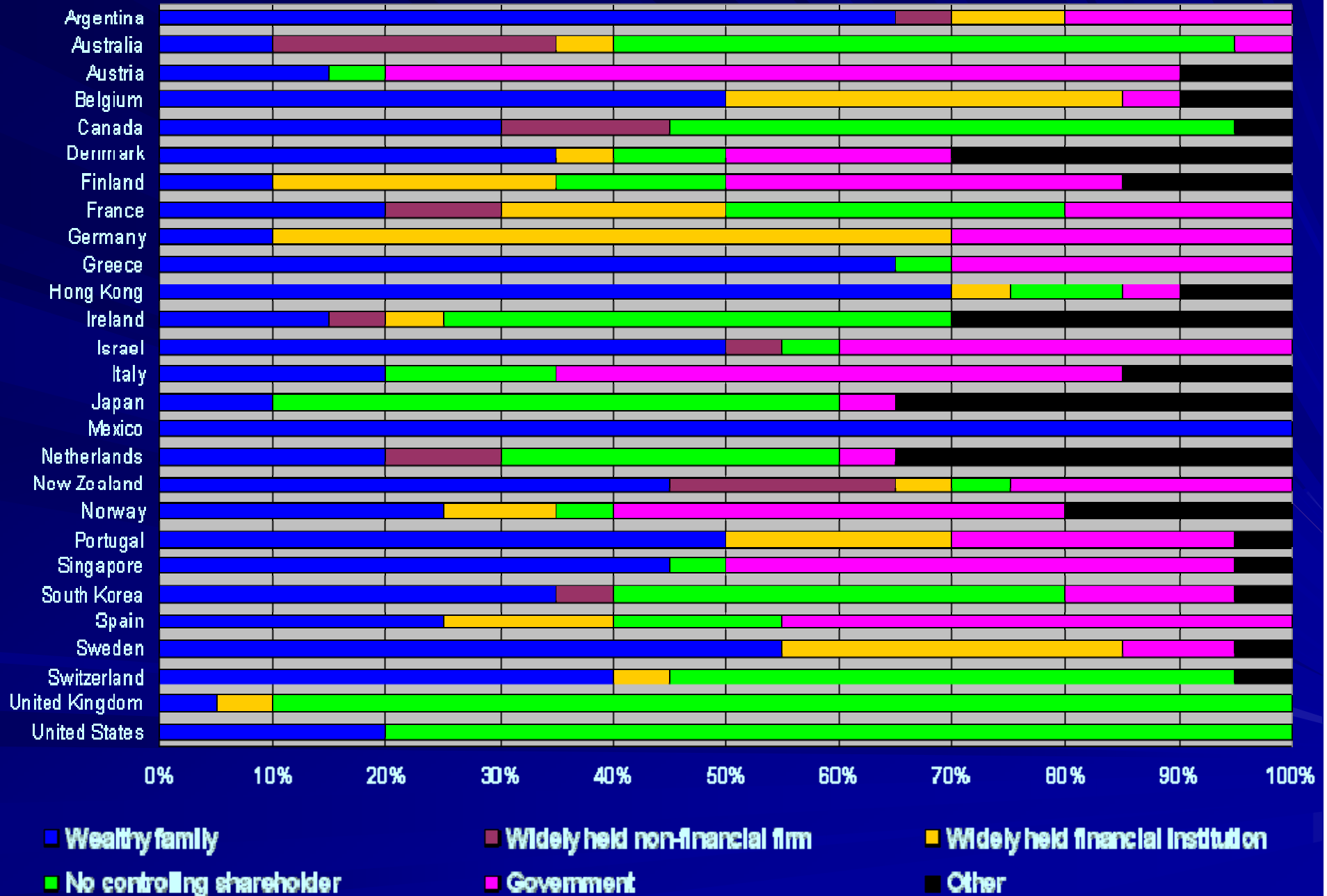


But Most Countries Big Companies Look Like This

Slim Helu Group (Mexico)



Who Controls the World's Great Businesses?



Why Are the English Odd?

- Formal Shareholder Rights: Few & Late
 - 1890 Directors Liability Act – shareholder can sue for ill-faith prospectus
 - 1900 Companies Act lets 10% block call shareholders meeting
 - 1948 Companies Act requires proxy voting
 - Mid '60s LSE disclosure requirements grow tougher
 - 1967 Companies Act forces ownership structure disclosure
 - 1968 LSE control block cap
 - 1980 insider trading illegal
 - 1986 Financial Services Act makes LSE regs “subordinate legislation”
 - Mid '90s tax reforms made share repos viable alternative to dividends
 - 1995 disclosure of director pay
- But
 - Very high historical dividend yields c/c other countries
 - UK firms had to rely on repeated securities issues, not retained earnings, to fund new projects
- Powerful institutional investors insisted on very high dividends

Self-regulation

- The Cadbury Committee and the Takeover Panel
- Entrust regulating of business to business leaders
- Hiring the fox to guard the henhouse?
- Oddly, it seems to work ...
- Why?
- “Self-regulation” is directed by institutional investors, not listed companies, brokers, jobbers, ...
- Upon closer inspection ...
 - Greed
 - Fear
 - Disloyalty

Greed ...

Labour Govt. & the Supply of Shares

- Top tax rates on personal income & dividends
 - Fluctuated between 83% to 95% from 1945 until 1980s
 - All “in-kind benefits” taxed as income
 - Closely held firm dividends & capital gains taxed as income
 - Inherited income taxed at 90% & non-monetary inheritances (deliberately?) overvalued by Inland Revenue
- To continue living in style ...
 - List your companies
 - Inherited shares can be valued at market price
 - Sell more stock each year
 - Capital gains untaxed until 1965, then at 30%

Greed ...

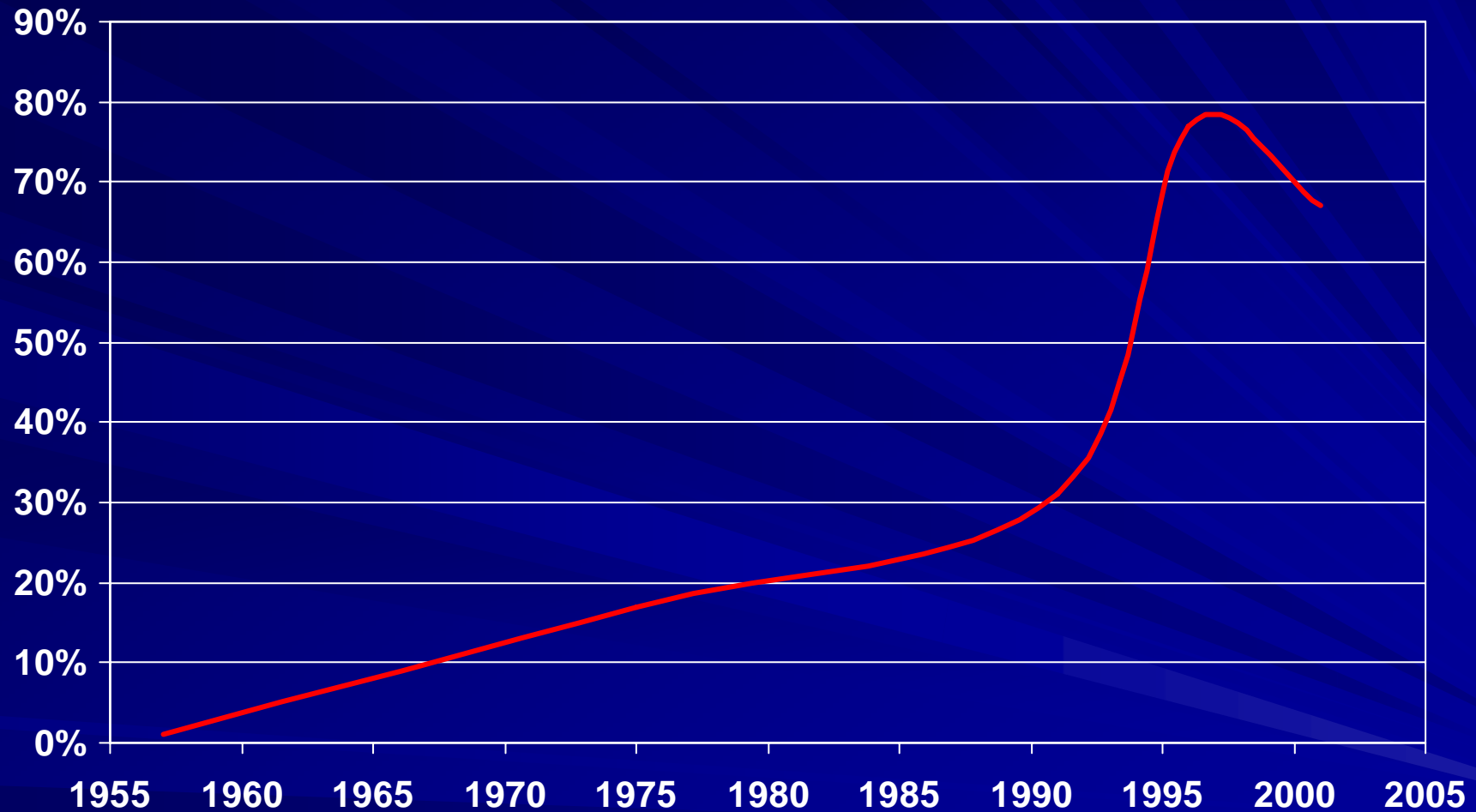
Labour Govt. & Demand for Shares

- Insurance companies as investment vehicles
 - Insurance policy contributions tax deductible
 - Insurance policy returns taxed at very low rate
- Pension funds and the victory of socialism
 - Companies pay taxes on earnings, including dividends paid
 - Investors pay taxes on dividends too, but get a credit for taxes already paid by the company
 - Pension funds paid no taxes, but still got the full credit for taxes paid by the company
 - Effective zero (even negative) tax rate on dividends received by pension funds

Bottom line

- Massive transfer of shares from (decreasingly) wealthy individuals to insurance companies and pension funds

Pension Fund Equity Holdings



As fraction of total UK market capitalization

Fear ...

■ Fear of nationalization

- Labour Party supports independent pension funds
- Union leaders like criticism of top management
- Unions support funds with high portfolio returns

■ Fear of losing influence

- Nascent pyramidal groups threatened dominance of pension funds and insurance co.s in 1960s
- Institutional investors responded by lobbying LSE for its 1968 Takeover Rule if you own > 30% then you must own 100%

■ Fear of losing trading volume, rather than listings

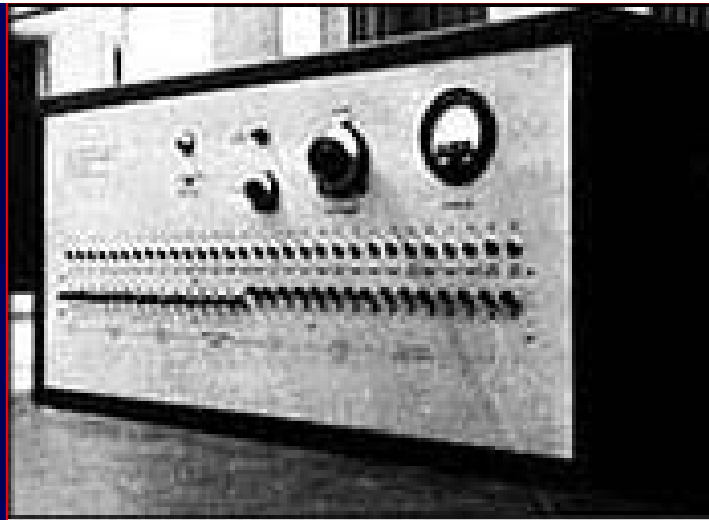
- The LSE tries to please institutional investors
- Stock markets in most countries try to please issuers

Disloyalty ...

- Milgram, Stanley. Obedience to Authority. New York. Harper and Row. 1974.



Stanley Milgram



The shock generator, showing the switched ranging from 15 to 400 volts



The teacher is shown how to use the electric shock apparatus



The teacher helps to strap the learner into the chair and helps place the electrodes



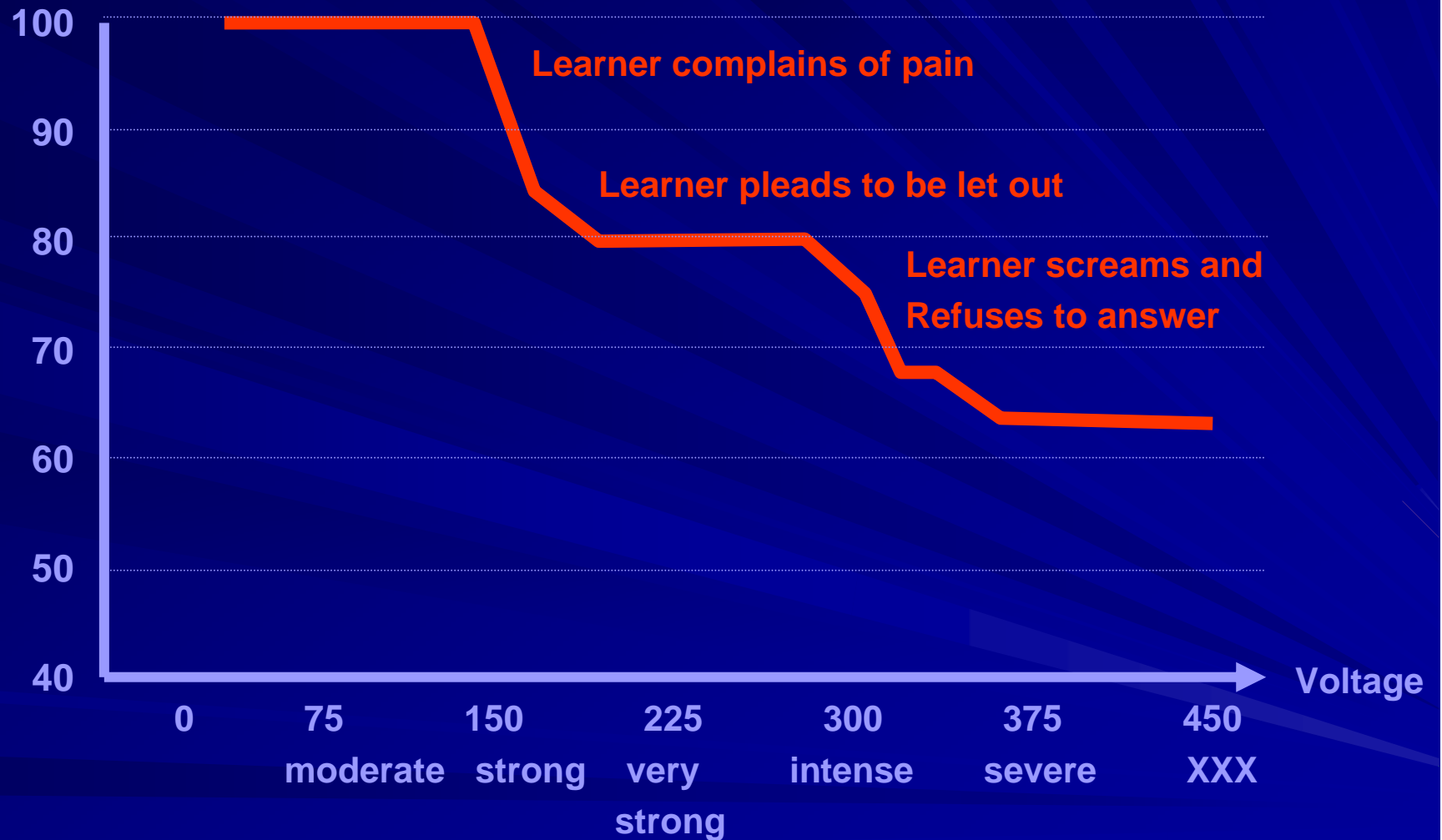
The teacher settles down to begin the experiment; calm and relaxed



A teacher holding the hand of the learner on the shock plate in the "Touch proximity" condition

Milgram Obedience Experiment

Percent of Subjects still obedient



Variants

- Location
- Age
- Gender
- Nationality
- Time period
- Social class
- Education
- Etc



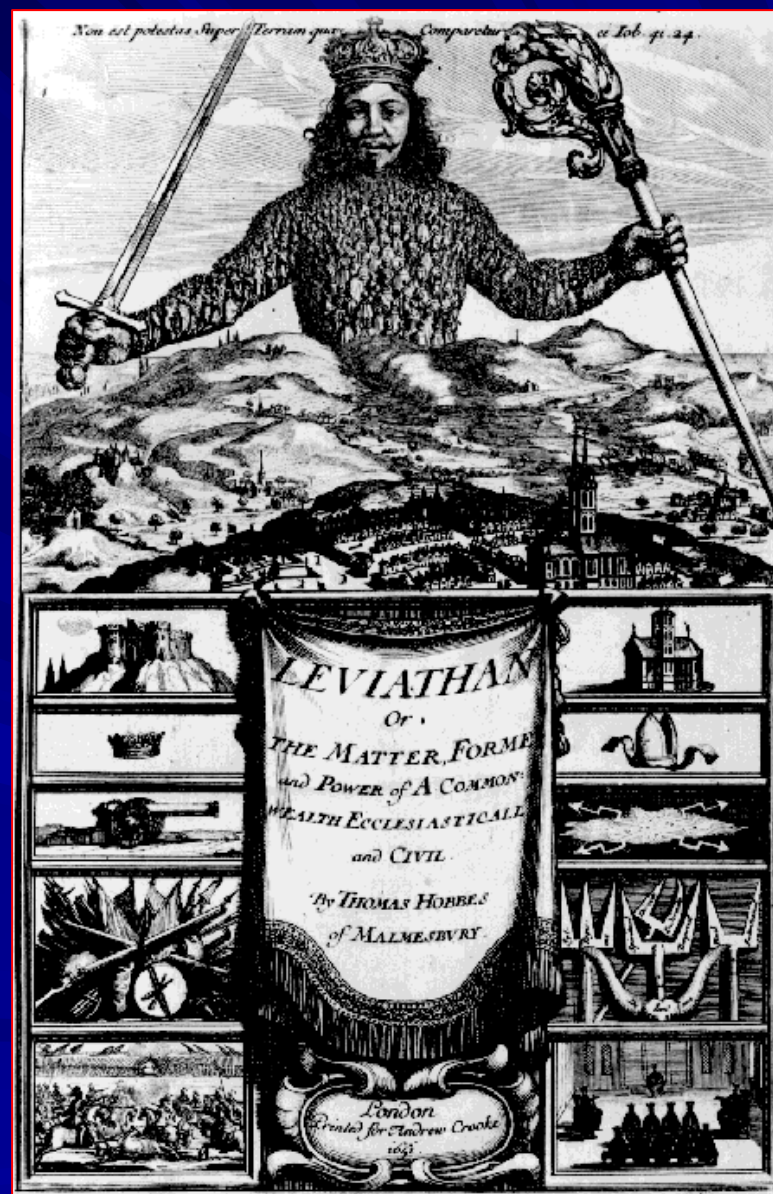
No Significant
Difference

- Exit interviews: Subjects stressed “loyalty” to the experimenter, “duty” to the experiment, and the importance of “doing what was expected of them”

Reconciled to Economics

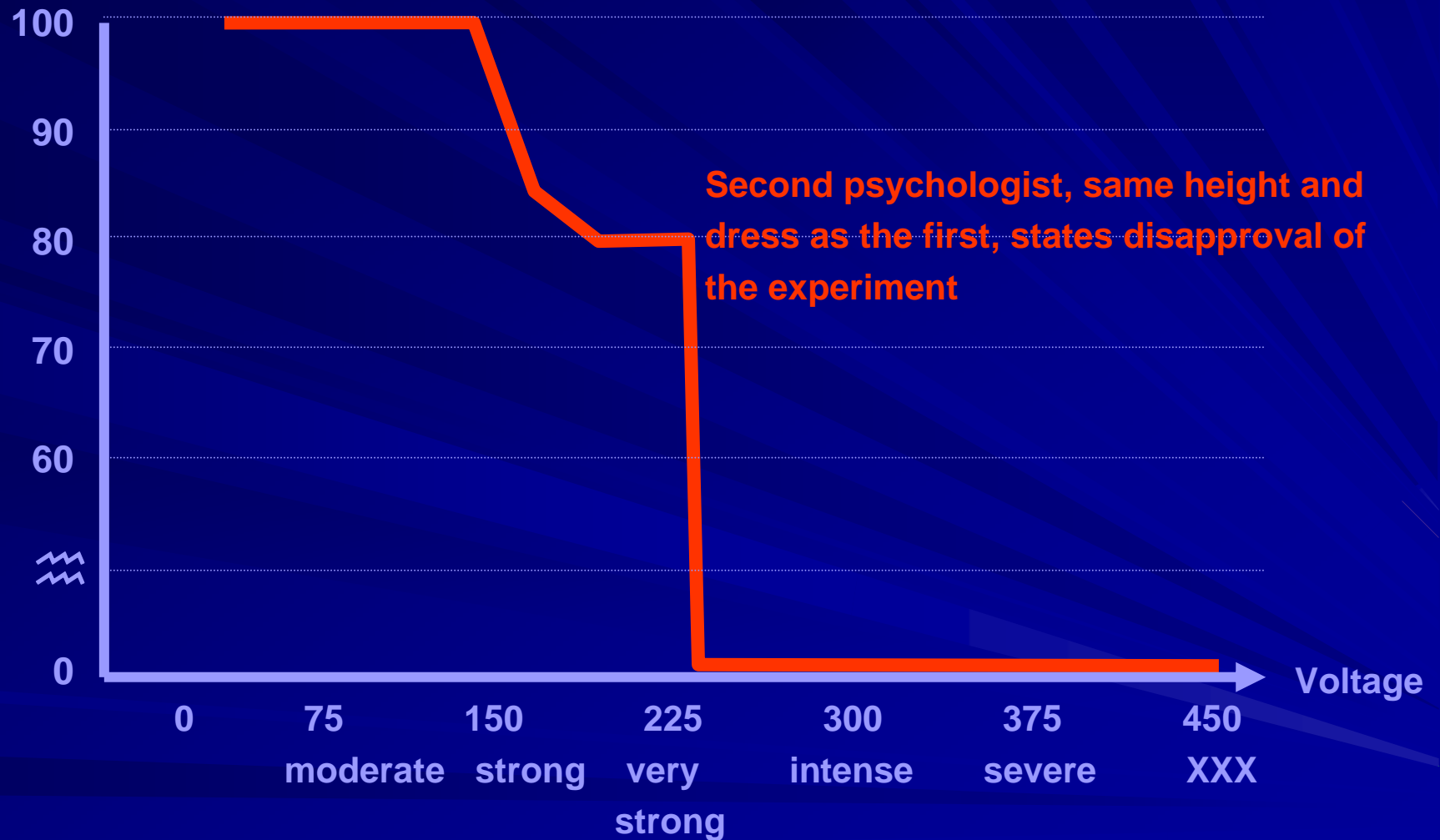
Hobbes (1651) *Leviathan*

- We submit to the State because anarchy is worse
- Milgram's subjects stressed feelings of loyalty and duty
- Why do humans derive such profound emotional satisfaction from self-sacrificing acts of loyalty?
- Is an obedience reflex neurologically hardwired?
- Does obedience to authority have more ancient evolutionary roots than Hobbes perceived?



A Rival Authority

Percent of Subjects still obedient



Disloyalty ...

- The capacity for disloyalty
 - Major British pension funds & insurance companies are independent of the corporations they invest in
- An expectation of disloyalty
 - The most “over-weighted” institutional investor’s duty is to lead a “backroom revolt” in a problem firm
- Institutional lobbying to build “rival authorities”
 - Independent directors
 - Independent chairs
 - Independent committees
 - Self-regulatory committees

Advocatus Diaboli

- The Holy Office of the Devil's Advocate created during the Counterreformation by Pope Sixtus V to renew popular respect for the Church by exposing fraudulent candidates for sainthood
- The Devil's Advocate was a canon lawyer ordered to contest potential saints' character & the veracity of their miracles
- Abolished by John-Paul II – more new saints since then than during the previous century

Advocatus Diaboli

- In parliamentary democracy
 - Leader of the Official Opposition
 - Two party system in which it is the duty of the leader of the opposition party to criticize the leader of the party (or coalition) in power
 - This imposes costs – delays, embarrassments, etc. but most people now believe democracy is the “least bad” political system
- In the Common Law legal system
 - Each side has lawyers, whose duty is to criticize the other side’s arguments and evidence
 - This imposes costs too – legal expenses, delays, etc. but LLSV argue that the Common Law is nonetheless the “least bad” legal system

Academia

- Devil's Advocates in academia
 - Discussants at conferences
 - Referees for journals
 - Outside reviewers for tenure cases
 - This imposes costs – bad referee reports, publication delays, etc. – but most academics now believe this is the “least bad” system for the advancement of research

Self-regulation

**“I want everyone to tell me the truth,
even if it costs him his job.”**

Samuel Goldwyn, Founder of Metro-Goldwyn-Mayer

- The British system works because pension funds and insurance companies are charged with criticizing corporate management – usually quietly and “behind the scenes, but always with the implicit threat of public criticism.
- Self-regulation works because it is mainly directed by pension funds and insurance companies – the designated devils’ advocates
- Pension fund & insurance company managers can “tell CEOs and controlling shareholders the truth” without getting fired