# PART I

# REGULATION AND HISTORY

CHAPTER 2

# REGULATION AND COMPARATIVE CORPORATE GOVERNANCE

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## Introduction

This chapter analyzes the relationship between regulation and corporate governance. Regulation, the issue and implementation of administrative directives and rules by legally mandated agencies, constitutes a major aspect of the governance of social and economic life (Carrigan and Coglianese, 2011; Majone, 1994 and 1997). The advent and spread of important economic transformations such as privatization and deregulation occur through the creation of new regulatory institutions (Levi-Faur, 2005). Policy-making in an increasingly liberalized environment is characterized by a paradigm shift in the role of the state from interventionist to regulatory (Vogel, 1996). The liberalization of economic sectors across economies does not imply the withdrawal of the state, but a redefinition of its role. Most notably, but not exclusively, this shift occurs through important political choices regarding the degree of independence, scope, and granted power of regulatory agencies. Corporate governance, on the other hand, refers to the structure of rights and responsibilities of the different stakeholders and its consequences for the process by which companies are controlled and operated (Aoki, 2001; Gourevitch and Shinn, 2005). Effective corporate governance entails mechanisms to ensure executives respect the rights and interests of company stakeholders, as well as guaranteeing that stakeholders act responsibly with regard to the generation, protection, and distribution of wealth invested in the firm.

Two theoretical perspectives are prominent in the study of regulation: principal–agent and governance. First, the study of regulation has traditionally focused on the principal–agent problem, i.e. the interactions between policymakers and regulators

(Laffont and Tirole, 1991). The analytical starting point is the divergence of interests between these two actors since the actions of (unelected) regulators might differ from the preferences of elected officials (Breyer, 1982). In particular, regulatory agencies can be subject to regulatory capture, i.e. aligning themselves with those they are supposed to regulate (Stigler, 1971). Theories of regulation based on regulatory capture highlight how regulators are more prone to adhere to the demands of organized groups rather than meeting the preferences of dispersed groups even if their mission is to protect the latter (Peltzman, 1976; Stigler, 1983). The process of regulatory capture emphasizes collective action and the intensity of preferences of the negatively affected parties to lobby for protection (Wilson, 1980 and 1989; see also Olson, 1965).

Building on the prominence of the principal–agent problem, regulation theorists have focused on how the electorally accountable principals seek to control the activities of regulatory agencies (Moe, 1987; Weingast and Moran, 1983). A critical dimension associated with attempts to control the behavior of regulatory authorities is that the independence of regulatory authorities is often seen as a key factor in limiting the potentially biased influence of elected officials (Thatcher and Stone Sweet, 2002). Two main mechanisms have been identified in this tightrope walk, namely the simultaneous delegation of independence and control over the activities of regulators (McCubbins and Schwartz, 1984). The first one, a police-control mechanism, is characterized by the direct and centralized interventions of elected officials, aimed at detecting deviations in the assigned missions of regulatory agencies. The emphasis is placed on formal institutional design, aimed at structuring the process of appointment/dismissal of regulators and the determination of budgets (Kiewet and McCubbins, 1991). The second mechanism, a fire-alarm oversight, is characterized by the presence of a system of rules and procedures that enable organized groups and citizens to detect such deviations and alert government officials. The emphasis is placed on the design of mechanisms that heighten the provision of external information flows, thereby enabling the principal to develop monitoring capabilities that could be used as a counterweight to the expertise of regulatory agencies. These two mechanisms share a command-and-control regulatory approach, namely the design of institutional regulatory features that would best serve to lessen agency costs.

Even though the principal–agent focus has been influential in the study of regulation, the need for the incorporation of the insights of complementary perspectives has been noted. For instance, the ability of organized interest groups to capture regulatory authorities fluctuates both over time and across institutional contexts (Culpepper, 2011; Wilson, 1980). This variation strongly suggests the importance of both the institutional context in which actors are embedded (Aguilera and Jackson, 2003; Gourevitch and Shinn, 2005) and the extent to which an issue is politically salient to the electorate (Culpepper, 2011). Part of the reason accounting for the low political salience of regulation is its complexity as it is not often easily translatable into issues that can be grasped by the electorate. Moreover, the ability of policymakers to shape and influence regulators' behavior is contingent not only on the presence of institutional control mechanisms, but also on the use of these mechanisms (Moe, 1985). The circumstances and issue areas where elected officials choose to exercise their legally based authority over the actions of regulators exhibit significant variations (Thatcher, 2002).

Second, the study of regulation has also been characterized by the importance of the governance approach (Kagan, 1994). The process of regulation is not simply a confrontation between the diverging interests of elected officials and regulatory authorities; it is also characterized by an interaction based on cooperation (Scholz, 1984). The assumption of the governance approach is that the failure of regulators to meet the preferences of policymakers does not reflect the presence of diverging interests, but that of the complexities of policy contexts; and that effective regulation requires coordination between the legislative authority of the principal and the activities of agents (Dorf and Sabel, 1998). Institutional mechanisms of authority delegation involve the setting of performance standards by the principal, but with the granting of substantial flexibility on the design of the most efficient and cost-effective procedure to meet these standards (Viscusi, 1983). Some monitoring mechanisms in this perspective are disclosure requirements, self-regulation initiatives, and legal requirements imposed on regulated authorities to gather information about their activities. An explicit assumption behind the cooperation and coordination nature of the interaction between elected officials and regulatory authorities is that regulators can often take a long-term view on problems given the absence of direct electoral accountability. Regulatory authorities can seek to protect their independence and enhance their reputation by rising above self-interested policy-making pressures (Carpenter, 2001).

The field of corporate governance possesses close affinities with the study of regulation. First, the literature in comparative corporate governance has emphasized the importance of the principal–agent problem in different forms. Early studies of corporate governance focused on the divergence of interests between principals and agents (Berle and Means, 1932; Jensen and Meckling, 1976). The key idea is that unmonitored managers will pursue goals that are not in the interests of shareholders—ranging from actions that allow them to profit personally (embezzlement, misappropriations) to empire building (hubris). These studies were organized around the following puzzle: why would minority investors provide funding to companies run by unaccountable, dominant managers? These early law and economics analyses of corporate governance, however, are plagued by a fundamental shortcoming despite their influence over the intellectual development of the discipline. The main point of contention is that ownership dispersion is only characteristic of a few countries, essentially Anglo-Saxon economies. Moreover, the analytical foundations of these early studies of corporate governance lacked a comparative focus. A second wave of studies based on the principal–agent problem emerged in the early 1990s with the aim of accounting for diversity in ownership structures across national systems of corporate governance. The extent to which minority investors are protected by law from expropriation by managers or controlling shareholders is the key argument accounting for differences in ownership structures (La Porta et al., 2000). The theoretical implication flowing from the presence of different ownership structures is that the nature of agency costs differs across national systems of corporate governance. There are many varieties of agency costs—which all contribute to destroy shareholder value—but for which different institutional solutions should prevail (Coffee, 2005; see Roe, 2002 for a critical analytical overview). A first type of agency costs is diversion by managers—stealing, embezzling, and shirking. A second variety of agency costs comes in the form of managerial mistakes—executives not being up to running the firm, plausibly because of changed circumstances. Institutions that work well in solving the first type of agency costs might not be as effective in dealing with the second variety.

Second, the area of corporate governance is also well suited to the study of regulation given the presence of different mechanisms of regulatory activities. Attempts to control the behavior of agents are also found alongside mechanisms of corporation. Some important monitoring mechanisms of corporate governance are found in the domain of corporate law and emphasize the importance of mandatory rules (Coffee, 1989; Gordon, 1989). However, regulation in the field of corporate governance is increasingly characterized by soft law where actors self-regulate themselves without possessing full legislative authority (Hopt, 2011). Soft law is characterized by the prominence of standardized reporting based on the comply-or-explain principle. Regulatory outputs based on hard versus soft law entail a tradeoff between flexibility and enforceability, with optimal governance being based on the importance of the local context (Aguilera et al., 2008). Hard law, such as the Sarbanes-Oxley Act, provides regulatory outputs that cover all companies operating in a jurisdiction, thereby ensuring the implementation of high minimum standards, but at the cost of the lack of flexibility regarding the characteristics of companies—blue chip versus start-up; family-owned versus ownership diffused; unmonitored insiders versus legally constrained blockholders. Soft law, such as the Cadbury recommendations of good governance in the United Kingdom, enables listed companies to mix different practices of corporate governance in diverse organizational environments, but could result in weaker degrees of enforcement.

Third, the growing importance of regulation in corporate governance connects to important debates that deal with the uneven impact of globalization on the evolution of national business systems. The advent of multiple market reforms—deregulation, privatization, liberalization, trade agreements, and the removal of controls on inward/outward movements of capital—is triggering change across national systems of corporate governance, yet without leading to full convergence of systems (Hall and Soskice, 2001; Vogel, 2001; Whitley, 1999). In a similar vein, the rise of the regulatory state across economies (such as the European Union) has been prominent, but has taken different forms across different varieties of capitalist economies (Fioretos, 2011; Vogel, 1996). In particular, the concept of regulation highlights the persistence of different types of state intervention in the wake of privatization and liberalization via the spread of national regulatory authorities (Thatcher, 2002; Vogel, 1996). The privatization and liberalization process should not be equated with deregulatory laissez-faire, but with the implementation of new settings of regulation (Jordana and Levi-Faur, 2004). The process of regulation highlights the importance of institutional redeployment in policy-making, i.e. state intervention taking place with the use of new policy instruments and redeployed on behalf of new objectives (Levy, 2006; Schmidt, 2009).

The rest of the chapter is organized as follow. In the next section, we discuss the two main theoretical perspectives on the origins of regulation: law and politics. We then highlight the contextually bounded consequences associated with regulation for the evolution of national systems of corporate governance. The issue of hard versus soft law is further examined in the concluding section of the chapter.

## The Origins of Regulation: Theoretical Perspectives

The introduction and spread of regulatory agencies across national systems of corporate governance has been impressive (Jordana et al., 2011; Majone, 1994). The range of economic sectors that have experienced the double movement of the decline of the interventionist state and the rise of the regulatory state is extensive (Levi-Faur, 2006). Nonetheless, the rise of the regulatory state has not resulted in convergence across national systems of corporate governance (Gourevitch and Shinn, 2005; Lütz, 2004). Important differences remain in the degree of independence of regulatory authorities, and the relationship of regulators with the business regulated (Thatcher, 2002). Economies, and national systems of corporate governance, exhibit significant variations with regard to the party politicization of appointments to posts at national regulatory agencies, legal impediments for the removal of regulatory officials, financial and staffing of regulatory agencies, and the use of legally entitled powers to overturn decisions made by regulators (Enriques, 2002; Etzion and Davis, 2008; Fioretos, 2010). Variations on these features result in differences in the degree of independence of regulators from elected officials. Moreover, the impressive spread of regulatory authorities across national systems of corporate governance is associated with an extensive range of outcomes regarding the extent to which appointed regulators have escaped the preponderant influence of corporate interests (Johnson and Kwak, 2010; Roubini and Mihm, 2010). The extent to which regulators moved back and forth between governmental positions and the (regulated) private sector exhibits substantial variations between national systems of corporate governance in the context of the widespread diffusion of regulatory agencies. Therefore, an important question concerns the factors that best account for the origins of these differences. The issue is not about the increasing importance of regulatory agencies, but of the presence of differences in the degree of independence of regulatory authorities, and the relationship of regulators with the business regulated. We provide an analytical overview of the contribution of two major theoretical perspectives on the origins of regulation in corporate governance: law and economics, and politics.

First, the law and economics perspective on corporate governance emphasizes the importance of institutional-legal arrangements in protecting the rights of minority investors given the extensively documented differences in ownership structures across countries (La Porta et al., 2000). Dispersed shareholders need some form of assurance that they will get a return on their investment before departing with their financial assets since a combination of standard tort law and private bonding is not sufficient to grant adequate guarantees to outsiders (Glaeser et al., 2001; Shleifer and Vishny, 1997). Specific institutions—rules and enforcement—in the areas of stock exchange regulations, accounting standards and financial transparency, corporate law, and takeover regulation protect minority investors better than some other institutions (Coffee, 2006; La Porta et al., 2000).

The development of regulation, and the presence of institutional differences between regulatory states, is at the core of the law and economics perspective on corporate governance, namely the closer affinities between independent regulatory authorities and institutional arrangements of legal protection found in common law systems. Legal rules in systems of common law are made by judges, based on jurisprudence, and inspired by general principles such as fiduciary duty (Coffee, 1999; Johnson et al., 2000). These general principles are applicable in new situations even when specific conduct that would violate the rights of minority shareholders has not yet been prohibited by statutes. Judges in common law systems have exercised greater discretion in evaluating whether even unprecedented conduct by the insiders is unfair to outside investors.

The development of regulation in some national systems of corporate governance is characterized by the high degree of independence, and authority, of regulatory authorities from elected officials (McCubbins and Schwartz, 1984; Thatcher, 2002). For the law and economics perspective, the development of regulation in corporate governance constitutes a largely technocratic endeavour where the main task of policymakers is to implement institutional features that better protect the rights of minority investors (La Porta et al., 2000 and 2006). Regulatory institutions characterized by understaffing and underdeveloped budgets will fare poorly in law enforcement, a phenomenon interpreted as a regulatory failure (Enriques, 2002; Jackson, 2007).

The law and economics perspective is highly influential in the area of regulation of corporate governance. It is intuitively correct in that why would outside investors provide funding if their legal rights were not well protected? Nonetheless, the perspective has been criticized on several grounds. First, the construction of institutional arrangements that protect minority shareholders is not "rocket science"—the reason why non-common law advanced capitalist economies have refrained for a long time from building them is better accounted for by their reluctance to embrace principles of shareholder value that are more likely to be associated with independent regulatory authorities (Roe, 2003). Second, the law and economics approach conceptualizes regulatory arrangements that protect minority investors as fixed endowments that are both necessary for economic activities to occur and that, once in place, are themselves immune to change. By contrast, Milhaupt and Pistor (2008) highlight the continuous interactive process between legal arrangements and markets that results from three features: the extent to which legal systems are centralized/decentralized in relation to law-making and enforcement processes; the presence of multiple functions performed by the legal system in supporting economic activities beside that of shareholder protection, and the contested nature of legal institutions that follows from their asymmetric distribution of gains for political and social actors. Third, the legal perspective on corporate governance is unable to account for the variation and similarities in the character of regulation. In the first instance, the United Kingdom and the United States—two common law legal systems—

have often implemented different types of regulation: the former has relied on voluntary approaches to regulation, while the latter, especially in recent years, has enacted mandatory features (Sarbanes-Oxley Act 2002; Dodd-Frank Act 2010). Moreover, differences between civil and common law legal systems have experienced erosion in recent years since both systems continue to regulate and codify; and recent legislation has generated opposite results than would have been predicted by the law and economics perspective. An example is the quite directive Sarbanes-Oxley Act in the United States in contract to the market-preferring, transparency-enhancing Kontrag Law in Germany (Roe, 2006: 468–82).

The second theoretical approach to regulation and corporate governance is the political perspective (Gourevtich and Shinn, 2005; Roe, 2003). The above discussion of regulation in corporate governance highlights the importance of politics. The point is not that institutional differences between legal families do not matter, but that current differences between national systems of corporate governance are probably better accounted for by more recent political decisions that lead some countries to embrace/denigrate principles of shareholder value than institutional-legal variables introduced some centuries ago (Roe, 2007).

The central feature of the political perspective on regulation in corporate governance is that differences in regulatory institutions of corporate governance reflect the extent to which the political climate of a country is conducive to the pursuit of market-oriented and shareholder value-driven policies (Roe, 2003). The diversity of regulatory institutional features represents the different outcomes of political, economic, and social struggles across national systems of corporate governance (Roe and Gilson, 1999). In European social democracies and in Japan, policymakers have traditionally emphasized distributional considerations that privileged employees over shareholders.

The political perspective on regulation in corporate governance highlights two elements of the relationship between regulatory institutions and outcomes. First, regulatory institutions are secondary to politics. The absence of institutional arrangements that would protect the rights and promote the interests of minority shareholders in advanced capitalist economies cannot be attributed to technological shortcomings or financial issues (Roe, 2002). For instance, the understaffing of stock market regulatory agencies in continental Europe and Japan is not a problem of expertise or budgetary constraints, but rather a politically conscious decision not to empower an institution whose goal would be diverging from political norms of legitimate market operations. Conversely, the presence of regulatory institutions that promote shareholder value in dispersed ownership economies reflects the prior acceptance of market principles that privileges, or does not discriminate against, the preferences of minority shareholders (Roe, 2002). Second, the existence of institutional variation within families of corporate governance, namely social democracies versus those where principles of unfettered markets are legitimate, is not central to the argument (Roe, 2003: 27–46). Regulatory institutional features designed to dampen the ability of management to implement strategies of shareholder value have been achieved in different ways in economies that were/are characterized by ownership concentration: legal rights of codetermination in

Germany, state activism in France, and social norms and informal arrangements in Japan.

The political perspective on regulation and corporate governance is highly insightful and has contributed to our understanding of the diversity of national systems. The design and implementation of regulatory institutions entail important distributional consequences (Hancké et al., 2007). The differences in the degree of authority and independence of regulatory authorities do matter for the allocation of resources in the economy via, most notably but not exclusively, their effects on the distribution of authority inside companies. Politics is highly important for regulatory governance. Nonetheless, the political perspective on corporate governance and regulation needs to be complemented by the notion of coalition formation (Aguilera and Jackson, 2003; Gourevitch and Shinn, 2005) and the extent of institutional complementarities leading to distinct varieties of capitalism (Hall and Soskice, 2001; Hall and Gingerich, 2009). In the first place, coalition formation inside a national system of corporate governance is not limited to a class conflict pitting employees against managers/shareholders as presented by Roe. Sectoral (shareholders against employees/managers) and transparency coalitions (managers against employees/shareholders) are also important across issues and between national systems of corporate governance. In the second place, national systems of corporate governance are embedded in specific varieties of capitalism characterized by significant differences regarding the extent and strength of institutional complementarities at the national level. Institutional complementarities are important in liberal market economies (e.g. United Kingdom and United States) and coordinated market economies (e.g., Germany and Japan). The insider model of corporate governance in liberal market economies fits well with external flexibility in industrial relations and general/transferable skills in education. The outsider model of corporate governance in liberal market economies fits well with the rigidity of employment relations and the firm-specific skills of employees. By contrast, institutionally hybrid market economies (e.g. France and Spain) are characterized by the absence of complementarities between the different spheres of the economy, most notably, although not exclusively, reflecting the presence of general/transferable skills and rigid labor markets (Goyer, 2011; Hall and Gingerich, 2009; Maurice et al., 1986).

The insight from the coalition model formation and the concept of institutional complementarities is that institutional regulatory features exhibit important variations within families of corporate governance. The low prominence of shareholder value in European social democracies can be achieved by either a class conflict or sectoral coalition type (Aguilera and Jackson, 2003; Gourevitch and Shinn, 2005). Moreover, the presence of labor market rigidities (difficult to fire employees) in European social democracies (OECD, 1999) constitutes a source of constraints on managerial autonomy in settings characterized by the importance of general/transferable skills, while representing an enabling feature that incentivizes insiders to build on the long-term skill of employees in settings dominated by the presence of firm-specific skills (see e.g. Goyer, 2011). Thus, corporate governance in European social democracies is compatible with important variations in the size of the private benefits of control (high in Italy; low in

Germany) and with employee participation (Germany) or exclusion (France) in the strategic direction of companies.

## The Impact of Regulation on Corporate Governance: A Contextualized Approach

An important debate for both policymakers and scholars is the extent and the form by which regulation shapes corporate governance outcomes within and across countries. How does regulation matter? For the specific case of corporate governance, the last two decades have witnessed the "globalization" of regulatory reforms across economies with the aim of increasing the rights of minority investors (Burkart and Lee, 2008; Cioffi and Hoepner, 2006; Deminor Rating, 2005; Goergen et al., 2005). The rise of the regulatory state in corporate governance reflects in great part the strategy of international diversification of institutional investors from liberal market economies (Clark and Wojcik, 2007; Goyer, 2006). The preferences of shareholder value-oriented funds stand at odds with the mode of governance of firms in non-liberal market economies characterized by the lower prominence of the rights of minority shareholders (Roe, 2000). The strategy of international diversification of UK/US institutional investors has generated an industry of best corporate governance practices characterized by the publication of guidelines lists of what are considered fundamental strategies to unlock shareholder value most notably, but not exclusively, in the form of codes of good governance (Davis et al., 2006; Aguilera and Cuervo-Cazurra, 2009). Among these best practices are the rules governing the market for corporate control (mandatory bid rule, ownership disclosure, principle of equal treatment), the independence of directors, voting rights characterized by the one share-one vote principle, and the expansion of issues for which shareholder approval is needed (Adams and Ferreira, 2008; Burkart and Lee, 2008; Goergen et al., 2005; Dalton et al., 2007).

Nonetheless, the impact of regulatory reforms designed to enhance minority shareholders' rights should not be interpreted in a cumulative manner, namely the more the better. A cumulative assumption on regulation neglects the importance of contexts (Goertz, 1994; Goyer, 2011; Hall, 2010). Even assuming the best-case scenario for regulation theorists, a high degree of independence of regulators from both elected officials and from regulated corporations, national systems of corporate governance remain different from each other. The consequences associated with the enactment of regulatory reforms are mediated by the characteristics of the institutional environment of the system of corporate governance in which they are embedded. In other words, the impact of any regulatory reform on corporate governance is dependent on the structure of existing institutional arrangements (Hall, 2007; Hall and Thelen, 2009). Even when dealing with identical regulatory reforms, the presence of interaction between institutions insures that the impact of such reforms will vary significantly across national systems of corporate governance (Aguilera et al., 2008; Hall and Gingerich, 2009; Hall and Soskice, 2001). Four examples illustrate well the contextually bounded consequences of regulatory reforms: boards of directors in Germany, private benefits of control, takeover regulatory reforms in the European Union, and the abolition of deviations from the one share-one vote standard in Germany. We discuss each of them in turn.

First, Roe (1999) provides an insightful treatment of context in his analysis of codetermined boards in Germany. The boards of directors (i.e. supervisory boards) of German companies have largely failed to act as a mechanism to defend the interests of minority shareholders since employee representatives occupy half of the seats. The other half is composed of directors elected by shareholders. These directors have not been independent for the most part. The size of supervisory boards in Germany is also large and reflects the introduction of codetermination. Nonetheless, Roe cautions about regulatory reforms that would increase the independence of directors elected by shareholders—and who would be serving alongside employee representatives. The key contextual issue in this instance is the empowerment of the boards of directors. Empowering the shareholder-elected part of the board in the form of director independence might produce unintended consequences from a shareholder value perspective. Empowering supervisory boards would also empower their employee half against atomistic, and independent, directors comprising the other half. Thus, substandard board governance is likely to be less problematic for minority shareholders than a fully empowered board where employee-elected directors could coordinate their activities. Legal reforms designed to promote shareholder value in Germany via greater board independence is likely to produce unintended consequences given the institutional arrangement of board codetermination.

Second, the extent to which private benefits of control, and regulatory reforms designed to eliminate them, are damaging for shareholder value remains an unresolved issue. The notion of the private benefits of control refers to the aggregate value a controlling owner can extract from her ability to determine corporate policies at the expense of minority shareholders (Dyck and Zingales, 2004; Johnson et al., 2000; Nenova, 2003). Control over the corporate strategy of the firm is valuable since large shareholders receive private benefits that are not shared with minority investors. Examples of private benefits of control are the ability of the controlling shareholder to transfer assets at below market prices between different companies in which he possesses a dominant position, increases in equity stakes through dilutive share issues and minority freeze-outs, and synergy benefits from the use of information in the operations of a firm that would be exploited by other companies also controlled by the large owner (Johnson et al., 2000; Zingales, 1998). The gains associated with these strategic options are not shared by minority investors. Nonetheless, regulatory reforms designed to reduce the ability of the controlling shareholder to extract private benefits of control entail ambiguous consequences for shareholder value. Gilson (2006) highlights the presence of a tradeoff associated with the presence of a controlling shareholder: monitoring of managers versus the extraction of private benefits of control (see also Mayer, 2001). Agency costs come in the form of managerial entrenchment (ownership diffusion) and extraction of private benefits of control (ownership concentration)

(Coffee, 2005; Roe, 2001). Moreover, empirical data reveals the presence of large disparities in the amount of private benefits of control in systems of corporate governance dominated by ownership concentration (Dyck and Zingales, 2004; Nenova, 2003). In other words, controlling shareholders could be associated with low or high private benefits of control. Thus, the impact on shareholder value associated with regulatory reforms to reduce the extraction of the private benefits of control is contingent upon the specific context of national systems of corporate governance. Several contextual variables have been highlighted: social norms about corruption and personal enrichment (Coffee, 2001), presence of non-pecuniary benefits of control (Gilson, 2006), strength of firm-level employees that act as monitors on insiders (Gourevitch and Shinn, 2005: 59–67; Fauver and Fuerst, 2006), and the presence of institutional arrangements that constrain large shareholders in related-party transactions for both actions that result/do not result in bankruptcy (Conac et al., 2007).

Third, the introduction of an impressive array of regulatory reforms aimed at providing greater protection to minority shareholders in the European Union has been largely inconsequential for the development of a level playing field in the area of the market for corporate control. Regulatory reforms of takeovers in the European Union have been important in several areas: increased ownership disclosure requirements, mandatory bid rule, and adoption of the principle of equal treatment for all categories of shareholders (Goergen et al., 2005). These reforms have decreased the ability of bidders to proceed to the acquisition of controlling stakes without being detected as well as preventing side deals that would result in no/low takeover premiums for minority shareholders. Nonetheless, markets for corporate control still exhibit important differences in the European Union in regard to the overall importance of takeover activities, the identity of acquiring and target companies, the methods of payment, the friendly versus hostile character of the transaction, the characteristics of the post-acquisition reorganization process, and the rules governing the bidding process (Capron and Guillén, 2009; Culpepper, 2011; Rossi and Volpin, 2004). The key contextual factor is that managerial protection against takeovers reflects the importance of functional equivalency, namely the presence of alternative mechanisms of protection against unwanted takeover bids. In particular, institutional arrangements of ownership structure and deviations from the one share-one vote standard have not converged in the European Union, with the implication that some firms are better protected than others against unsolicited takeover bids (Valdivieso del Real, 2009). The consequences associated with the introduction of many pro-minority shareholder measures in the European Union reflect the interaction between the new institutions and those that were already in place.

Fourth, regulatory reforms aimed at eliminating deviations from the one share-one vote principle will produce different consequences according to the prevailing ownership structures of listed companies and the types of deviations previously used by firms (Adams and Ferreira, 2008; Burkart and Lee, 2008). The regulatory reforms of German corporate law (Kontrag law) illustrate this point in two ways. In the first instance, the power of banks in German corporate governance has been sharply reduced with regulatory reforms of proxy voting (Deeg, 1999; Höpner and Krempel, 2004). Prior to the 1998

Kontrag law, financial institutions in Germany were able to exercise significant voting power in companies through their role as custodian of shares since minority shareholders did not generally provide banks with specific voting instructions (Edwards and Fischer, 1994). With the introduction of the Kontrag law, however, German banks are unable to use voting power associated with custodian shares unless they have been authorized to do so. Regulatory reforms of proxy voting in Germany are potentially conducive to shareholder value but only in a specific context. The Kontrag law has undoubtedly reduced the power of banks—a specific category of shareholders who were almost always allied with management (Deeg, 1999; Fiss and Zajac, 2004; Gourevitch and Shinn, 2005: 164–7). On the other hand, however, large-controlling owners are unaffected by the Kontrag regulatory reforms since they never faced coordination problems, as compared with small-dispersed shareholders, to vote their equity stakes themselves. Large owners in Germany did not rely on the proxy voting of banks to protect themselves against takeovers, but on ownership concentration (Culpepper, 2011; see also Kogut and Walker, 2001).

In the second instance, the regulatory reforms of the Kontrag law have not necessarily promoted the interests of minority shareholders since they have in fact encouraged further ownership concentration in some German companies by eliminating all forms of deviations from the one share-one vote standard. The importance of institutional arrangements of voting rights in corporate governance reflects the process by which shareholders translate their equity stake into voting power (Yermack, 2010). There are three main forms of deviation from the one share-one vote principle: voting rights ceiling which caps the amount of votes any shareholder may cast regardless of the total number of stocks held; unequal voting rights which award multiple voting rights to specific categories of (usually long-term) shareholders; and non-voting shares which (usually) provide fixed dividends payments at the expense of participation in the affairs of the company (Burkart and Lee, 2008; Goergen et al., 2005). All forms of deviations from the one share-one vote standard have been eliminated with the passage of the Kontrag law in Germany.

The presence of deviations from the one share-one vote standard has been interpreted as strategic choices to deter takeovers and, thus, contrary to the interests of minority shareholders (Nenova, 2003; Zingales, 1995). However, the introduction of regulatory reforms designed to eliminate deviations from the one share-one vote standard should not be interpreted as a straightforward improvement of the rights of minority shareholders. The dominant ownership structure specific to a national system of systems of corporate governance shaped the dynamics of the consequences of regulatory reforms (Cools, 2004; Enriques and Volpin, 2007). The use of voting ceiling caps is best suited to settings characterized by ownership diffusion (Goergen et al., 2005: 252–3). Voting ceiling caps reflect managerial attempts at entrenchment in the context of ownership diffusion, thereby highlighting the divergence of interests between dispersed shareholders and managers (Davis, 1991; Morck et al., 1988). Unequal voting rights and non-voting shares, in contrast, constitute mechanisms by which large blockholders seek to create a gap between their ownership stake and their voting power (Zingales, 1995). Controlling shareholders can maintain their control over the strategic direction of companies at lower costs by raising additional equity funding from the greater public through unequal voting rights and non-voting shares. However, the effective use of unequal voting rights and non-voting shares presupposes the prior existence of some form of ownership concentration. The implication of the above discussion is that while the elimination of unequal voting rights in Germany has made it harder for large owners to control companies without committing funding, the abolition of voting ceilings caps has provided strong incentives for bidders to acquire large stakes in companies without fearing that their new position as controlling owner would not be diluted by limited voting power. The impact of the elimination of deviations from the one share-one vote standard is inconclusive (Burkart and Lee, 2008).

Similarly, and more broadly, Enriques and Volpin (2007) cast a critical eye on newly implemented regulatory reforms designed to improve the legal rights of minority shareholders in France, Germany, and Italy. Their skepticism reflects the presence of two types of agency costs faced by minority shareholders: separation of ownership from control and the incentives of controlling shareholders to capture private benefits of control (Roe, 2002). These two types of agency costs contribute to the destruction of shareholder value, but their containment is shaped by different legal-institutional arrangements (Coffee, 2005). The issue is that regulatory reforms in these three continental European economies have primarily aimed at controlling the behavior of opportunistic managers, not at curtailing the expropriation incentives of controlling shareholders (Conac et al., 2007). Legal empowerment of shareholders is more likely to translate into shareholder value in the presence of ownership diffusion, thereby highlighting how the same regulatory reform may engender different consequences based on the importance of ownership structure as a contextual variable.

## Hard and Soft Law in Corporate Governance

Corporate governance regulation is embedded in the legal apparatus of corporate law which primarily deals with five common characteristics of business associations, which are: legal personality, limited liability, transferable shares, delegated management under a board structure, and the ownership structure (Hansmann and Kraakman, 2004). One corporation can have, at once, all these characteristics, i.e. a large-scale publicly held firm. Others might have some deviations from one or more of the five characteristics to adjust the contingencies of the business, such as a small or closely held (i.e. private) firms, and cooperatives. Yet, despite differences in the forms of business organization, the baseline regulatory paradigm provides legal mechanisms to control these five core attributes of firms and to constrain corporate actors by requiring them not to take particular actions, or engage in transactions, that could harm the interests of other stakeholders (i.e. shareholders, and other corporate constituents such as management, employees, and creditors).

There are two broad regulatory mechanisms in corporate governance (Aguilera and Cuervo-Cazurra, 2009; Hopt, 2011). Regulation can take the form of statutory rules (i.e. hard law) which relate to prohibiting some kind of behavior and are characterized by the use of a "one size fits all" approach designed to address common governance problems; regulation can also constitute standards of best practice, leaving the compliance determination to firms, i.e. they are not legally binding by nature, and are characterized by the "comply-or-explain" approach that allows firms to carry out the governance mechanism that best fits their particular contingencies (Kraakman et al., 2004).

The importance of the soft law approach in corporate governance can be traced to the launch of the Cadbury Committee Report (FRC, 1992) by the Financial Reporting Council in the United Kingdom and of the Principles of Corporate Governance (ALI, 1992) by the American Law Institute in the United States. Aguilera and Cuervo-Cazurra (2004) highlight how corporate governance codes are designed to address deficiencies in corporate governance systems by recommending comprehensive sets of norms on good practices to firms in different regulatory environments. The content of many of these codes stipulates guiding principles on board composition, ownership structure, shareholder activism, and executive compensation schemes (see also Aguilera and Cuervo-Cazurra, 2009). Indeed, most advanced and emerging economies have relied on codes of good governance based on the "comply-or-explain" principle as an expediting mechanism to update their corporate governance regulation. For example, according to the European Corporate Governance Institute, 88 industrialized and developing countries had issued 310 corporate governance codes and/or principles by 2011. The spread of corporate governance codes was particularly encouraged by the European Union (EU) Directive 2006/46/EC, which promotes their application by requiring that listed companies refer in their corporate governance statement to a code and that they report on their application of that code on a "comply-or-explain" basis.

It is important to inquire why soft law prevails on the international corporate agenda when national regulators and stock exchange commissions have the power to enact hard laws that legally bind governance practices. According to Ogus (1995: 97), the materialization of self-regulation is justified in terms of public interest where three conditions are satisfied. First, that the activity is afflicted by some form of market failure, in particular negative externalities and information asymmetries. Second, that private law is inadequate or too costly to correct under failure. Third, that self-regulation is a better method to solve problems instead of using public regulation. Hart (1995: 688) claims that the case for the government to impose statutory rules on corporate governance on the grounds that "the world has changed" is not strong, as it does not allow firms to adapt governance mechanisms to their contingencies in an efficient manner. Indeed, the UK Corporate Governance Code, when defining the "comply-or-explain" approach seeks to recognize that "... an alternative to following a provision may be justified in particular circumstances if good governance can be achieved by other means. A condition of doing so is that the reasons for it should be explained clearly and carefully to shareholders, who may wish to discuss the position with the company and whose voting intentions may be influenced as a result" (FCR, 2006).

In an opposite direction and despite its new voluntary code of good governance (i.e. "Principles of Corporate Governance," NYSE, 2010), the federal government in the United States has developed and implemented substantial regulation to set stringent requirements to achieve extensive oversight of corporate management by the board and audit committee (i.e. Sarbanes-Oxley Act 2002), to limit executive pay and the firm's control of the proxy process (i.e. Dodd-Frank Act 2010), and to ban specific corporate governance provisions (e.g. staggered boards and CEO duality) (Shareholder Bill of Rights Act and Shareholder Empowerment Act 2009) (Larcker et al., 2011).

Therefore, a relevant question is what factors may account for country's choice of approach to regulation. Two broad perspectives have been identified. First, the choice of regulation reflects the ability of regulated interest groups to capture the state (Djankov et al., 2002). Regulation is conceptualized as a less efficient mechanism where interest groups (regulated firms) may extract considerable private benefits if they can formulate and themselves enforce the relevant legislation. The incentives of regulated groups, as well as their ability to capture the state, entail a path-dependent evolution in the introduction and implementation of new regulatory mechanism (see e.g. Bebchuk and Roe, 1999).

Second, various institutional factors may affect a country's choice of approach to regulation. For example, in the UK there is a long tradition of self-regulation (Cheffins, 1997). In addition to the existence of powerful professional and shareholders associations, such as the National Association of Pension Funds (NAPF), the Association of British Insurers (ABI) grants some enforcement powers. Although their influence on corporate governance matters is open to debate (Becht et al., 2009), their presence, together with other institutional features of the UK economy such as strong networks within the City of London,[1] and a certain path-dependence of the self-regulation mechanism, provide the foundations for the UK governance regulation emphasized by the "comply-or-explain" principle.

Other important institutional factor that might explain the distinction between the regulatory arrangements is the characteristics of institutional investors. Aguilera and Williams (2006) argue that the attitude and behavior of shareholder value-oriented institutional investors constitute the missing link to understand the dissimilarities between UK and US corporate governance. In the British case, pension funds and insurance companies, which are long term oriented, are the dominant categories of investors. On the other hand, mutual funds, which have a shorter-term outlook, are dominant in the American capital markets. In the former, corporate governance codes are suited to long-term orientation of pension funds. In the United States, in contrast, listed companies increasingly have found themselves confronted by shareholders who want to influence corporate management both directly through activism, and indirectly, provoking further arguments for government regulation (Copland, 2011).

Another important question is whether hard and soft law is effective in triggering good corporate governance practices and in solving corporate governance problems. Corporate governance scandals and empirical studies show that compliance with rules (i.e. hard law) and standards (i.e. soft law) has not always translated into effective governance (Larcker and Tayan, 2011). Regarding hard law, an interesting example is the case of Enron (Coffee, 2002), which was compliant with NYSE requirements at the time of the corporate governance scandal in 2001. In the case of soft law, a recent study (RiskMetrics, 2009) concludes that the "comply-or-explain" approach formally adopted by the European Commission in 2006, while receiving strong acceptance from the corporate and the institutional investor community, suffers from implementation deficiencies, particularly concerning the level and quality of information on deviations by companies and a low level of shareholder monitoring.

Additionally, the corporate governance and financial literatures are not conclusive on whether these governance mechanisms, hard or soft law, have an effect on firm performance. On the one hand, Alves and Mendez (2004) find that the Portuguese code of corporate governance does not have a systematic effect on firm returns; yet, compliance with the structure and functioning of the board of directors is positive correlated with abnormal returns. DeJong et al. (2005) report that the Netherlands' self-regulation initiative had no effect on corporate governance practices nor on their relationship with value. On the other hand, Fernández-Rodríguez et al. (2004) suggest that the market reacts positively to announcements of compliance with the code of corporate governance in Spain. In the UK, Dedman (2000 and 2002) provides consistent evidence that, after the implementation of the recommendations of the Cadbury Committee, firms' governance practices reduced the agency cost of managerial entrenchment and enhanced board oversight with respect to the manipulation of accounting numbers and the discipline of the top executive. Additionally, Goncharov et al. (2006) show that firms with higher compliance are generally priced at a premium in Germany. These mixed and inclusive findings suggest the importance of the context in which firms are embedded (Aguilera et al., 2008). The same regulatory variables can result in different outcomes across contexts that are characterized by interacting institutions (Goyer, 2011; see also Goertz, 1994).

Thus, we have described two mechanisms of corporate governance regulation, namely the "one size fits all" approach from hard law and the "comply-or-explain" approach of soft law. In addition to these two "ideal" cases, there are also interesting hybrid forms of hard and soft-law. For example, in 2000, the Brazilian Stock Exchange (i.e. BMF & Bovespa), aiming to solve legal deficiencies in investment protection and to foster the capital market, designed a dual regulatory regime where firms can choose among four levels of listing requirements, offering progressively higher levels of minority shareholder protection (Gilson et al., 2011). The innovative dimension of the Brazilian market regulation is that it recognizes that some existing listed firms would find it difficult to adopt the new rules since they are quite demanding from a legal perspective compared to the traditional market rules. The BMF & Bovespa proposed two differentiated levels of corporate governance practices, level 1 and level 2 (Carvalho and Pennacchi, 2012). This innovative regulatory duality provides protection to entrenched owners (who would otherwise be opposed to the reforms), while advancing a new governance regulation in order to attract new sources of capital.

# Conclusion

In this chapter, we have presented an analytical survey of the main forces shaping regulation and how in turn regulation becomes an important contextual factor for corporate governance practices. However, we caution against becoming overly structuralist for two reasons. First, as we have shown in the last section on soft versus hard law, there are plenty of unwritten regulations, such as implicit codes of conduct, that mandate how economic exchanges take place. These soft norms fill in voids for formal hard law and often become an important mechanism for innovation in the regulatory sphere. Second, firms and actors within firms have the ability to make choices within institutional constraints and more precisely within regulatory choices (see e.g. Whittington, 1988). Regulation has become increasingly important for issues of corporate governance, but its impact remains contextually bounded. We are referring not just to the radical choice of complying or not with regulation, but also to the degree to which firms internalize the regulations into their organizational and strategic firm choices. Hence, future research should pay attention to these complementary and substitutive relationships as well as to the levels of regulation internalization.

There are two interesting areas of research on regulation and corporate governance that need further attention. The first concerns the regulatory existence of the multinational firm, and related multinational enterprise ventures, and how they structure their governance, not only around foreign subsidiaries in different regulatory regimes but also in relation to other international governance forms such as strategic alliances and equity joint ventures. Second, in the currently shifting world of nations where emerging market firms from state capitalism systems are becoming established in the traditionally industrialized world, and also turning into world leaders in many different industrial sectors, we need to better understand how their often hybrid forms of public-private ownership, professional-political managers, and overall different rules of operating within the governance realm might affect not only their competitiveness but also those of non-emerging market firms (*The Economist*, 2012).

## Note

1. We thank Igor Filatotchev for highlighting this point.

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