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HANDOUTS

CORPORATE GOVERNANCE

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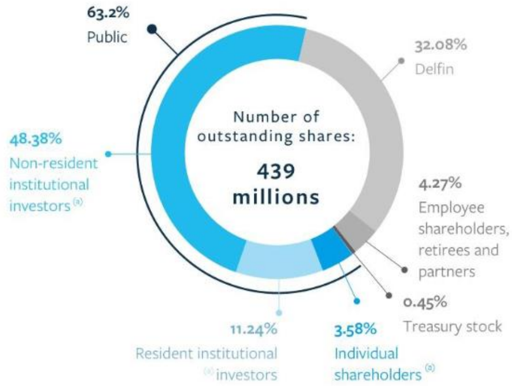
CORPORATE GOVERNANCE

The separation between ownership and management

When Leonardo del Vecchio died 3 years ago, the world' largest eyewear group faced a power struggle. Who really controls the company? Family heirs, French partners, or institutional investors? Without clear governance, even global giants risk uncertainty and internal fights.



Through the holding company Delfin, Del Vecchio controlled the largest stake in *EssilorLuxottica*, which share (32,08%) has been divided to the eight heirs. In case of **listed companies**, such as EssilorLuxottica, in order to have the control the company the number of shares needed for the control is the 25% (in coherence with the European community). Because of that, we can define this company as a family-controlled firms. *The decision before being applied needs to be approved by 88% approval of Delfin's shareholders* -> this means the family must act unanimously to exercise control. It can be possible that their children must be agree about everything in the company. At the moment, the children are working pretty well together, but

Meta (Facebook) -> the main decision maker in Mark Zuckemberg who, with just 15% of equity, he's the controller of more than 50% voting rights. What happens when one person can make a huge bet with almost no checks and balances? In the US, in particular if you are the entrepreneur, it is considered normal to have a higher power. Mark Zuckerberg holds both CEO and Chairman positions at Meta, combining top executive and board leadership roles. Despite repeated shareholder proposals to separate these roles, governance changes remain blocked by his dual class share control. Meta uses a dual-class share structure -> Zuckerberg owns 99.8% of Class B shares, giving him control of ~58% of total voting rights while holding just ~13% of economic ownership. In addition, we have a limited Board Independence

- ➔ The structure has resulted in a board with limited independence, and limited pushback even on proposals meant to empower independent directors. 60% of non-insider shareholders supported granting the Lead Independent Director the power to add agenda items without Zuckerberg's approval, but it failed due to his voting control

After the dead of Giorgio Armani, we are facing a situation where there is not a clear succession plan, as there are no direct heirs. One of the most important issue is to keep the value of Giorgio Armani but also decide to list the company or not (it will take 5 years and then the approval of the majority of the BoD -> a reason might be to keep the values and the vision of Giorgio, but we have to firstly understand who will inherit the company).

What is Corporate Governance?

Definitions of Corporate Governance -> rules, mechanisms and best practices (no written rules, no mandatory) in order to best manage the company, exercise the control by the owners of the company and their representative in the Top Management Team (TMT) and configure the ex post distribution mode of the value generated by the company.

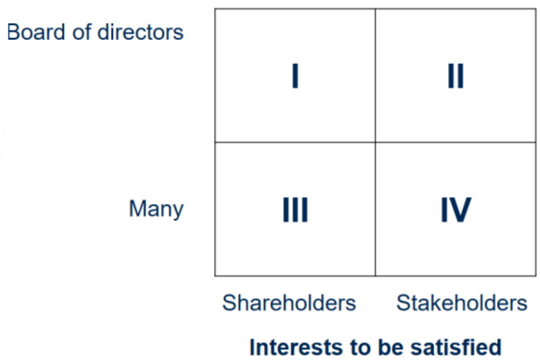
Corporate governance is the system by which companies are directed and controlled. *Boards of directors are responsible for governance*, while *shareholders appoint the directors and auditors* and must ensure that an appropriate governance structure is in place. The board's responsibilities include *setting strategic aims, providing leadership, supervising management, and reporting to shareholders on their stewardship*. The board's actions are subject to laws, regulations, and shareholder approval in general meetings (Cadbury Commitee).

Even though these are not the only definition of CG, all the possible one have in common that see it as everything can be done by the company to *use the resources in a productive way* in order to *met the expectations of the stakeholders*, both combining:

- An internal dimension, relating to the ways in which power is assigned and shared within the company. It defines the role, the composition, and the functioning of the board of directors, the incentives established by the management and the structure of ownership, as well as the internal audit system.
- An external dimension, which includes the rules and institutions in charge of protecting the investors and regulating contacts between the company and its stakeholders. It defines the set of laws and regulations aimed at protecting investors and stakeholders in general against opportunistic behaviour. In this dimension, we also include the capital market and the market for corporate control.

The definition of CG, can be identify by **two variables**:

- *Structures and mechanism of CG* -> is the company managed only by the BoD or there should be a complex structure where different structures resolve the different problems?
- *Interests to be satisfied* -> should we be interested in satisfying the shareholders or the stakeholders?



In the **first quadrant**, there is the narrowest view of CG. The company should be managed by only the BoD (which is assigned to resolve also the conflicts between shareholders and managers) and their aim should be to satisfy the interests of the Shareholders -> 3 main players:

- *Shareholders* -> they provide equity capital (so their return is not fixed, as it depends according to the profits and dividends generated by the company) and it is possible to expropriate their value -> they have the right to appoint the representative in the BoD that allow their interests to be satisfied
- *Board of Directors* -> they have fiduciary duties towards the shareholders and must verify managers are working to satisfy their interests
- *Managers* -> they have to operatively manage the company in order to respect the objectives set out by directors

This view today is not followed anymore. In this narrow view of corporate governance understood from the *Anglo-Saxon perspective* and indicating the set of governance mechanism of a *large, listed company*, usually with a *widespread shareholder base* and strongly posing the problem of protecting the interests of small shareholders against potential abuses resulting from managerial discretion. The two main issues generated by this model are that it does not take into account the importance of all the other stakeholders and because it sets the bases for the agency problem and the proliferation of "bad governance" situations.

In the **second quadrant**, more attention is given to the different stakeholders, even though the BoD remains the most relevant mechanism of corporate governance. Might be a little be difficult to face all these problems.

In the **third quadrant**, both internal and external mechanisms available to the company to satisfy the interests of the shareholders. We refer to the entire set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how risks and returns are allocated. These arrangements include *corporation law* and *boardroom practices*, but also corporate finance, securities and bankruptcy law, financial institutions, labour relations, contract law, property rights, compensation systems, and internal information and control systems.

Finally, the **fourth quadrant** has the broader view of CG and the most used by companies. The characteristics are:

- The company should be managed in order to satisfy the interests and the requests of several stakeholders, and the corporate mechanisms should involve both internal and external instruments in order to do so
- Consideration should be given to the different models of ownership (by distributing the ownership between the different parties involved in the company) and management (different distribution of power and responsibilities between managers, directors and owners, also with the possibility of people covering overlapping roles) different from the traditional one
- The model should include additional actors from the ones previously mentioned.

Corporate governance deals with the ways in which suppliers of finance to corporations ensure themselves a return on their investment. At the same time, good corporate governance consists of structuring, operating, and controlling a company to achieve the following:

1. *Fulfil the long-term strategic goals of the owners*
2. *Consider the interests of employees* (past, present, and future)
3. *Address the needs of the environment and the local community*
4. Maintain *strong relations with customers and suppliers*
5. *Ensure compliance with all applicable legal and regulatory requirements*.

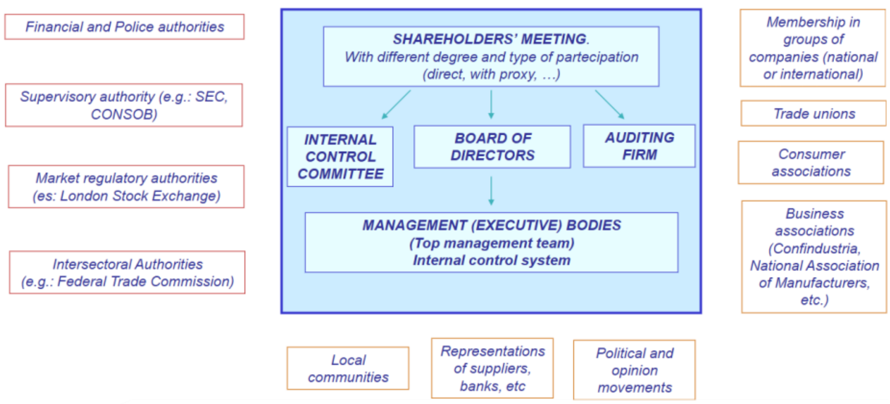
For example, if we take the Business Roundtable (the meeting of the most relevant US CEOs), we can see that their purpose is to "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. **We commit to**:

- Delivering value to our customers.
- Investing in our employees.
- Dealing fairly and ethically with our suppliers.
- Supporting the communities in which we work.
- Generating long-term value for shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."

In addition, when we talk about "**shareholders**" within a company, depending on the corporate structure they might have a more relevant role to play and different mechanisms, in particular when we have a concentrated and not concentrated structure. In fact, we have to make the distinction between "*large and active shareholders*" (who are more involved and interested in the managerial functions) and "*small shareholders*" (who usually limitate their participation as interested only in the economic interest) -> the "interest of the shareholders" is not always the same. Together with the instrument to support and protect the interest of all kinds of shareholders, we have also to include also the **instruments used to protect the interests of the different stakeholders**, both:

- *Internal actors* -> we have to combine the need of shareholders to maximise the return of their investments (even though we have differentiated the interest of small and large shareholders, as the second are more likely to be connected to managers' activities inside the company), the *correct role and responsibilities attributed to managers*, and the role of internal bodies that need to verify everything work as planned without any contrast. This usually occurs by appointing an *internal control committee* (to ensure that they are conducted in compliance with the law, the company bylaws and proper manager practises) and the *audit function* (which is attributed to an internal or an external committee depending on the fact that the company is public or not)
- *External actors* -> there are several players that can influence the outcome of companies, ranging from Supervisory authorities, passing by trade unions and arriving at local communities. The role and the power of these players is very different if we consider different countries and different sectors. For example, if *strictly regulated sectors* (such as credit), regulatory institutions have a central role in *determining what companies can and can't do* and it can have a significant impact on strategic choices of the company.



<u>The traditional corporate governance problem</u>

Initially ownership and management were united = <u>decision-makers were also those risking their own capital</u>. Over time, several factors changed the scenario:

- *Company growth*
- *Financial market transparency*
- *Need for professionalized management*
- ➔ <u>progressive separation between ownership and control</u>

The Anglo-Saxon approach is based on the public company (PC) ownership type. PCs emerged in the US in the 1930s and remain the dominant ownership structure in Anglo-Saxon countries (particularly fragmented), born in order to <u>separate the ownership and control, which is necessary in order to separate the legal responsibility of the company from the one of the landers</u> (now it is the most widespread type of company in countries characterised by market capitalism, such as USA and UK).

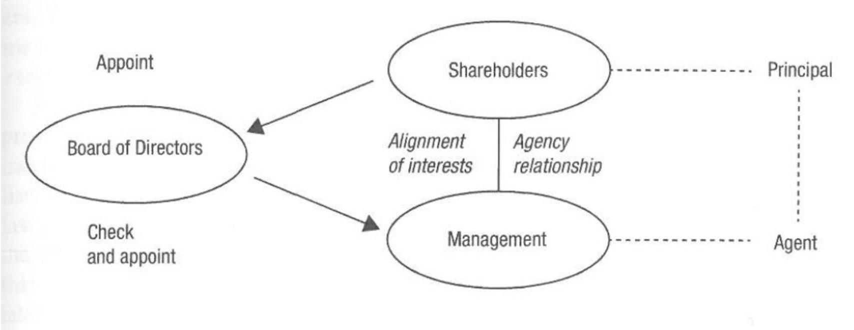
PC definition -> <u>Listed companies, with an high number of small and passive shareholders where none of them has a such relevant amount of the shares to make it possible and convenient to take part in the company governance</u> (highly fragmented ownership structure) -> usually, *no more than 5% of shares*, but the world is never black or white (we have to consider factors like coalitions). Consequently, they <u>neither vote to nominate the directors in the board</u> -> they rather "*vote with their feet*" (selling their shares when they disagree with governance decisions), even though today this practice is less common after the introduction of "good governance" practices.

In US public companies (1960s–70s), boards of directors held supreme power. <u>Directors often appointed by the board itself</u> (passive shareholders, because there were no complex control systems, so it is possible to propose the list of members of the BoD and then it was approved immediately). <u>Many directors were simultaneously top managers (inside directors) with little or no outside representation</u>, causing a *strong temptation to act in self-interest rather than in the interest of dispersed small shareholders*. Today's problem is to identify the mechanisms, policies, structures and rules to avoid this behaviour, as the possibility for the company to face decrease in profitability and productivity.

Where there is a <u>marked separation between ownership and control</u>, the *improper* and *harmful exercise of powers* and delegated power by directors and managers can <u>lead both to hidden consequences</u> such as *inefficiency*, *failure to meet profitability* and *development expectations*.
Agency theory -> <u>a contract according to which a person (the *principal*) delegates to another person (an *agent*) to fulfil a task which implies a power, for the agent itself, to take decisions on behalf of the principal</u>.

In the "**classic scheme**", shareholders are the principal, as they appoint the BoD. The BoD appoint and monitor the Top Managers Team (TMT), so the agent becomes the TMT -> the agency relationship is built between shareholders and TMT. This relationship is described in the following graph:

Figure 2.3 The "basic scheme" of the relationship between ownership, managers and board of directors according to agency theory



Source: Minichilli (2012, p. 24).

The delegation of power by the principal in favour of the agent generates *information asymmetry* and *divergence of interests*. Two main consequences:

- if *both principal and agent are utility maximisers*, the agent will probably act in his/her interest rather than in the interest of the principal
- the principal will be thus compelled to arrange safeguard mechanisms (contracts, controls, incentives, guarantees...), which are often extremely costly.

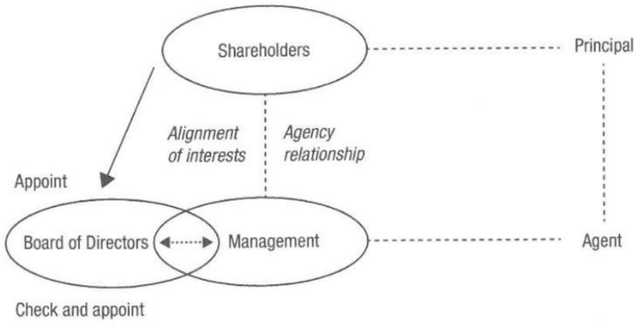
In governance literature, the relationship between shareholders and directors is considered an agency relationship -> Goal: minimize **agency costs** through an effective governance structure, given ownership type and institutional context. The agency costs are usually the sum of:

- *Monitoring costs (for the principal)* -> asking the agent to provide enough guarantees and information following specific schemes
- *Incentive costs (agent)* -> all the costs aimed at aligning the interests of the agents with the one of the principles, such as stock option
- *Residual losses* -> completely eliminate the agency costs is basically impossible, so we have to consider these too.

In this context, the *role of the BoD is central*, as a correctly appointed and configured BoD is the best guarantee of a balanced relationship between shareholders and managers, which ensure a *good alignment of interest*, *proper control of the job carried by manager* and a *reduction in agency costs*.

Is it the best configuration for PCs (which is the most common scheme applied today)? Are we sure there are no overlapping roles? Usually, we have the CEO who is the overlapping position, for example. *Information asymmetry is a problem*, as TMT know everything about the company, while BoD or shareholders don't, so they do not have the same amount of information.

Figure 2.4 A first variant: the overlap between the board of directors and management



Source: Minichilli (2012, p. 25).

First variant -> with this scheme, the Board of Directors is not only the organ that *controls* the TMT, but also *support* it in making the most important decisions for the management of the company itself -> it is *compromised the total independence of the BoD* (which is fundamental to create a system of check and balances to compensate the TMT).

In this view, because the BoD has both the roles of controlling and supporting the Management team, it is common that its composition is a mix of both *internal* (executive) and *external* (independent) directors -> it is necessary to identify the optimal level of overlap between control and management, in order to avoid the risk of "domain" established by management team, which will make more difficult for the BoD to exercise its controlling activity, increasing agency relationship problems and, therefore, agency costs.

Second variant (typical of companies where there is a high concentration of ownership, such as in family-managed businesses) -> we have at least one person sitting in all the bodies, causing an overlapping not only between TMT and BoD, but also between these two and the shareholders. Even though it might seem that this structure ensures the *complete alignment of interests*, we haven't solved completely the problem, as there are different types of conflict

- *Majority vs minority shareholders* (Agency problem type II, or "principle-principle problem") -> there could be situations where the interests of these two groups of shareholders do not match, in particular regarding the important strategic decisions, the risk the company has to face and the orientation of choices. These conflicts might be stopped by blockholders (such as the State, the family or Venture capital) who decide to impose their decision because they won't face any opposition
- *Conflicts between ownership representatives and directors* -> it can lead to anomalies to the governance structure in general, as there could be situations where "controllers" (such as the independent advisors) are appointed by "controlled" people (shareholders), although they are equally responsible for the fate of the company
- *Coexistence of owners and external directors* -> it might be difficult to have an harmonious governance of the company. This can happen, for example, in the relationship between members who belong to the controlling family (that has a power structure, an internal legitimacy and a sense of belonging) and those who don't (that can cause a feeling of exclusion)

Possible examples of managerial misbehaviour

Both directors and top managers may prioritize personal interests over shareholders. The most common reasons are:

- *Human nature* -> the energy, honesty and intelligence of a person can influence his propensity to opportunistic behaviour -> it varies from person to person, even though it is common in nature for a person to use all the possible means to pursue one's own privilege
- *Different risk appetite of directors and managers* -> different individuals in the same situations can make different decisions both for pursuing their own interests but also because of a different propensity to risk
- *Limited rationality, information asymmetry, the impossibility of complete contracts and uncertainty* -> situations of limited rationality cause information asymmetry between the actors involved, making more difficult to define clear contracts and ensure conditions of uncertainty

The specific origins of bad governance are:

- *The separation of ownership and control* -> concentrations of power in the hands of executives where various factors converge, such as the *temptation of directors and managers to pursue personal objectives*, cause *information complexity* and the *difficulty in controlling this instinct*
- *The leverage effect of "private benefits/public costs"* -> there could be situations where managers may take opportunistic behaviours and receive additional benefits, of which the high costs will be spread among the vast majority of shareholders. The additional problem is that most of the time, because of information asymmetry, the presence of these benefits is occulted and show their effect only when serious and manifest consequences appear.
- *Imperfect markets* -> the different degrees of freedom and transparency in the different markets make it difficult to delegate the problem of CG to the mere functioning of the market
- *The inherent weakness of all formal and bureaucratic controls* -> even though there has been an increase in regulation and bureaucracy, which led to the introduction of formal control systems, they continue to show weakness -> caused by information asymmetry (make it easier to hide knowledge), impossibility to drawing up clear contracts (and, therefore, establish the most appropriate control system) and separation of ownership and control

The signs of bad governance.

After all these considerations, the **signs of "bad governance"** refers to all the circumstances where the director or managers, deviated by their agency mandate, damage the interests of the owner in order to prioritize theirs. The most typical signals are:

- *Empire building* -> top managers prioritize dimensional growth over profitability, often taking excessive risk compared to company's policies, in order to *obtain additional power, obtain higher remuneration/benefits and increase their prestige*.
- *Shrinking* -> favouring low-risk personal strategies, restricting personal commitment and tensions, based on the assumption that the value of a company is generated exclusively by teamwork, making it almost impossible to identify the individual contribution to it -> *high incentive for managers to delegate their work to others*
- *Personal enrichment* -> this can be done by using unfair practices or even illegal ones, such as *using hierarchical power to obtain salaries and benefits outside of the market or using personal information to obtain personal profit* (insider trading). This situation can be manifested by

different methods, such as creating a separated legal entity controlled by the manager himself (or by his trustees) and buy from this company goods and services at a cheaper price or sell to this entity its services.

- *Entrenchment* -> erection of barriers to protect from potential hostile takeover that will change the management team (one of the most expensive manifestations of the agency problem). It can be conducted by different means, such as ant-raid clauses, golden parachutes and shareholders agreements
- *Excessive focus on short-term results* -> the goal is to present the best possible results to financial markets by sacrificing the medium- and long-term results if necessary. This is done for increasing the top managers salaries and creating the conditions for opening the doors for more prestigious jobs
- *Transfer the benefits to third parties* (such as phenomena of nepotism within the company) -> the potential risk is that there won't be a qualified managers to cover this role, but only for its belonging to the controlling family, compromising the future and the success of the company.

Responses to the problem of bad governance.

What are the possible responses to bad governance behaviours?

- **Make the markets efficient and rely on them**
  - *Market for goods and services* -> because the company is meant to produce goods and services to satisfy its customers' needs, the management will be directed to adapt in order to create value for shareholders
  - *Financial markets* -> according to this theory, the equity market is the best measure to quantify the value created for shareholders. It is a measure that reflects the expectations of investors about the future performances of the company. As a consequence, it can be used to evaluate the performance of managers and can be used for these last as an incentive in case their remuneration is linked to the share value.
  - *Market for corporate control* -> its role is to asses the managerial position to the people who are capable of creating value for the company itself. When the company is managed in an inefficient way, there are consequences in the stock price, which usually goes below its potential. Among the hostile ways of relocating corporate control, there are:
    - *The battle for proxies*, which occurs when a shareholder of a company not satisfied with the performance of a board of directors presents an alternative list of candidates proposed by the management.
    - *Friendly takeover*: Usually refers to a favourable and friendly decision to reshape the governance bodies and mechanisms of a target company
    - *Hostile takeover*: in which the corporate raider makes a public takeover of the entire capital of the company or a significant part of it, at a fixed price. With it, the possibility of appointing a new board and a new CEO.
  - *Market for top manager* -> the possibility for managers to be changed by different and more competent managers represent a powerful reputational deterrent
- **Define and impose structures, rules, mechanisms**
  - *Board structure* -> the BoD is the most relevant method to exercise control over management, but there could be problems in defining a proper definition of tasks and a composition and structure that allow its proper functioning. Regarding the scope of

action of the BoD, there are 3 main aspects, which are who makes the basic decision for the company (define which goods/services to be produced, how to finance the company, define the size of production, define policies of diversification/differentiations...) and selecting/encouraging/evaluating the TMT (by the identification of the CEO, his/her area of action and responsibility, his/her remuneration, how to evaluate performances). Regarding the structure and functioning of the BoD, we have to keep in mind:
    - *The composition of the BoD* -> how many directors to appoint, which are their responsibilities, which are the criteria that need to be used for identify them...
    - *The structure of the BoD* -> who is the CEO and the chairman, the overlapping roles between them, the role of independent directors and the creation of different committees...
    - *The way in which the BoD operates* -> providing information to directors, frequency and manner in which meetings are held, decision-making style of directors and board...
  - *Control Mechanism* -> we have to make a distinction between:
    - Internal control system -> usually it's defined by the law and regulation available in the country in which the company operates. The most common systems are the *two-tier systems* (divides the corporate system into 2 different bodies, the management board and the supervisory board), the *one-tier system* (the management is in charge of a single board and the control committee is appointed between the members of the boards) and *the ordinary system* (there is a clear distinction between the management board, the control body and shareholders' meeting)
    - External control system -> it refers to the *independent auditors*, including the time limits for their office imposed by law, as well as the role of supervisory authorities for the proper function of the market
- **Privilege some ownership structures rather than others**
  - *"Pure" public company* -> the presence of a widespread shareholder basis allows the company to grow faster than the companies with concentrated structure, they have a better and clearer separation of roles (making less ambiguous the functioning of the overall system of governance) but they are more exposed to problems connected to managerial discretion
  - *Block holding group* (such as the family owner of the company or the State) -> there is a clear distinction between shareholders and managers. In addition, the presence of a dominant group of shareholders and managers that represent their interests seems to resolve partially the agency problem. Even though these companies have shown to be more resilient during economic crisis, the ambiguity in responsibility and the possible overlapping roles represent a threat to the efficiency of this system.
  - *Institutional investors* -> The manager policy of institutional investors was inspired by the logic of active management of a securities portfolio. It is characterised by investors activism aimed at making proposals, pressuring the board of directors or the CEO of a company and censuring ring, and fighting cases of overcompensation of top management. This new method of operating is considered a new model for production of owners' interests, particularly useful in overcoming the problems of companies fragmented ownership structure

Aligning interests - Incentives

— **Ex-post dealing** of managerial opportunism: it's not effective since it can be too late

— **Ex-ante incentive contracts** to align directors and managers' interests to those of investors (high powered incentives):

Through **stock incentives**:
- stock options
- stock granting
- (but…they create enormous opportunities for self-dealing)

Leveraging on **reputation** that directors and managers have to defend on:
- the capital market (where they usually ask the money);
- the market for top managers (if they want to keep their job).

Fiduciary duties -> directors have fiduciary duties towards the corporation, the most important of which is *pursuing company's objectives* and *satisfy shareholders' interests instead of theirs*. There is no specific guidance on how to acknowledge the rights of other interested parties affected by corporate decisions. Fiduciary duties, together with legal sanctions in the event these are breached, are a good substitute for financial incentives and contribute to align directors' and shareholders' interests. Directors are, in fact, highly concerned about potential stockholder's suits and their personal liability.

The role of shareholders hasn't been the same along **history**:

- *Before the 1990s* -> *Institutional investors were active investors* (stock picking), but *passive shareholders* (little involvement in corporate governance)
- *After the 1990s* -> *Growth of index funds* (passive investing (replicating benchmarks such as S&P 500, MSCI World), *new proxy voting rules and ESG concerns* = more shareholder activism

➔ Results:
  - Passive investors → cannot easily sell (must hold all index components)
  - Active shareholders → use voting rights and engagement to influence governance

Large shareholders have an incentive to monitor the managers and the power to replace them. Not all large blockholders are good shareholders, as they can be tempted to make their own interests rather than the interests of the minority shareholders (and so expropriation and misallocation are equally likely). Typical large shareholders that are considered good "watchdogs" are the institutional investors, e.g. pension funds and mutual funds (e.g. Calpers, BlackRock).

The use of **financial debt** can change management incentives due to the *different time distribution of cash flows*. This because with *equity* there is no contractual obligation to pay dividends and to reimburse it. Instead, with *debt*, we have:

- Reimbursement plan and the regular payment of interests
- Can reduce free cash flow, and the related managerial discretion to allocate funds deviating from company's objective
- It implies also the creation of conflicts of interests between creditors and shareholders:

  - *asset substitution*, it gives shareholders an incentive to take risky investments as the positive results are mostly acquired by them, while the negative ones are on the creditors' shoulders
  - *debt overhang*, a company with high debt can lose investment opportunities as it can have problems in finding new suppliers of funds.

The level of legal protection for shareholders and creditors varies significantly across countries:

- Weak protection → ownership concentration acts as a substitute, allowing blockholders to safeguard their interests.
- Strong protection → dispersed ownership structures are more viable.

	Anti-directors Rights	Creditor Rights	Efficiency of the Judiciary	Accounting Standards
Common Law	4.00	3.11	8.15	69.62
French Civil Law	2.33	1.58	6.56	51.17
German Civil Law	2.33	2.33	8.54	62.67
Scandinavian Civil Law	3.00	2.00	10.00	74.00
World	**3.00**	**2.30**	**7.67**	**60.93**

Shareholders versus stakeholders view of the firm: the "Corporate Purpose"

The **corporation exists primarily** to maximize shareholder value. Shareholders, as residual claimants, are the ultimate owners and managers act as their agents.

Assumption	**Explanation**	**Example**
Corporation's purpose = maximize shareholder value	Shareholder wealth is the ultimate corporate goal	**Coca-Cola** focuses on dividend stability and growth for long-term shareholders
Shareholders are residual claimants of profits	They receive what remains after all obligations (debt, wages, taxes) are paid	**Apple** distributes dividends and share buybacks from residual income
Managers and boards act as agents of shareholders	Agency theory: managers must act in the best interest of owners	**ExxonMobil** board pressured to change climate policies after shareholder push
Stakeholders considered only instrumentally	Employees, customers, suppliers are important only as means to shareholder ends	**Amazon** invests in logistics efficiency mainly to improve profitability and shareholder value

In this table, there is small mistake: boards do not act as agents, rather appoint and monitor managements (hence acting as principals as well).

The instrumental role of stakeholders is given by the fact that by *maximising the company profits and interests*, stakeholders concerns or priorities get addressed better and more efficiently. They are more like the mean rather than the end goal of the firm. The corporate purpose aims at least to financial sustainability and improves corporate value, as once this is reached, the company can focus on different strategic goals and objectives.

For the shareholder view to work, we must assume that markets are efficient and that incentives push managers to act in shareholders' best interests.

Assumption	**Explanation**	**Example**
Maximizing shareholder value → maximizes corporate value	Shareholder value = proxy for overall efficiency	**Apple** reinvests profits in innovation, benefiting shareholders, employees, customers
Financial markets are efficient	Prices reflect available information	**Tesla** stock reacts immediately to announcements (innovations, recalls)
Shareholder value maximization disciplines managers	Poor performance punished by falling stock → pressure on managers	**Boeing** CEO dismissed after 737 Max crisis
Stock-based incentive plans align managers with shareholders	Executives' pay tied to stock → alignment of interests	**Amazon** CEO package tied to long-term stock growth
Market for corporate control disciplines managers	Poorly performing firms become takeover targets	**Yahoo!** (decline, Microsoft's hostile bid, later acquired by Verizon)

The firm is a **nexus of contracts** (implicit & explicit) regulating rights and duties of stakeholders:

- Explicit contracts = legal agreements (salary, loan repayment, supply deals)
- Implicit contracts = informal expectations (job security, product quality, lo ng-term trust

To ensure long-term performance, companies must establish *contracts that attract key resources* and *motivate stakeholders* to behave honestly. **Ownership rights** are the key governance mechanism:

- Residual income rights: right to appropriate profits after all obligations are met. (Example: Apple distributes dividends to shareholders after paying employees, taxes, and debt)
- Residual control rights: right to control decisions and company assets (Example: Microsoft shareholders vote on dividend policy and elect board members)

Residual control rights should be *allocated to shareholders*, but why?

- *Shareholders receive residual income*
- They are at *risk of expropriation by managers* (residual control rights empower shareholders to decide when contracts are incomplete)
- *They must decide on key corporate matters* (i.e. dividend policy, capital increases, corporate by-laws, election of board members...)

Example General Electric (2018): after years of poor performance, shareholders used their residual control rights to replace board members, push for the CEO's dismissal, and approve a major restructuring plan

Ownership rights are a powerful governance mechanism, but *not a full solution*. The most important risk is the possibility of controlling shareholders who may expropriate other stakeholders' investments by exploiting contract gaps. Nonetheless:

- Contracts are incomplete
- Judicial systems and markets are imperfect
- Allocating ownership rights remains an important tool to mitigate stakeholder conflicts and agency costs.

Two competing conceptions -> **property vs social entity conception**:

	Property Conception	Social Entity Conception
Definition	Corporation as a *nexus of contracts*	Corporation as a *social institution*
Assets	Belong to shareholders	Used for the benefit of multiple stakeholders
Role of managers/boards	Agents of shareholders	Trustees balancing diverse interests
Primary purpose	Maximize shareholder value	Create long-term value for shareholders **and** stakeholders
Examples	**ExxonMobil**: focus on shareholder returns	**Unilever**: "Sustainable Living Plan" balancing profits with social/environmental goals

Stakeholders influence the corporation through different types of power:

VOTING POWER	POLITICAL AND REGULATORY POWER	ENVIRONMENTAL AND SOCIAL POWER	ECONOMIC POWER
Exercised through **equity stakes** (ownership of company shares) Rights: elect/remove board members, approve dividends, M&A, by-law changes	Influence through taxation, regulation, subsidies, licenses Governments, regions, regulatory authorities	Customers (sustainability demands), Local communities (social license to operate), Public authorities (environmental standards, emission rules)	Employees (labor contribution), Customers (demand, brand loyalty), Suppliers (critical inputs, supply chain), Competitors (market dynamics, price pressure)

Different views of corporate governance (and corporate sustainability)

	Unitary perspective	Balancing perspective
External perspective	**Shareholder definition** Focus: maximizing shareholder value *Example:* ExxonMobil prioritizes shareholder returns	**Stakeholder definition** Focus: balancing interests of all stakeholders *Example:* Unilever emphasizes sustainable growth for customers, employees, and communities
Internal perspective	**Managerial definition** Focus: interests of managers (empire building, perks, job security) *Example:* Cases like Enron show managerial capture and self-interest	**Firm definition** Focus: what is best for the firm's long-term survival and competitiveness *Example:* Toyota invests in innovation and quality for sustainable competitiveness

Global governance failures: Enron and Theranos

Enron Case study

-> Founded in 1985 in Houston (Texas) from the *merger of two gas companies*, Enron has grown into one of the largest energy firms in the world. It transformed itself from a traditional energy company into an energy trading powerhouse, pioneering new financial products and markets. At its peak, Enron was ranked 7th in the Fortune 500 and seen as a symbol of innovation, until its collapse in 2001 exposed one of the largest accounting frauds in history.

Q1. What was different in the Enron business compared to similar companies in the energy industry?

Exploiting the deregulation of the industry in the early 90s, Enron changed its core business from natural gas distribution (connecting upstream producers and downstream local utilities downstream) to a natural gas bank (or energy powerhouse), acting as an *intermediary between the producers and users* and carrying out risk management activities on contracts for the supply of electricity, natural gas, and water. The company shifted its focus to financial engineering and trading.

Q2. What were the implications of Accelerated Earnings methods (mark-to-market accounting) for Enron?

In 1991, Enron was granted the *permission to record Volumetric Production Payments (VPPs)* using mark-to-market accounting, meaning that they *reported expected market value of the assets on its balance sheets* (based on market prices in future years when they expect to sell the assets). This practice resulted in particularly volatile, and therefore risky and uncertain, income statements, as no one knows if the prices and the buyers are going to be the same. The main problem of this accounting treatment is that the company records high profits on income statements, but it lacks cash flows (as these are going to be present only in the future, when the company will actually sell the furniture), misleading investors and analysts about the real performances of the company. That's why Fastow (CFO) established a system of SPEs to raise funds on the market. However, the high profits mislead analyst about the company's actual performance. *Example*: Enron signs a 20-year contract to supply gas. Instead of recording revenues year by year, Enron *estimated the total future profit* and *booked it immediately as current income*. If the market price later changed or costs increased → the contract could even lose money, but the profit was already recorded.

Q3. Use of SPEs/SPVs (Special Purpose Entities/): Why didn't banks do adequate due diligence?

In the second half of 1990, Enron started to establish an intricated network of activities off their consolidated balance sheet. The entities constituting the network were the so-called *Special Purpose Entities (SPEs)*. Some of these entities, known as raptors, acted as external guarantors for Enron in the event of impairment of financial assets in Enron's financial statements. The main goal was therefore reducing both group's losses and debt. Banks *did not perform adequate due diligence* due to the high financial reward that was at stake: Enron's top management put pressure on investment banks to invest in these entities (i.e. SPE) to avoid losing their fees of hundreds of thousands of US dollars. There was a clear conflict of interests between banks and Enron as they used to earn fees from Enron.

SPEs: Legal entities created outside the main company generally used to hold assets or debt separately from Enron's balance sheet. The main purpose is to *manage risk, finance specific projects, keep liabilities separate*. Enron's used them to transfer debt to SPEs, as to keep it off from consolidated balance sheet. They reported only profits, hiding losses and liabilities. Used complex, opaque structures so banks and auditors didn't (or wouldn't) question them.

Enron appeared much healthier than it really was -> Investors, analysts, and regulators were misled about financial stability. *Simple Example*: Enron borrows $1 billion → instead of recording debt, creates an SPE. SPE holds the debt, Enron shows only the cash inflow. Balance sheet looks clean, but the risk is still Enron's.

Are SPEs illegal? They are created to better manage risk, finance specific projects and keep liabilities separate. Theoretically they are not illegal, but you should give perfect information.

Q4. What were the main reasons for Enron's collapse?

From 1999 to 2001, the first problems appeared. The biggest problem at the time was the plant at Dobhal, India, which was the world's largest combined-cycle power plant, whose construction had contributed to feeding Enron's reputation in front of Wall Street. The project proved too expensive and not economically viable. As a consequence, the state of Maharashtra declared that it could not comply with the terms of the contract for purchasing energy produced at the plant.

Later on, the company started investments in the so-called "new economy", deviating from its core business. For example, it entered in an agreement with Blockbuster with the aim of becoming the first on-demand TV operator in the US. Given that the agreement would materialize in the coming years, Enron established a *complex financial structure to anticipate revenues over time*. It established a non-consolidated company called "Braveheart" and sold the Blockbuster agreement to Braveheart in exchange of USD 155 million. At the same time, it entered an agreement with an investment bank where Enron received USD 115 million in exchange of future cash flows. In case of agreement failure, Enron would have repaid the USD 115 million immediately. In March 2001, the agreement with Blockbuster was withdrawn and activated the contractual clause of repayment by Enron to the investment bank.

There were *problems of accounting fraud, asymmetric information, lack of independent auditor* (Arthur Andersen was not fully independent). Arthur Andersen was allowed to provide Enron *advisory services and earns fees on them along with the auditing services*. This is forbidden by Italian law now. Also, SPEs played a role in hiding crucial information. There was also a toxic corporate culture and poor SEC oversight, which allowed excessive risk taking and conflict of interests which eventually. Regulatory gaps enabled manipulation, like the absence of an independent regulatory body.

Lesson: The Enron case demonstrates that without independent oversight and transparent reporting, complex financial innovations (e.g. mark-to-market accounting, SPEs) can be exploited to conceal risk and inflate performance. Effective corporate governance requires strong and independent boards, auditor accountability, and regulatory frameworks that keep pace with market innovation.

Theranos case study

Theranos was founded in **2003** by **Elizabeth Holmes**in Silicon Valley, Theranos promised to revolutionize healthcare with a technology able to run hundreds of blood tests from just a finger-prick sample. Backed by influential investors and a high-profile board, the company reached a valuation of

$9 billion, becoming a celebrated Unicorn. But in 2015, investigations revealed the technology **never worked as advertised**, leading to one of the most famous startup frauds in history.

Q1. Which was the reason for Theranos' success?

The main reason for Theranos' success was the revolutionising blood testing technology that the company had apparently developed. According to the founder Elizabeth Holmes, such technology would have allowed for *quick and comprehensive tests with just a few drops of blood* from a finger prick. The market was hyped about revolutionary blood-test, and also the charismatic nature of the founder, Elizabeth Holmes, attracted investors and had strong media appeal (see interviews on Forbes and Fortune).

Q2. What are the peculiarities in a "Unicorn" like Theranos compared to traditional businesses?

These businesses become quickly popular and increasingly gain value by promising cutting-edge technological development or through unprecedented industry breakthrough. Furthermore, when "unicorns" are on a positive momentum, they can explode in terms of market valuation and easily and quickly attract financing funds. The *valuation of a startup* is in fact based upon expected rather than actual results. There was also *secrecy around their technology*, with limited disclosure. The reliance on private capital does not force the company under the strict market scrutiny. The product got to the market after 10 years and over those 10 years there was little public info available regarding the technology used by Theranos.

Q3. What were the main differences in the Theranos collapse compared to Enron and Satyam?

The Theranos collapse was not caused by a shift to a risky and highly volatile business model, as it was the case for Enron. It was rather a natural collapse due to the fact that the company never developed the technology they claimed, and which was the main reason for Theranos' high value. Furthermore, given the *complete absence of external auditing* and verification of disclosed information, the role of whistleblowers seems to play a more relevant case for Theranos, along with a public investigation carried out by the Wall Street Journal, which highlighted and explained the fraud behind Theranos.

The main difference is that Theranos was not a listed companies as it was instead the case of Enron. In fact, Theranos was in a pre-IPO stage, no widespread public investors. *The fraud* was tied to scientifical/technical claims while *Enron's fraud* was due accounting tricks. Finally, there was little division between ownership and management, with Holmes also actively leading Theranos' operations.

- ➔ In both cases, the first doubts did not come from the authorities, but from the journalists

Q4. What is the role of the founder, Elizabeth Holmes?

Elizabeth Holmes was the founder and a key person for Theranos. She probably relied on her reputation as former student of Stanford University and actively *set up a unicorn which was nothing more than an empty box*. She established a corporate culture shaped by *NDAs*, l*imited cooperation across divisions*, and *other limitations due to minimize the risk of spreading information* that could contrast the prevailing positive narrative about the company.

She was a *centralizing individual*: *CEO and public face*. Cult like leadership style (the young genius who leaves university to start her own business) and furthermore, *her appeal* allowed her to attract board members with great standing in the financial community (e.g. secretary state). Most of these notorious individuals were politicians and had all the interest to stay close to a potential revolutionary entrepreneur.

Q5. What the role of financial market and individual investors?

Financial markets and investors naively decided to *invest resources in a company which had unverified disclosure* and whose *financial statements were not subject to external revision* of an independent auditor. Aa such, they accepted to invest in a black box which eventually resulted a scam and, as such, in a waste and misallocation of investors and financial markets resources. *Venture capitalist and wealthy individuals* are attracted by disruptive innovations, and, due to FOMO, they invested with relatively weak due diligence

Q6. What are the technical ways through which the scam was possible?

Through manipulation of results (usually cherry-picking) and poor-quality control measures, along with the fact that blood tests were run on ordinary machines (which were bought on the market) and so not on an innovative and technologically advanced equipment. Specifically, one of the main whistle-blowers (i.e. Tyler Schulz) revealed that the Theranos has manipulated a process known as *proficiency testing*, which was a key indicator highly trusted by federal and state regulators to monitor the accuracy of lab's tests. Furthermore, Mr. Schulz found high variability in results when tests were re-run on the same blood sample. For example, a validation report about a test to detect a sexually transmitted infectious disease stated that the test was sensitive enough to detect the disease 95% of the time. But when Schulz looked at the results, he found out that sensitives were around 65 to 80%, nowhere near the 95% claimed on the validation report. In short, the main causes are the fact that the *proprietary technology was kept secret*. Furthermore, the company used misleading and falsified demos. This was possible due to lack of external peer revied and scientific validation

Q7. What are the main reasons for Theranos failure?

- The *too charismatic entrepreneur* (Elizabeth Holmes) concentrated too much power
- There was *no independent board expertise*. The board was in good faith in this case, but they lacked biotech and medicine industry expertise.
- *Secrecy and opacity*. Investors and equity partners did not have access to financial data
- *Hype of "Unicorn" culture*, which leads to FOMO among investors
- *Weak due diligence* from VCs due to "me-tooism" as the first, credible investors started to invest.

Enron and Theranos: characteristics in common

What factors and conditions enable or facilitate the bankruptcy of very large and well-known companies, even after long periods of corporate illegality? What role and responsibility does corporate governance (internal and external) have? To answer these questions, we can resort to the analysis model of McKendall and Wagner (1997), according to whom "corporate illegality" ultimately depends on three factors:

- *motivation*
- *opportunity*
- *choice*

The role of motivation -> Hiding negative, declining, and/or below-investor and market expectations -> Losses and Debts, often due to strategic or managerial mistakes (excessive and unprofitable growth, empire building, excessive risk-taking, poor diversification or internationalization decisions, etc.), the effects of which accumulate and worsen rapidly, following periods of success/innovation.

- Hiding shortfalls and misappropriations of resources by entrepreneurs, shareholders, and managers.
- Supposedly revolutionary business models, which lead to the birth of "unicorns" thanks to market euphoria and the "myth" of stereotypes, especially in the Silicon-Valley

The role of opportunity -> The long perpetration of managerial misbehaviour and its failure to be detected by control authorities is also due to the exploitation of interconnected "opportunities":

- Complex corporate and organizational structures**,** which facilitate the hiding of losses and debts and make their detection difficult (i.e.: Special Purpose Entities).
- Weak governance systems, which fails to prevent, recognize, or suspect certain behaviours, due to:
  - Inadequate composition of the Board of Directors and its committees
  - Failure of the internal (Internal Auditing Committee, Supervisory Board) and external (Auditing Firm, Consob/SEC, investment banks, analysts) control system, which raised no objections, concerns, or "suspicions"
- Absence of (strong) regulations (i.e.: the possibility of combining audit and consulting services) and conflicts of interest.
- A "me too" mechanism between media and investors, where each invests or gives media visibility because others they consider credible have invested or talked about it

The role of choice -> Even when there are motivations and opportunities, the adoption of illegal behaviours and actions ultimately depends on a choice made by management and entrepreneurs. This choice, in turn, depends on:

- The role of ethics in organizational culture and values (i.e.: culture "subject to the god of money ", the myth of «self-made man» of the Silicon Valley, the absence of the values of integrity and transparency emerge in a historical and geographical context where the pursuit of maximizing shareholder value was the main goal.
- The values and objectives of the company's CEO and top management (i.e. management willing to bend the ethics and well-being of the company to their own goals of personal enrichment)

Corporate governance mechanisms: the board of directors. Beyond compliance: making boards effective.

The role of the board of directors in company governance

The **Board of Directors (BoD)** is the central body in corporate governance, and represent the interface between the people who finance the society (*shareholders*) and those who are in charge of using that resources to create value (*TMT*). Literature and codes state that boards have three main tasks:

Strategic task	Monitor (control) task	Networking task
• Define mission and vision • Examine & approve strategic plans • Support company development	• Monitor performance and management behavior • Oversee both operational and strategic objectives • Guarantee compliance with rules • Assessment of risks	• Enhance corporate reputation and legitimacy • Ensure effective engagement of shareholders • Manage relationships with stakeholders

It is clear that the first role of the BoD is to *control the managers* because the shareholders, both large and small, are unable to directly and effectively exercise the owning right they hold. The controlling activity exercised by the BoD, with the aim of satisfying the interests of both shareholders and stakeholders, is done by:

- *Evaluating the results achieved by the company*
- *Verification of the validity of the decisions taken by managers*
- *Control of compliance with the rules and regulations of the company*
- *Verification of the effectiveness of internal reporting systems, fairness and transparency* (including accounting)*, of everything that happens in the company*, and must ensure *effective control mechanisms* at all levels of hierarchy
- *Evaluation of the most relevant players*

The board's controlling role has an increasingly broad meaning and contours, being responsible for the transparency and fairness of everything that occurs within the company. This also means *building an adequate and informative reporting systems*, which, for example, describes which are the risk the company is facing, which are the possible risks that will emerge in the future, and which are the instruments the company intends to use to face them.

At the same time, it is not possible to reduce the activity of the BoD to a mere supervisory role, as it also play an *important role of service by helping the TMT in the decision-making process*. The most common activities done for conducting this role are:

- *Contributing to the strategic decision-making process*
- *Examining and approving strategic and industrial plans*
- *Examining and approving strategic and extraordinary operations*
- *Making choices related to the financial structure of the company*
- *Defining the remuneration policy of the top management*

- *Defining the fundamental rule of CG, as well as guidelines for the governance of the firm*

It is clear, in the end, that the Board of Directors plays a **dual role of checks and balances** done to *avoid the TMT to abuse of their power and create a long-term sustainable growth for the company*. In addition, we have to consider, as we said before, that the scope of activities conducted by the BoD is much broader than in the past, as it also represents the most important contact between the company and the external environment. This is about connections with financial institutions, political world and all the different stakeholders, with the aim of *ensuring access to critical resources, encouraging the commitment of important external decision-makers and increase the legitimacy from its stakeholders*.

The international corporate governance codes

Because of the importance of this body, and after the corporate scandals occurred during the previous century (where the role of the BoD was just of ratifying the decisions that have been discussed withing the TMT), it has been clear that it was necessary to create **international corporate governance codes**, made of principles, rules and best practices aimed at making the board a corporate body of effective control and guidance of the company. These codes were, in the beginning, based on the Anglo-Saxon ones, which have been the first to be developed. After years, different countries have developed their own code, aligning it with the characteristics of the different economic systems. There's been a rapid spread of corporate governance codes as a tool by European Stock Exchange not only to ensure *greater transparency* and *fairness* in the application and respect of the principles of good governance, but also specially to encourage the spread of some practises which, up to the 1990s, existed exclusively in the Anglo-Saxon context.

The **first version of the UK corporate governance code** was born in 1992 as a response to major corporate scandals associated with governance failures in the UK. It was published by a committee chaired by Sir Cadbury. The committee was formed in 1991 after Polly Pack, a major UK company, went *insolvent after years of falsifying its financial reports*. The last version covered financial, auditing, and corporate governance matters, and contained the following three basic recommendations:

- the separation between the CEO and chairperson of companies
- the minimum numbers of nonexecutive directors should be three, and two of them should have no financial or personal ties with the executive directors.
- each company should have an audit committee composed of nonexecutive directors.

These principles were added to the listing rules of the London Stock Exchange in 1994. The code was based on the theory of that protection of shareholders' interests requires a reduction in agency costs and in the cost of risk capital.

In July 1995, the Greenberry report was published. This report recommended further changes to the principle of the country code, among which were: the *introduction of remunerations committee composed without executive directors*, and that the *compensation of directors should be related to long term performance* and *their contracts should be disclosed and re-negotiated each year*. Among the innovations proposed in the combined code were the introduction of the chairperson as the leader of nonexecutive directors, and the disclosure of all kinds of remuneration, including pensions. The existing approach to the corporate governance obligation to "*comply or explain*" was strengthened, and more stringent criteria of the *board composition and evaluation of independent directors were approved*, removing some of the discretion that the code allowed.

The last phase of the evolutionary path of the UK corporate governance code is the new edition issued in July 2018, published by the financial reporting council - the independent regulator in the UK and Ireland. The new English code has been revised with the goal of simplifying it as much as possible. It is now *visibly linear*, with a *structure limited to principles and provisions*. In its revised version the code now has **five sections**:

- *board leadership and purpose.*
- *division of responsibilities*
- *composition, succession, and evaluation*
- *audit, risk, and internal control.*
- *remuneration*

According to the FRC, the main changes of 2018 code include:

- *workforce and stakeholder engagement*: the code asks boards to describe in their annual report how they stakeholders' interests and matters have been considered in board discussions and decision making. In relation to the workforce, free recommended methods of engagement are set out in the code:
    - a director appointed from the workforce
    - a formal workforce advisory panel
    - a designated non-executive director
- *culture*: boards are asked to create a culture aligned with the company's purpose, values, and strategy.
- *succession and diversity*: to facilitate effective succession planning, the chair should not remain in his or her post behind nine years from the date of their first appointment. Boards are expected to have the right mix of skills and experience, constructive criticism, to promote diversity, and to strengthen the criteria concerning independence of the nonexecutive directors.
- *Remuneration and long-term incentive plans*: The code emphasises that remuneration committees should consider workforce remuneration and related policies when setting the remuneration policies for the executive directors. Remuneration committees will now be expected to apply discretion in cases where formulaic outcomes are not justified.
- *Significant shareholder dissent at the general meetings*: the 2018 code sets how companies are expected to respond when 20% or more of shareholders votes are cast against a board recommendation for a resolution. Companies will be expected to explain the actions they intend to take to consult shareholders to understand the reasons behind the dissent.
- *Companies below the FTSE 350*: until revision, smaller companies benefited from a number of less stringent requirements. Now, their position has been brought into line with the FTSE 350 in some areas.

The characteristics of the board of directors

An important factor developed along these codes regards the **characteristics of the BoD**. The assumption underlying the requirements of the board is that it functions more effectively when certain characteristics that qualify independence and competence are respected, by guiding the behaviour of the board and generate an efficient and ethically correct behaviour of the company. The 3 main factors we have to analyse are:

- *Board composition*

- *Board structure*
- *Board working style*

Since the 1990s, regulation of boards of directors has spread across Western countries (the «proliferation» of codes is commonly traced back to the 1992 Cadbury Report in UK). **Convergence** has emerged: many "good practices" look similar across very different contexts (with some concern about national specificities, especially in ownership structures). Governance regulation combines *hard law* (e.g. Civil Code, Consolidated Law on Finance) and *soft law* (self-regulatory Corporate Governance Codes adopted by listed companies).

Corporate Governance Codes:

- *Nature*: non-binding, voluntary reference models ("best practices")
- *Scope*: organizational and functional recommendations, largely similar across countries
- *Rationale*: protecting shareholders' interests → reduction in agency costs → lower cost of risk capital
- *Compliance*: listed firms must disclose reasons for any non-compliance (comply or explain principle)

Board composition

There are several factors regarding the composition of the board that needs to be analysed. The three most relevant factors of concern are about the *dimensions* of the board, the *type of directors* and *diversity* among them. The assumption underlying these requirements is that the board functions more efficiently when there are *certain characteristics* that qualify its *independence* and *competence*. In other words, there is an implicit belief, that certain structures can guide the behaviour of board members and consequently contribute to efficient and ethically correct behaviour by the company, as well as assembling the resources and skills necessary for long term development strategy.

The first one regards the **dimensions**. Theoretically, it is believed that the optimal number of members should be between 7 and 15. However, we have to take in consideration different factors such as the *size of the company, the ownership structure, the demand of independence/variety between the board members*...

➔ It should not be too small (which will sacrifice the complexity and variety in ideas that can guide the company to develop better decisions) but neither to large (which can cause information redundancy, reduce decision-making capacity and support substantial board free riding). Only France and Germany usually have BoD bigger than the recommended dimension.

The second aspect regards **the different "types" of directors and their mix within the board**. The most important categories of directors are:

- *Chairman* -> is the member who *leads the board* and is r*esponsible for the overall effectiveness of the company*. It should have *objective judgement* and *promote open debate* around tables. Among the roles of the chairman, we have:
  - Organizes and manages the work of the BoD
  - Sets the agenda, chairs meetings, ensures a culture of openness and debate
  - Ensures that directors receive accurate, timely and clear information
  - Share (and discuss) the outcomes of the board evaluation
  - Holds no executive powers (except information rights)

  - It's the pivotal for creating overall board effectiveness and it's responsible for involvement of non-executive members.
- *Chief Executive Officer (CEO)* -> is the *member who received from the BoD extensive management power regarding all aspects of the company or just specific ones*. Usually, the CEO is a single person, but there could be situations where multiple CEOs are present to spread management responsibility. The CEO is responsible for proposing company's strategy and for its success, but there could be situations where quantitative limits are imposed for the scope of action of the CEO, beyond which the authorization of the board is necessary
- *Internal directors (or executive directors)* -> members who have executive functions within the company bringing specific skills to the board discussion and informed decision-making with a deep operational knowledge of the company and a high degree of involvement.
- *External directors (or non-executive directors)* -> these are members of the board who are not delegated or don't have management functions within the company they belong to. Their role is to *bring their skills and experience developed outside of the company*, in order to analyse the situation from a different perspective, monitor management effectively and foster the dialogue -> their role might be essential when the interests of the shareholders and those of the executives do not coincide.
- *Independent directors* -> non-executive directors without financial, professional, or personal ties that may compromise their independent judgment. The independence of a director is evaluated at the first appointment and re-assessed annually, but ongoing monitoring if relevant circumstances arise. Independent directors provide leadership and oversight vis-à-vis the CEO and executives, ensuring decisions protect all shareholders and stakeholders, and they should meet at least once a year without the other board members. The number of independent directors depends on the different codes. In UK, at least half of the board, including the chairman, should be independent, while in Italy it is different in case you are a big company with concentrated ownership (1/3 of the board), a big company without a concentrated ownership (1/2 of the board) or you are not one of these categories (at least 2 independent directors). In order to be classified as independent, there are some requirements -> here's a list of situations in which the independence of a director can be compromised:
  - Is a significant shareholder (with relevant influence)
  - Has been, in the last 3 years, an executive or top manager of the company, its subsidiaries, or major shareholders
  - Has had significant commercial, financial, or professional relations with the company in the last 3 years
  - Has received significant additional remuneration beyond the director's fee (in the last 3 years)
  - Has served on the board for more than 9 years (even non-consecutive, in the last 12)
  - Holds an executive position in another firm where a company executive is also a director
  - Is shareholder/director in an entity belonging to the network of the company's statutory auditor
  - Has family ties with controlling shareholders or executive directors

The third element of the board structure that needs to be analysed is the **diversity** within the BoD, which can be analysed considering different criteria:

- *Mix of skills and knowledge* -> it is impossible that, within the modern board structure, there is one single director who has all the skills needed to manage efficiently the company. There should be financial experts, those with market strategic vision, budget experts… to have a positive effect on the quality of decision-making by reducing the group-think effect.
- *Demographic terms* -> we have to consider diversity regarding age, gender (in particular considering the presence of women, which has been shown to have benefits on the quality and intensity of debate, improving climate and internal cohesion within directors and bring different skills. We have also to consider that the average age of board member is currently 60 years and it has increased in the previous years, indicating a low turnover rate) and nationality (relying on managers coming from different nationalities is something that depends by the culture of those countries and the scope of action of that company)
- *Professional background of different board members* -> *professional background is the logical antecedent of certain behaviours, skills and discussions styles* = it is possible that consultants, lawyers and bankers will have a different leadership style. Obviously, also the personal characteristics of directors will influence the leadership style, having in some cases someone more charismatic or someone more recognised for their competence.

Board structure

Even though appointing specific people for covering specific roles is the first step for creating an efficient BoD, another important aspect is its **structure**. The most relevant issues connected to this aspect are:

- *CEO duality* -> one person holds both CEO and chairman role, even though it is a common recommendation to have these roles separated, even though it could potentially lead to a stronger leadership (that's why there are some people that support this position). The main reasons behind this position are:
  - *Excessive power in the hands of a single person*, limiting the independence of the BoD from the TMT of the company
  - *Differences in skills and abilities required* -> more analytical and strategic for the chairman, while more operational and managerial for the CEO
  - *The chairman assumes a leadership position and requires a different level of time and commitment compared to the CEO*

  There are some people that support the presence of CEO duality, in particular top managers -> they see the overlap between the chairperson and the CEO as an opportunity to express clear leadership both within the board of directors and outside it, convening a sense of unified direction.
- *Lead independent directors* -> appointed when CEO duality exists. He is an independent director who is assigned particular tasks, such as chairing meeting of external advisers, assessing the CEO and discussing aspects of the operation of the board with the chairman itself -> *Ensures checks and balances*. Role effectiveness depends on independent and involvement
- *Board committees* -> specialized bodies created within the BoD to support informed decision-making process on specific issues. They strengthen governance by providing expertise and independence in key areas. They have investigative, advisory, and preparatory roles (proposals, recommendations, opinions). The Board of Directors defines the tasks of the committees and determines their composition, giving priority to the competence and experience of their members. The international CG codes suggest creating at least 3 committees:

- Audit, Risk & Control:
  - *Role*: Responsible for monitoring and examining the work of executives and the proper functioning of the BoD, ensure the independence and the effectiveness of the functioning of the internal and external auditing system.
  - *Composition requirements*: at least 3 independent members (two in cases of companies below the FTSE 350), no chairman of the society and at least one independent member with recent and relevant financial experience
- Remuneration:
  - *Roles*: defining the remuneration policies for the managing directors and for directors covering particular positions -> fundamental role in case incentive programs (such as with stock option or stock granting) are used for aligning interests of the shareholders and managers, in order to support company strategy and promote long-term sustainable success
  - *Composition requirements*: at least 3 independent directors (two in cases of companies below the FTSE 350), the chairman can sit but it needs to be independent, and he/she cannot chair the committee
  - *Executive directors*: the total vesting and holding period should be at least 5 years, with the aim to ensure that directors' incentives are better aligned with long-term shareholders' interests.
  - *Non-executive directors*: their remuneration should reflect the time commitment and responsibilities (taking into account also the participation to the committees). Their remuneration should not include share options or other performance-related elements.
- Nomination (it has a more relevant role in companies characterised by a high shareholder dispersion):
  - *Roles*: selecting new directors, checking skills gaps and evaluating the board itself, presenting the proposed appointments to the shareholder meetings (in order to avoid assuming people that are appointed just because they are close to the chairman of managers). In order to do so, they have both to check what has been the process for appointment and how the board evaluation has been conducted (both considering the evaluation criteria of external advisors and check if the policies of diversity and inclusion have been respected). The committee is proposed to take a consultative and initiative-taking role in identifying the optimal composition of the board, indicating other professional figures who can accomplish its proper and effective functioning. Committee can make use of external resources, such as open advertising or external search consultancy. It is extremely relevant in situations characterized by fragmented ownership; less relevant in companies with more concentrated ownership structures.
  - *Composition requirements*: majority of members should be independent

These committees are not in charge of decide anything, as they support the work of BoD. If you are in the BoD, you have the responsibility of the company by law -> If you leave the decision power to the committee, it's like delegating this responsibility to the committee

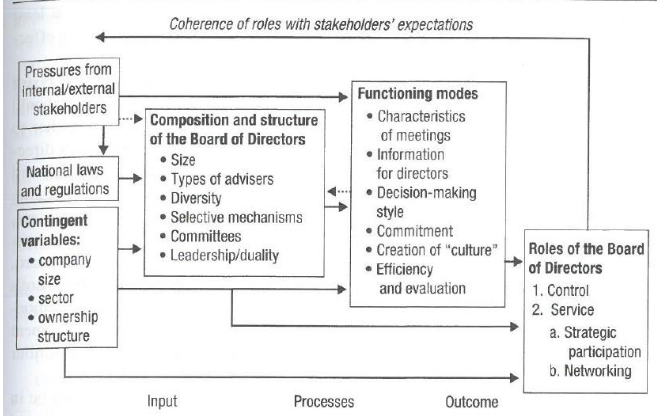
Board working style

In the past, a lot of emphasis has been given to the composition and the structure of the BoD, without taking in account its functioning.

- *Meetings*:
    - Frequency and duration: *high number of short meetings* (avoids long an tiring discussions and improves the efficiency of meetings, but an high number of meeting might be seen as a symbol of crisis) or a *small number of long meetings* (reduces the travel issues but you could lose some strategic opportunities) -> someone says one per month with an average duration of half a day -> it depends also by the time directors want to devote to the meetings, but on average a director should dedicate 10 working days to the function of the BoD
    - Quality of sitting -> *time, place, organisation*
- *Information* -> making the information available to directors is a fundamental step in order to create and stimulate a fruitful debate and increase the productivity/efficiency of the meetings:
    - the meetings should cover all the topics -> financial results, budget, strategy composition, with a comparison with competitors and year-to-year data
    - certain quality should be respected -> must be *timely* (sending the information at least 5/6 business days in advance in order to make the people capable to study it and identify issues), *complete* and *reliable*
    - Integrity safeguards -> it should be prevented the misuse of confidential or price-sensitive information and conflict of interest procedures: disclosure + abstention from voting
- *Decision-making style* -> encourages open debate and constructive conflict (it depends on the people around the table and on the leadership of the people around the table) and avoid "board silence" (passive or disengaged members). Balance creativity with discipline. A fundamental role is played by the chairman, as he is the person who defines the topics that are going to be faced during the meetings. In order to create an involving culture of openness, some guidelines the company could follow are:
    - Creating a climate of trust by sharing important information with directors
    - Stimulate a culture of "open dissent" in order to encourage silent directors to take a position
    - Use a "fluid range of roles", which means asking them to think creatively and create alternative scenarios
    - Ensure individual accountability, by giving constant and detailed information to the board and periodical feedback about strategic and operational topics
    - Evaluate the performance of the BoD with particular attention to the quality of the discussions during the meetings, the credibility of the relationships and the capacity to manage conflicts -> this evaluation can be done both regarding the entire BoD or individual directors.

➔ Analysing the strengths and weaknesses of the BoD is a fundamental requirement in order to create a cohesive and efficient working group.

Figure 3.1 A summary scheme of the composition, structure, and functioning of a modern board of directors



Source: Minichilli (2012, p. 135).

Why board processes matter? Independence alone is not enough: many failed firms (Enron, Theranos, WorldCom, ..) had a majority of outsiders on their boards. What really drives effectiveness are people and how the board works: interactions, dynamics, and decision-making.

Board processes and board engagement

The Passive Board	The Certifying Board	The Engaged Board	The Intervening Board	The Operating Board
This is the traditional model. The board's activity and participation are minimal and at the CEO's discretion. The board has limited accountability. Its main job is ratifying management's decisions.	This model emphasizes credibility to shareholders and the importance of outside directors. The board certifies that the business is managed properly and that the CEO meets the board's requirements. It also oversees an orderly succession process.	In this model, the board serves as the CEO's partner. It provides insight, advice, and support on key decisions. It recognizes its responsibility for overseeing CEO and company performance. The board conducts substantive discussions of key issues and actively defines its role and boundaries.	This model is common in a crisis. The board becomes deeply involved in making key decisions about the company and holds frequent, intense meetings.	This is the deepest level of ongoing board involvement. The board makes key decisions that management then implements. This model is common in early-stage start-ups whose top executives may have specialized expertise but lack broad management experience.

Objectives	Challenges	Drivers of adoption
• Strengthen external accountability • Build and protect corporate reputation • Improve internal effectiveness	• Risk of self-serving assessments • Lack of true independence ("super partes" attitude often missing)	• Governance codes recommend periodic evaluations • Pressure from investors and stakeholders • Need to refresh and revitalize the board's role

The board evaluation

The board should pursue objectives such as *instilling discipline among board members*, *increase the overall discipline among board members*, *ensuring continuous monitoring of the processes* and *increase the external accountability*. In order to obtain these results, a fundamental instrument is establishing an effective *board evaluation system*. The **most important reasons** to support this idea are:

- The "habit" for companies to carry out vertical evaluations
- The substantial unwillingness of directors to be evaluated (as most of the time the role of director represents the peak of a manager's career)
- The risk of collusion in case of peer evaluation
- Self-celebratory attitudes in the case of self-valuation

The UK Governance Code suggests that the annual evaluation of the board should consider *the results achieved by the board, its composition*, *diversity* and *how effectively members work together to achieve objectives*, while individual evaluation should consider *if all directors contribute effectively to the work of the BoD*, in particular considering the time dedicated to the board activities and committees. The *outcomes* from the board evaluation should be *shared* with and *discussed* by the board itself and the chair should act on the results of the evaluation by recognizing the board's strengths and weaknesses.

A recent debate is about the type of assessment, which means if the evaluation should be conducted in the form of *self-evaluation* or *include external actors*. In many companies, the board assessment is conducted by the chairman (even though this method lacks independence and objectivity), other cases this role is covered by an experienced independent director while in other this role is covered by the audit committee.

Self-assessment requires a *lot of effort in terms of time, agreement on its goals and honesty by directors* and, above all, *how rigorous this internally driven evaluation approach will be*. This method is useful to make directors think about their personal contribution to the board results, but it might lack of objectivity. One way to resolve this problem is to introduce a *system of peer evaluations*, which can be useful to get a more rounded vision of the strengths and weaknesses of each director and helps identify potential knowledge and skill gaps in the board.

Even though in the first place the idea of being evaluated was not accepted by everyone, today the most relevant concerns are about what should be evaluated. The aim of the evaluation is to analyse the board as a unit, and because of this, the evaluation should explore:

- *Mix of skills, knowledge and experience of the members of the board and its committees*.
- *Succession and development plans*
- *Key board relationships*, in particular the ones present between chair/chief executive, chair/company secretary, chair/senior independent director...
- *Quality of the information provided* on the company and its performance
- *Quality of presentation on the board*
- *effectiveness and clarity of the decision-making process*

➔ externally facilitated independent assessment has become more common in these years = external evaluator should meet with the executive team in order to capture their view.

The OECD report identifies **five international practises for board evaluations** across twenty countries around the world:

- *Countries without board evaluation regulations*: among the countries analysed, only China has not yet introduced any rules or best practises on board evaluation. Member commitment is measured through three standards: duty of care, duty of loyalty to exclude the self-dealing transactions, duty of good faith and fair dealing.
- *Countries with emerging board evaluations practises*: in Israel only, banks have a legal requirement to conduct valuations, but companies are gradually introducing a new practise.

- *Countries with implicit board evaluation requirements*: companies in Türkiye are strongly encouraged to produce a written document for the annual shareholders meeting, covering the information about their monitoring activities. In Poland, there is a similar self-assessment mechanism of the supervisory board. Despite these practises, in both countries there is no evidence that such requirements are leading to more frequent and in-depth board evaluation processes.
- *Countries with a board evaluation principle* in their corporate governance codes: most countries have now incorporated board evaluation principles in their corporate governance codes security regulations and company laws. Among these, we found Japan, Switzerland, Germany, Austria, Hungary, The Netherlands, Italy, France, The United Kingdom, Luxembourg, Singapore, South Africa, and Brazil. Specifically, Japan adopted corporate governance code in 2015 that includes principles on the evaluation of board effectiveness. The same happens in Switzerland. Among others, the Netherlands, Italy, France, and the UK provide examples of more detailed assessment requirements. Frequency of board assessments ranges from every year for Italy, to every two years for Luxembourg. All the five countries ask for the disclosure of the evaluation results in the annual report.
- *Countries where the border valuation rules and regulations*: while other countries adopt a comply or explain approach, under which deviations from best practises are accepted, a fifth approach consists in explicitly legally binding rules and procedures. India, Spain, and the United States have a legal requirement to perform annual board effectiveness evaluations.

The OECD report identifies four main questions that best practices around the world that should be answered for the Board evaluation:

- *When should the board be evaluated?* Traditionally, at least once a year, but the number is extremely firm-specific, and it might depend on the life-stage of the company, sector and culture -> it should be carried when the company believes there is the need.
- *What should be evaluated?* The evaluation process includes the board, the single directors and the board committees. The goal of the evaluation is to ensure that the processes enabling the board to deliver effective and meaningful strategic advice are put in place.
- *Who should conduct the evaluation?* All board members should be actively involved in the evaluation process, but the evaluation should be practically implemented by specific structures such as the chairmen, the lead independent director or board committee, according to the specific needs of the company
- *How the evaluation should be disclosed?* It should address the process and its functioning as well as cover the major results but should not disclosed individual assessment results or personal information.

The future challenges

The need for governance bodies and mechanisms to adapt to the often rigid and prescriptive provisions of the various international codes has often led to excessive emphasis on compliance. In fact, research have shown that governance indicators related to the board structure, the independence of directors and the functioning of the various committees (often called the *"hard" element*) are not the best predictors for the governance performance. These should be integrated also with the *"soft" indicators*, such as the *working relationships between directors*. This implies giving importance not only to the forma but also to the substance of the culture and the practices within the board. In particular:

- *Excessive compliance means tighter agendas* and significant increase in the workload of directors and a reduction in the time available for them to deal with business issues. Because these issues are linked to the verification and compliance with rules and procedures, they are not very consistent with the leadership role.
- *The board's relationship with the management has changed* -> in the past, directors have typically relied on senior management for all their information and delegated the task of strategic guidance to the senior managers, today their role has changes, focusing more on verifying the "correctness" of management action.
- *The pressure for immediate and measurable results is strengthening short-termism* -> the obsession of manager for quarterly results has limited the ability for the BoD to plan for the long term, leading managers to focus more of "tactic" rather than "strategy" -> it is more difficult for an independent director to gather information about the strategic view of the company unless this is a priority of the board as a whole.

The awareness of these limitations is a fundamental step toward the BoD regaining its fundamental role of leadership in the company -> it is necessary for the directors to assume (both individually and collectively) a long-term vision that is functional to the long-term development and success of the company. In order to do so, there are some steps that can be followed:

- *Define and manage the company for the long term* -> shared the understanding between directors and senior managers of what it means "long term". Discussion of specific strategic issues represent an intervention into the long-term strategy of the company, with a long-term impact on the organizational level. For example, some companies have decided to delist themselves in order to be freer and to focus on long-term innovation and investment.
- *Give priority to human capital* -> the bet mix of perspectives and skills is necessary withing the boardroom. This means finding the best combination for gender and background, and that the individual contribution to the board is not related to the age or the tenure.
- *Take leadership in strategic discussion* -> together with long-term financial discipline, the BoD should ensure the long-term strategic management of the company -> this can be done in numerous ways, such as implementing "residential" meetings (which last 2/3 days) including the management of the company in order to force directors to consider only the long-term implication of management proposals.
- *Give shareholders a voice* -> it can be reasonable to give shareholders the final word regarding strategic decision.

Unilever Case

Unilever is a global consumer goods leads, created by the merge of two companies that are located in two different countries with two different structures (UK are more focused on the monistic, while the Dutch are more dualistic). The portfolio includes 400+ brands in Foods, Home Care, and Personal Care and it operates in 150+ countries with billions of consumers worldwide -> 2008 turnover was €40.5 billion. Main competitor: Procter & Gamble (P&G), larger scale, US-based.

Key Governance Context

- Dual corporate structure: Unilever N.V. (Netherlands) & Unilever PLC (UK), operating as a single entity -> Once you become a shareholder, you must become one of both companies -> they have to operate as a unique company
- Hybrid structure due to UK vs. NL legal systems.
- Historically complex board, with executive and advisory directors.

The BoD in UK we have 20 members, of which 8 executive directors and 12 non-executive directors (of which all are independent). The structure of the BoD in NL structure is the same, but the advisory members cover the role of supervisory directors.

Composition:

- Size -> 20 if we look at the formal size of the BoD is too much, while if we look at just the executives (as the advisory directors have no right, so they have no responsibility), so we look at the substantial structure is more fitted -> in 2008 the size has been reduced to 13 members (11 non-executives, 2 executives), committees only non-executives, board self-evaluation.
- Executive/non-executive directors -> if we look at the people that is sitting in the BoD, they are all members of the TMT, so there is a complete merge -> non-executive are just formally independent -> this can lead to a lack of effective monitoring
- Diversity -> they are all skilled members, but they might lack of experience in this field
- Chairman and CEO -> there are two chairmen, we have no CEO in charge of both company -> we don't have a problem of CEO duality, but there is a problem of leadership -> 2005: Group CEO introduced, one non-executive Chairman
- Problems with the committees:
    - Audit committee -> it is not composed only by independent members
    - Nomination committee -> both Chairmans are sitting in the nomination committee. We don't know if they are also the chairman in the committee, but even though they are respecting the requirement of majority of independence, not all the members are non-executive
    - Remuneration committee -> all ok

The Ownership structure and Related Governance Models

A governance system is a country-specific framework of legal, institutional and cultural factors that shape how stakeholders (managers, employees, shareholders, creditors, customers, suppliers, government) influence decision-making. Main governance systems (Different models of capitalism → different governance logics):

	US	UK	Japan	Germany	Italy
Family firms	47,9	29,6	22,2	14,6	**67,2**
Other companies	1,1	4,1	**31,2**	**42,1**	4,9
Foreign shareholders	6,2	13,7	10,3	8,7	17,0
Banks	2,6	2,3	**13,3**	**10,3**	0,5
Institutional investors	**41,9**	**50,1**	22,5	20,0	3,4
State	0,3	0,2	0,5	4,3	3,0

- *Anglo-Saxon (USA, UK, Canada, Australia)*:
  - Market-oriented, "outsider system"
  - Strongly competitive and transparent financial markets
  - Active monitoring of managers and directors by markets
  - Dispersed ownership structures, rising role of institutional investors
  - Hostile takeovers relatively easy to execute
- *Germanic / Japanese (Germany, Netherlands, Switzerland, Japan):*
  - Network-oriented, "insider system"
  - Weak transparency and limited competition in financial markets
  - Few public companies; dominance of industrial groups and cross-shareholdings
  - Banks play a central role, often acting as controlling shareholders
- *Latin (France, Italy, Spain, Greece):*
  - Dominance of families as controlling shareholders
  - Pyramidal groups enable family capitalism and control
  - Frequent shareholder agreements and coalitions
  - Banks less relevant as shareholders, but central in debt financing
  - Limited role of financial markets
  - Strong role of the State: shareholder, regulator, and financer
  - Weak role of employees, except in specific employee trusts
  - Few large-scale corporations compared to other models

The ownership structure is the first important variable that needs to be analysed in defining the variety of corporate governance model. Within the capitalist model, there are 2 characteristics we can use to define the ownership structure, which are the degree of ownership concentration in the hands of a single person and the identity of the controlling individual.

Ownership concentration

With regards to this aspect, there are various combinations of possible ownership concentration, that we can classify using the number of shareholders and the shares owned by each of them. According to these criteria, we can have:

- *A company with only one shareholder that owns the entire company* -> this is an extreme case but also very widespread, in particular within the *companies that are not very large in size*. The single owner exercise at the same time the role of governance and management, and it is often reluctant to sell shares to others.

- *Private company with several shareholders* -> shareholders can be different both in number and type, and it is a structure often used by larger companies (who exercise more complex strategies and offer a wider range of products). Because of this, the owners might be *all members of the same controlling family, a coalition of controlling families, a mix coalition of families and other entities or a mixed coalition of other entities*.
- *A company listed in the stock exchange with a controlling shareholder* -> it is not necessary to hold the absolute majority of capital shares (50%+1) in order to be a blockholders, as it is sufficient to have the majority of the majority of voting rights. In case the company is highly fragmented, owning 10% of the shares is more than enough, but this amount can rise up to *25% in case of family-owned listed businesses*. This is because the fragmentation of the ownership (caused by the listing process) allows the controlling shareholder to exercise ownership rights more immediately than other "minority" shareholders. This is also caused by the fact that most of the time for minority shareholders the costs of exercising their voting rights are higher than the benefits emerging from the good governance.
- *A listed company controlled by another company or a shareholders' agreement* -> The controlling shareholder is not a single family, but a single separated entity or a group of entities linked by a *shareholders agreement* (which is a way by which a group of individuals who, individually, would not have the strength to control the business, decide to be contractually bound for exercising their voting rights for a period of time, in order to reach the necessary "critical mass" to control the company)
- *The company is listed in the exchange market without a controlling shareholder* -> there is a large number of shareholders who cannot (because of the number of shares) or do not want (because they are institutional investors) participate directly in the governance of the company.

➔ The analysis of the ownership concentration is fundamental for understanding and evaluating the way in which ownership rights are exercised.

There have been many studies that tried to understand if the presence of a controlling shareholders is capable of resolving the agency problem and what are the consequences on the performances of the company. According to these studies, these relationships are influenced by the legal and governance system in which the company operates -> the concentration of ownership tend to be "endogenous", being more present in civil law countries rather than common law countries -> in the Anglo-Saxon countries the presence of blockholders seems to be irrelevant in the value of a company, while in the European countries the result is more ambiguous.

Owner identity

The identification of the nature of the shareholder is fundamental to understanding the dominant economic objectives, which is associated with the contextual assessment of the costs and benefits associated with the nature of the ownership. The different owners can be:

- *Family or individuals* -> they often play the dual role of owner and managers, acting in their own name and their own behalf (not through representatives) -> natural alignment of interest. The loyalty of family members allow them to *partially overcome the problem of managerial incentives* and increasing the overall business profitability. At the same time, most of these enterprises are *more risk-averse* than other enterprises and it is more common that they erect barriers against hostile takeovers (producing negative effects due to entrenchment). In addition, the family businesses are often accused of "familism", which causes problems connected to the succession, nepotism and differences within the family for the objectives that need to be pursued.

- *Institutional investors* (such as mutual funds, pension funds or insurance companies) -> they are very common in Anglo-Saxon countries, which are much more market efficient. They are *more propense to risk* and they usually have *long-term horizon* and a *close relationship between managers and company*. Because they are regularly rated based on their financial performance, they are more directed to the creation of shareholder value. At the same time, the focus on financial performances can cause the managers to focus more on the short-term performances of the company and the fact that institutional investors represent a "specialised" category of investors means that their intervention in questions of corporate governance can be incisive. We have to keep in mind that, because *these shareholders most of the time work in highly regulated sectors supervised by the government, there is a lower risk that they operate to extract private benefits*.
- *Banks* (very common in Germany and Japan) -> they can provide financial services to industrial enterprises, making use of the privileged access to capital, information and all other assistance and advisory services that modern banks offer. The companies owned by banks are less likely to be subject to credit restriction, and the high regulation that characterise the bank sector reduce the risk for fraudulent/opportunistic behaviours. In addition, we have to remind that the possibility for banks to participate in specific sectors is prohibited, they are more risk adverse than other shareholders and are less likely to participate in management questions.
- *Enterprises* -> the ownership from another company is particularly convenient in case the companies involved operate in similar sectors. The circumstance can manifest itself in "vertical" relations in different phases of the productive chain, in which the two companies *can access to specific assets and technologies as well as higher frequency of transaction*. At the same time, the presence of cross-shareholding can also act as a *deterrent for hostile takeover* and can *increase the extraction of private benefits* on behalf of the controlling shareholders at the top of the corporate pyramid.
- *State or other public entities* -> the main reasons for state intervention are manifold, and most of the time rely on the realm of "market failures" (the political relevance of the good or service offered) -> there are some business where private companies cannot operate (for the mechanisms of the market) and others where it is believed that the presence of the State is preferred (even though it might cause inefficiencies).

The various forms of ownership structure

There are different variables to be taken into account when defining the characteristics of the ownership structure of a company, which allow us to make an initial *classification of the different "types" or "archetypes" of enterprises*. Examples of these variables include not only the ownership concentration, but also the size of the company and the legal environment in which the company operates.

Public companies

A *public company* is a listed company with a widespread shareholding adopted by large companies located in countries with high level of investor protection and transparent and efficient capital markets. As long as ownership is concerned, they are characterised by low concentration of shares and *difficulty in ascribing a "identity" to the various entities holding shares in its equity capital*. If in the past a shareholder who was not satisfied with the performance of the company was capable of resigning from the company by selling its shares, in recent years the growing dialogue between institutional investors and company management has led to a market reversal of course -> institutional investors have increased their interest in company corporate governance and are more willing to engage in a constructive "collaboration".

From the governance perspective, there is the maximum degree of separation between ownership and control, which creates the conditions for *managerial opportunism*. On one hand small investors do not have the skill not the incentive to exercise effective control. On the other hand, managers are tempted to maximise their personal advantage to the detriment of maximising the overall value of shares -> transparency of the system of governance and the independence of the BoD are vital.

Mixed coalitions

This system is common in systems where investors protection is lower and there is a moderate capital intensity. The *presence of various entities* means that there is a great heterogeneity in the ownership identity and a lower concentration of shares. On one hand this causes that it is rather *likely* that the presence of different types of parties holding equity capital will lead to a *divergence of interests* (in particular when the balance between the interests represented by the different owners changes over time). On the other hand, there could be *difficulty of creating balance within the governance bodies* of the various entities represented in the company's capital (causing a much higher complexity in the governance structure).

➔ It is difficult to identify a prevalent strategy common to all companies belonging to this category, as depending of the size of the ownership shares their strategy might be different depending on the reason of the real existence of the coalition.

Multi-National Enterprises (MNEs)

A *multi-national enterprise* is a peculiar property model, as they have to combine the public interest they have to satisfy at corporate level and the interests of the minority of shareholders at the local level -> they have to balance the leadership of the parent company with the autonomy of the local branches. This concept needs to be elaborated considering two variables:

- The *ownership structure of the parent company*, as this will be reflected in the ownership structure of the local subsidiaries -> *widespread shareholding* (which adopt the "managerial" system at the local level) vs *concentrated/family shareholding* (which creates a structure of reporting that facilitates the control and centralization of the decisions at the corporate level)
- The *ownership structure of the subsidiary* needs to be taken into account, as we have to take in consideration also the interests of the minority of shareholders at the local level (as, for example, the subsidiary is listed in the local market).

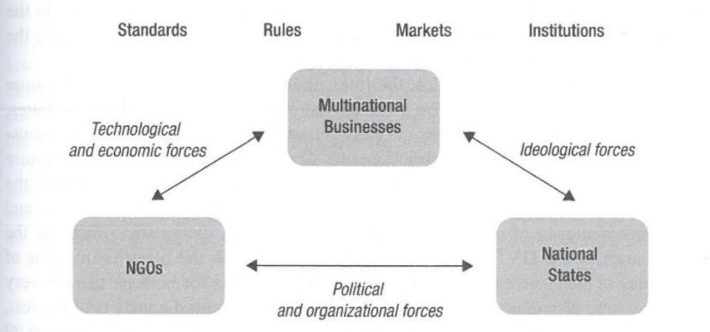
There are many ways to carry out international cross-border activities, which are divided into equity methods and non-equity methods. The two main ways in which it can be achieved are:

- **Wholly Owned subsidiaries (WOs)** -> the local subsidiary is wholly owned by the parent company -> there are the typical problems of the composition + functioning of the BoD at the local level and how this should interact with the one of the parent companies.

From the <u>property point of view</u>, the *two levels should be considered separately*. At <u>corporate level</u>, the *group can have the most disparate ownership structures* (family control, concentrated control, fragmentation of shareholders...), while at the <u>local level</u> there will *always be control by the parent company*. This ownership structure guarantees the greatest <u>degree of convenience for the corporate level to intervene in the governance decisions of the subsidiary</u>. In addition, it is believed that with this structure the objective of the subsidiaries is going to be the maximisation of the parent company's shareholders, and they are much more efficient (having to focus only on the local market). There are 3 main problems connected to this structure:

- *<u>Classic agency problem between Wos and the parent company</u>* -> in particular regarding the mechanisms that should be provided for in the subsidiary, due to the importance of the strategic problems that arises at local level.
- *<u>Analysis of the potential contribution of the Board of directors and executives at the local level</u>* -> we have to find the right mechanisms that are compatible with the specific characteristics of the multinational enterprise in question. Because of this, there are several systems that have been developed by the literature:
    - *Direct control* -> governance function at the local branch are carried out entirely or almost entirely by the parent company
    - *Dual reporting* -> the local governance functions are shared between the parent company and the local BoD
    - *Advisory board model* -> the BoD is composed of local people who are not formally recognized as directors but hold specific roles and responsibilities towards the parent company.
    - *Local board model* -> the subsidiary is managed by a local BoD which assumes both the legal and the strategic and legal responsibility toward the parent company
- *<u>Main challenges connected to the operations located in different countries</u>* (as every country has its own system of capitalism and its own typical structure of governance) -> the management of "<u>global governance</u>" believes that multinational companies should *progressively lose their national proclivities in favour of "universal" governance and management models*. In reality the <u>definition of the governance structure</u>, which variously direct the behaviours of multinational companies, is the result of the <u>influence of several players</u> (such as institutions, governments and other organizations). Empirical evidence shows that most multinational companies diverge systematically in their governance model, which is more true in companies that have a governance structure different from the public company (the objective of attracting capitals in different markets is less relevant than in the companies with fractional ownership and strong international presence).

Figure 4.1 The forces and actors that define global governance structures



Source: Adapted from Levy & Newell (2006, Fig. 7.1).

- **International Joint-Ventures (IJVs)** -> two or more separated legal entities, each of which participate in the initiative by going the mere role of investor, actively contributing to the decision-making process -> the intercultural and inter-organizational nature of these entities make its management enormously complex due to its "hybrid" nature -> the *fit between partners is the key*. So, factors such as *strategic asymmetries, the diversities between parent companies, the complementarity of resources and the continuous interchange of skills and resources* are fundamental elements that need to be considered.
  The most relevant risks are related to the *conflicts of interest or lack of fit*, which can be because most of the time partners involved are competitors, the time horizon of a IJV is not particularly long and there is the severe risk for opportunistic behaviour from the other partners. Because of this, several mechanisms need to be implemented in order to limitate risks:
  - *Coordination mechanisms between parent company executives and joint venture executives*
  - *The role of the BoD of the joint venture and the strategic and control process*
  - *Means of "socialization" between managers*
  - *Definition of incentives for joint venture managers*
  - *Involvement of representatives of the parent companies in the senior management positions*

  Because of this, most of the time IJVs are governed by detailed and comprehensive *corporate by-law* that include all aspects of the governance (such as the definition of the corporate's objectives, the capital structure, the voting system in shareholders meetings…). However, these are not the only methods for operation. Others are the "memorandum of understanding" (the parties define the fundamental objectives and the collaboration agenda), the "training agreement" (a detailed document that contains all the details that form the bases for the cooperation between parties), confidentiality agreement (by which the parties prevent the disclosure of confidential information), bilateral due diligence procedures (recognition of legal, capital and financial situation of the counterparts while entering in the agreement), the shareholders agreement (which defines the rights and the duties of shareholders), an agreement of the functioning of the Board of Directors, a budget agreement and an operational plan for certain period of time.

State-Owned Enterprises (SOEs)

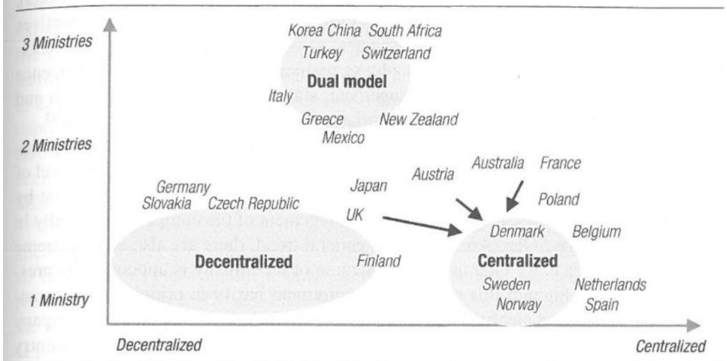
This type of structure is characterized by a particular *high concentration of ownership*, both in listed and unlisted companies -> the goal is to *maintain full control of the company and avoid having to share important governance decisions with others*. The right of control is exercised by Ministries or by public bodies who, on the other hand, do not have any right to cash flow -> very peculiar type of representation, as it involves a complete separation between control and ownership. As well as in public companies, the owners appoint their own representatives in the management of the company. The difference is that, within the SOEs shareholders representatives are appointed satisfy different objectives at the same time, and not just the interest of the shareholders. The distance between the ultimate owner of the company (citizens) and those who have to manage it can lead to public managers to showing little interest in business efficiency.

The two main reasons that justify the direct intervention of the State are the *allocative inefficiencies* and the *social importance of goods/service offered*. There is a wide variety of reason for the state intervention which reflects the different dynamics of the various models of capitalisms = great heterogeneity among SOEs -> there could be the companies specialised in specific sectors of public interest (which most of the time regards the provision of services connected to the general welfare).

The heterogeneity of the sectors in which the SOEs operate and the intensity of the state presence implies that different governance models are created:

- *Decentralised model* -> the SOE is under the control of the appropriate Ministry of the business in which the company operates. It has the advantage of sectoral and functional specialisation, it's the system that guarantee the best results in terms of performance and effectiveness of state-owned companies, but it can lead to excessive fragmentation.
- *Dual model* -> the responsibility is shared between the Ministry responsible for the specific function and a central Ministry, most of the time the Ministry of Finance and Economy -> agency problem connected to the sharing of the responsibility and information between the two entities, but we still have the specialisation of the governance power (at least for one of the Ministry)

Figure 4.2 **Governance models of state-owned enterprises in the major countries**



Source: Minichilli, A., Turrini, A., Valotti, G., & Zattoni, A. (2010), *Governance of State Owned Enterprises: A Worldwide Review*, Ernst&Young – SDA Bocconi research report.

- *Centralized model* -> the governance is exercised by a single central Ministry (most of the time the Ministry of Finance and Economy), most of the time by the creation of specific agencies -> it lacks specialisation, but it allows the centralisation of the responsibility

Regarding the *mechanisms of appointment and composition of the board of directors and the management of the company*, it highly depends by the difference between the *different tradition, cultures, and political influences in the social life and economic activity*. The presence of the State within the BoD can vary from zero to all of the board, with differences regarding the internal dynamics, independence from political influence and representation of any minority shareholders -> in some cases the presence of the state is represented by ½ representatives independently by the number of shares or a number of representatives proportional to the ownership. SOEs have also a peculiar method for the appointment of the CEO and chairmen. Usually, these processes lacks transparency and have a strong political influence. The level depends by the single countries, as in some cases it is a completely political act while in other there is the chairman that needs to coordinate the election of the CEO.

Private equity and venture capital

Firstly, some definitions:

- **Private equity** can be defined as the process of investing in risk capital, including operations carried out in all the different phases of the life cycle of a company subsequent to the initial one.
- **Venture capital** means investing in intermediaries specialising in medium and small companies, especially in the start-up phase, with high growth potential and relative ease of exit from the investment.

Several studies have shown that companies who are funded by venture capital funds invest more in R&D on average than other companies and the rate of sales growth up to double that of traditional companies. Because of this, venture capital tend to finance companies that are not only in the development stage, but in companies that operate in sectors with high level of growth potential.

Regarding the *mechanism of governance* of these companies, we have to make a distinction between the pre-investment phase and investment management phase.

The *pre-investment phase* is the crucial phase for assessing the potential and the success of the operation by directly screening the projects and classify them as "good" or "bad" according to the business plan presented by future entrepreneurs -> information asymmetry between investors and entrepreneurs is going to be very small because of the expertise of investors in making these kinds of evaluations. In order to assess an opportunity, investors look at:

- *Attractiveness of the project* -> size of the outlet market, growth potential, product attractiveness, business strategies…
- *Quality of TMT* -> both in demographic characteristics and presence of the appropriate mix of knowledge, skills and professional background
- *Terms of agreement* -> the duration of the investment, which allows the investor to finance the project step by step -> it encourages the entrepreneur to behave efficiently, but there could be some opportunistic behaviour.
- *Financial and exit conditions of the agreement* -> both considering the sales of shares in the company through an Initial Public Offering, the sales of shares of other companies, the repurchase of shares by the company itself, the sale of shares of another investor or the reorganization/liquidation of the company.

The investment management phase consists of all the mechanisms to govern the relationship between the venture capitalist and the entrepreneur. Those *mechanisms* need to be separated between:

- Control over the entrepreneur -> usually done by appointing some representative of the venture capital into the BoD of the company, which can access to critical information (such as the overall profitability of the initiative) and monitor the behaviour of the TMT
- Support to the entrepreneur -> advice to the entrepreneur to transfer knowledge and provide analysis on critical activities

The type and frequency of interaction will depend on numerous factors such as the development stage of the company, the previous experience of the CEO in the sector and the rate of technological innovation.

Most of the interaction and mechanisms that are present for the venture capital are present for the private equity too. In particular, a long-term investment in a non-listed company is characterized above all by the allocation of controlling rights to the lander -> substantial power of control and influence over the strategic decisions of the TMT of the company, even though the success of the investment relies a lot on the ex-ante screening phase,

"Non-capitalist" enterprise

It is another group of companies with different and specific legal and ownership structures, even though they usually have a marginal and secondary role within society, but they are particularly spread in specific sectors that have significant social impact. Examples of these enterprises are:

- *Cooperatives* -> producers and workers cooperatives, social cooperatives, housing cooperatives, agricultural cooperatives...
- *Professional partnerships* -> present in specific sectors with professional jobs such as law firms or consulting firms
- *Non-profit institutions* -> special category of enterprise with no legal owner since no one exercise control rights.

Cooperatives represent the most relevant type of enterprise both in terms of diffusion and incidence in the overall economy of a country. If we consider the producers and workers cooperatives, they are usually born in particular conditions, such as the inefficiency of the labour market, the possibility to produce goods and services of public relevance and legislation that encourage cooperations in all of their forms.

The strategy of these companies are based on management simplicity, business and geographical focus and reduced diversification. The operating of the cooperative also depends on the real reason it has been created, which is meant to create critical contribution to the company and ensure mutual benefit for those who make this contribution.

The overlapping role of owners and workers have some significant consequence on the company size (usually of reduced dimension), attitude towards risk (more risk averse) and the overall governance structure (because they have to represent the entire society, there could be some limitations in determining a rather high complexity of governance and management when the number of partners-workers increases).

Ownership structure, corporate governance, and corporate strategy (OGS)

The relevance of the topic

The so-called *public companies* represent a limited model of ownership, especially in Europe. There has been an *increase in the dominance of large institutional investors*, especially the Anglo-Saxon countries (they hold 70% of market values). There are new ways of doing business, such as high-growth start-ups (such as Facebook, Uber, Airbnb). Family-controlled firms, which seemed destined to «evolve» into public companies, also play a crucial role and remain dominant in some parts of the world (i.e. Asia).

Recognizing the unavoidable variety means starting from the assumption that **there are no superior forms of ownership**, and that the coherence relationships between ownership structure, governance structure and strategies (OGS) depend on contextual conditions (*contingency approach*).

On the contrary, similar economic activities are often carried out within different ownership structures with comparable results (see, for instance, the automotive sector). Although the corporate governance practices have often considered the ownership an "exogenous variable", a more realistic view of corporate governance requires careful consideration of ownership characteristics for two reasons:

- Ownership is often offspring of the institutional and legal context to which it belongs (determining a parallelism between models of capitalism and ownership forms)
- Ownership always exercises a direct or indirect influence on the strategic choices of the companies, and therefore on their ability to achieve satisfactory results

Relationships between ownership, governance, and the strategy

A basic model

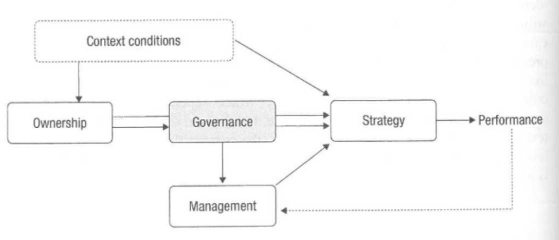
Which forms of ownership are best suited to the pursuit of certain strategic choices?

This question raises two concomitant needs. Firstly, we have to identify the *characteristics* and *"strategic priorities"* of certain ownership models with respect to others -> it allows us to understand if a strategic decision is taken because of the governance structure. On the other hand, it is important to recognise the various combinations of "*governance x ownership*", which largely depends on the *model of capitalism* and *other non-institutional context conditions*, both at macro and micro level. On the other hand, the model assumes the existence of casual relationships between the variables that see ownership as the ultimate determinant of the choices of complete governance and management, as well as the resulting strategic choices. In both cases, the goal is to understand how the design of the overall system of governance results from a long analytical process.

The theoretical model of reference is based on contingency arguments according to which there are no higher economic configurations of *universal validity*, but there are *different configurations* that depends on *several conditions*, which can both refer to the competitive context of the institutional context in which the company operates

-> if these elements are recognised as valid, a causal relationship between **ownership, governance and corporate strategy (OGC)** seems to be established.

Figure 6.1 The causal relationships between ownership, corporate governance and strategy: the OGS model



Source: Minichilli (2012, p. 197).

Control Enhancing Mechanisms (CEMs) -> are legal or contractual tools that allow shareholders (typically controlling ones) to exercise voting power disproportionate to their actual cash-flow rights. Some examples:

- *Deviation from the proportionality principle (one share one vote)*
- *Shareholders' agreements*
- *Pyramidal groups, and the stock pyramiding effect (chains of ownership):*
- *Combination of the former mechanisms*

Pyramidal group as CEM -> let's suppose shareholder A owns 51% of Company B, and Company B owns 51% of Company C -> Formally, A controls C (because A controls B, and B controls C). But in terms of cash-flow rights:

- A holds 51% of B ×51% of C = 26% of C's equity
- Yet A exercises 51% of the voting rights in C

➔ Through a pyramidal structure, a controlling shareholder can leverage a small capital stake into majority control. This makes pyramidal groups a classic Control-Enhancing Mechanism (CEM), as they create a gap between voting power and cash-flow rights.

There are several **context conditions** that need to be taken in account in the OGC:

- *Performance achieved* -> the state of health of a company is a fundamental indicator to understand if the current model of OGC is consistent with the objectives the company aims to pursue. In case there is a mismatch, several practices can be put in action, such as the *replacement of management* (including one/more external managers), considering a *corporate/ownership restructuring* (in order to inject new skills in the system) or, in case the crises is prolonged, an *hostile takeover* can be an alternative -> even particularly positive performance can lead to important rethinking of the consistency of the OGC system.
- *The values, interests and resources of the current owners* -> the vision and values of the owners can lead to changes in the perception of the company's current performance and perspective. For example, the values can lead to a "closed" configuration of governance and management bodies, making them participate in more active way in the management of the company itself.
- *The pressures and opportunities arising from the competitive environment* -> the opportunity can arise in the form of *growth opportunities*, *investment* or *risk aptitude*, which implies an additional work for identifying the resources to respond to these pressures. These opportunities might collide with the values of the current owners -> possible solutions are changing the values or the beginning of a crisis.
- *The pressure and opportunities arising from the institutional context* -> the institutional context plays an important role in defining which are the most dominant models of ownership and governance present in a country.
- *The pressure and opportunities offered by other context conditions* -> the context conditions are not limited to the role played by market regulators, but it is influenced by the *communication* and *transport infrastructures*, the *educational* and *training system* and the *available technology*.

Consistency relationship between the variables of the model

What are the characteristics of the 3 main variables that identify this model?

- **Ownership structure** -> the distribution of ownership rights between the different parties involved in the life of the company. They involve *rights/duties to take the final decision in administrative decisions*, *step-ups*, *liquidation of the company* as well as the *right/duty to enjoy on the positive/negative results generated by the company*. Ownership rights can be classified according to different criteria:
    - The *classes of stakeholders* with ownership rights
    - The *number of roles played* by the same group of people
    - *Number of people* belonging to the *same category of owners*
    - The *interest and convenience of owners* to actively participate in shareholder's meetings
- **Strategy** -> the configuration of company's activities both at corporate and competitive choices. It regards defining the *size of the economic units, the objective rate of growth, the appropriate level of risk, diversification, vertical/horizontal integration*… it is closely related to the characteristics of the context in which the company operates or plans to operate.

- **Governance structure** -> the w<u>ay the company can exercise its ownership rights</u> through the *establishment of bodies*, the *appointment of its members* and the *definition of rules/mechanisms that govern these bodies*. The definition of rules <u>involves the leadership of the company,</u> and it regards the identification of the CEO and TMT, and it is strictly connected to the ownership and governance characteristics. There are some <u>typical structures</u> that can guarantee the performance over time:
    - In context characterised by *low market efficiency* and a *widespread presence of family-owned companies*, the <u>listing of the company</u> is only <u>appropriate when there are specific growth target or requirements</u>. The challenge of dimensional growth, which can often be imposed by the competitive environment, requires proprietary and governance structure capable of attracting large volumes of resources from different classes of capital providers
    - The company's growth in <u>size increases its capital requirements</u> and thus the <u>number and diversity of risk capital providers</u> and increasing the complexity of governance structure -> it requires a governance structure capable of attracting large volumes of capitals
    - <u>Diversified growth strategies</u> involve a series of *changes within the OGC* structure because:
        - They require substantial financial resources
        - They need to redesign the entire governance structure of the company
    - <u>International expansion strategies</u> require a *similar restructuring of the governance and management bodies of both the parent company and the subsidiaries*. In particular, the parent company requires managers and advisors with international experience, while at local level it will be necessary to establish the adequate level of autonomy of the local branch.
    - <u>Expansion strategies through replications</u> are effectively implemented through *proprietary structures* such as franchising networks: the design of governance structure must consider the dynamism and lack of a homogeneity of the competitive contexts in which the various aggregated units operate.
    - <u>Growth strategies that required instinct and complementary skills</u>, but do not seek acquisition or mergers, are effectively implemented through *strategic alliances*.

Where **ownership is sufficiently fragmented** to be <u>unable to play an active role</u> in the company's strategic decisions (such as in the case of US public companies) <u>governance management bodies will take on a central and predominant role</u>. Some authors have investigated the relationship between the *composition of the board of directors* and *corporate strategy decisions*, showing that the <u>greater the presence of external directors, the greater is the propensity to take risks</u>, and consequently choose diversifications. Some authors found that *greater political, academic, an international experience* of board members <u>positively influences the level of CSR activities</u>. Other studies have investigated the relationship between the board composition and some specific strategic decisions, including for example investments in R&D and the innovative potential of the company

Research by Kor, showed that <u>stronger and more independent boards</u>, having a *longer-term vision* due to their representation of shareholders' interests, <u>favour higher investments in R&D</u>. The author found that having short tenure managers, separating the CEO and the chairperson duties, avoiding conflicts and institutional ownerships are particularly effective in promoting such investments. Study shows that <u>companies led by older CEOs</u> showed <u>lower growth rates, sales, and performance</u>, especially in those industries characterised by *high creativity, high technology, and human capital intensity*. They also found that younger CEOs are more likely to exit the business, which support the hypothesis that they are *more likely to adopt high risk strategies* then they older counterparts. A recent study showed that in the case of *severe financial losses*, the replacement of CEOs with longer tenure positively impacts performance, especially when the successor is an outsider. Indeed, the longer an executive has been operating in a company, the higher is its commitment to the status quo, and so the lower the probability of needed substantial changes being implemented. This research finds that positive turnaround situations are more likely to occur when an output oriented the CEO (with a background in sales or marketing) is replaced by a throughput-oriented CEO (with a background in operations or accounting), while the opposite tends to hurt performance.

The **presence of a controlling shareholder** will have two types of consequences:

- on the one hand it is expected that the company's governance bodies will be designed according to the needs, wishes, and the vision of the owner. Nonfamily executives are particularly effective in the case of ownership dispersion at the family level since multiple owners monitor them. In this context, *the ownership group can increase its monitoring capability, without increasing agency costs*.
- On the other hand, this configuration of a model, characterised by *less delegation and power to the governance and the management bodies*, suggests that the controlling shareholders has a direct impact on the strategic choices, according to their own values, objectives, end available resources. They found that *family managed and family-owned firms* are *more likely* than no family firms to *prefer the less risky greenfield investments over acquisitions*.

As family firms reconcile both economic and financial goals with the family centric social goals of preserving of the stock of social emotional wealth and transferring the business to the next generation, they tend to be *more risk adverse than non-family firms*. On the one hand, studies on ownership concentration show that the presence of a controlling shareholder produces more benefits in Latin countries than in Anglo-Saxon countries, within certain limits. Minichilli found that the governance arrangement combining family CEO leadership with less concentrated ownership appears to have markedly different impact on performance before and during an exogenous shock. While this configuration produces good performance during a crisis, it is interesting to note that this configuration had the worst performance before crisis. Together, this evidence confirms the importance of considering multiple governance levels as well as the need to contextualise the conditions for the effectiveness of different governance arrangements. Private family firms are less likely to conform to industry practises than listed family firms, which must face the additional pressure of the market and its expectations. On the contrary, listed family firms, given their often-unconventional governance structure, must show investors they have a strong adherence to sound business practises.

The identity of the controlling shareholder influences strategic decisions and their financial results. An institutional investor will tend to operate with a *greater propensity to risk*, *with strategic choices oriented towards for long term* and the *creation of value for minority shareholders*. Similarly, a bank-controlled company will be more likely to pursue *expansionary strategies* because it has *fewer restrictions on the granting of credits*, and thus more cash to invest. Conversely, the circumstance in which the controlling shareholder is another company may represent an element of considerable benefit if the two companies operate in related businesses, which those favours access to valuable technologies or exploration of common resources and platforms. Gomez found that the more the family control increases, the *less the likelihood of acquisitions*, and that when the family firms do decide to acquire, they *opt for related targets under normal conditions*, and unrelated ones in cases of underperformance. In normal times the future financial gains brought by a diversified portfolio are trumped by the social emotional endowment of the family; while in times of crisis, financial concerns lead to a higher propensity for diversification.

Considering the propensity of a State to operate in regulatory sectors, the *lower efficiency* which is believe to derived from its pursuit of *strategies with strong social connections* seemed to be counterbalanced by the *advantages derived from operating in context characterised by the ex-ante definition of tariffs*, as well as the concrete protection against excessive competition.

The role of ownership in strategic choices

The **ownership structures** can be classified according to some principal dichotomies:

- *companies with controlling shareholders* versus *public companies*
- *companies with a strong controlling shareholder* versus *without a controlling shareholder*: with distinction between a strong controlling shareholder, and a shareholder with a relative majority.
- *monolithic controlling shareholder* versus the *acquisition of numerous and unequal shareholders*.

Among the **dichotomies** referring to the **owner identity**:

- the *controlling private shareholder vs the public shareholder*: private controlling shareholders usually have in common the desire to maximise the profitability of the company, the controlling public shareholder will be subject to strong pressure from political parties to define broader strategic objectives.
- The *purely financial controlling shareholder vs the industrial partner*, customer, competitor, or supplier
- the *controlling shareholder with little knowledge of the business vs the controlling shareholder with specific skills*: where distinction is particularly relevant to understand the type of contribution a controlling shareholder will be able to make to the business.
- The *controlling shareholder with cash to burn vs the leveraged shareholder*: while a controlling shareholder with excess of cash is considered more willing than others to inject new equity capital and make the necessary investments for growth, the leveraged controlling shareholder will be primarily concerned to generate income for the sole purpose of repaying debt, therefore it will put the needs arising from the company's financial structure before those of its sustainable development.

Among the **pressures to which a controlling shareholders may be subject** in defending his or her own strategic orientation there are:

- pressure from stakeholders without ownership rights: a controlling shareholder must also consider important external pressures from other stakeholders that increasingly influence the strategic choices of the companies.
- The activism of non-controlling institutional investors, the degree of autonomy of a controlling shareholder in making strategic choices may vary a lot depending on the behaviour of non-controlling institutional investors.

It is important to recall **some examples of corporate strategic choices**:

- *International growth and expansions policies*: a company may opt for internal growth policies, through investments in the core business, or by expanding in adjacent businesses. Alternatively, it can opt for external growth policies, through mergers and acquisitions with other companies operating in similar or even quite different sectors.
- *Decisions to diversify growth through diversification* is one of the possible ways in which a growth path can be achieved; in absence of growth ambitions, the reasons must be sought in the attempt to diversify risks.
- *R&D investment policies*: another option is to invest in research and development at the corporate level, in order to have an impact on the different business units of a group. It will be influenced by sectoral dynamics, as well as by the company's potential to use the spillover effects in terms of new technology and new skills on a large set of products and services.
- *Entry into groups of companies or merger integration with the parent company*: possibility of joining a group of other companies that allows continuing to compete on a scale sufficiently large for the characteristics of the industry, but not reachable independently.
- *Strategic alliances*: any type of strategic alliance, whether equity or non-equity, aims to allow the company to enjoy the benefits of both internal development and acquisition, without having to bear the difficulties and risks that were present.
- *Decision to restructure* through these investments, layoffs, and disposal of non-core business: one of the most traumatic policy options is the need for the company to pursue restructuring and recovery paths that re-establish conditions of efficiency and overall financial equilibrium.
- *Choices involving corporate social responsibility and relations with stakeholders without ownership rights*. Set up strategic choices at the corporate level, which are increasingly crucial for best survival and development of a company.
- *Onerous capital increases and dividend policies*: set of corporate strategic choices concerns the relationship between the owners and the company. In this respect, it is essential to understand whether and to what extend existing shareholders are willing to provide capital increases, which are often necessary to pursue many of the strategic options listed above. They include the choices relating to the payout ratio, which are fundamental to understanding the extent and methods of distribution of cash flows to current shareholders.

There is a **relationship between the characteristic of ownership and the company's strategic choices**:

- *private controlling shareholder, strong, monolithic and with excess of cash*. The presence of a single private shareholder, with the absolute majority control and substantial financial resources, create the *optimal conditions for courage and expensive strategy choices*. In this regard, the controlling shareholder with the above characteristics is available for additional substantial investments even with medium- and long-term returns. The need of resources to finance such operation means - at least pro tempore - low dividends. A stronger controlling shareholder with substantial financial resources may be also favourable to capital increases if they do not excessive weaken is control excessively.
- A *heavily leveraged control to shareholder*: a controlling shareholder who is heavily indebted, very often because of having made his acquisition through leveraged buyout mechanisms. It is likely to have a limited portion of the company's equity capital, opening to additional possibility of conflicts at the ownership level. The controlling shareholder needs to maintain his debt payments, translates into a set of conservative strategic choices, if not voluntary downsizing, with little investment, low orientation to growth and risk, and the search for opportunity for

cash generation. It is likely that the controlling shareholder will pay high dividends, especially if the holding company holds the debt.

- A *strong public controlling shareholder*: public control by an entity with sufficient final resources freely available. Although, this circumstance does not exist at this historical moment, this kind of controlling shareholder will be able to make large investments, even if they tend to be with low risk and with assured returns over the medium and long term. Publicly controlled companies will often be led to undertake acquisitions of other companies in financial difficulties, even in unrelated businesses, to ensure their survival and to preserve their employment, even though it is contrary to large restructurings and dismissals
- *Current controlling shareholder, who is also competitor, customer, or supplier*. In these circumstances, and especially if there are plans to acquire or merge with the parent company, the controlling shareholder will be in favour of streamlining and restructuring operations to create synergies between the parent company and their subsidiary, and will also be in favour for it is investment of non-core activity. If the subsidiary is listed on the stock market, the parent company that is a customer or supplier of a subsidiary will tend to behave as a related party.
- *Purely financial, but active minority shareholders*: they may be in favour of rationalisation, simplification, restructuring, and the pursuit of efficiency. For these reasons, the presence of financial shareholders in the capital will make diversification operations more complex, because they prefer to hold mono-business in their portfolio, with simple and transparent ownership structures.
- *Stakeholders without ownership rights but with great influence*: this situation exemplifies how some actors can exert, by law, any influence even greater than the usual one exercised by the owners. Operating in a really regulated sector results in a company having a set of reduced or strongly conditioned strategic options, with possible obligations of separation between different products or services offered, and with possible strong limits to its growth in size and the explosion of economies of scale or scope for antitrust reasons.

The relevance and the new frontiers of corporate governance

To prevent mistrust on the part of savers, and thus better protect the interests of those who finance companies without being able to influence their decisions, several countries have introduced reforms to strengthen their regulatory system and punish those *responsible for corporate crimes*. The US Congress approved the Sarbanes-Oxley act of 2002 in response to the failures of Enron corporation, Tyco international PLC, and WorldCom; Italy approved law 262/2005 containing provisions for the protection of savings and the regulation of financial markets in response to the crash of Parmalat and Cirio. Many problems that caused the 2008 financial crisis have not been resolved, such as the *culture of short-term profit maximisation and excessive bonuses to top managers*. To prevent new financial crises in the future, the big issue for corporate governance scholars is to find the right balance between economic and social goals, and individuals and communities' goals. The shared value approach can have a big role in this.

ESG investing is often considered synonymous with sustainable or responsible investing. The concept was used for the first time in 2005 in the publication of a United Nations study entitled Who Cares Wins. Over the following years, investors have become increasingly interested in ESG issues: in 2018 investor held $11.6 trillion in assets chosen according to ESG criteria, a 44% increase over the 8.1 trillion just two years earlier. Following the spread of SRI investments, there has been an increasing need for a framework that can be used to assess the sustainability of an investment. ESG ratings are synthetic judgments that certify the solidity of an issuer, a security or a fund from the point of view of ESG fundamentals.

Breaking down ESG we find:

- **ENVIRONMENTAL** criteria: which includes a *company's energy use, waste, pollution, natural resource conservation, and Treatment of Animals*
- **SOCIAL** criteria: examine *how it manages relationship with employees, suppliers, customers, in the communities where it operates*.
- **GOVERNANCE** criteria: deal with the *company's leadership, executives' pay, audits, internal controls, and shareholder rights*.

Why ESG is crucial

- Capital access: ESG criteria drive investment decisions of sovereign funds, pension funds, asset managers, and retail investors
- Risk governance: ESG factors are central to identifying and managing risks
- Stakeholder expectations: growing pressure from customers, employees, regulators, and society
- Business opportunities: new markets and innovation linked to sustainability

➔ ESG commitment directly affects long-term corporate sustainability

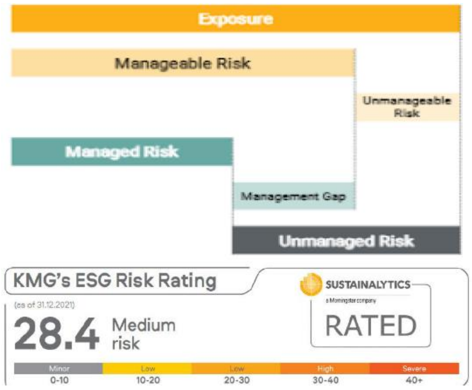
MSCI Framework -> MSCI uses a rating system designed to identify industry leaders and leaders based on their exposure to ESG risks and their ability to manage those risks relative to peers. ESG risks and opportunities (called Key Issues) may vary by industry and company. **The final rating is relative to the company's peers in the industry**. Results are aggregated into an overall ESG rating (from AAA = leader to CCC = laggard).

The Sustainalytics ESG rating measures the level of exposure to unmanaged ESG risks. The rating is composed of three blocks:

- **Corporate governance**
- **Material ESG issues (MEI):** relevant topics (e.g., recruitment, diversity, etc.) that must be managed, and which are identified at the sub-sector level
- **Idiosyncratic ESG issues:** unpredictable or unexpected issues, specific to the individual company and not tied to its specific sub-sector.

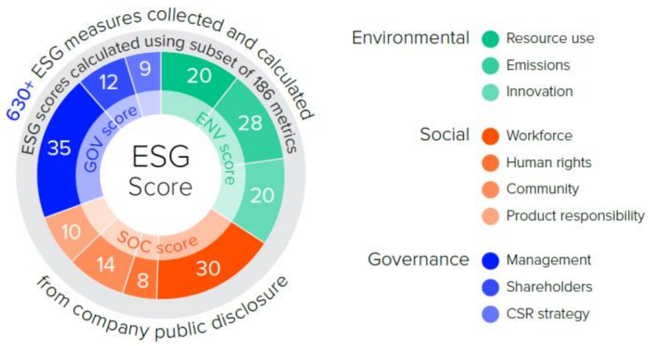
Methodologically, for each material issue the following is determined:

- **The level of exposure to material ESG risks,** distinguishing the unmanageable component (e.g., CO_2 emissions for oil companies) from the manageable component with ESG policies and programs
- **Management,** which reflects the effectiveness with which a company manages the ESG risks to which it is exposed.



The company's unmanaged risk is composed of "unmanageable" risk and the "management gap," which reflects risks that could potentially be managed but are not. The final ESG rating is calculated as the sum of the unmanaged risks cores for each material ESG theme (the lower the value, the better the rating).

Refinitiv calculates the ESG score based on **630 ESG metrics** monitored at the company level. The metrics are then grouped into **10 categories** related to the **three sustainability pillars**. The score for each ESG pillar is obtained by adding the relative weights of the categories, which differ **depending on the specific sector for environmental and social categories**. For the governance pillar, the weights remain unchanged across all sectors. The pillar weights are normalized to percentages between 0 and 100. The final rating (ESGC) is then adjusted to take into account the **scoring of ESG controversies** that impact the company's sustainability conduct.



Moreover, where are regulatory requirements for reporting on ESG information. The *European Union* is strongly supporting the *transition to a low carbon*, *more resources efficient*, and *sustainable economy*; in 2018 the European Commission adopted a package of measures implementing several key actions, in its action plan on sustainable finance. Then, it is necessary to establish communication standards to make *data comparable* for investing purposes. Company reports may play a role in efficaciously encouraging investors to change their focus from short term financial results to long term value creation: Directive 2014/95/EU is the first step in this direction. It requires large companies to disclose information on the way they operate and manage social and environment challenges, in their annual reports from 2018 onwards.

Shareholder activists are shareholders who acquired minority stakes in a publicly traded company to put public pressure on its management, and to influence board decisions. The goals of activist shareholders can be either *financial* (especially in the case that where management is doing poorly) or *non-financial*. The activity of activist shareholder covers a broad range of strategies, ranging from *hostile battles* to *cooperative discussions* with the company board of directors. The methods of activists' shareholders may range from *dialogue with managers*, to *formal proposals*, or even more *aggressive tactics* to force changes.

Some final implications and suggestions

A greater awareness of the importance of strong and competing governance bodies is required. Moreover, the owners of companies should also pay attention towards assuring a high quality of the boards of their companies:

- a real boost towards the independence and competence of the board of directors, favouring directors with the personal independence of judgement.
- the search to ensure quality information and debate on the BoD, so that advisors can fully contribute to major strategic decisions.
- continuous training of directors, especially in the case of new appointments

Nowadays there is a greater awareness among entrepreneurs that the ability to move effectively in ever changing markets will depend more on the quality of governance. Based on the experience of other European countries and considering clear scientific evidence from the AUB observatory of Italian family firms, the first code of corporate governance, called "Principles for Unlisted Family-Controlled Companies" was published in Italy in 2017. The code aims to go beyond the previous family governance models, in order to enhance efficient and effective mechanism, and proposes 13 principles that can be applied to all unlisted family companies with revenues higher than 10 million of euro, adding 6 other principles for larger and more complex family companies.

Designing governance for effective decision-making: the case of private and family-controlled firms

What are family-controlled firms?

One category of ownership structure of a particular importance is represented by **family-owned enterprises**. Family firm institute estimates show that *family business generates from 70 to 90% of the world's annual gross domestic product* and dominate *most small medium sized private companies*. Ownership concentration will be particularly high for unlisted family businesses, with concentration increasing as the size of a business decreases and tending towards total control in smaller companies. The ownership concentration will be lower in *listed family businesses*, where control can be ensured by a share of capital that varies from 5 to 10% in the Anglo-Saxon context, to 25 to 30% in the European countries. According to the EU, a business can be **defined as a family business** where the *absolute majority of the voting rights* (and therefore in essence of the shares, which control can be direct or indirect) is in the ends of the *founder*, his *family*, *children*, or *direct descendants*, and *at least one representative* of family sits on the board or holds a manager position in the business. This percentage is reduced to 25% in the case of listed companies.

For distribution of family-controlled firms around the world

Family businesses in Europe play a key role, accounting for 85% of all businesses and 70% of total GDP, as well as 60% of employment. In the United States family business account for around 90% of total businesses and contribute to generating 57% of national GDP and employment, but they record - on average - superior income performance and value creation compared to other types of companies.

The peculiarities of family-controlled firms

The literature agrees on some **common traits among family businesses**:

- personal relationships and mutual knowledge between the different actors, preceding connection through ownership and the business, of links between family members
- an elevated level of ownership concentration, which in turn ensures a high degree of stability in the ownership.
- an elevated level of participation by the owner family in the ownership, governance and management of the company
- coexistence of economic and noneconomic objectives and the longer-term orientation that is the pursuit of noneconomic objective entails.
- A basic strategy orientation for the company permitted by the venues and culture of the semi owner.
- Local roots -> Strong attachment to the territory of origin
- the difficulty in getting out of the ownership structure, both *financially* and *emotionally*, because of difficulty in finding partners acceptable to the family owners.

These are all aspects which can turn into *positive* and *negative* aspects for the company. The attitude of family-owned companies seemed to be determined mainly by their size -> while *small and medium enterprises* appear to be opposed to business diversification, *their growth in size* often accompanied by an increase in the number of generations involved and substantial growth in the resources invested, leads to a change in the trend. Here are typical trades of these types of companies that are markedly healthy and which therefore **positively influence their performance**:

- The patient capital of the family, which favours *long term objectives and returns over short term ones*: constant accumulation of resources and the achievement of a long-lasting strategic position. There is a high incidence of re-invested profits, as family businesses prefer to use internal resources.
- Emotional commitment -> The strong emotional involvement of owners, managers, and employees of the company
- A culture that favours all the actors identifying with the company, thus reducing turnover.
- The accumulation of social capital as a moral resource for the enterprise, which benefits from the positive values linked to family relationships, on both personal and business nature.
- The ability to generate unique resources: the most valuable resource is the human capital, which represents an added value.
- Continuity of leadership, showing greater resilience in tough times: the overlap of the roles of owners and the top managers represents the best guarantee of solidarity and commonality of intent between family members towards each other.

There are also **negative aspects** among the characteristics of a family-controlled companies:

- then appropriation of the resources and assets of enterprise to satisfy parochial family desires
- the nepotism, the altruism of parents, and the distorted selection of management as the complexity of business grows. It is often necessary to consider the widest possible pool of candidates for leadership.
- a conservative attitude and risk aversion, which curb innovation and strategy in favour of safeguarding accumulated assets. The consequences of this attitude could be problems of

growth, competitiveness, and profitability, as well as a low propensity to invest in innovation and R&D.
- The excessive effort expended in managing family emotions and conflicts.
- The uncertainty and risk associated with generational turnover.

Family ownership in different theoretical frameworks

Assuming that in any contractual relationship (and in particular in a company) there is an *intrinsic conflict of interest* between the principal and the agent, agency theory posits the potential for family firms, guided by family executives, to take advantage of lower agency costs because owners and managers interests are *perfectly aligned*.

Stewardship theory highlights family members attachment to the business, which is seen as a *source of family and personal pride* and an *opportunity for economic wealth that must be preserved*. Stewardship is achieved by *valuing family resources* for the benefit of all actors involved in the company, including employees, outsiders, and future generations.

For fulfil these conditions, there must be a specific attitude by the family and all its individual members towards ensuring that there is an *intrinsic alignment of interests and values* between the different actors, *without the need for ad hoc mechanism*. Studies on family firms' performance have found that the optimal conditions to benefit from agency and stewardship advantages are when the *firm size is small*, and the *ownership is highly concentrated*.

A completely different interpretation of family business has been proposed by the **theory of resources**. When applying the resource-based view to the context of family businesses, some scholars have coined the term *familiness*, to indicate that unique set of tangible and intangible resources that would only be available to this type of businesses, and that would allow such firms to build or destroy a competitive advantage:

- *a culture based on trust and cohesion* among all members.
- the presence of the *founder as an individual able to bring unique skills and abilities to the company*.
- the *management of human resources based on relationships*.
- the *possibility of creating a family like network of relationships*.
- the *long-term vision of a family*

The **social emotional wealth theory** tries to reconcile the positive and negative aspects of family involvement highlighted by previous theories. From the perspective of the SEW, intrapreneurial families *continuously make important decisions*, establishing in each specific circumstance *how much a given decision can influence their social emotional endowment*. This is an assessment that often disregards the economic and financial implication of a particular choice. SEW theory is based on the idea that the decision makers may be either inclined or adverse to risk, depending on the circumstances. While the stewardship approach principles that family members operate unconditionally for the good of a business, just because of their belonging to the family, this SEW perspective argues that family members act for the good of the business primarily as a matter of economic convenience, consisting of maximising their social emotional endowment.

The corporate governance of family-controlled firms.

The **overlap of family members in ownership and government** raises a number of issues in relations to the role, composition, and functioning of the board of directors:

- the overall design of governance systems of the family businesses, with the explicit provision for a formal and informal bodies.
- the specific roles of the directors with respect to the needs of a family business
- the openness to nonfamily members, and their expected contribution to the effective functioning of the board of directors.

Unlisted family firms will be characterised by a high homogeneity of interests and consequently high interest in actively participating in the governance and management of a company. In unlisted family businesses the problem will be primarily that of balance within the family, involving a continuous search for an *appropriate mix of internal and external professionals*, as well as *establishing career paths* and *governance and management positions* that are satisfactory for all family members involved in the business. The board of directors plays different, and in some ways even broader, articulated, and potentially useful roles in the management of their relationship between the family and the business. Among them:

- the *role of motivator*: in cases where only one person owns of a majority or the whole equity capital and simultaneously plays the role of leader within the company, a well-structured and functioning board of directors can be extremely useful as a counterweight to the entrepreneur. This is one of the most important obstacles to the widespread presence of external directors in family businesses.
- *The participatory role*: in family business is characterised by the presence of no managing family owners, a well-functioning board represents a mean for allowing these individuals to maintain good knowledge of a business, and two participate in the major strategic decisions.
- *the role of auditor*: a well-functioning board can allow its members to monitor the work of the CEO.
- the *role of facilitator*: a well-functioning board can also be extremely useful in situations of interpersonal tensions between owners who hold high number of shares.
- the *role of governance* consists of the ability of a board of directors to make the most important strategic decisions. Is often limited in family-owned enterprises, where the board of directors is established more for the above reasons, than to effectively manage the enterprise.

The main challenges of family firms: openness and generational change

There are **two main challenges** that family businesses must face over time: *opening to external professionals*, and *generation change*. There is a broad consensus in international literature on the **advantages of having external directors** in the governance of a family business.

- *Control*, since outsiders stimulate discipline and responsibility on the part of the leaders and the management.
- *Strategy*, given that external directors bring experience and skills to integrate the knowledge of a company.
- the *management of family enterprise relations*, since they favour the proper formulation of these relationships, and professionally plans successions processes for the firm.

Family businesses should learn how to assess the contribution of external members within the board of directors and should not just include them in the face of financial difficulties. The contribution of nonfamily board members *is not only measurable in terms of short-term economic results* but translates into *greater transparencies of management*.

Another crucial issue for the **continuity of the family businesses concerns generational change**. In family-owned businesses, the transmission of a social emotional heritage of the controlling family is added to the need to transfer their managerial skills. Generational changes are not just a change of individuals, but a **critical life-cycle event**. It represents both a risk and an opportunity to *rethink ownership structures, redesign governance mechanisms and review organizational and strategic choices*. In some circumstances, the generational transition can take place in a traumatic way. Common causes of traumatic succession are sudden loss or unavailability of the entrepreneur, no heirs willing to continue the business, appointment of unfit heirs due to "family logic" or irreconcilable conflicts among family members.

The process of succession in some control companies is often at destabilising and intrinsically navigate phenomenal, due to a combination of *organisational* and *emotional stress*. The main mechanism that qualified managerial turnover in a family-controlled business, in a manner consistent with the objective of conserving the above-mentioned intangible assets are the *advanced planning of the succession at the top*, the *existence of a mechanism of internal competition between the various candidates for the succession*, the *decision to recruit an outside CEO*. According to the theory, this mechanism would represent a set of conditions through which entrepreneurial families could counterbalance the negative effects of successions on the firm's performance. Theory and practise indicate **7 conditions for success** that can facilitate and hopefully lead to a successful generational turnover:

1) *distinguish the business from the family*.
2) *applying modern system of governance*, starting from a clear definition of roles, a careful attention to the composition of the board of directors
3) *assess competence rather than the family relationship*, which is even better if conducted with the help of a third party.
4) *define - early and well - the shared rules for change*, with adequate planning that gives priority to the company's competitiveness objectives and with adequate legal structures that allow the formation of a stable majority.
5) *prepare for the unexpected from a patrimonial point of view.*
6) *planning objectives and process*
7) *involving third parties was the key to many successful successions*.

The **process** of generational change begins when parents become aware that they want to pass on the business to their children. After the young people complete their studies, it is recommended that they have professional experience in other companies, so that they can c*omplete their training, experience working for a boss, and demonstrate their skills*, while realistically assessing their potential. A recent study concluded that the habit of passing the family firm to the first born is the *worst financial choice for the firm*. Choosing a subsequently born child significantly increases the firms post succession's performance with return on assets 39% higher than in the firms that appointed first burn. In his first experiences with the family firm, it would be preferable for the young family member to learn how to absorb the tacit knowledge of entrepreneur, which cannot be separated from executive action. The *third step* regards coexistence

	2013	2023
Less than 50 years	31,3%	16,9%
50- 60 years old	26,8%	29,5%
60-70 years old	23,2%	28,1%
More than 70 years	18,7%	25,5%

In the last decade there has been a progressive aging of company leaders: **more than 1 leader out of 4 is now over 70 years old**

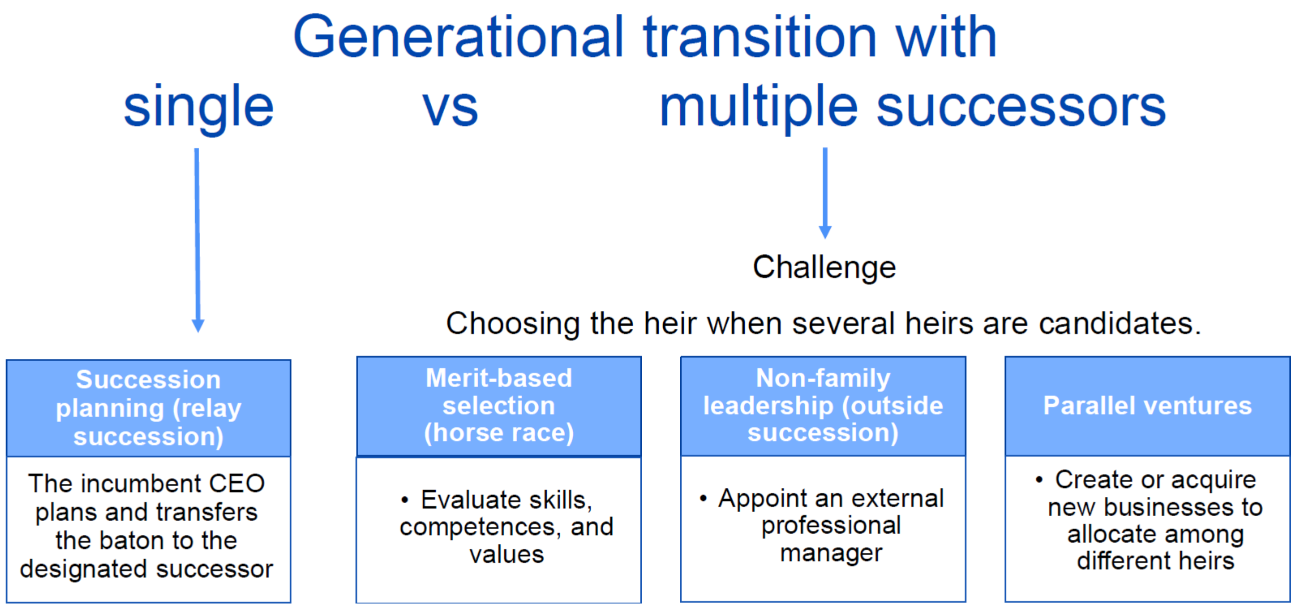
Despite the slight acceleration in generational transitions since 2020, the **speed of the change remains very low**

All family firms > 20 mln in revenue	Period 2013-2019	3-years period 2020-2022
% companies which underwent a generational transition	1,5% per year	2,1% per year
Number of companies which underwent a generational transition	127 per year	181 per year

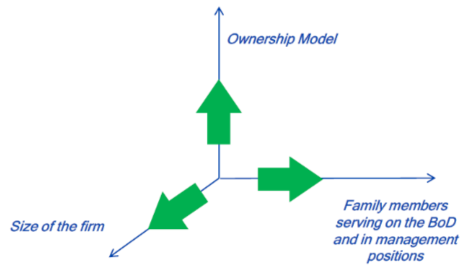
among the generations -> it varies from case to case. In this stage, communication is particularly important, including *mutual listening between parents and children*. The succession is considered complete when there is a total passing of the baton - where the sons take the role of the parents, who will continue to be part of the family merely as consultants based on their experience over many years.

The **key steps** for a correct generation transition:

- Succession as a process, NOT an event, marked by coexistence rather than replacements
- Nurturing responsible ownership values & entrepreneurial spirit in next gen
- Treasure some «good practices» to design and guide main steps along the process: we know what works (on a tailor-made basis)
- Proper planning approach: flexibility and adaptability «on the way» + careful monitoring and evaluation of main steps
- Senior and next gen's endless and generative commitment to grow, individually and together, and to keep communication effective
- Involving the right third parties (e.g. independent board members, trusted advisors or non-family owners)



Why Do Family Businesses Need Governance? «Governance is the means of stewarding the multigenerational family organisation.....[it] establishes the processes whereby: strategic goals are set, key relationships are maintained, the health of the family is safeguarded, accountability is maintained, and achievement and performance are recognised» [Goldbart, Di Furia 2009]. At some point, all family firms will inevitably be involved into critical questions: *what is our vision for the future? How much influence do we have over various decisions? Where are the decisions made?* As the family firm moves along the 3 axes, the system governing the decision-making process must be updated accordingly, taking into account the increase in complexity and the needs of the stakeholders.



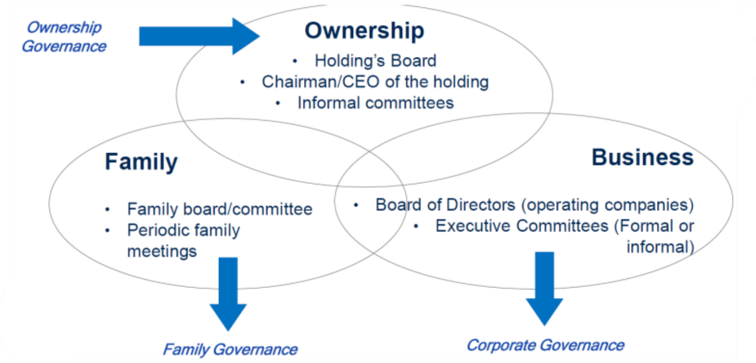
When governance become critical?

- *Growth& Success* -> Strengthen decision-making capability, reinforce corporate structure and build and consolidate reputation (to support alliances and international expansion)
- *Tensions & Conflicts* -> Introduce governance mechanisms to manage conflicts (family vs. non-family) and prevent interpersonal tensions from absorbing entrepreneurial and managerial focus
- *Ownership Changes* -> Growing number of family members (succession), entry of other families or external shareholders and entry of financial investors (e.g., private equity)
- *Generational Factors* -> Aging of the company leader, need to plan generational succession and heirs requesting access and clear entry rules

The effective design of a good corporate governance structure **has some costs** (i.e. cost of time, resources, professional advice..). But also great **benefits**:

- *Stronger and more effective decision-making*
- *Better risk monitoring and control*
- *Improved reputation and credibility with stakeholders*
- *Easier to attract and retain strategic partners*
- *Reduced family tensions and conflict management*
- *Greater clarity in family–business relationships*

Governance dimensions in family businesses



Ownership governance -> it has the main purposes of *exercise ownership rights, protect the financial wealth of the family and guarantee compliance with the legal and accounting requirements*. Main governance mechanisms are *shareholders' meeting, by-laws and shareholder agreements*.

Family governance -> it has the main purposes of *support the family's well-being, ensure effective functioning of the family and manage the relationship between the family and the business, as well as other shared assets or interests* (such as the family office, family foundation, philanthropic initiatives, and other family ventures). The main structures are:

- *Family Meetings* (family membership body) -> the comprehensive forum of the family for discussion, which gathers all adults family members. They discuss all family-related issues, but decision making powers are delegated to family council.
- *Family Council* (family leadership body) -> a group of family members appointed by family assembly which organizes and oversees family activities, establishes policies for the family,

set the strategic and organizational planning of the family and its relationships and interactions with the business.

- *Family Constitution* -> agreement in the form of a statement of intent that regulates members' relationships with the business and spells out the family's values, purpose, and vision, role expectations, principles, procedures, activities, and decision-making processes that regulate all family activities. This operative guide often includes: family history, family vaues, rules concerning the functioning of family governance bodies, the involvement of family members in the business or the succession process.

Board of directors (BoD) at holding level -> we can divide the responsibilities of the BoD at the holding level into two categories:

- *Corporate & Group Responsibilities*
    - Financial oversight: approve balance sheets, capital increases, acquisitions, transfers
    - Group governance: act as owner in subsidiaries; appoint directors and auditors of operating companies
    - Strategic monitoring: approve plans and budgets; assess performance across the group
    - Legal duties: fulfil law and statutory obligations
- *Family-related responsibilities*
    - Family agreements: draft, apply, and review rules and shareholder agreements
    - Next-gen development: support education, career orientation, assess suitability of heirs
    - Family in management: decide on promotions, compensation, and exits
    - Family–firm interface: mediate and manage family–business relationships

The **tasks** of the Operating BoD are:

- *Strategy*
    - Protecting shareholders' interests and implementing their decisions
    - Decide on the company's strategy
    - Mitigating shareholder conflicts (e.g., majority vs. minority; family vs. non-family; one branch of the family vs. another)
    - Promoting the unity and long-term commitment of the owning family
- *Control*
    - Ensure ethical business management and adequate internal controls
    - Review the company's financial situation
    - Be a respectful critic of management by asking insightful questions
    - Ensure that family logics (nepotism) do not prevail over business logic
- *Family-firm relationship*
    - Provide knowledge and useful contacts through its own network
    - Support succession processes (e.g., Nomination Committee)

Effective Board -> composition and functioning

- Composition → balance of executive & non-executive directors; independence & competence
- Size & frequency → 7–9 members; at least 6 meetings/year
- Agenda & preparation
    - Annual calendar; focus on strategic issues

  - Advance distribution of materials
  - ~3 hours preparation for each hour of meeting
- Board culture → active, engaged, not just a "rubber stamp"

Effective Board -> Leadership & Challenges

- Decision-making→ clear voting rules (simple vs. qualified majority for critical decisions) and distribution of power to avoid dominant influence
- Size & frequency → 7–9 members; at least 6 meetings/year (half a day)
- Meeting management→ trustful climate, open debate, formal minutes by the Secretary, periodic self-assessment
- Role of the Chairman
  - Defines agenda with CEO
  - Moderates debate & summarizes views
  - Decides when to vote and close decisions
- Challenges
  - accepting structured governance (vs. informal style), agreeing on "investing" in the BoD
  - Balancing multiple roles (family member, manager, board member)
  - Investing adequate time & embracing constructive criticism

Outsiders in family businesses

Why outsiders matter? They increase transparency, open governance to external views, reduce "closed system" risk typical of Italian family firms. Types of outsiders

- Family members not involved in the business
- Affiliated non-family directors
- Independent non-family directors

Control	Stimulate discipline, encouraging closer monitoring
	Monitoring, conflict of interest protection
	Safeguard minorities
Strategy	Bring expertise, Strengthen decision-making
	Support managerialization
	Enhance stakeholder relations
Family-firm relationship	Succession planning
	Next-gen training
	Less emotional/more professional conflict management

Governance and Managerialization: the organizational structure

- Entrepreneurial firms are often managed in a largely entrepreneurial way:
  - Flexible
  - Stakeholder-oriented
  - Highly participatory encouraging the participation of all company stakeholder
- Weaknesses:
  - Oversimplified or non-formalized structures
  - Unclear roles and responsibilities → ambiguity and inefficiency

- Committees/working groups often long, inconclusive, lacking agenda & minutes

Managerialization at the top requires a careful assessment and re-design of the organizational structure; of managers' profiles and behaviours; and in general, the overall evolution of the company towards a modern management model.

The Internal Control System – PwC guest speaker

Definition and structure of the Internal Control System

According to CNDCEC, Governance and Internal Controls in unlisted Companies in light of Business Crisis Code, «*The **internal control and risk management system** consists of the set of rules, procedures, and organizational structures aimed at enabling the identification, measurement, management, and monitoring of the main business risks*». The CoSO – *Internal Control –Integrated Framework* (*CoSO Framework*), issued by the *Committee of Sponsoring Organizations of the Treadway Commission* in 1992 and updated in 2013, defines the internal control and risk management system as a **process** implemented by the Board of Directors, Management, and all personnel, **aimed at accomplishing the following objectives**:

1. *effectiveness and efficiency of operational activities*
2. *reliability of financial information*
3. *compliance with current laws and regulations.*

In the current economic and regulatory context, the **greatest challenge** of an efficient Internal Control System is certainly represented by the knowing how to effectively coordinate roles and responsibilities in such a way as to leave no gaps in oversight/controls, while avoiding duplication of activities. An effective internal control system helps ensure "*the safeguarding of company assets, the efficiency and effectiveness of business processes, the reliability of information provided to corporate bodies and the market, compliance with laws and regulations as well as the corporate by-laws and internal procedures*".

General principles for the effectiveness of the Internal Control System:

- *The separation of roles and tasks (Segregation of Duties -SoD)* in terms of:
    - Authorization to execute the operation
    - Recording of related data
    - Management, including the physical or virtual handling of assets involved in this operation.
- *Accountability*: assignment of responsibility to a person or organizational unit for the result achieved, based on their corporate tasks.

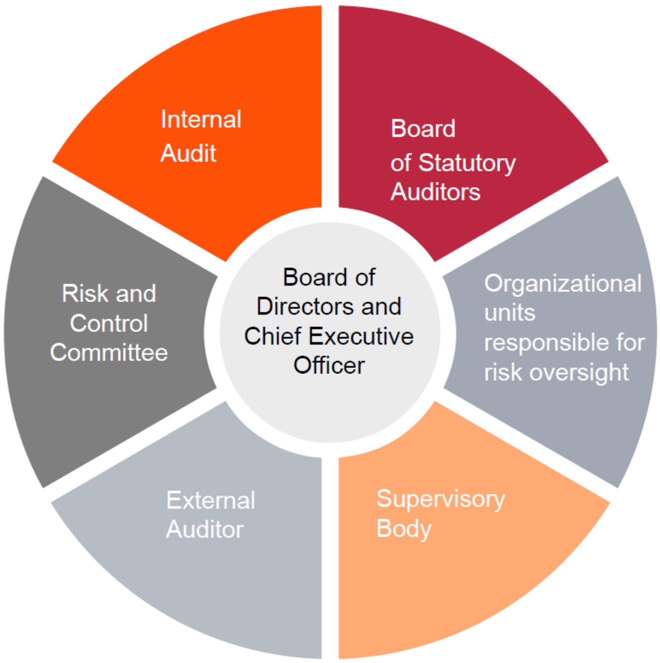
- *Data and information traceability*: represents the possibility to retrace the process in order to trace the source of data and information, therefore making the activity reliable, reconstructible and assessable.
- *Proportionality*: focus, in relation to the size and organizational complexity, on the most sensitive and deserving areas of control, designing effective structures and adjusting resources and methods more or less intensely in relation to their risk profile.

Declination of controls for the purpose of an integrated governance system:

- First Level Control
  - It typically consists of a procedural, IT, behavioral, administrative-accounting nature aimed at ensuring the proper execution of operations
  - These are fundamental controls, assigned to the company's operational lines, namely to the function managers/directors (so-called Operational Management), who are also entrusted with the task of identifying, assessing and mitigating risks, actively contributing to the definition, updating and integration of internal procedures that ensure operational activities are carried out in line with the objectives set at the company level.
  - The task of the function managers/directors is to guarantee the diffusion of regulations, policies and procedures tailored to the company's requirements, as well as overseeing their proper implementation.
- **Second Level Control**
  - It oversees the *risk assessment and control process ensuring its consistency with business objectives and adhering to organizational segregation criteria sufficiently to allow effective monitoring*
  - *Top management* is responsible for introducing Risk Management and Compliance functions into the organization, in order to support and/or monitor first-level control activities. The organization of these functions may differ according to industry sector and company size; however, second-level control functions typically include the following:
    - Risk Management function (or a Risk Committee) that monitors and facilitates the implementation of Risk Management practices by the company's operational *management*; it also assists *risk owners* in defining their risk exposure *targets*.
    - Compliance function that monitors various specific risks such as, for example, non-compliance with laws and regulations. In carrying out its duties, Compliance reports directly to the *Top management*, and in some cases, directly to the Administrative Body.
    - Control function that monitors financial risks and any issues related to financial reporting
- **Third Level Control**

- It provides "independent assurance on the design and operation of the overall Internal Control System, accompanied by improvement plans defined by Management"
- The Control and Supervisory Bodies and the Internal Audit are the functions generally responsible for carrying out third-level controls. The third line of control usually aims to provide assurance, reporting directly to Top Management and to the Administrative Body, on the following topics:
    - the effectiveness and efficiency of operations; the safeguarding of company assets; the reliability and integrity of reporting processes and compliance with laws, regulations, policies, procedures and contracts;
    - all elements of risk management and the internal control framework;
    - the company as a whole, its divisions, subsidiaries, Business Units and both business and staff function.

Which are the Company bodies and the departments involved in the Internal Control System?



What are the roles and responsibilities of the various players in the Internal Control System?

Board of Directors -> It is responsible for the **business management** -> Article 2380-*bis,* paragraph 1, of the Italian Civil Code: the business management is carried out in compliance with the provision of Article 2086 Civil Code, second paragraph, and is exclusively responsibility of the directors, who perform the operations necessary for the implementation of the corporate purpose

It evaluates the **adequacy of the organizational, administrative and accounting system** -> Article 2381, paragraph 3, of the Italian Civil Code based on the information received, it evaluates the adequacy of the company's organizational, administrative and accounting structure

Examines the **strategic industrial and financial plans** prepared by the delegated bodies -> Article 2381, paragraph 3, of the Italian Civil Code it examines the company's strategic, industrial, and financial plans; it evaluates, based on the report of the delegated bodies, the overall trend of management.

Responsibilities of the Directors:

- *Towards the company* (article 2392 of the Italian Civil Code): Directors are jointly liable:
  - for damages resulting from the breach of these duties, unless they concern the specific responsibilities of the executive committee or functions specifically assigned to one or more directors;
  - if, being aware of harmful events, they fail to do everything possible to prevent, eliminate, or lessen the resulting damage.

  The liability does not extend to the one among them who, being free of fault, has recorded without delay his dissent in the book of meetings and resolutions of the board, giving immediate written notice to the chairman of the board of auditors.

- *Towards the corporate creditors* (article 2394 of the Italian Civil Code): Directors are liable towards the Company's creditors for the non-compliance with the obligations related to the preservation of the corporate assets.
- *Towards shareholders and third parties* (article 2395 of the Italian Civil Code): Directors are liable for their own fault or negligence related to the exercise of their duties that damage the assets of individuals or third parties.

Chief Executive Officer -> According to the provisions of article 2381, paragraph 5, of the Italian Civil Code the delegated bodies:

- ensure that the organizational, administrative and accounting structure is appropriate to the nature and size of the enterprise;
- report to the Board of Directors and the Board of Statutory Auditors, with the frequency set by the Company's by-laws and in any case at least every six months, *on the general management trend* and *its foreseeable evolution*, as well as on the *most significant transactions* carried out by the Company and its subsidiaries.

According to the provisions of article 2392, paragraph 1, of the Italian Civil Code they are jointly liable to the company for damages resulting from the breach of these duties

Board of Statutory Auditors:

- *Compliance with the law and the Company's by-laws* (article2403 of the Italian Civil Code) -> the Board of Statutory Auditors verifies:
    - the compliance of acts and resolutions of the corporate bodies with laws and by-laws provisions (as well as codes of conducts)
    - the adequacy of the organizational structure and procedures to ensure that the Company operates in compliance with the law and the Company's by-laws
    - the possession of the necessary authorizations to carry out the Company's activities and the maintenance of the required qualifications.
- *Observance of the principles of correct management* (art. 2403 of the Italian Civil Code) -> Supervision consists of verifying that the management decisions comply with the general criteria of economic rationality. The Auditors must ascertain, based on the information received, that the following actions are not carried out:
    - activities unrelated to the corporate purpose
    - activities in conflict of interest with the Company
    - manifestly imprudent or risky actions
    - actions that could jeopardize the integrity of Company assets
    - measures intended to overrun or alter the rights granted by law or the bylaws to individual shareholders
    - actions contrary to resolutions of the shareholders' meeting or the management body
    - operations carried out without prior adequate assessment on their asset, financial and economic evaluation.

- *Adequacy of the organizational structure* (art. 2403 of the Italian Civil Code) -> The Board of Statutory Auditors shall ensure that decision-making power is distributed and actually exercised according to appropriate criteria of competence and responsibility. In particular, the Auditors shall verify:
    - that the Company allows the pursuit of the corporate purpose
    - the presence of a well-structured Company organizational chart containing a clear identification of functions, tasks and reporting lines
    - the existence of procedures that ensure the personnel have adequate skills to carry out their assigned duties
    - the effective communication throughout the Company of directives and corporate procedures, as well as their subsequent compliance
    - that Directors continuously exercise the management of the Company.
- *Responsibilities of the Board of Statutory Auditors* (art. 2407 of the Italian Civil Code)
    - Direct responsibility: «they are responsible for the truth of their statements and must maintain confidentiality on the facts and documents of which they have knowledge by virtue of their office».
    - Indirect or joint responsibility: «They are jointly liable with the directors for the actions and omissions of the latter, when the damage would not have occurred if they had exercised their duties in accordance with their position».

Supervisory Body -> **Company's body with independent powers of initiative and control** pursuant to article 6 of Legislative Decree no. 231/2001, appointed by the management body.

- It oversees the effectiveness of the Model 231, which involves verifying the consistency between actual behaviours and the established model.
- It assesses the adequacy of the Model 231 or its ability to prevent the commission of the listed offenses provided for by Legislative Decree no. 231/2001.
- It analyses the maintenance over time of the Model 231's effectiveness and functionality requirements.
- It oversees the necessary dynamic updating of the Model 231, should the analyses carried out require corrections and adjustments necessary, through:
    - suggestions and proposals for adapting the Model 231 to Company bodies and functions.
    - follow up: verification of the implementation and actual functionality of the proposed solutions.

Responsibilities of the Supervisory Body: The responsibility of the Supervisory Body falls under professional liability pursuant **to article 2236 of the Italian Civil Code**, under which, if the service involves solving problems of special technical difficulty, the service provider is liable for damages only in cases of wilful misconduct or gross negligence.

External auditor -> The person in charge of the auditing is called upon to:

- Verify during the financial year the regular maintenance of Company accounts and the correct recording of management transactions in the accounting records (article14, paragraph 1, letter b) Legislative Decree no. 39/2010)
- Express an opinion on the annual and consolidated financial statements, where prepared, with a specific report and illustrate the results of the external auditor (article14, paragraph 1, letter a) Legislative Decree no. 39/2010).

Responsibilities of the external auditor (article15 pursuant to Legislative Decree no. 39/2010):

- External auditors and auditing firms are jointly liable with each other and with Directors towards the Company that assigned the audit, its shareholders, and third parties for damages resulting from the failure to fulfil their duties. In internal relationships between joint debtors, they are liable within the limits of their effective contribution to the damage caused.
- The person in charge of the assignment and the employees who collaborate in the auditing activity are jointly liable with each other and with the auditing firm for the damages resulting from their own failures or unlawful acts towards the Company that assigned the task and towards the damaged third parties. They are liable within the limits of their effective contribution to the damage caused.

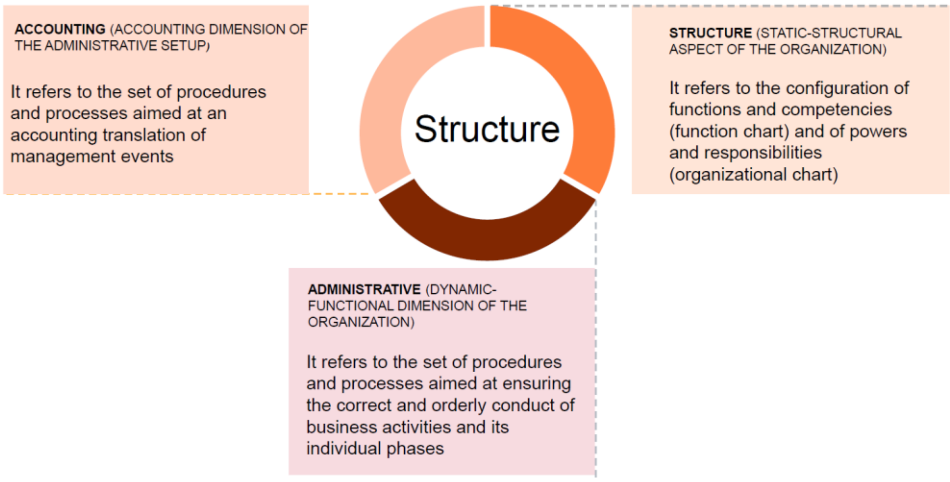
Risk and Control Committee -> The Risk and Control Committee is assigned the task of assisting the Board of Directors in defining the guidelines of the internal control and risk management system, and in assessing the adequacy of the system itself. According to the provisions of Recommendation 35 of the Corporate Governance Code, the Risk and Control Committee, in assisting the administrative body:

- evaluates, after consulting the executive responsible for the preparation of corporate accounting documents, the external auditor and the control body, the correct application of accounting principles and, in the case of groups, their consistency for the purposes of preparing the consolidated financial statements;
- assesses the suitability of periodic information, both financial and non-financial, to correctly represent the Company's business model, strategies, the impact of its activities, and the performances achieved, coordinating with any committee required by recommendation 1, letter a);
- examines the content of non-financial periodic information relevant to the internal control and risk management system;
- provides opinions on specific aspects related to the identification of main business risks and supports the assessment and decisions of the governing body regarding the management of risks arising from harmful events of which the latter has become aware;
- reviews periodic and particularly significant reports prepared by the Internal Auditor;
- monitors the autonomy, adequacy, effectiveness, and efficiency of the Internal Auditor;
- may entrust the Internal Auditor with carrying out checks on specific operational areas, simultaneously notifying the chairman of the control body;
- reports to the Board of Directors, at least during the approval of the annual and semi-annual financial report, on the activities carried out and the adequacy of the internal control and risk management system

Internal Audit -> The Internal Audit *continuously verifies the adequacy of the company's organizational structure and monitors the functionality of the overall Internal Control System.* According to Recommendation 36 of the Corporate Governance Code, the head of the Internal Audit:

- verifies, both on an ongoing basis and in relation to specific needs and in compliance with international standards, the effectiveness and suitability of the Internal Control and risk management system, through an audit plan approved by the administrative body, based on a structured process of analysis and prioritization of the main risks;
- prepares periodic reports containing adequate information on its activities, on the method used to manage the risk, as well as compliance with the plans defined for their containment. The periodic reports include an assessment of the adequacy of the Internal Control and risk management system;
- also at the request of the control body, promptly prepares reports on particularly significant events;
- sends the reports referred to in letters b) and c) to the chairman of the control body, the control and risk committee and the administrative body, as well as to the chief executive officer, except in cases where the subject of such reports specifically concerns the activities of these bodies;
- verifies, within the scope of the audit plan, the reliability of the information systems, including the accounting recording systems.

The object of control and the protected asset: organizational, administrative and accounting structure



The adequacy of organizational, administrative and accounting structures -> The National Council of Certified Public Accountants and, more generally, the doctrine identify, as indicators of adequacy of organizational, administrative and accounting structures:

- The drafting of a **company organizational chart** and a **function chart** that clearly identifies tasks, functions and reporting line
- The adoption of a **system of delegations and proxies** that assigns clear and appropriate powers to specific individuals within the company
- A clear and detailed indication of the main **risk factors**, taking into account also the size and nature of the business
- The existence, updating and diffusion of **procedures** that ensure **the efficiency and effectiveness of risk management** and the control system
- The completeness, timeliness, reliability and effectiveness of **information flows** between corporate bodies and functions

- The existence of **procedures** that ensure the presence of staff with adequate competence to perform the functions assigned
- The adoption of an **accounting system**
- The adoption of a **corporate compliance system** based on the business sector also through the implementation of Organizational, Management and Control Models **pursuant to Legislative Decree no. 231/2001**
- The **diffusion of corporate documentation**, in order to provide adequate information to all those who deal with the Company

Risks for the Company in case of non-compliance with the provisions:

- **Preservation of Company's assets** as generic security for fulfilling obligations towards third parties (article2394 c.c.)
- **Non-compliance with obligations** related to the preservation and integrity of Company's assets (article2394 c.c.)
- **Fraud and unfaithful behavioral**

Liability for the entrepreneur in case of non-compliance with the provisions of art. 2086 of the Italian Civil Code -> The entrepreneur or administrative body has a clear and explicit obligation to establish an organizational, administrative and accounting structure appropriate to the nature and size of the business, also for the purpose of timely detection of business crises and loss of business continuity. If the entrepreneur or administrative body fails to take such measures, their conduct constitutes mismanagement, resulting in the administrators being held liable for failing to provide the Company with adequate organizational, administrative and accounting structure.

Cases of adequacy or inadequacy of the structure: real-life experiences:

- Lack of controls on incoming goods at the headquarters of an Italian commercial company belonging to a well-known pharmaceutical group. Instead of the contractually agreed supply (printing of books and publications on studies conducted by the Company), reams of A4 paper sheets were delivered, and despite the non-existent supply, the printer still received the agreed payment and, in agreement with the general manager of the company, created the funds to carry out corrupt actions towards public clients of the pharmaceutical company.
- A startup operating in the non-food product distribution sector launches a massive campaign to open new stores without first implementing any business plan or system to monitor incoming and outgoing cash flows. The company enters into crisis and is subsequently declared bankrupt. The Sole Director is held liable to the company's creditors for the damages caused to the integrity of the company's assets due to his imprudent and negligent behavior.
- Significant delay by the Sole Director of a company in preparing the financial statements and in establishing an adequate organizational, administrative and accounting structure, and subsequent report to the Court by the Board of Statutory Auditors pursuant to article 2409 of the Italian Civil Code for serious acts and irregularities committed by the executive body, with a request for the removal of the Sole Director and the subsequent appointment of a special manager.
- Lack of controls in the personnel selection process and the resulting hiring of the son of a public official who chaired the tender commission responsible for awarding the contract to the company that proceeded with the hiring.

<u>Article 3 of the Business Crisis Code as amended by Legislative Decree June 17, 2022, no. 83</u> -> In relation to the organizational, administrative and accounting structure, article3 of the Insolvency and Crisis code is amended by Legislative Decree no. 83/2022 at paragraph2 and introduces new paragraphs 3 and 4:

- **Paragraph 2** specifies that the structure must have an organizational, administrativeand accounting nature pursuant to article 2086 of the Italian Civil Code, for the timely detection of a state of crisis and the adoption of appropriate initiatives.
- **Paragraph3** provides that the structure «*shall allow to: identify of any **imbalances of a patrimonial or economic-financial nature**, related to the specific characteristics of the company and the business activity carried out by the debtor;*
    - *verify **the unsustainability of debts and the absence of business continuity prospects** for the next twelve months and the warning signals referred to in paragraph 4;*
    - *obtain **the information needed to use the detailed checklist and perform the practical test** for verifying the reasonable achievability of the restructuring referred to in article 13, paragraph 2*».
- **Paragraph4** identifies ***the indicators to promptly foresee the emergence of the business crisis***.

<u>The signs for the timely emergence of the business crisis</u> -> The Legislative Decree no. 83/2022 has eliminated the definition of crisis indices and indicators previously set out in article 13 of the Business Crisis and Insolvency Code (CCII). The only regulatory reference can now be found in the amended **article 3, paragraph 4,** regarding the "adequacy of measures and structures for the timely detection of business crisis", which identifies the following signs to foresee the early emergence of business crisis:

- the existence of wage debts overdue by at least 30 days amounting to more than half of the total monthly payroll;
- the existence of supplier debts overdue by at least 90 days that have exceed the amount of outstanding (not overdue) debts;
- the existence of exposures to banks and other financial intermediaries that have been overdue for more than 60 days or that have exceeded the credit limits granted for at least 60 days, provided these exposures represent at least 5% of the total exposures;
- the existence of one or more of the debt exposures outlined in article 25-novies, paragraph 1 (i.e., thresholds for reporting to qualified public creditors).

What benefits, for the Company and corporate bodies, can arise from adopting an adequate organizational structure?

- Improved corporate governance and efficiency through the adoption of *corporate governance* models and adequate internal control systems
- Reduction of the risk of insolvency and financial distress due to the failure to promptly adopt the necessary tools to overcome the business crisis
- Reduction of the risk of fraud and unfaithful behaviour and the consequent damages for the Company, as well as possible actions against the management

- Greater access to credit lines and financial leverage thanks to the implementation of effective control measures
- Prevention of crisis risks and loss of business continuity through careful and constant monitoring of corporate crisis indicators

Corporate governance: origins and meanings

Corporate democracy: an "ancient" issue

Where does CG come from? **CG** is a *set of rules* to help managing a company in the proper way for ensuring a return to shareholders and stakeholders. It is about of *institutions* to make the company more efficient, where the efficiency can *be measured by the ROI* or *the satisfaction of stakeholders* (which is an enormous group of different individuals that ask different things from the company).

The creation of good institutions improves "*performances*" -> this concept can be applied to a broader vision of performance, so not just on financial performance (so on profits, revenues, ROI, EPS...) but also different types of performance (such as GDP). What does it mean "good institutions" (the term institution can be substituted with every word that means prescriptive, such as rules or practices)? Institutions can be of two kinds:

- *Bad institutions* -> they foster extractive behaviour (the practice where managers operate just for their own interest to extract as many resources from the company without aiming at reaching the shareholders' goals), commonly known as agency issue -> CG reduces the incentives for misbehaviour.
- *Good institutions* -> They foster redistribution -> governance has to create institutions that foster redistribution and, in the end, on the basis of this we are correlating the cost of corporate governance with the good performances.

Corporate Governance is not an abstract topic, as it has history, which means there are reasons behind the choice of what is a good institution. People started to talk seriously about corporate governance in Europe and US in the 1990s. We tend to *associate CG with companies* and in particular with joint-stock companies, which is different from listed companies. **Joint-stock companies** are companies where the capital comes from main owners of capital-> the first joint-stock capital companies have been created *in Europe during 16th-17th century* (so they are a man-made thing), where shareholders put their money in the activity (most of the time it consisted of trade) and *managers of these trades used money of shareholders for the activity* -> no CG in this type of company. Shareholders had high level of return because they *operated in monopoly* + managers were notoriously corrupted, also because most of the time the *rich people that covered the role of shareholders were members of the government* -> increasing privileges for operating in trades and increasing influence over politics.

Historically, there have been cases of corporate governance even though they were not properly called in this way, but it had a completely different structure from the one we have today. For example, today most of the corporate governance set of rules share the principle "one-share-one-vote" (every share entitles you to a single vote in the BoD). But in reality, until 1860s (so in the post-civil wars period), because the structure of companies was so democratic (which refers to the democratic influence in political meaning), social equality prevailed over one-share-one-vote principle -> this occurred because the difference in power between the different shareholders was not that wide -> the main shareholders suffered of "vote limitations".

The impact of Big Business and of the Second Industrial Revolution

The US economic development in XIX century, especially after the Civil War (1861-65) pushed the legislation in different direction. Companies during **second industrial revolution** were *capital intensive* (railways first, then steel, chemicals, refining, shipbuilding, explosives...), because they have a continuous productive process to generate economies of scales and produce a quantity of goods enormously bigger than the period before. In addition, because of the explosion of capital-intensive businesses, also the amount of CAPEX (Capital Expenditure) has increased significantly compared to the First Industrial Revolution in order to produce the amount of goods that allowed the company to become profitable. 2 main problems:

- *A first set of problems: Fear for democracy and the struggle against trusts and cartels* -> When a company starts to employ high number of people and has a monopolistic position in a strategic sector (so it is important for the everyday life of all citizens, such as AI today), they are *not a private business anymore*, but they start to be *a social and political problem and interest*, as they influence society and politics. In the US, they created anti-monopolistic laws, as a *monopolistic company is a threat to society because it obtains to much political power* (most of the time, the company was obligated to split into two different companies), such as it happen with Rockefeller, where with Standard Oil they obtained so much power that they had a significant influence on the Congress and also in the choice of the president of US.
- *A second set of issues: the need of additional capitals has an effect over the number of listed companies* (which started to arise in this period) -> as the public companies started to exist in this period, also the agency issue started to arise. The American contradictory paradox started in those years. On the one hand, a strong push towards economic growth, on the other one, the need of regulations. The two main consequences of this situation have been:
    - a *growing separation between ownership and management* (control). New cohorts of salaried managers and professionals are increasingly hired (which are creating a new social class), which are different from the shareholders or the family members that actually owned the company -> *rise of "Agency Conflicts"*
    - these conflicts are worsened by the *decreasing number of large blockholders* (so a shareholder that owns a huge portion of shares and can basically make all the decisions) and the *prevalence of small shareholders scarcely interested in supervising the management's actions*

➔ public companies started to have all a standardised structure

Table 2 Sectoral Breakdown of Traded Stocks on the NYSE

	1885	1890	1895	1900	1905	1910	1915	1920	1925	1930
Total	151	264	263	296	341	331	420	670	774	1,273
Railroads	122	194	160	161	168	146	146	150	131	151
(%)	(81)	(73)	(61)	(54)	(49)	(44)	(35)	(22)	(17)	(12)
Utilities	5	15	26	32	34	34	34	11	38	89
(%)	(3)	(6)	(10)	(11)	(10)	(10)	(8)	(2)	(5)	(7)
Industrials	24	55	76	103	139	151	240	509	605	1,033
(%)	(16)	(21)	(29)	(35)	(41)	(46)	(57)	(76)	(78)	(81)
Coal & mining	11	20	19	18	22	30	36	44	29	25
(%)	(7)	(8)	(7)	(6)	(6)	(9)	(9)	(7)	(4)	(2)
Other	13	35	57	85	117	121	204	465	576	1,107
(%)	(9)	(13)	(22)	(29)	(34)	(37)	(49)	(69)	(74)	(87)

Source: Author's analysis based on data from *Manual of Statistics, Financial Review, The Annalist, Bank & Quotation Record*.

The Great Crash (1929) and the firm

Until 1929 many companies introduced new financial products: on the one hand, to *reinforce the ownership structure* and the biggest shareholders, on the other one to *raise new financial resources* among the public. The one share-one vote rule was widespread. From early 1920s, since the corporate law did not require it, the companies started to introduce the multiple vote shares and the nonvoting shares. The **Great Crash of 1929** made evident the risks for minorities in front of the unlimited power of management, strengthened by *relevant information asymmetries* (and/or lack of transparency of the decision process) for shareholders. A vision emerges (Berle 1931): "All powers granted to a corporation or the management of a corporation (...) are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.

This perspective is reinforced in a very influential book *The Modern Corporation and Private Property*, which conveys a clear message:

- The overwhelming majority of listed companies are managerial public companies (so no blockholders).
- Managers are supposed to act in the interest of shareholders only, but the empirical evidence shown in the research affirms that managers are guided by other types of interests (like power, their own remuneration...) -> how is it possible to avoid "agency conflicts" aligning the interests of managers and owners?

While Berle & Means' perspective is very close to the present emphasis on the concept of shareholder value, it wasn't the only one. Other authors argued that "[business] is private property only in the qualified sense, and society may properly demand that it be carried on in such a way as to safeguard the interests of those who deal with it either as employees or consumers even if the proprietary rights of its owners are thereby curtailed.

In 1934, new rules concerning *transparency* and *amount of information for the market* have been introduced (e.g. intermediate reports, so provide information on a regular basis), as before the *companies were not obligated to disclosure several information to shareholders* -> during the Great Crisis of 1929 thousands of companies went to bankruptcy, but no one really know why because of the absence of these disclosures. In the same year, as an *example of good institution* that have been introduced for the efficiency of the system, we have the introduction of the *Security and Exchange Commission* (Joseph Kennedy, first chairman), following some *legislative provisions* (Securities Exchanges Act, 1934). Not only positive effects: *boards became less independent, their size increased and there was less local director monitoring*

➔ No one was talking about CG or agency theory, but the essence of the problem was there

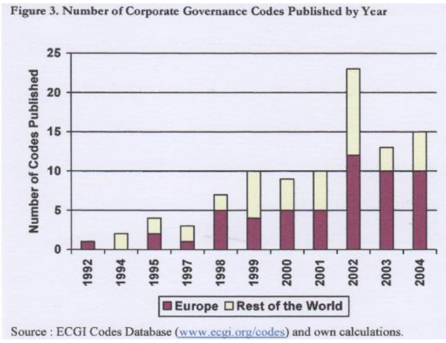
A new season (1970 - 1990s)

Nothing "relevant" happens in the long phase going from the WW2 to the 1970s, a phase characterised by a *positive economic cycle in the Western World* (the Economic Miracle, where in particular US had basically no competitor around the world, but also the companies that operated in countries deeply wounded by the war were growing at a very high speed), represented by the increasing level of EBITDA of companies that ensured money to shareholders as a consequence of the new mainstream about the superiority of the market and the deregulation (both in the United States and United Kingdom) -> this was the reason why anybody was asking for regulation in terms of Corporate Governance.

Three events bring Corporate Governance issues back at the centre of the debate:

- The *global crisis of the 1970s* highlights the *managers' (scarce) accountability*, in particular by institutional investors that have higher power -> here there are people who started proposing the need of CG
- In capitalist economies, *stakeholders start to raise their voices* (not only shareholders, but also employees, such as what happened in Germany from 1976)
- In the 1980s and 1990s the *privatization process involves a rising number of institutional investors* (pension and mutual funds) which *require better corporate governance practices*.

➔ After 1990s', *CG became finally a problem of common concern*, that was not meant to be regulated solely by governments (which started to reform the financial markets, promoting transparency and accountability), but also by groups of companies and categories of associations (so a sort of "self-regulatory activity")



An example is the introduction of **Cadbury Committee** during 1992 (founded by Sir Adrian Cadbury, chairman of Cadbury Schweppes). The reasons behind the introduction of the committee (promoted by the Financial Reporting Council, LSE and the Association of professional accountants -> no government!!) was the *increasing lack of trust in (and accountability of) the management of listed companies due to some scandals and corporate failures* (Wallpaper Coloroll; Maxwell Group) as a consequence of criminal outlaw practices (Bank of Credit and Commerce International). Main points of the first report of the committee (1992, the first ever form of CG code in history):

- *introduction of independent directors, instruction of audit committees*
- *define the different responsibilities of CEO and board*
- Introduction of a *nomination committee* (to prepare the list of the new boards' members) and a *regulation committee* (to establish the rewards of the top managers and the members of the board)
- *comply or explain principle* -> listed companies were obligated to comply with the rules of the new codes and, in case this did not happen, they had to explain why

After the introduction of the Cadbury Committee, the demand for a regulation of CG grew internationally (in Italy, Germany, US, China...), as it is possible to see from the graph. OECD started in 1999 and continued until 2023 (last version) to publish the general rules that should have been followed by different countries for the national legislation.

Towards an international code?

In 1998, the *OECD* summarised many aspects of the discussion and of a different result of the implementation of **the first codes of corporate governance** in a publication that became a sort of guide for late-comer countries in this subject. Many emerging economies and the BRIC countries used the OECD principles of corporate governance when they established their first codes of corporate governance.

Even though the crises that occurred in XX century regarded the agency problem, after the beginning of XXI century further problems occurred -> the United States, which have been for decades the frontrunner of any discussion about corporate governance, did not introduce a real code for many years. At the beginning of 2000s, a **new wave of corporate scandals and failures** (Enron above all), further accelerated the «demand» for transparency and accountability, and for minorities' protection.

A «demand» which is increasingly global, due also to the *globalization of the institutional investment industry*, which also ask for a relatively «homogeneous» behaviour across borders (such as the compliance with ESG and CSR).

Another wave of reforms follows the **global financial crisis of 2008** (which reduced the overall trust in financial institutions and forced the US administration to intervene), in three directions:

- A control over the remunerations of the top management and above all of CEOs particularly in the finance and insurance industry
- The role of the big shareholders, the professional capabilities of the board and the abuse of moral hazard.
- The lack of independence of rating agencies
- A better control over the revision process and over the relationship between consulting companies and their clients, in order to avoid rotation systems

The **European Commission** intervened in the discussion about the consequences of the crisis over the corporate governance. In April 2010, the commission for internal market and services announced the publication of a *green paper* -> the aim was to start a real debate at the European level over the role and governance of auditors. Moreover, a Commission staff working document was issued in November 2010 with the title *corporate governance in financial institutions*. The document stressed *how to improve the functioning and the composition of boards* of financial institutions to enhance their supervision of senior management.

Recently, three main debates:

- In the Summer of 2019, a document of the Business Round Table (basically the association of leading US. Employers) suggests that *maximizing shareholder values is not anymore the sole goal of the company* -> «broader interest such as those of the employees, the environment and the customers – a real change for a more sustainable capitalism"
- The *relationship between ESG standards and the value of the corporation*
- *Ethics and moral obligations in business*

THE ANGLOSAXON WAY: the origins of the «shareholder value»

Have America's industrial giants forgotten what they are for?

The article points forward:

- Relationship of one characteristic of average listed American corporations, which is fragmented ownership, and obsession with pure short-term financial returns (like quarterly reports)
- Which is the relationship between the two previous factors and the culture of the company (which seems to be something completely immaterial and philosophical, but in reality it is something that gives a competitive advantage)

<u>*Boing*</u> -> the merger with McDonnell Douglas, which was considered to be necessary, was a disaster -> <u>culture of Boing</u> (which put engineers at the centre of the activity of the company and in the decision-making process, in particular in areas critical for aircraft safe and innovation) <u>was to prioritize quality over short-term results</u> -> the mergers has changed the culture.

As Colin Mayer has affirmed, even though the <u>obsession for short-term results</u> (also called “crisis capitalism”) <u>harms companies</u>, we have to keep in mind that the “*villain*” is the <u>*dispersed ownership*</u> -> because the ownership of the company is diluted between small and big investors, the <u>primacy of short-term results going to shareholders reduce the investments</u>. In this sense, the “angels” for companies are those committed owners who are ready to sacrifice short-term results for other metrics (such as the aircraft’s safety level in the case of Boing). Let’s see some examples:

- <u>*Kodak*</u> (good example of why companies prioritize short-term results over strategic change by choice) -> The primacy of the stock market distorted the company from opportunities (moving from analogue cameras to digital cameras) and for preserving short-term results -> They thought that they were the leaders + they were generating high margins from these products, but they did not want to change and collect the opportunity, because it would have required high amount of capital and management resources -> it is better to continue to give short-term results than make investments.
- <u>*Dupont*</u> (good example of why companies prioritize short-term results over strategic change because they were forced to)-> They were a chemical company operating in several sectors, such as chemicals, fertilizers, explosive. As all the companies, they had a R&D department capable of developing a fibre, extremely expensive, which is known today as nylon. They decided to leave it in the closet as it was expensive to produce and there were alternatives to produce, for example, stocking for ladies which were made in silk. With WW2, because silk was not available anymore (as the main producers were countries in South-East Asia such as Japan or China, with which US did not have a good relationship), they were basically forced to use nylon even though it was more expensive
- <u>*Novo Nordisk*</u> (is an example opposite to the previous two companies) -> this is a leading chemical company established in Denmark which developed obesity drugs. This company is owned by a committed owner, a Scandinavian foundation focused on innovation, social purpose, long-term thinking and financial success

William Lazonick -> <u>US companies have prioritized *distribution of dividends* to shareholders and *stock buy-backs*</u> -> in both cases you give money to shareholders (“*downsize-and-distribute*”), which is a general trend which is opposite to the strategy of “*retain and reinvest*” (such as Pfizer -> the company has conducted buybacks until 2000s, they decided to stop and focus more on innovation -> allowed them to have a leading role, alongside BioNTech, in producing a vaccine for Covid-19 when the pandemic swept round the globe). In terms of strategy there are always critical moments, where you need creativity and shifts. <u>Top executives need support of rule makers</u>, such as *middle management and investor relations*. Short-term can destroy existing capabilities and hinder capability of CEO/executives to proceed in the process of innovation.

The «shareholder value» principle

What are the origins of the SHV? <u>Today</u> (2019-2021), the leading US companies are supportive of a <u>«stakeholder oriented» approach</u>, putting a minor emphasis on the principle of «shareholder value maximization». Two pillars: *shareholders' «equality»* (one share-one vote) and *shareholder primacy* -> the shareholder primacy coincides with the shareholder value (SHV) creation «golden rule», and is still a guiding principle (for instance, in the case of institutional investors) with a very deeply rooted philosophy.

The SHV principle dates back to the 1970s -> usually, in order to say when the SHV principle has been introduced, we refer to M. Friedman, "*The Social Responsibility of Business is to Increase its Profits*", The New York Times Magazine, 1970, which affirms that the **social responsibility of a business** is to *make profits for shareholders*. Friedman's article was a critique to the behaviour of US top management in a phase of the history of the US capitalism characterised by an *intensive, short-sighted value destruction* -> they gave themselves the right to pursue this goal because they were dominant all over the world. How can be value destroyed? Some (interesting) lessons from 1970s America,

Typology	1949	1954	1959	1964	1969	1974
1. Monobusiness	42,0	34,1	22,8	21,5	14,8	14,4
2. Vertically integrated	12,8	12,2	12,5	14,0	12,3	12,4
3. Multibusiness (one dominant SBU)	15,4	17,4	18,4	18,4	12,8	10,2
4. Multibusiness (related diversifiers)	25,7	31,6	38,6	37,3	44,4	42,3
5. Conglomerates	4,1	4,7	7,3	8,7	18,7	20,7

In the 1970s companies, in particular the biggest ones, were behaving in the way of **destroying the value** -> not in the sense that profits were not distributed but reinvested in the company, but in the meaning they were underperforming (in the sense that they could have potentially done better, even though they were profitable companies). From the table, the trend we can spot is a *significant reduction in the mono-business companies* (such as Boing) and a significant i*ncrease in multi-business companies with a related diversification* (such as Dupont) and *conglomerates* -> the "*destruction*" was the consequence of a widespread strategy of non-related diversification undertaken by the largest US companies starting from the mid-1960s.

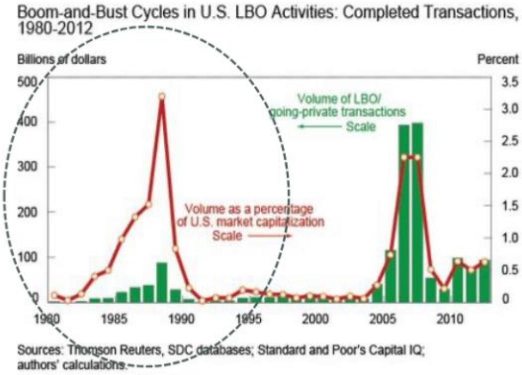
The **reasons** for this non-related diversification were many, among which:

- The *countercyclical strategies of top management*, willing to keep high ROA and ROE (at the corporate level) in a phase of structural stagnation and competitive challenges -> The US were the most relevant companies all over the world, but they were challenged by European and Japanese companies -> when you start losing market shares and become less profitable, a strategy is to diversify by buying out companies that are already doing well in a new sector (such as companies producing cookies that enters in alcohol and cigarettes) in order to compensate the business that is underperforming.
- The *prevailing remuneration strategy of top management privileging both returns and "size"* (market share). Managers are remunerated with a *fixed amount* + *variable amount* (which is the most significant part of the remuneration) -> the size of the company was directly correlated to the remuneration plan 50 min
- The development of *management techniques of purely financial nature* (returns) enforced by the instruments forged by consulting companies (e.g. BCG relative market share Matrix -> it was very easy to understand, in particular for CEO that are simple people, but it was a dangerous matrix, because it tells you to invest/disinvest based on pure financial results and not of culture)

Conglomeration strategies are in general justified by a management-driven strategy of risk-diversification in *situations of institutional/normative voids and market failures*. Also, can *effectively* *promote a better internal allocation of financial resources*. However, their management can be problematic, resulting in a *corporate value inferior to that which can derive from a corporate break-up* -> shareholders were happy for a short period of time, based on a significant level of trust on management caused by the absence of several information that, after several years, are mandatory to publish (such as strategy, financial returns, dividends, EBITDA…). On average, the so-called "**conglomerate discount**" amounts to about *one third of the (theoretical) corporate value*. In the end, they demonstrated to destroy more value than the one they were able to create (conglomerates are still present today because in specific cultural context, such as in Japan, they are a very wide used structure).

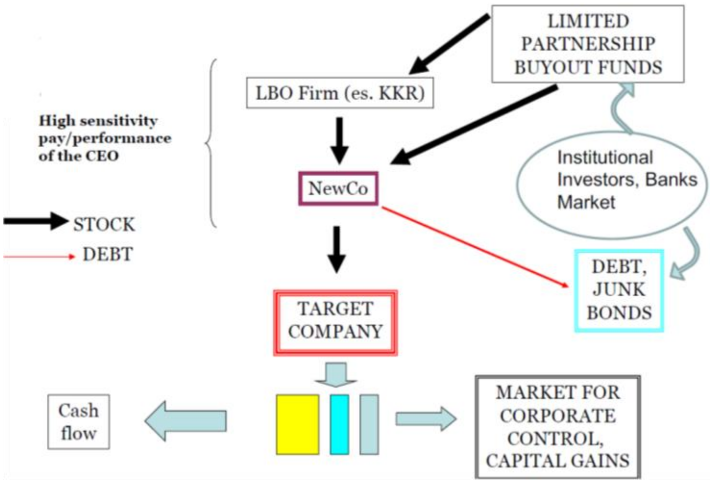
The revolution of the 1980s

When does the SHV obsession come from? As a consequence, between the late 1970s and above all during the 1980s the number of **Leveraged-Buyouts (LBO)** starts to increase involving large market caps. This is a practice by which a company decide to take over a company by using financial resources of other financial institutions. When the LBO regards a *conglomerate*, once they have obtained the control, it was common to break it down into different companies, in order to protect the value that would have been eliminated with the conglomerate. This practice is *usually a good move* (in particular in case we have a star company), *unless the companies that compose it are dogs* (as it usually leads to layoffs).



Sources: Thomson Reuters, SDC databases; Standard and Poor's Capital IQ; authors' calculations.
Note: *LBO* is leveraged buyout.

The basic principle is that a (listed) target company, *undervalued by the market* but with some potential value and assets can be taken over by an (hostile) bidder. The bidder is endowed by financial resources (debt, bonds, equity) in part *granted by the assets and cash-flow of the target*. Of course, all the financial resources involved in the transaction are *«high-risk» rated* (junk bonds, because companies that were conducting the LBO were promising high returns. Usually, when companies issue a bond, they promise at least the capital but also the interest).



Perfect targets of LBOs were *conglomerates discounted by the market but with good assets, quite acceptable cash flows and with a medium-low level of indebtedness* -> once a company was able to convince banks and other financial institutions to raise the resources for conducting these operations, it was possible to generate new resources. LBOs have been negatively seen by the public opinion (financial engineering, lay-offs, restructuring) but can be an efficient way to «recreate» the value «destroyed» by the conglomerate discount.

LBOs require:

- An *efficient market for corporate control*
- The *willingness to maximize a «hidden» value for shareholders*

- An *efficient management of the companies after the takeover and the break-up,* in order to maximize the value for the bidder (and for other shareholders)
- *Effective instruments to promote the alignment of the interests* of managers and shareholders, such as the stock options
- The «LBOs season» shows also the *relevance of institutional investors*, and in particular of pension funds, among the main providers of financial resources for the bidders

Institutional investors and Corporate Governance

Institutional investors reading

The reading analyses how large institutional investors, **BlackRock, Vanguard, State Street, and Fidelity**, have evolved from *traditionally passive shareholders* into *active corporate governance actors,* exercising substantial influence through proxy voting, engagement with management, and independently developed stewardship guidelines. Their growing ownership concentration means that *shares now "weigh" more than they "count",* reshaping governance outcomes in public corporations.

1. Rise of Institutional Investor Power

- Institutional ownership of U.S. public companies rose from 32% in 1980 to 73% in 2017, with the top 100 institutions holding over half of total equity.
- Major asset managers increasingly engage directly with firms, rather than relying solely on proxy advisors, and have developed *in-house voting guidelines to fulfil fiduciary duties*.
- Empirical research shows that even "passive" investors meaningfully affect governance via large voting blocs, contributing to more independent boards, fewer takeover defences, and reduced unequal voting rights structures.

2. Engagement Mechanisms and Incentives

- Institutional investors use both "voice" (engagement) and "exit" (threat of selling) to discipline management, with effectiveness depending on ownership size, coordination among investors, and governance context.
- Incentives to engage are economically meaningful: a 1% increase in firm value can translate into significant additional management fees, justifying investment in governance efforts.
- Engagement tends to substitute for hedge fund activism, particularly in large firms.

3. Governance Best Practices: Areas of Convergence

Despite stylistic differences, the four investors broadly agree on several core governance principles:

- **Board Structure and Independence**
    - Majority-independent boards are universally required. All favour independent audit, compensation, and nomination committees, though with varying strictness.

    - Strong opposition to over boarding, with limits on the number of boards directors may serve on. *Preference for annual director* elections over staggered boards, due to their antitakeover and entrenchment effects.
- **Shareholder Rights**
    - General opposition to *poison pills* and *antitakeover devices*.
    - Support (with variations) for proxy access, typically allowing shareholders with ≥3% ownership for three years to nominate directors.
    - Preference for majority voting rather than plurality voting.

4. Key Areas of Divergence

ESG and Sustainability

- *State Street* and *BlackRock* explicitly integrate ESG and sustainability into governance, with State Street adopting systematic ESG scoring (R-Factor).
- *Vanguard* and *Fidelity* maintain a more shareholder-centric approach, addressing ESG primarily when it is financially material.

Board Diversity

- All support board diversity, but differ in prescriptiveness:
    - *State Street* sets explicit thresholds (e.g., ≥30% women and representation from underrepresented groups).
    - *Fidelity* and *BlackRock* endorse diversity with more flexible, principles-based standards.
- Academic evidence on performance effects is mixed, but diversity is consistently linked to improved monitoring behaviour.

CEO Duality (CEO–Chair Separation)

- All recognize the governance risks of CEO duality.
- *BlackRock* supports separation with flexibility if a strong lead independent director exists.
- *Vanguard* and *Fidelity* generally oppose mandatory separation proposals, favouring case-by-case assessment.

Unequal Voting Rights (Dual-Class Shares)

- Theory generally supports one-share-one-vote (1S1V) for efficiency and accountability.
- However, dual-class structures are acknowledged as potentially beneficial for innovation and long-term vision, especially at IPO stage.
- Investor positions diverge:
    - *State Street* promotes strict 1S1V.
    - *Vanguard* accepts dual class shares with sunset provisions.
    - *BlackRock* and *Fidelity* support recapitalization toward equal voting over time.

5. Executive Compensation

- All four investors emphasize long-term value alignment.
- Common principles include:
    - Opposition to front-loaded awards, excessive golden parachutes, and automatic equity increases.

    - Support for performance-linked pay, vesting periods, clawbacks, and transparent disclosure.
- *Fidelity* and *Vanguard* apply more contextual, case-by-case evaluations, while *BlackRock* and *State Street* use more structured frameworks.

Overall Conclusion

The document concludes that while BlackRock, Vanguard, State Street, and Fidelity share a common objective (*long-term shareholder value maximization*) they pursue it through distinct governance philosophies.

- BlackRock: principles-based, ESG-aware
- State Street: system-oriented, ESG-integrated
- Vanguard: pragmatic, case-by-case
- Fidelity: shareholder-centric, materiality-focused

Collectively, their influence has fundamentally reshaped U.S. corporate governance, making institutional investors **central architects of modern governance norms**, rather than passive owners.

Activist investors mount record number of attacks against companies

The article documents a **record surge in shareholder activism in 2023**, with activist investors launching an unprecedented number of campaigns against public companies worldwide. This escalation reflects declining share prices, tougher macroeconomic conditions, regulatory changes, and a **broadening pool of activist actors**, increasing pressure on corporate boards and executives.

Record Levels of Activism -> 252 new activist campaigns were launched globally in 2023, a 7% increase year-on-year and the highest level on record, according to Lazard. Targets ranged from underperforming firms to major blue-chip companies, including *Disney, Salesforce, and Starbucks*, indicating that even large-cap firms are no longer insulated from activism.

Geographic Expansion and Regional Dynamics -> Activism showed a *strong regional dimension*:

- Europe: 69 campaigns, with the UK leading activity; most demands focused on M&A, divestitures, or strategic restructuring.
- Asia-Pacific: 44 campaigns, driven largely by local hedge funds, with Japan a major hotspot.

Lazard attributes the rise in global activism to a “breakout year” in Europe and Asia-Pacific, marking a shift away from U.S.-centric activism.

Evolution of Activist Tactics -> Activists typically acquire minority stakes and push for changes aimed at boosting share prices, such as:

- *Board representation*
- *Asset sales or break-ups*
- *Strategic redirection*

While early activism relied heavily on public confrontation, much of today’s engagement occurs behind closed doors, though *high-profile proxy fights* continue to attract *public attention*. Companies are increasingly inclined to settle quickly to avoid prolonged proxy contests:

- Only 37% of successful campaigns lasted more than 90 days in 2023.
- 34% settled within one week, signalling faster escalation and resolution.

High-Profile Campaigns and Case Examples

- *Disney*: Trian Partners sought board seats, triggering one of the most contentious proxy fights in years between Nelson Peltz and CEO Bob Iger.
- *Illumina*: Carl Icahn pressured the company over its acquisition of Grail, culminating in a divestment.
- *Starbucks*: A coalition of labour unions (Strategic Organizing Center) launched a proxy contest over alleged human capital mismanagement, illustrating activism driven by non-traditional, single-issue coalitions.

Broadening Activist Base -> More than 40% of activists launching campaigns in 2023 were *first-time activists*, indicating a *democratization and diversification of shareholder activism*. Europe, in particular, saw a surge in new entrants following a *period of restraint* caused by *energy shocks* and *cost-of-living pressures*. This trend expands the range of stakeholder's boards must engage with, including investors holding relatively small stakes.

Structural and Regulatory Drivers -> Universal proxy rules (introduced in 2022) ensure all board nominees appear on company ballots. While they have not materially increased the number of board seats won by activists, they have:

- *Lowered barriers to entry*
- *Increased perceived threat to incumbent boards*

A resurgence of "wolf pack" dynamics has emerged, with multiple hedge funds independently targeting the same large-cap companies (e.g., Salesforce faced up to seven activists simultaneously).

Overall Conclusion -> The article concludes that shareholder activism has entered a **new phase of scale, speed, and diversity**. Activism is no longer dominated solely by a small group of hedge funds, nor confined to struggling small-cap firms. Instead, it has become a **systemic feature of modern corporate governance**, intensified by global economic pressures, regulatory changes, and a widening activist ecosystem. As a result, boards face heightened accountability and must be prepared for rapid, multi-front engagement with increasingly sophisticated and varied shareholders .

Definition

An «**institutional investor**» may be defined as a specialized organization which primary goal is to invest its own assets or assets/resources hold on behalf of others (individuals/families/other companies/organizations and even governments) to increase these assets' values and returns. The institutional investor derives its own profits from *its activity of asset management*. Profits (fees) are of course a *function of the amount of assets managed* and the *overall returns* -> talking about institutional investors is something extremely broad, as it includes very different entities. For example, if we consider a hedge fund, they have a *very short orientation*, they apply *extremely aggressive governance* and *actively critics to management*. On the other hand, a sovereign fund they have to manage the *resources given by the population*, so they invest for *long-term, safe return* (because they have to invest in the behalf of the present and the future generations).

There are several taxonomies of institutional investors:

- *Multi-lateral investors* (such as pension funds, endowment funds, bank trust department, insurance companies and sovereign wealth funds) -> they have a more diversified approach, regarding strategy, view, sectors and financial instruments used (not only equity, but also fixed asset, such as currencies)

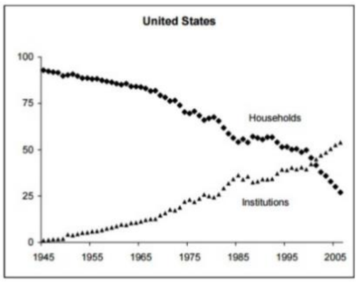
- *Equity market-driven investors* (hedge funds, mutual funds, VC and PE) -> these are investors that only invest in equity and are the kind of people that you can expect to have a more aggressive and activist behaviour, even though with different attitude (as now, for example, PE/VC have a more long-term view compared to hedge funds)

➔ Obviously, there are differences between countries

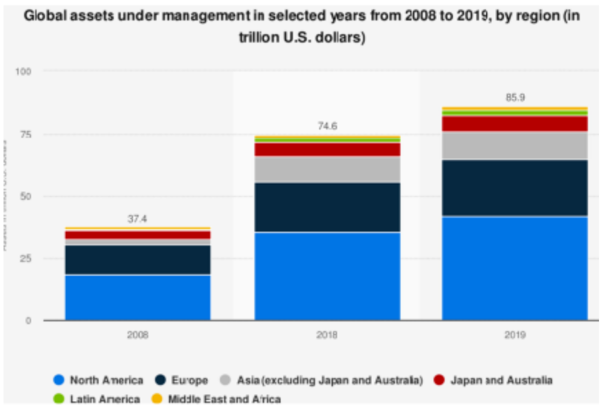
A growing relevance

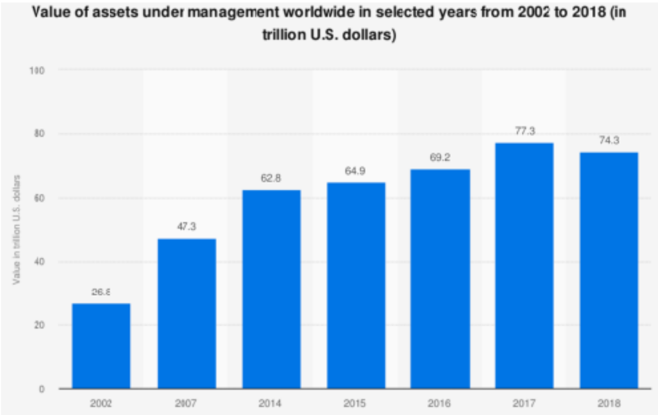
The relevance of institutional investors as agents investing on behalf of others (in particular in equity market) has been growing over time, with differences in different geographic contexts. Among the advanced economies, the US stock market is the first to be impacted by the presence of institutional investors (in particular during 1980s and 1990s), but now the presence of institutional investors is a *global phenomenon* (in particular between developed countries, with differences among them) -> institutional investors are a powerful force that drives the behaviour of companies and governments towards a source of homogeneity and, on the other hand, reducing the characteristics of local economies (for example, Japan has been resisting from the penetration of equity market from foreign multinational companies and institutional investors).

% of total equity in the US. Market hold by



At present, the institutional investors' AuM (Asset under Management) reach in total 70-75 $tn (depending on which category we consider together). Geographically, they are mainly concentrated in mature/advanced economies.

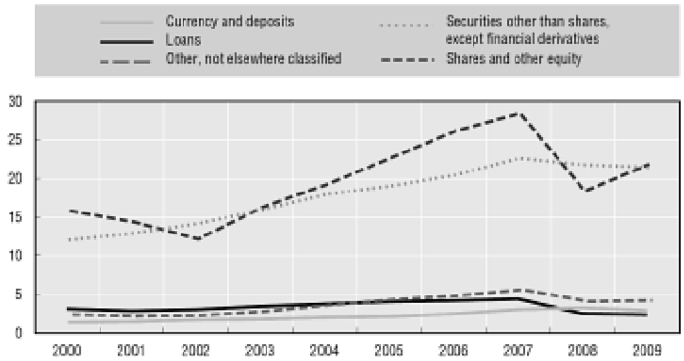




This picture can help us understand what we mean by multilateral investor. Obviously, equity and other securities (bonds) are the most relevant financial instruments, followed by real estate (which is included in the "Other" category) and currencies.

The reasons for the growing relevance:

Figure 1.3. **Type of financial assets managed by the industry (in trillion USD)**

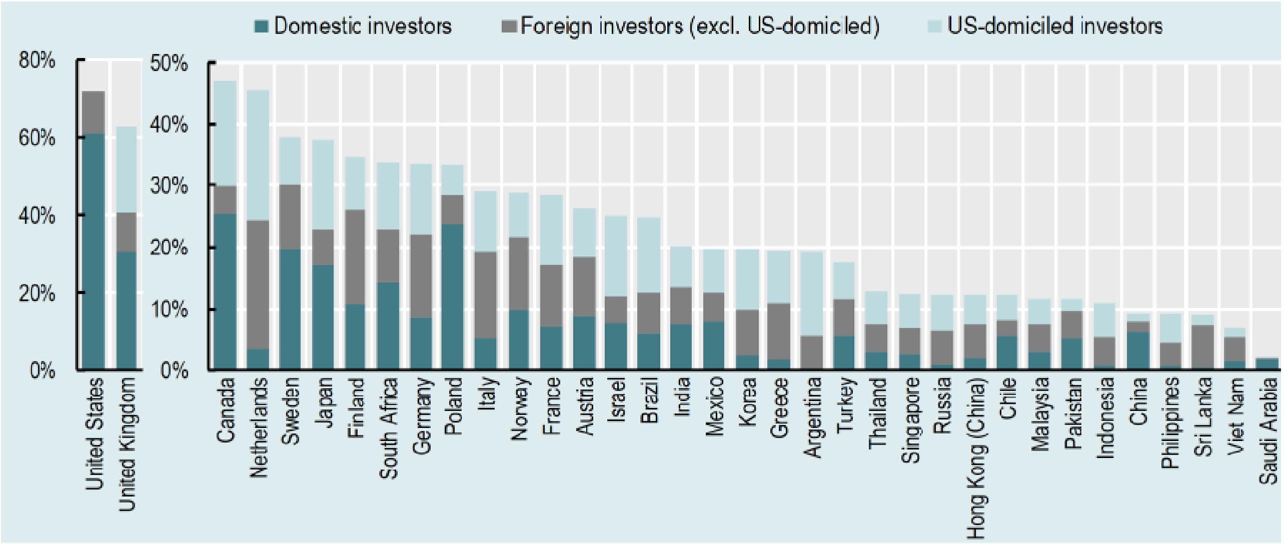


Source: OECD, *Institutional Investors Database* (http://stats.oecd.org/index.aspx).

1. *Population ageing and growing demand for cumulative pension programs, even in welfare-based economies* -> several systems have been built on the creation of pensions, in particular thanks to pension funds (which are strictly regulated, such as a limited amount of money you can invest in every asset category, and they tend to have a conservative behaviour) based on accumulation (which means that you become the author of your future). This system has been spreading in countries like Italy where the system of redistribution was in charge.
2. The reason at the previous point which *increasingly benefit of «specialized», ad hoc management of assets*, in order to maximise the return
3. A *favourable orientation of domestic legislations towards the funds' presence* -> not everywhere these investors had the possibility to operate -> for example, before 1980s it was not possible for mutual funds to operate in Italy
4. A *growing liberalization of capital markets and their globalization*
5. The *emergence of «new» typologies of institutional investors endowed by consistent resources* as for instance the Sovereign Wealth Funds -> they are growing in terms of number and geographical diffusion (in particular in growing countries, where they have several natural resources) and money spent -> they are an instrument of political economy, so the use of resources for political reasons, such as increasing the level of transparency in a system or a level of soft power of a country (for example, the fund own a company that can be useful in another country for building a new infrastructure, increasing the influence of the country that owns the Sovereign Wealth Fund)

Institutional investors find more difficult (or are less keen) to invest in systems where markets for operational control that are *less transparent or more volatile* -> for example, the cluster of emerging countries there is a lower penetration than the European countries.

If we see countries such as Italy/Germany/France/Austria... (which are not volatile and not much dangerous), the presence is less relevant than countries which are characterized by the Anglo-Saxon system -> this is caused by the lower presence of public companies and the higher presence of private blockholders that are controlling the company (such as families).



Institutional investors and conflicts

Institutional investors can be seen as harmful for society or beneficial depending by countries. The presence of institutional investors (in general) is at the basis of many possible (and simultaneous) principal-agent conflicts, as:

1) *Principal-agent*, when the institutional investor is the principal -> the institutional investors is equal to the other shareholders, and the manager extracting value from the company harms both of them
2) *Principal-principal*, when the Institutional investor clashes with a controlling shareholder regarding goal and objectives -> for example, a sovereign wealth fund, which is characterized by a long-term view with a low-risk expectation, and another fund, who would like not to spend money to R&D and distribute those money for the distribution of dividends to shareholders

Recently, more and more investors tend to adopt an **«active» behaviour** (so, not limitate the action of investors to hold the investment and disinvest when they are not in coherence with management), by means of different instruments of «moral» suasion over directors and other shareholders, as:

- *Informal meetings*
- *Press campaigns*
- *Voting campaigns* (involving other investors, based on reputation) -> example is asking the company to better promote the use of the tunnel that connects UK and France in order to reduce carbon emissions
- *Focus lists and rating systems*

What is the percentage you need to have in order to call the shots? If you own 50%, it means that you have control. If you own 20%, you have to register the equity investment differently from an accounting perspective. If you decide to purchase 5% of a company in a single moment, you have to declare your intentions. If there is a dispersed ownership, you have to invest a little bit more than the smallest owner -> it can be increased in case there is a coalition, but it is very unlikely.

THE EUROPEAN CONTINENTAL MODEL (FRANCE AND GERMANY)

Germany's model of worker-employer decision-making proves resilient

The article talks about the Germany's model of Corporate Governance which include workers in the decision-making process (for the company that have over 2000 employees must allocate half of the seats on the supervisory boards to worker representatives) and give very strong workforce law protection (generous parental leave, strict dismissal rules, flexibility, possibility to work part-time in the future...). In particular, regarding the possibility to make their voice heard, this is generally about topics connected to workforce (hours, hiring, remote working...), and it has been fundamental to balance the interests of employers and employees in a constructive way (differently from France, where the workers' representatives have played more in a competitive way).

It has been shown also that the German method helps companies to keep jobs and talented workers also in context of crisis or structural shifts in the different industrial sectors, such as the transition to electromobility, digitalisation and decarbonisation to remain globally competitive. All of these challenges are being addressed by including workers, because industrial transformation must happen "with workers, not against them". This should be made coherent with the traditional standards of job protection typical of German culture (same benefit written before + the possibility to think about themselves after time shifts end) and be coherent with new models of working (work and family [to] sabbatical, part-time models...).

A «different» capitalism: main features

In 1993, soon after the *end of the Cold War* and the *fall of communism*, it was over the ideological struggle between the model of capitalism and communism, which had a different role for society, individuals but in particular for companies (in a communist countries, companies and market did not exist, no marketing, no stock exchange...). Once the Soviet Union was over, one model of production remained and was resisting, which was the capitalist way of production (based on capital, means of production, work, profit...). In that year, a Franch journalist, Michel Albert, published an influential book about the **European Continental vision of «capitalism»** (and its relationship with society), based on markets, labour, investments, profit... If we look at the largest companies in the end of 90s, they all follow the capitalist structure, but they are not all American, as it is possible to notice some European or Japanese companies -> these companies have different models of Corporate Governance (in terms ownership structure, governance behaviour...).

Albert pointed out the **radical differences between the «Reinisch»** (he used this term in order to include both France and Germany) and **«Anglo-Saxon»** version of capitalism:

- *Community vs. individual* -> while the US capitalism is largely based on *individual success* (we might substitute this with shareholder-centred), the European tradition is about *collaborative*

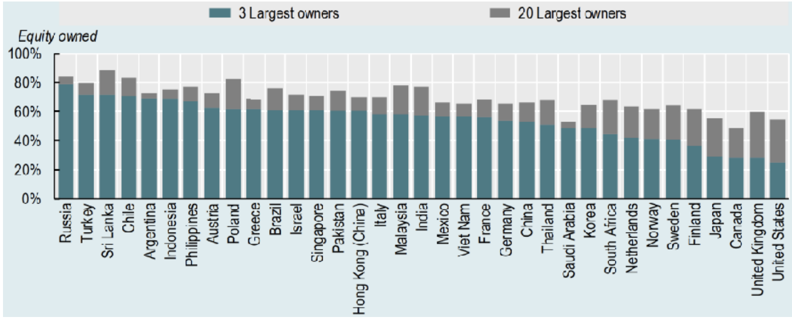
capitalism (so something for the common good. We might substitute this with stakeholders-centred)
- *Continuity vs. change*
- *«Tradition» vs. innovation* -> the high rate of breakthrough innovation is directly connected to the presence of Anglo-Saxon system
- *Long-term vs. short-term* -> in the Anglo-Saxon way it is more common to have companies that are *short-term oriented* (because of compensation structures, the activism of institutional investors, the market discipline, the dispersed ownership structure...) while the European companies are more *long-term oriented*
- *Cooperation vs. pure competition* -> this can be seen at level among companies. The antitrust in US has started to operate only in 1891, while in Italy in 1970s -> the presence of cartel (a collaboration between companies in order to set common standards, split precisely the market, set the prices), that today is illegal according to European rules, has been tolerated and sometime incentivised. The problem of cartel is *the presence of a monopolies/oligopolies* and the *higher prices for consumers*, but at the same time it is *possible to plan in the long-term*, as it allows you to know how much you have to produce and you are forced to innovate in order to become more efficient

These different views had (have) of course **an impact on ownership structures and governance «practices»**:

- *Concentrated ownership* (compared to the Anglo-Saxon system, there is a relatively lower number of public companies, so companies where there are no shareholders exciding 5% of share capital): there are several types of blockholders (so entities that not only exceed the 5% limit, but their control is justified by a control of shares above 10%, such as individuals, families, State, with the States are becoming increasingly aggressive by increasing the stakes, having a stronger control and buying back companies that were previously privatized -> might increase the principle-principle agency problem), thanks to the presence of Control Enhancing Mechanisms (CEMs), which allow a shareholders to increase the level of control in the company with a limited investment of capital (a sort of leveraged control), such as *dual class shares* (different categories of shares), *loyalty shares* (it has been reintroduced in many European countries, which in some cases can allow a single individual to double the power in a company if you keep the shares for a long time), *pyramidal groups and cross-shareholdings* (which is a system to avoid takeovers)
- *The prevalence of Bank finance over the Stock Market* -> numbers are changing but it is still relevant. This is because today in Europe the Stock Market is basically made of banks, which differs from the industrial base of the European economies because of the size of companies. In addition, traditionally banking systems have been chosen by large corporations for financing their projects.
- *An inefficient market for corporate control* (low number of takeovers) -> The relevance of the banking system for the financing activity and the concentrated ownership has lead to a low number of takeovers (in 55 years in Germany there have been just 3 registered hostile takeovers).
- *«Stakeholders' Capitalism»: Co-determination*
- *The Board's structure: Two-tier Boards and CEO duality* -> CEO duality is still present in several countries even though OECD general principles suggest eliminating it.

Ownership Concentration

Continental European capitalism is characterised by a *high degree of ownership concentration*. The high level of ownership concentration still holds as a structural feature which, notwithstanding the *ongoing reforms and pressures* from institutional investors, is still in place, due also to some "*political decisions*". For instance, the Florange Law in France (2014) which allows (when the qualified majority at the AGM is not against) to shareholders who keep a company's shares in their portfolio for more than 2 years, to double their voting rights. A similar mechanism is active in Italy since 2014. Loyalty and dual-class shares are *mostly diffused in Northern and Southern Europe*. If we see the table, it is possible to notice how in European countries the percentage of equity that is controlled by the 3 largest owners is always above 50% (most of the time reaching easily 60%).



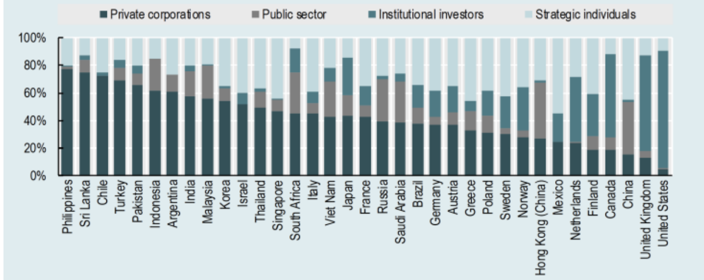
Ownership structure

As far as the "nature" (typology) of blockholders is concerned, recent research shows the persistence of categories consolidated in the Continental Europe's tradition, that is:

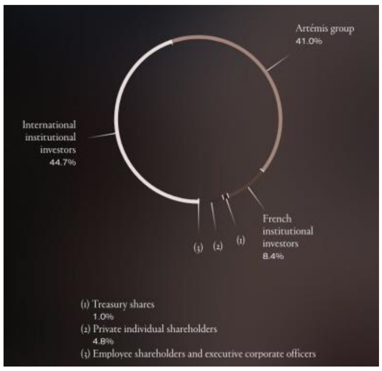
- *Families/individuals* (via direct ownership and/or holdings) as main controllers is something that characterise basically all European countries
- The *State* (in particular in France, Italy and Spain. Because of the Federal structure, it is less common to find it in Germany) once was quite pervasive, now still present in some strategic industries
- *Banks* (still very relevant blockholders in Germany) through proxy voting
- *Other companies via Business Groups* (Everywhere)
- *Foundations* (typical of Scandinavian countries)

Figure 10. Category of the largest investors at the company level

The figure shows the category of the largest investor in each market. For example, in Chile 7 out of 10 listed companies have a private corporation as the largest owner. Data refers as of end 2017.



Institutional investors (domestic or international) are increasingly present even if to a still minor extent than in Common Law countries. For instance, pension and mutual funds today control more than the 50% of the capital of the CAC (Cotation Assistée en Continu), which include the 40 largest listed French companies. If we take the example of the group Kering, we can see that institutional investors holds the absolute majority of shares, but in reality the controller of the company is the holding Artemis group (which, thanks to multi-vote shares, have the 58% of direct ownership of the company) -> typical structure of European large groups. In addition, if we look at the structure of Artemis Group, this is owned for more than 50% by the Financiere Pinault, which is a holding company that allows the Pinault family to own the Kering group and exercise its power over it.



Is corporate governance a state affair? From Colbert to the privatisation process of the 1980s

The **State** has always not only played a key role in the French economy, but also a highly active role in promoting economic development. The period of *royal manufacturers* lasted until the *second part of the 18th century*. Altogether, *more than twenty companies were established*. The literature considers most of them as the first example of State-owned companies, and their directors as the first managers of modern times. The man who symbolises this culture is certainly Jean Baptiste Colbert, the Minister of Finance under King Louis XIV. Colbertism became synonymous with state intervention.

In the early 1970s, there were **four kinds of companies** among the top 200 French firms: *family-owned firms; those under foreign control; the rest were a mixture of state and technocratic firms*. However, there was some confusion about the relationship between ownership and management. In the State-owned or State-controlled companies there was *a combination of different choices and values*. The *SNCF* (French state-owned railway company) was *highly politicised* and its *business logic and aims were mixed with social objectives*. The composition of *Picheney's board* (chemical French firm), originally based the *on technocrats, add progressively changed to include lawyers and representative of ministers*.

The governments veto power over *transactions with foreign currencies* de facto represented a powerful *instrument for blocking any foreign takeover bid*. In 1986, the elections of the Assemblée National, the French parliament, gave the majority to the centre right parties. The new Prime Minister privatised many, but not all the companies that had been nationalised in 1982. That privatisation programme continued after 1988. The discussion about corporate governance that started in those years in many Western countries had an influence on these events. Since the approval of the corporate law in 1967, the French firms had a choice between the one tier and two-tier systems, but there was never a discussion about this topic, and de facto all French companies were using the one tier system.

The French State firmly controls some strategic companies considered to be of «*national interest*» (national champions, such as communication, energy, defence, transportation…). Control is in general *partial* (below 50% thanks also to the Florange law, usually around 28%) and the State is frequently *sided by institutional investors*. The State's control is exercised by vehicles such as *banks, holdings and agencies* (for this factor, France and Italy are very similar) as for instance the Caisse Depot et Consignations, Agencie Participations de l'Etat, Banque Publique d'Investissements.

The evolution of the ownership structure, the PDG, and the new corporate governance

In contrast with the situation in the 1970s, in the late 1980s the **cross-shareholding system**, together with interlocking became the most popular instrument for keeping control of companies. The share of foreign ownership is impressive: between 1985 and 1997, foreign owners have increased their share of Stock Exchange capitalization from 10% to 35%. The so-called Comité Viénot published its report in 1995: it was 20 pages, compared to the 91 of the Cadbury report and the 59 of the Greenberry report. What was surprising was that the French document dealt with broader issues: *representation of the employees, the shareholders' employees, and the minority shareholders in companies with a block holder, and without a controlling shareholder*. The document highlighted the most relevant tasks of the board of directors, but its main point was a proud defence of the role of *the President Director General*, known in France as PDG. This function combines the function of a chairperson of the board of directors and the CEO. The document indirectly criticises the Cadbury report on affirming that the dissociation of function was not a panacea. The responsibility for mistakes depends on the person, not on the function. The report confirmed that the 1940 law, unifying the two roles, was a response to many mistakes and dysfunction of the past.

One year later, in 1996, there was another Commission, which produced the Marini report, but focused on the *modernization of company law*. In 1999, Viénot chaired another Commission to answer some questions from the Minister of Justice, which had proposed to separate the office of chairperson of the board of directors from the office of chief executive officer. The new report approved this proposal, and it added some recommendations about the disclosures of the compensation.

The consequences of the Enron scandal in the USA, including the role of their audit company Arthur Andersen, provoked a new debate in France: the question concerned **whether to reinforce financial reporting and internal control**. The Bouton report was the first complete programme for better corporate governance in France. Its focus on *transparency, ethics, and recommendations for the financial code was accompanied by many suggestions for internal control procedures*. During the following years, there were several amendments of the code. The first one occurred in 2010, when the *gender issue was finally introduced* -> it established an obligation to have a minimum of 20% women in the board in the next three years, and at least 40% in the next six years. The new code introduced the following: an *advisory vote on executive compensation, the reinforcement of the comply or explain principle, the restriction of the number of offices for executive directors, and a deeper transparency of multiyear variable compensation*. Still another version of the code appeared in 2016. It resulted from a very innovative system: public consultation throughout a website instead of again setting up a new Commission. The most important recommendations specified the mission of the board of directors, which should focus on promoting long term corporate value creation by considering the social and environmental ramification of its activities.

Protecting minority shareholders, or favouring long term investors? The French dilemma

According to the law, a **takeover bid's validity** is confirmed only if the offer wins over most of the shares and the voting rights, without counting the shares and the voting rights already in possession of the takeover company. The Florange law, which came into force in 2015, introduced automatic double voting rights for *shares that had been held by a shareholder for more than two years in registered form*. Prior to the new law, companies were free to offer this privilege according to their bylaws. Now, for the listed companies, the double voting right is automatic *unless differently established in the bylaws of the company*. It is possible to opt out, but to do so, it is necessary to get the approval of their shareholders meeting, with a *majority of at least 66% of those with voting rights*.

Many commentators stressed that the French State was the biggest beneficiary of this regulation, because it could *reduce it shares without reducing its voting rights*. On the one hand, those firms that adopted the double voting rights, particularly those with a large block holder, experienced negative reaction from their foreign institutional shareholders and an increase in the cost of capital relative to other firms. On the other hand, the market has reacted positively to successful opt out votes.

The State as Owner in France

We have to keep in mind that the strategy States have been applied for the control in strategic sectors has changed significantly. During the previous century, most of the State companies were inefficient, politically driven and corrupted, driven for the sole purpose of employment and owning 100% of the companies controlled (there were very rare cases where this was not the case). The new model of State control is significantly different:

- The State controls a limited amount of the companies (as we said before, it is difficult to go above 30%)
- Managers are usually not politically appointed (or, when they are, they are very good)

As we said before, it is more common that States want back the control of several companies operating in strategic sectors. The reason behind it is that the States want to avoid the complete privatisation and the control to be moved completely to countries that might be hostile to the home State (such as China wanting to control European companies).

In **France** since the mid-90s, the entrepreneurial associations e.g. Mouvement des Enterprises de France(MEDEF) and Association Française des Enterprises Privées (AFEP), the club of the largest private corporations, support the publication of **Codes of best practices in Corporate Governance**. The most recent is the AFEP-MEDEF Code (version 2018): a summary of the Best Practices concerning the duties of directors and of the committees. AFEP/MEDEF on Board Structure:

- Board: Monistic/Dual (elective)
- Separation of roles – President/CEO (elective)
- Independent directors (50% threshold in the case of public companies with diffuse ownership, 30% in the case of concentrated ownership)
- Audit committee (compulsory by law), Nomination and Remuneration Committee (recommended)

At the very origins of the German model

Germany's economy is today the largest in Europe and the fourth in the word. The **economic development** of the country was intervened with the second industrial revolution and with the emergence of new capital-intensive industrial sectors. The acceleration of the process benefited from reinforcement by the state after the completion of the unification process, and by the policies implemented by the ruling classes. The so-called *marriage between rye and iron* (names for the great agricultural states of the Prussian region, and the cool and metallurgical interests of the Ruhr) was cemented by the *military technocracy*. As the country developed, these sectors became more important and influential, and the nationals' industrial firms became bigger. With the passage of the first **German corporate law in 1870**, there was the unification of the different corporate legal systems in the German states at the time. Among the most important aspects of the law was the *prohibition of dividend distribution* by the Aktien Gesellschaften, the public stock companies. The same law mandated the *creation of two-tier system of governance*, based on the Aufsichtsrat (supervisory board) and a Vorstand (executive board). Minority shareholders not only *kept their rights* but even *increased them*. They could now *bring an action against persons legally responsible for the company* based on having only 10% of shares instead of 20%.

The bigger the companies became, the smaller was the presence of small shareholders. The most relevant and obvious point was the increasing role of the banks among the shareholders. This was true only in certain particular sectors. The coal, iron, steal, heavy mechanical, electromechanical, and the transportation sectors were the most involved in this process.

After World War I, the very confused situation of the country led to a *couple of years of substantial risk of a revolution*, and *constant social and political the stabilisation*. This pushed forward the tripartite arrangement, which came from the war experience, *an agreement between the State, representatives of the industrialists, and the labour unions*. This was later ratified by the Parliament and permitted the creation of worker councils at companies, which were established by the new constitution of the Weimar Republic, and gave employees the right to nominate one or two members to the supervisory boards.

The **Nazi regime** abolished this practise. The entire economy was based on the Fuehrerprinzip, that represented the Nazi concept of personal leadership. In the companies the result was very endorsement of the power of the Vorstand, also from a legal and formal point of view, the supervisory board continued to exist.

Germany between ordo-liberalism and Mitbestimmung

After World War II, **the workers councils** were re-established, thanks to the agreement between the German unions and the British military authorities is controlling the northwestern part of the country. Slowly over the 1950s, first in the coal and iron industry, this model of industrial relations came into effect, but it was *not clear which kind of companies had to follow this rule*, which other kind of companies were just suggested or were free to adopt or to reject it.

The *choice of liberalism* in economics was accompanied by the introduction of strong political institution supervision. The **State** functioned as a sort of referee -> the only party authorised to *put all the economic and social actors in the same competitive position*. The chief result of this culture approach was the progressive establishment of Soziale Markt Wirdschaft, a system permitting the cohabitation, and even the merger, of the principle of economic liberalism with the ideas of social equality.

However, the government and the parliament approved a **new corporate law in 1965**. Its aim was to encourage the firms to access the stock market instead of relying on the traditional relations with their banks or using their own financial resources. The law modified the previous situation by again giving more power and influence on the supervisory board. The most important reform concerning corporate governance came in the 1970s. In 1976, the parliament passed the Mitbestimmungsgesetz, the co-determination act. Now, in all the AG, between 30% and 50% of the seats of the supervisory board were to be allocated to representatives of the unions. The law is compulsory for all the GmbHs with more than 500 employees and for all the stock corporations (AGs). In companies having between 501 and 2000 employees, including the public stock companies, the private limited liability companies, and others, the shareholders representative occupied two third of the seats and the employee representative one-third. Between the 6 and 21 nonexecutives, compose the supervisory board.

Towards the code of corporate governance

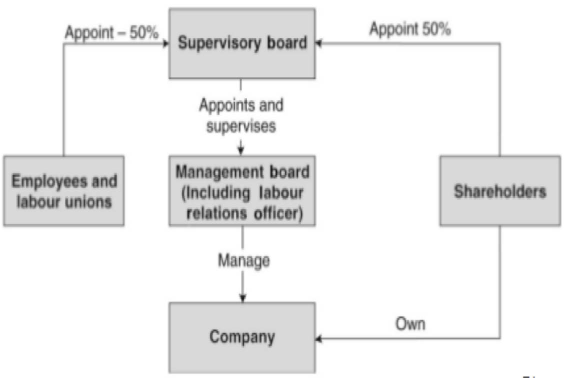
In 1999, the German Bundestag past the Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), the **Law on Control and Transparency in Business**. It specifies and extends the provisions of the German Commercial Code and the stock corporation act. KonTraG extended the liability of the management boards, supervisory boards, and auditors in the German companies. The law requires the *publication of reports on risk and the company's risk structure in the management report of the company financial statements*. The other critical issue is the introduction of *more formal contracts between the supervisory board and the auditors*. The Aufsichtrat is now the representative of the company. Finally, the law introduced *improved condition for the shareholders* through the emanation of a *multiple and equal voting rights*, and the *facilitation of the claims against members of the Vorstand and Aufsichtsrat*, as well as establishing *some minor rules concerning proxy* *votes by the banking institutes*. Additionally, the law requires the supervisory board to appoint the auditors, to receive the audit reports, and to include the auditors in the board's balance sheet meeting.

Proxy voting in Germany

The high degree of blockholders traditionally characterising the German capitalism (even though it has spread also to other countries) has been until recently the consequence of the widespread use of the "*proxy vote*" (the possibility of separating the administrative right from the voting right of the share -> it gives the possibility to possess the share and exercise the administrative rights while leaving the cash flow right to the owner of the same share). "Proxy voting" was (and is) exercised mainly by the main Banks of the country, but it is more spread. Besides their role of lenders, banks had also a relevant influence as "indirect" shareholders. Now all CG codes prescribe to banks to *disclose the ownership and the potential vote as a consequence of proxy votes*, which has been something added recently -> before it was not required, which made this information not available to the public and made takeover more complicated. This (together a wide presence of control enhancing mechanisms as pyramidal groups and multiple-voting shares) *reduced dramatically the efficiency of the market for corporate control* (see Pirelli vs. Continental -> we are in 1992, Continental is a Germany mid-size company specialised in a segment of the market -> during 90s' because there was a slight decrease in the market of automotive, the tires was suffering a crisis, which cause a consolidation in the sector in order to rationalize the production -> in Europe, a try has been tried by Pirelli in order to fuse with a complementary company in order to conduct an efficient takeover. Pirelli thought that the majority of shares were owned by retail companies -> Pirelli collected money by several players in order to start buying shares -> once they reached 35% of shares, they found out to be the smallest within the owner of the company, as the representatives of the three biggest banks in the company owned thanks to proxy vote slightly less of 65% of the capital. After discovering this situation they had to sell the shares they bought for repaying companies that financed the operation, making Pirelli lose huge amount of money).

Stakeholder Capitalism: Co-determination

The Continental version of capitalism is still today characterised by a strong emphasis on internal consensus and stakeholder protection (in particular for workers), leaving less protection to shareholders (like it happens in Anglo-Saxon countries) -> the so-called «*Social Market Economy*». An extreme version of this is the co-determination principle in Germany. In 1976 the co-determination (the *presence of employees' representatives inside the Board* -> this is the way by which workers protect their interest, different by the strike method used in Italy and France) is introduced by law in *all the joint-stock companies (AG) and limited liability companies (GmbH) with more than 500 employees* -> companies with more than 2000 employee is compulsory to have 50% of the Supervisory board composed of representatives of the employee. The philosophy of co-determination is to *frame the actions of the management boards* (both supervising and executive) in a consensual relationship among the main stakeholders and labour, because the company belongs to both of them.



Towards a modern Corporate Governance

By the end of the 1990s, following a general trend in developed economies, it was undertaken a first wave of normative actions in the area of CG, aimed at increasing transparency and directors' accountability. In Germany: the **Cromme Committee o Kodex (German Corporate Governance Code)**, which came into effect in 2002 and has been updated until 2019 with gender quotas.

Main elements:

- *Dual structure confirmed*
- *Comply or explain*
- *One share one vote* (in principle, exceptions to be motivated)
- *Pre-emptive rights* (right of shareholders to acquire new shares)
- *Duties of management board members/supervisory board members and remuneration policies*
- *Conflicts of interest to be disclosed*
- *Committees inside supervisory board*
- *Regulation of proxy vote* (not forbidden but subject to full disclosure)

The difficulties despite the long tradition: scandals, institutional investors, and German corporate governance

A study published by the Economist in 2009 affirmed that 83% of German managers survived in 1995 considered that the companies they worked for belong to stakeholders rather than shareholders. Some 60% said that saving jobs was more important than paying dividends. In this respect, all the conditions existed for increasing frictions between the management, the supervisory boards, and the shareholders.

In the following years, **many scandals** damaged the image and the reputation of many German companies. A series of Siemens scandals between 2007 and 2015, all of them based on bribes paid to get lucrative contracts in Greece, Italy, China, and Kazakhstan, provoked deep changes in the management. Siemens' first reaction was to claim innocence and to blame events on a small criminal gang. The reality was quite different: when calculating the cost of a project, Siemens' employees included nuezliche Aufwendungen, a common tax term which in English is translated as *useful expenditures* -> everybody in the company knew that the expression meant bribes. This scandal provoked a huge reaction among Siemens' small shareholders. The leaders of the company tried to calm down the critics with an extra dividend. Additionally, the company tried to dispel the negative atmosphere by nominating Gerhard Cromme as the head of Siemens.

Volkswagen put the quality and the performance of German corporate governance model at risk at least a couple of times. The so-called **diesel scandal**, that was first discovered in the USA in the second half of 2015, and later in Europe, concerned about 10.7 million cars that were equipped with a software that cheated on emissions tests: they emitted up to 40 times the permitted level of nitrogen oxide. Despite all their declarations of innocence, the CEO and many other top managers were accused of misconduct and charged with the responsibility for this crime. The reputation not only of Volkswagen, but of the entire German manufacturing industry, was at risk. Even counsellor angle Angela Merkel was suspected to have had some knowledge and to have hidden it. The cost of the scandal for the company was very dear: Porsche paid 535 million of euros for negligent violation of supervisory duties. This fine came one year after for €1 billion by the public prosecutors in Braunschweig. In the end, the diesel scandal costed the company about €25 billion.

However, the **situation is improving**. A study has shown that in 2003 the average supervisory board member at a public company sat on 1.9 boards, that figure decreased to 1.6 in 2014. This means that a *new generation of supervisory boards has new members emerged*, which is more active, and more committed to its important job. Some of the pillars of German corporate culture are changing. The *role of the banking system is no longer the same*, and the *rules governing the mechanism of the proxy vote have been improved and based on more transparency*. Thus, banks must inform customers that they may choose to have their voting rights exercised by the bank or by a shareholder association. In addition, a bank must inform its customers when it holds 5% or more both of their voting rights if the company is listed, or if the bank was a member of the company's most recent underwriting syndicate. Finally, the bank must also advise customers in the case that one of its managers or employees is a member of the management or supervisory board of the respective stock corporation.

JAPAN: TRADITION AND MODERNIZATION

Landmark Toyota deal sets back Japan's corporate governance pitch

The article argues that Toyota's $33bn take-private of Toyota Industries (TICO) has undermined Japan's narrative of corporate governance reform, reviving concerns about minority shareholder protection, conflicts of interest, and opaque valuations. While Japan has made real progress toward shareholder-friendly governance, this deal exposes how legacy group structures and relational governance still dominate in critical moments, damaging investor trust.

Context: Japan's Governance Reform Narrative -> Japan has spent the past decade promoting a **governance turnaround**, marked by:

- Introduction of stewardship and governance codes
- Reduction of cross-shareholdings
- Rising shareholder proposals
- Gradual consolidation of corporate groups

These changes were intended to signal convergence toward **Anglo-Saxon governance standards**, especially improved minority shareholder treatment. The Tokyo Stock Exchange's leadership was preparing to market this progress to global institutional investors, until the TICO deal intervened.

The Toyota Industries Take-Private Deal -> Toyota Industries is being taken private via a **complex group-led transaction**:

- Led by Toyota Fudosan (a private Toyota group company)
- Partly financed by Toyota Motor
- With Akio Toyoda personally investing, while simultaneously chairing Toyota Motor and Toyota Fudosan

Toyota Motor and affiliated entities already own **42.3% of TICO**, reinforcing control. The transaction structure (outlined in the chart on page 3) highlights:

- Intricate intra-group financing

- Limited checks from independent third parties
- Structural power asymmetry vis-à-vis minority shareholders

Minority Shareholder Concerns -> The deal has triggered **"bad-old-days" governance complaints**, including:

- Low takeover premium: ¥16,300 per share, a 23% premium, compared with investor estimates above ¥20,000
- Opaque valuation methods, particularly regarding TICO's under-valued real estate assets
- Weak board independence, with doubts over whether the board adequately challenged the parent group

Investors argue that the deal disproportionately benefits Toyota Motor and Akio Toyoda personally while leaving minority shareholders undercompensated.

Structural Governance Issues Exposed -> The article uses three counterfactuals to underscore systemic problems:

1. **Pre-reform Japan** -> Ten years ago, such a deal would have been accepted as "just Japan." The concern today is that reforms may be **cosmetic rather than enforceable**.
2. **Foreign bidder comparison** -> Had a private equity firm (e.g. Blackstone) bid for TICO, the board would likely have produced robust asset valuations to resist underpricing. The absence of such scrutiny in an intra-group deal raises red flags.
3. **Precedent risk** -> he fear is that other conglomerates may feel **emboldened** to replicate similar transactions, weakening Japan's emerging market for corporate control.

Broader Implications for Japanese Corporate Governance -> The deal highlights enduring features of the **Japanese (and more broadly Continental/relational) governance model**:

- Strong controlling shareholders
- Group loyalty over minority protection
- Boards that prioritize harmony and hierarchy over confrontation

While these features can support long-term stability, they also suppress contestability, limit accountability and undermine fair value realization for minority investors

Overall Conclusion -> The Toyota Industries take-private illustrates the **fragility of Japan's governance reform story**. Despite significant progress, the episode shows that when core group interests are at stake, **relational capitalism still overrides market-based discipline**. For global investors, the message is not that Japan's reforms are meaningless, but that **they remain incomplete and unevenly enforced**, especially in transactions involving powerful corporate groups .

The takeover fight that could reshape Japan

The article examines **Alimentation Couche-Tard's unsolicited approach to Seven & i Holdings**, owner of 7-Eleven, framing it as a potential **watershed moment for Japanese corporate governance**. The bid tests whether Japan is prepared to accept a genuine market for corporate control, including foreign takeovers, after a decade of governance reform. Regardless of the outcome, the case exposes deep tensions between **shareholder value, national interest, stakeholder capitalism, and cultural resistance to M&A** .

The Bid and Its Symbolic Significance -> Canadian convenience-store group **Couche-Tard** has made an unsolicited but friendly approach to acquire **Seven & i Holdings**, a deal that could exceed **$50bn**. The transaction is widely viewed by bankers, investors, and policymakers as **the most consequential takeover attempt in Japan's modern history**. The bid is seen as a "day zero" moment that could:

- Legitimize hostile or unsolicited takeovers
- Trigger a wave of domestic and cross-border M&A
- Transform Japan into an active market for corporate control

Why Seven & i Is Vulnerable -> Despite operational excellence and domestic dominance, **Seven & i has underperformed** both Japanese and global peers in terms of shareholder returns. Structural weaknesses include:

- A conglomerate structure with non-core businesses depressing valuation
- Persistent conglomerate discount
- Historically weak capital allocation

Activist investors (notably **Third Point**) previously pressured the company to rationalise assets and governance, partially paving the way for Couche-Tard's approach.

Governance Reform as an Enabler -> The bid has been facilitated by **revised M&A guidelines issued by Japan's Ministry of Economy, Trade and Industry (Meti)**, which encourage companies to seriously consider bona fide takeover offers rather than reflexively rejecting them. This represents a sharp break from Japan's traditional governance model, which relied on Cross-shareholdings, poison pills and cultural and informal barriers to takeovers

Resistance and Cultural Constraints -> Despite reforms, strong resistance remains:

- Public scepticism about foreign ownership of "national champions"
- Government concerns that convenience stores constitute "lifeline infrastructure", potentially justifying intervention

The article highlights a persistent belief that **foreign owners cannot manage culturally embedded Japanese businesses**, even when performance lags.

Shareholder Value vs Stakeholder Model -> the takeover exposes Japan's unresolved question: **"For whom is a Japanese company run?".** Many investors argue that rejecting a credible bid without transparent justification would undermine Japan's governance reforms and damage global investor confidence. Others fear that Couche-Tard's cost-focused model could **erode customer experience**, a core stakeholder priority in Japan's relational governance system.

Market-Wide Implications

- Investors are holding Seven & i shares on the belief that valuation cannot revert to pre-bid levels, regardless of the outcome (page 8).
- Lawyers and bankers report a surge in inquiries from Japanese companies seeking advice on takeover defence, suggesting systemic spillover effects.
- Activist funds believe their influence may now be eclipsed by foreign strategic bidders, accelerating governance convergence faster than domestic activism ever could.

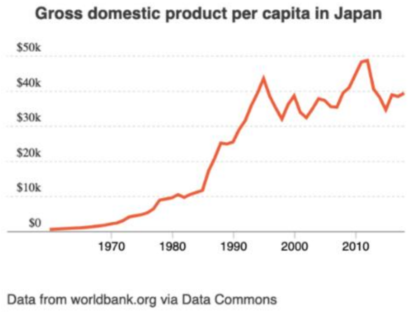
Overall Conclusion

The Seven & i takeover fight represents a **litmus test for Japan's corporate governance evolution**. It confronts the country with a choice between:

- Preserving a stakeholder-oriented, culturally insulated system, or
- Embracing shareholder capitalism and an open market for corporate control

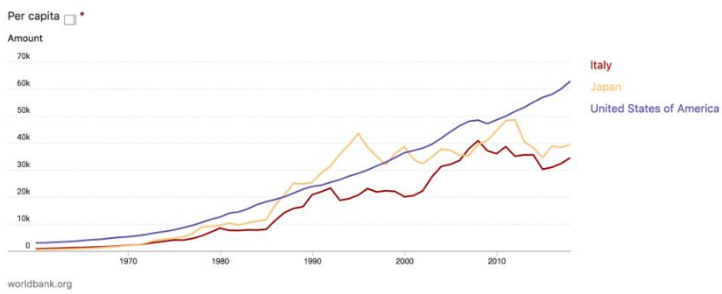
The article concludes that **even a failed bid would permanently alter expectations**, making it harder for Japanese companies to claim they are "not for sale at any price" and marking a structural shift in how governance, ownership, and control are contested in Japan.

A modern capitalism?



Japan has been *attached to several traditions* but there has been also the *pressure for some changes*, which also affect Corporate Governance. In addition, we can say that traditionally the presence of M&A deals and the penetrations by foreign countries have been very low. With a GDP per capita of about $ 40k Japan ranks *today among the first 30 countries in the World* economy.

Japan has been the only the Asian country that has been pursued a *modern industrialization process before* the WWII, starting from 19th century, which lead the country to have an imperialistic behaviour. They restarted the growth after the WWII, and in 1990, when the country's GDP per capita peaked, Japan was considered to be the credible competitor of US, as in 1989 the GDP per capita of Japan was very close to surpass the one of US. The ingredients of its economic and technological success were a mixture of state intervention and private initiative.



Between *1990 and 2010* there has been a slow growth and seemed to stop growing, like a situation of stagnation, as the GDP per capita was oscillating but the rate of growth, at a certain point, stopped. This does not mean that Japan became a poor country, as they still have a GDP per capita higher than other important countries such as Italy (which is a very similar country in terms of geography, natural resources, demography...). In which sectors is Japan strong? *Software, semiconductors, automotive, chemicals* -> they are all capital-intensive sectors, as Japan is a land of big companies (differently from Italy)

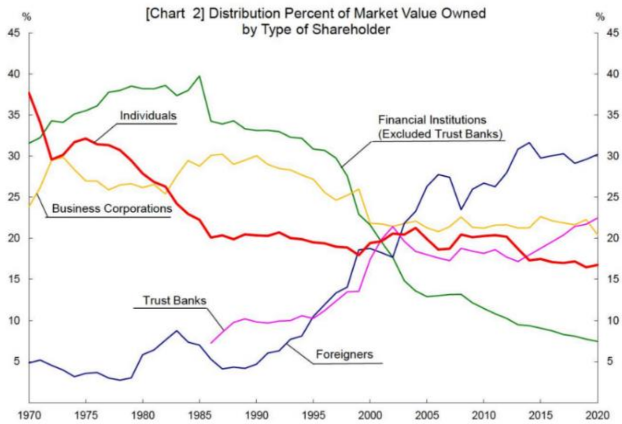
Japan is a relatively "small" country in terms of *size*, *territory* (because of the morphology of the territory, there is less space for cities to grow) and *population*. However, its economy has been since the beginning of the industrialization process characterized by a relevant section of big private business, internationalized and competitive abroad, in medium-tech industries and in mass production/using economies of scale.

Japanese, USA and Chinese companies (Fortune Global 500)

	Japan	USA	China
2005	68	176	16
2010	71	139	46
2020	53	93	124

Japan is consistently present in Fortune 500 in the 500 largest companies worldwide by turnover. From these data we can see the decline of the US (they haven't failed, simply they have been kicked out by someone else, such as China), where their decline is even faster compared to the Japan's. A high number of joint-stock companies, or Kabushikigaisha (5,6 million), more than 10,000 with a Joint Stock Capital of 500mn Y (Euro 3 mn), by the end of 2020, 3,823 listed companies in the country's 4 Stock Exchanges (Tokyo, Nagoya, Fukuoka and Sapporo).

Ownership structures of listed companies

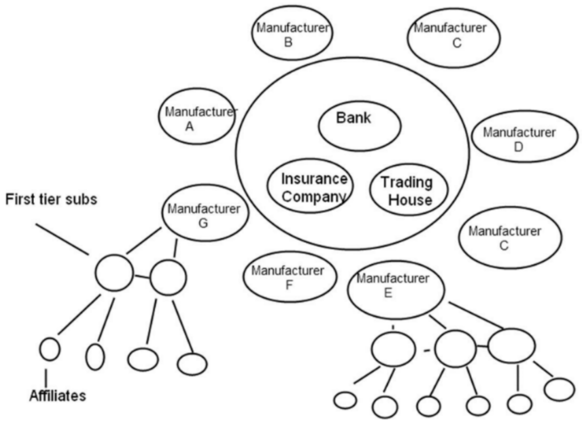


Japan is not a country where there is an abundancy of public companies -> the presence of **blockholders** in Japanese companies is very high. Today the most relevant ownership categories are (in order of relevance) *foreign investors* (individuals, funds and companies -> frequently present, but most of them are not able to control), *Trust Banks* (the subsidiaries of a bank that act as institutional investors), *Other companies* (non-financial), *Domestic individuals/households, financial institutions* (Banks/Insurance companies, which nowadays are negligible). The overall relevance of the above-mentioned categories has been changing after the financial crisis of the early Nineties and during what has been defined as the "lost decade" -> individuals and financial institutions, that in 1970 represented more than half of shareholders in listed companies, have been substituted by foreign companies and Trust banks.

Notwithstanding the changes in the weight of the different categories, the present distribution of ownership typologies mirrors some of the structural aspects of the Japanese industrial culture, which in their turn have an impact on the mechanisms of governance:

- A still *relevant presence of horizontal and vertical business groups* (Keiretsu), characterised by a dense web of *cross ownership* (in the case of vertical keiretsu, including suppliers)
- A *relevant role of the financial system*, with the presence of banks and insurance companies as important shareholders of companies
- A *still relevant role of employees*, even if without a formal representation as in Germany
- The *pervasive, even if formally «hands-off» role of the Government*, through informal pressure, retired officers (the amakudari) and industrial policies, but without the instrument of the State-owned Enterprise system

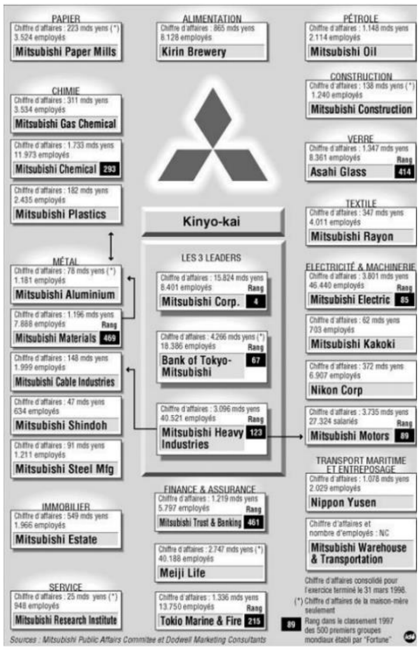
Keiretsu



Literal meaning: «*interest groups*», «*clusters*», «*trusts*», characterised *by cross shareholdings*:

- Horizontal (very large companies, leaders in very different industries)
- Vertical (companies in the same industry connected by subcontracting hierarchical relationships)

➔ Differently from Western business groups**, Keiretsu are not legal entities** (for instance, they do not have a consolidated balance sheet, they do not have shareholder meetings...)



What normally happens in **western groups** is that there is a single holding company which exercise control over the companies belonging to the group because it owns some shares of the subsidiary. In addition, groups are considered to be separate entities, so they have to publish their own BS. In a **Keiretsu**, the most relevant companies (such as banks or insurance companies) are all linked by cross-shareholding, but of *small portions* but *multiplied for every company belonging to the keiretsu* (like Manufacturer A owning 2% of Manufacturer B). Mitsubishi is the classical example of Keiretsu -> it is famous for cars and air conditioning, but it is virtually present in every sector.

As we said before, Japan has conducted an industrialisation process even before the WWII. The prevalent protagonists of the industrialisation were a *series of big companies which had the structure of a group* -> there is the holding company controlled by a *family*, usually operating in *commercial activities*. After that you have grown, you need a bank (for draining resources, which gave financial instruments only to the companies belonging to the zaibatsu) and an insurance (because you a commerciant and you are afraid of risk). After that, they want to move to different sectors, such as *steal*, *textile* and *chemicals*...all of them there connected to the commercial company, the bank or the insurance company -> **ZAIBATSU** (that, even though they were just 5, they employed the majority of people), which contained all the elements necessary to guarantee the protection of the ownership structure and their good corporate governance.

After the end of WWII, the original plan of American occupation, headed by general MacArthur, was for the dissolution of the economic instruments of Japanese aggression and the introduction of an industrial democracy -> families are removed from the ZAIBATSU structure. Some zaibatsu were eliminated, thanks to the anti-monopoly law established in 1947, while some other were reorganised/split into different companies, making them *public* and create a stock exchange market. However, from the 1950s onwards, the **managers** of these listed companies were afraid of a cancellation of Japanese entrepreneurial culture and so they *avoided mergers and foreign investments* -> quietly they started to *rebuild the connections by small purchases*, creating the Keiretsu (i.e. old Zaibatsu but lacking the holding control of families which was predominant in Zaibatsu), such as with Mitsubishi. The case of Toyota. In practice, it looks like a normal public company. However, the ownership structure is the one of a Keiretsu. The project was supposed to Americanise the Japanese economy and reform the capital market to enlarge the number of publicly held companies, where the limit on the bank's shareholding was put at 5%.

Major Shareholders (Top 10 Largest Shareholders)

(As of March 31, 2020)

Names	Number of shares (1,000 shares)
Japan Trustee Services Bank, Ltd.	357,634
Toyota Industries Corporation	238,466
The Master Trust Bank of Japan, Ltd.	201,990
Nippon Life Insurance Company	127,332
JPMorgan Chase Bank, N.A. (standing proxy: Settlement & Clearing Services Division, Mizuho Bank, Ltd.)	101,530
DENSO CORPORATION	89,915
State Street Bank and Trust Company (standing proxy: Settlement & Clearing Services Division, Mizuho Bank, Ltd.)	78,582
Mitsui Sumitomo Insurance Company, Limited.	56,814
Trust & Custody Services Bank, Ltd.	51,089
Tokio Marine & Nichido Fire Insurance Co., Ltd.	51,064

Notes: The percentage of shareholding is calculated after deducting the number of shares of treasury stock (496,845 thousand shares) from the total number of shares issued.

Major Shareholders

(As of March 31, 2020)

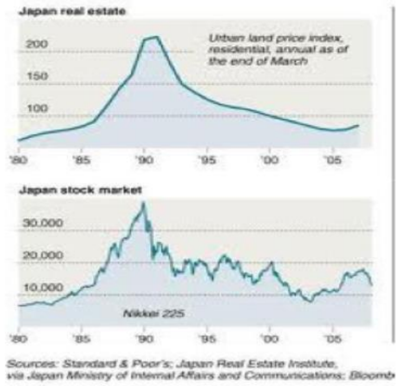
Name of shareholders	Number of shares held (thousand)
Toyota Motor Corporation	76,600
DENSO Corporation	29,647
Towa Real Estate Co., Ltd.	16,291
Toyota Tsusho Corporation	15,294
The Master Trust Bank of Japan, Ltd. <Trust Account>	14,598
Japan Trustee Services Bank, Ltd. <Trust Account>	11,173
Nippon Life Insurance Company	6,580
Aisin Seiki Co., Ltd.	6,578
Aioi Nissay Dowa Insurance Co., Ltd.	4,903
NORTHERN TRUST CO. (AVFC) RE SILCHESTER INTERNATIONAL INVESTORS INTERNATIONAL VALUE EQUITY TRUST	4,512

In practice, put all together, the companies in a Keiretsu with cross holding constitutes blockholders that protect Keiretsu. There were two kind of keiretsu: *horizontally diversified business groups*, and *vertical manufacturing networks*, which also includes a vertical distribution. However, the vertical structure provides a *very solid and strict hierarchy to this kind of keiretsu*.

But when we consider the **corporate governance issue**, in both variants, public shareholders only have access to *minority interests*, rendering them irrelevant to corporate governance. In general, we can affirm that in both kinds of keiretsu, there is an *efficient level of coordination without centralised control*, as in the time of zaibatsu. The ethical ties among the different components of the keiretsu are strong. This permitted Japan to avoid all hostility covers after World War II.

The American dream of Americanising Japan and having the Japanese fall in love with American business model did not last extraordinarily long. By the end of the 1960s, the widely held firm had practically disappeared, and the keiretsu occupied all the available space. This was also the period of the best performance of the Japanese economy, which grew between late 1950s and mid 1970s by an average of 9% per year. However, Japanese political subordination to the USA never permitted economic issue to destabilize the long-term relationship between the two countries.

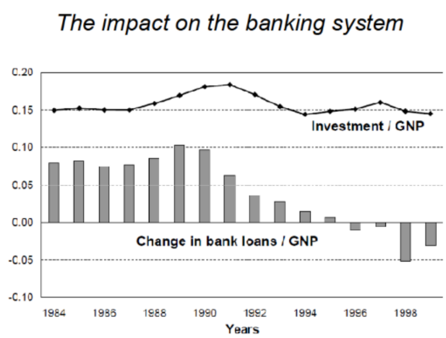
The lost Decade and its Structural Effects



The case of Seven eleven is also very emblematic. It proved that the system tries to insulate against the presence of foreign investors.

A structural transformation in the Japanese *ownership* and *governance structures* take place after the 1990s, after the **financial crisis** that hit the banking system. The speculative real estate and stock bubble of late 1980s provoked a *rejection from which it hardly recovered over the following decade*. The effects have been:

- A *restructuring of the banking system* -> (rescued by the Government's and by the Central Bank's intervention) are much more severely monitored in their lending activity.
- A *reduced pervasiveness of banks* in the keiretsu system



In particular, the *banking system*, which in the late 1980s was the most solid and dynamic in the world, was the first to show its hidden weaknesses. After that moment, companies in Keiretsu started to obtain less financing from the banks in the Keiretsu (as it is possible to see from the sharp decrease in the amount of investments over the GNP, Gross National Product, and the amount of bank loans over GNP after 1990). Furthermore, after the crisis, there was the separation of *retail* and *investment banking* activities, which explains the rise in number of trust banks.

The predominance of the traditional actors (banks, industrial companies, insurance firms), meant that *Japan was not attracting foreign investors* that in the late 1990s - early 2000s *were much needed* to revise the Japanese economy, especially the big firms (something that never happened in Japanese history) -> on the long term, it allowed higher transparency and accountability. The seduction offensive to succeed had to include a rise in the dividends paid by the Japanese firms. Since early 2000s, many Japanese listed companies announced buybacks before the end of fiscal year. Investors welcome this strategy, which was aimed to increase profits per share.

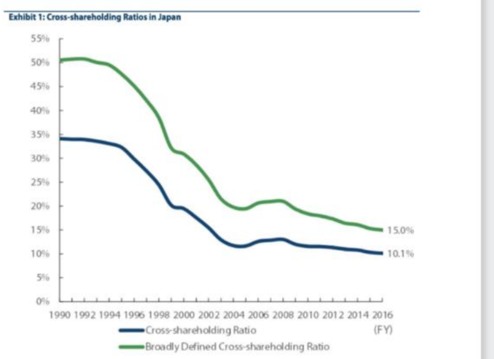
Another element that changed was the excessive number of board members. The tradition of enlarging this body was connected, on the one hand, with the need for forming consensus on the most important decisions; and on the other hand, the keiretsu structure pushed hard for that approach

The evolution of CG codes

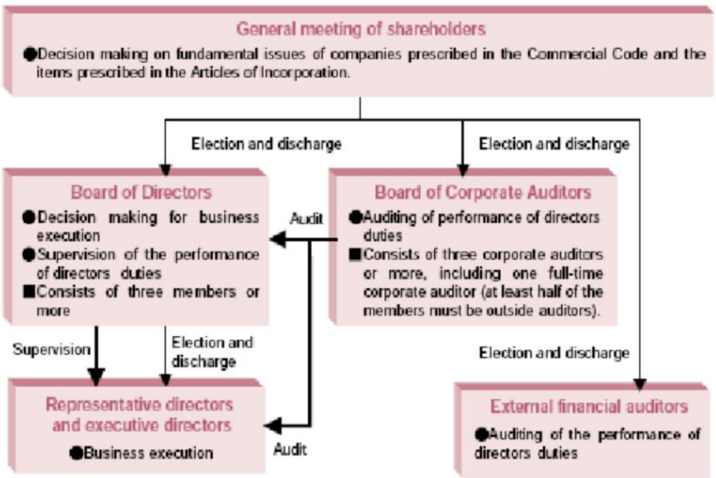
After the crisis, we had some **effects on the CG structures and practices**. In particular, it is possible to notice an impact on:

- *Effects on cross shareholding*
- *Effects on transparency and information*
- *Overall reforms in CG practices*

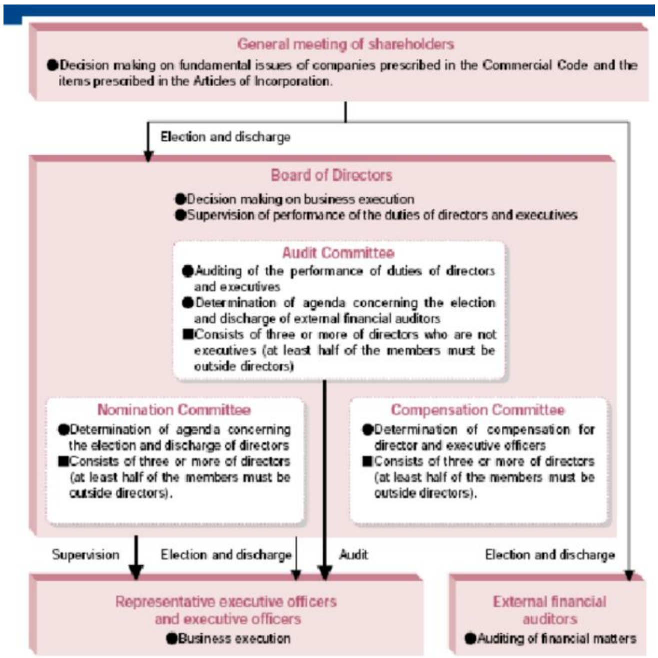
Firstly, it is possible to notice a sharp **reduction in the cross-shareholdings**, that moved to 50% of companies to about 15%.



Second, a **reform of the corporate governance code** had to be done. The traditional model for listed companies was based on a corporate auditor's system.

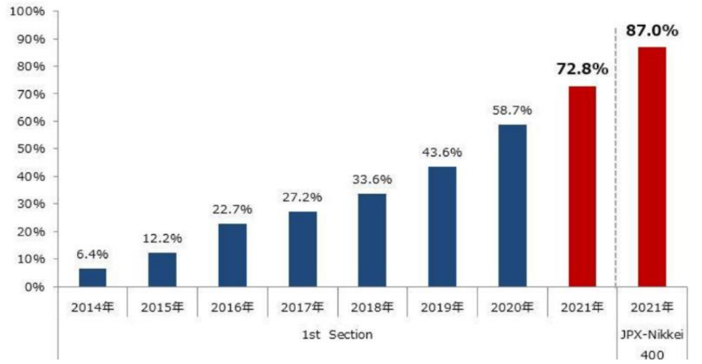


This system was <u>not considered enough efficient by foreign investors</u>. Starting from 1997 (revision of the Anti-monopoly law) and from 2002 (revision of the Commercial Law) some reforms which encouraged convergence between the *older Japanese corporate governance model* and the *American model*, but the text also *contained many echoes from the or OECD principles*. Starting from 2003 it is <u>possible to (voluntarily) introduce a committee-based CG system</u>, but this is still a rare event.

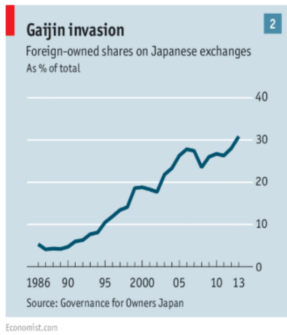


A second step takes place since 2015 in the framework of the reforms promoted by the Prime Minister Shinzo Abe (*Abenomics*). The new CG code suggests the appointment of (at least two) independent directors ("comply or explain", which means that the company should have explained why they decided to not comply with the rule). The "philosophy" of the Code is to:

[Ratio of 1st Section Companies with 1/3 or more Independent Directors]



- *Promote the stability and growth of the industrial system*
- *Attract foreign capitals*
- *Increase the value of companies* on the basis of SHV practices



Basic "pillars" of the Code are:

- *Shareholder rights/Anti-director rights* and *equal treatment* among shareholders
- *Cooperation and stakeholders' orientation*
- *Accountability of the Board*
- *Transparency and information*
- *Shareholders' involvement*

The code, according to the general economy policy of the government, seeks growth-oriented governance by promoting *timely and decisive decision making* based upon a *treatment and fair process* which fulfils the *company accountability and responsibilities to shareholders* and the stakeholders. The code does not place excessive emphasis on avoiding and limiting risk, or the prevention of corporate scandals. Rather, its primary purpose is to stimulate healthy corporate entrepreneurship, support sustainable corporate growth, and increase corporate value through the mid to long term. The gender issue was also addressed in the code. Before 2014 only 20.4% of NIKKEI 225 companies had appointed a female director. The situation has improved in the last few years, but still the figures are not good. In 2019, about 57% of Japanese companies had no female board representation.

While there are only very few companies with three committees, the system of *company auditors* is a traditional system of corporate governance unique to Japan. Company auditors are responsible for *auditing and supervising the executive function of a board of directors*. It has been noted that this model permits companies to take decisions quickly, enabling outside directors to concentrate on fulfilling their original expected roles. In the meantime, the reform permitted a sharp reduction in the number of board members, who are now *no more than 15*. The code permits duality: to nominate a CEO and the chairperson from among the members of the board. Usually, the latter is the founder of the company or a descendant of the founder.

Marco Lavazza (guest speaker)

Company overview

Lavazza is a premium coffee company -> they are an international group born in Italy which only produces coffee (in different ways, by different means, using different types of advertising, but only producing coffee). Today it is a company that uses “Lavazza Group” when they talk about themselves around the world -> in the previous 10 years, they have conducted some acquisitions that allow the company to operate in different countries, such as Carte Noire, Merrild and Kicking Horse. The company can be defined as a Family Business as the 100% of Lavazza Group (the holding company) is owned by two families, 6 people in total shown in the picture).

Lavazza Board:

Why is the company little different from other companies? 12 years ago, the company was growing, and the 6 owners previously shown were also the managers of the company (for example, Marco Lavazza was the responsible for M&A deals, the cousin Giuseppe Lavazza was the responsible for Marketing and the cousin Francesca was in charge of the Communication department). At that point, they had to decide if they wanted to remain local or becoming really international, as at that time they were they were the biggest between the smallest and the smallest between the biggest -> they believed to have the capabilities and the resources to become international and compete with the big players. They found Antonio Baravalle, the current CEO, and with him the family decided to make a step-back -> not managers anymore, just shareholders, and they opened the board to other members. This is not a process that started just 12 years ago, as even from the beginning of the company, the firm had to import a product, the coffee, that was not present in Italy and needed to be imported, even though the founder saw some opportunities for this product.

The first expansion in Europe and US occurred in 1982 and continued until 1990, starting with France as French was the closest language to the Turin's dialect. In 2015, in the year of 120th anniversary, they have started the M&A processes (which not only they helped the company to grow, but it also contributed to change the mentality). The company nowadays operates in 140 countries, has 11 subsidiaries all over the world, 9 production plants located in 5 countries, which gives work to 5,500 people, and also thanks to the M&A deals they have doubled the amount of revenues and NI compared to 10y ago, reaching the current, respectively, 3,35bn€ and 82mn€.

Operation

The coffee is a product that needs to be produced in the equatorial area of the world, and because of this 86% of coffee sourcing comes from South America (49%) and South-East Asia (36%), together with Central America (6%) and Africa (9%). This production allows the company to produce 240.000 tons of coffee per year and deliver +35bn cups of coffee every year.

There are several big competitors in the international landscape, among them the most important are Nestle, JDE, Keurig DrPepper and Starbucks, for a market that is values 120bn$ worldwide and a projected CAGR of 6.8% between 2021-2026. Among the competitors, Lavazza is the only company that is controlled by a family and produces exclusively coffee.

Every company has issues in the market in which it operates. The issues of the global coffee market are:

- Climate change and bad weather conditions in producing countries such as Brazil or Vietnam has cut supply in the previous two years
- An increase in demand from emerging countries such as China
- Government and regulators are introducing new standards such as PPWR (Packaging and Packaging Waste Regulation), EUDR (European Deforestation) or CSDDD (Corporate Sustainability Due Diligence Directive)
- Much higher shipping costs -> since 2023, vessels have been forced to take the longer routes around the bottom of Africa in order to avoid the attacks of Houthi rebels in the Red Sea

Strategy

The strategy of the company is based on three pillars:

- International Growth -> the company is leader in Italy, but they are expanding in Europe and US

  - North America Case History -> America is now the 4th business unit for the group and there have been marketing investments with the US Open and museums such as Guggenheim. Lavazza achieved 12% growth rate in the US market and they are the single serve market as it is the most dynamic sector
  - The China Case history -> they have established a joint venture with Yum China (it is a branch of an American company in China but with an international management team), as there was not a proper coffee chain in the country before. The joint venture plans to accelerate expansion of Lavazza Cafè in China and extended partnership to product distribution. There are 200 coffee shops already open, and they are aiming to 1,000 in the next years
- Sustainability and Innovation -> innovation should be the nr.1 priority of every company (in order to have a product that can be better, for resolving problems in a company), and innovation can be sustainable -> one of the main reasons Lavazza is still present in the world
- Tennis and other sports partnerships -> there are different partnerships with tournaments (such as Wimbledon, ATP Finals, US open ... where Lavazza presents itself as a company that carries the Italian way of living life -> they struggled at the beginning, but after few years they were the tournaments requesting to remain) and tennis players (such as Sinner, who is a sponsor since 2019 and will continue to be so until 2030). Some of the partnerships they have more global perspective, others that are more dedicated to the local communities

In addition to this, there are several marketing campaigns that help Lavazza build its own image and role around the world and bring the Italian identity without considering particular stereotypes. For example, they affirmed that AI is important, but it is nothing compared with the feelings that make us humans, and Lavazza tried to bring this concept through the use of coffee, by making a little cute robot serve coffee dreaming about human feelings.

Tablì

One of the most important problem of the current generation is the production and waste management of plastic -> the problem is not the production of plastic, but the use of plastic by man. To try to solve the problem, even though Lavazza has spent millions of euros to make the plastic renewable, they have invested to resolve the problem -> a coffee capsule made only of coffee, called Tablì, and a specifically designed machine with a cutting-edge delivery system. It took 5 years to come to this invention -> the company might be slower in making this innovations, but they made a complete revolution in the sector that needed to be perfect in order to respect the standard, which is the consistency and taste of Italian expresso.

Sustainability has always been in Lavazza's DNA and a fundamental component of the value "Responsibility". Together with this one, the other values are Authenticity, Passion for Excellence and Inventiveness, which are always respected in the activities of the company itself and the projects conducted by the foundation. The foundation counts 29 projects in 18 different countries, that allow the company to reach +137,000 people. The main objectives of the project conducted by the foundation we have:

- Increase the productivity and quality of coffee plantations
- Promote entrepreneurship and independence among coffee growers
- Improving the quality of life and conditions of coffee-growing communities
- Mitigate and counteract the effects of climate change

OWNERSHIP STRUCTURES AND CORPORATE GOVERNANCE IN CHINA

In Xi's China, the Business of Business Is State-Controlled

The article argues that under **Xi Jinping**, China has decisively moved toward a **state-controlled economic system** in which businesses (private and foreign alike) are required to align with the priorities of the Chinese Communist Party. Market mechanisms formally remain in place, but in practice **political loyalty, national security, and party control now take precedence over commercial autonomy**, reshaping China's business environment and dampening confidence among entrepreneurs and foreign investors.

Xi Jinping's Policy Direction -> At the 2022 Communist Party Congress, Xi Jinping affirmed a clear shift in emphasis. His speech largely **downplayed markets and private enterprise**, focusing instead on:

- National security
- Anti-corruption
- Strategic state-led projects (e.g. spaceflight, supercomputing)

References to market reform were minimal and framed strictly within **"socialist market economy" rhetoric**, reaffirming that markets operate only insofar as they serve party objectives. The simultaneous **delay in releasing GDP data** reinforced concerns that economic transparency is now subordinate to political stability.

Expansion of State Control Over the Economy -> Xi's governance has accelerated a long-term trend toward **greater state dominance**, where **State-owned enterprises (SOEs)** are explicitly described as "pillars" of the Communist Party. From 2019 to 2021, SOEs acquired **more than 110 publicly listed companies** worth over **$83 billion**, reversing decades of gradual private-sector expansion. Policies such as debt crackdowns and regulatory campaigns have disproportionately affected private firms, while SOEs have remained insulated.

The Private Sector Under Pressure: The Holitech Case -> The article illustrates the policy shift through the story of **Holitech Technology**, a private display manufacturer. Founded by Wen Kaifu, Holitech grew rapidly during China's reform era and expanded globally. In 2018, a government-led campaign to curb corporate debt pushed the company into crisis. A state-owned group stepped in, acquiring a **controlling voting stake**, effectively transforming Holitech into a **state-influenced enterprise**. The company was subsequently integrated into party-led initiatives, including:

- Mandatory party committees
- Political education programs
- State-directed industrial and rural development projects

Leadership was transferred to a party-affiliated executive, marking the end of private control. This case exemplifies Xi's model of **"unifying the private sector around the party."**

Treatment of Prominent Entrepreneurs -> High-profile business leaders who challenged regulators or policy direction, such as **Jack Ma**, have been silenced, sidelined, or subjected to regulatory action.

Once-celebrated technology companies are now tightly constrained by oversight, content controls, and political scrutiny. The result has been a sharp decline in entrepreneurial visibility and risk-taking.

Foreign Companies and Market Access -> Foreign firms face increasing political and operational constraints. Market entry is often conditional on **state-approved partnerships**, with authorities influencing partner selection. The American Express example shows how foreign firms must adapt to:

- State monopolies
- Political preferences in joint ventures
- Resistance from state-owned incumbents

Foreign companies encounter:

- Data localization requirements
- Content censorship obligations
- Political backlash for perceived criticism of China's policies

These pressures have forced some firms to either **scale back operations or exit China entirely**, as illustrated by Stellantis' withdrawal from its Jeep joint venture.

Blurring of Politics and Business -> The article emphasizes that **commercial decisions are increasingly political decisions**. Business strategy must align with:

- Party ideology
- Employment priorities
- National security concerns

Executives report growing **direct political interference** in corporate governance, investment approvals, and operational control. For many firms, participation in the Chinese market now requires **acceptance of sustained political oversight**.

Overall Conclusion -> The article concludes that under Xi Jinping, China has moved decisively away from the reform-era model that encouraged private initiative and foreign investment. While markets and private ownership still formally exist, **the Communist Party has reasserted ultimate authority over economic life**. Businesses are expected not merely to comply with regulation, but to actively advance party objectives. This transformation has reshaped incentives, reduced transparency, weakened confidence, and fundamentally altered how business is conducted in China.

The basics of Chinese capitalism

Figure 1: Fortune Global 500 Companies, 2000-2020

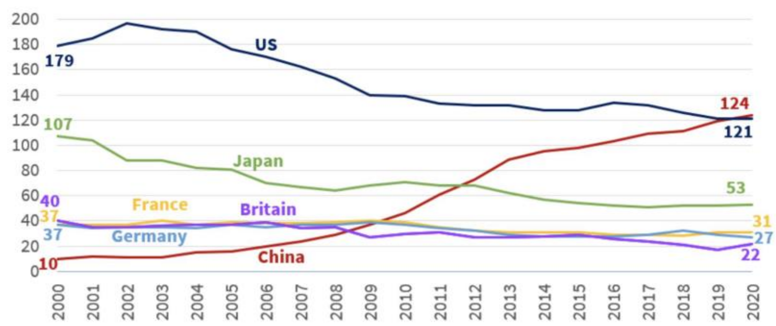
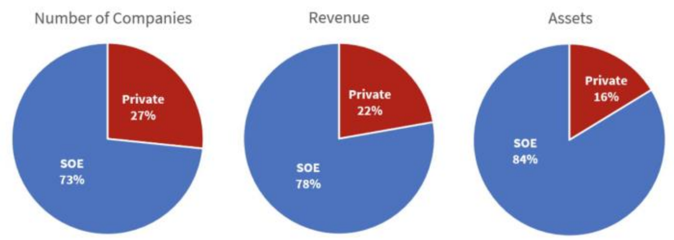


Figure 5: Chinese Companies by Ownership (2020)



Source: Fortune Global 500; Wind; Tianyancha

We can define the **Chinese capitalism** as a complex and articulated entrepreneurial system characterised by the *presence of some of the largest World's enterprises*, increasingly dominant at the global level. As it is possible to see from the graph, starting from 2000, when the number of Chinese companies belonging to Fortune 500 was basically irrelevant, there has been a sharp increase that was opposite to the sharp decrease that characterised the US, until 2019 when there has been the surpass. As far as ownership structures are concerned, the Chinese peculiarity is the **overwhelming presence of SOEs (State-Owned Enterprises)**, dominant in almost all the industries considered as «*strategic*» by the Government.

As far as the largest (private and SOEs) companies are concerned, *ownership concentration is still prevalent*. Among the different categories of shareholders/blockholders, two stand out:

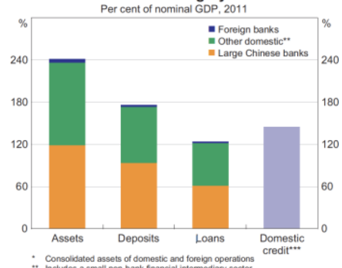
- *Central/local Government*. Main goals: profitability/ public good provision/industrial policy/long term geopolitical strategies
- *Families/individuals*: profitability

As elsewhere, blockholders take the relevant strategic decisions. In private companies, *ownership and management coincide*, but among SOEs, the top management include *CCP (Communist Chinese Party)* officers.

-> The **main agency conflict** is therefore between *blockholders and minorities*. Of course, this is even more evident in the case of SOEs.

The banking system

Graph 1
Chinese Banking System*
Per cent of nominal GDP, 2011



* Consolidated assets of domestic and foreign operations
** Includes a small non-bank financial intermediary sector
*** Includes renminbi loans, entrusted loans, trust loans, letters of credit and bank-accepted bills
Sources: CEIC; China Banking Regulatory Commission (CBRC); RBA; banks' annual reports

Five main banks: *Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC), Agricultural Bank of China (ABC), Bank of Communications (BCOM).* Listed in Hong Kong but firmly under the control of the Government, these five banks account for about the 50% of the assets of the banking sector and of the total of the deposits. The banking system is a powerful instrument in the hands of the Government for:

- *Supporting and directing the SOEs system*
- *Achieve medium-long term strategic objectives*
- *Regulate the economy*

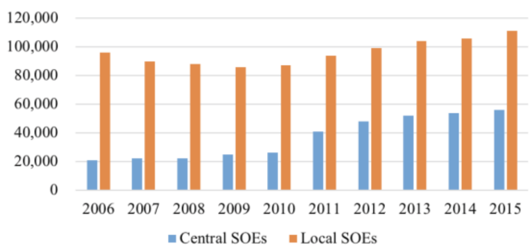
From State to Market

We can divide the companies into 3 categories according to the industry in which they belong:

- *Strategic and key industries* (such as defence, power generation and distribution, telecom, oil and petrochemical, coal, shipping, civil aviation…) -> the objective is to maintain the 100% ownership or the absolute control in these SOEs, and *increasing state-owned assets in these industries*
- *Basic and pillar industries* (machinery, auto, IT, construction, steel, base metal, chemicals, land surveying, R&D…) -> the objective is to maintain the absolute or the conditional relative controlling stake in order to *enhance the influence of state ownership* even if the ownership share might be reduced when it is adequate
- *Other industries* (Trading, medicine, investments, construction materials, agriculture, geological exploration…) -> maintaining the necessary influence by controlling the stakes of the key companies, while in non-key companies the ownership is clearly reduced

Obviously, over time the number SOEs and local SOEs have changed, with the local ones that have always been the most present.

Figure A3: Number of Central SOEs and Local SOEs



Source: Finance Yearbook of China 2016

The Stock Exchange and the regulation of listed companies

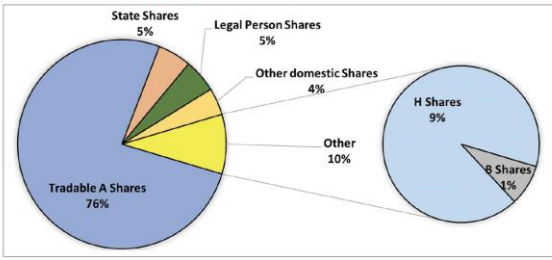
The process of modernization, liberalization and privatization is at the basis of the so called "**socialism with Chinese characteristics**", which is basically balancing (informally regulated) private initiative and State-ownership. After the opening (1990 and 1991) of the two main stock-exchanges in Shanghai and Shenzhen, in 1992 becomes operative the *China Securities Regulatory Commission (CSRC)*, in charge of supervising the behaviour of listed companies, which since then increase in number (and capitalisation). The share capital of Chinese listed companies may include *four typologies of share* (plus one)

- *A shares*: Ordinary shares, traded by domestic retail investors.
- *B shares*: Ordinary shares, USD face value in Shanghai and HKD in Shenzhen, traded outside of the market by foreign investors. A very small percentage.
- *H shares*: Ordinary shares listed in HK, with face value in HKD, reserved to foreign investors

- *State Shares* (Non tradable): in reduction, since 2005 substituted by A shares
- *Legal Person Shares*: only for domestic social legal persons traded outside of the market

Rathnayake, et al.: Does Corporate Ownership Matter for Firm Performance? Evidence from Chinese Stock Exchanges

Figure 1: Layout of the registered shares in China



Source: Authors' computation from the CSMAR database for the year ended on December 31, 2017 with 3348 listed companies' data. Other domestic shares include executive shares, public offering to strategic investors and other uncategorized shares

The enlargement of the Stock Exchange calls for some sort of *CG regulation*. In 2002 the CSRC introduced a **first CG code based on the OECD principles** (basically, duties and responsibilities of Directors, and shareholders protection). The Chinese system is *shareholder-oriented but with emphasis on stakeholders*, based on a *dual structure* and *particularly sensible to the agency conflict opposing majorities to minorities*.

The economic reforms

The **reforms launched in 1978** changed the Chinese economy in many respects. From *agriculture* to *industry* and *banking*, all sectors have been modified. The foundations were first laid in the primary agricultural sector, with *new land management* and the *creation of township and village enterprises*, the *closure of the communal farms*, and the *partial liberalisation of prices* of agricultural products to *create internal demand in rural areas*. After this, came changes to the banking system with the creation of four state banks: *Bank of China, the people's banks of China for industry and commerce, the China Construction Bank, and the agricultural Bank of China*.

In 1979 *Deng Xiaoping*, the architect of the **Chinese economic reforms**, proposed the introduction of a law to attract foreign investments in *designated special economic zones (SEZ)*. One year later, in 1980, China joins the World Bank, and the state-owned companies were *allowed to keep a share of their profits to finance investments* and *give out productivity prizes and bonuses*. The Bank of China became the central bank in fact and in law. By 1985, the number of SEZ rose to 14, and internal migrants moved in tens of millions to these areas along the Chinese coast where foreign companies paid much higher wages. In 1986, China applied to become part of the GATT, the first step on the way to the subsequent entry into the WTO. In the meantime, in 1981, trading in treasury bonds was resumed, while in 1984, stock and enterprise bonds emerged in Shanghai and a few other cities -> however, *trading activities were not yet formalised*. All these changes had various consequences, not all of them positive. Concerns in the Chinese Communist party, and in society in general, became more acute among those who worried about the changes in course, and those who wanted the change to accelerate.

The collapse of the USSR and the transition in Eastern Europe dealt a hard blow to the conservative wing of the CCP, which remained hostile to the economic changes that had been taken in place in China for almost 15 years. But after just over 2 years of stagnation, Deng was finally able to relaunch his reforms in 1992. In the following autumn, the CCP Congress defined the aim of the path outlined by Deng as the socialist market economy. In the same year, the Congress of the CCP confirmed that vision, affirming that a market economy was compatible with socialism, and that private ownership in the industrial sector was again permitted.

The Chinese stock market and the introduction of corporate governance

The *first IPO* was carried out by a Shanghai based firm in 1984 while over the counter trading followed in the Shanghai in the mid-1980s. The *first security exchange* opened in Shenyang in 1986 and because of that on November 26, 1990, the *Shanghai Stock Exchange came into existence*. The China securities Regulatory Commission started operations in Shanghai the same year. It is not independent like the American model, since it is *directly controlled by the executive power*, the State Council.

In December 1993, the first company law passed in the National People Congress. The State Council issued a special regulation raising governance standards of *overseas offerings*, followed by mandatory obligations. A major challenge for the first half of this period was to reform the non-tradeable state shares, the *large block shares owned by the state* and that *could not be liquidated throughout Stock Exchange*. Another highly debatable local solution implemented was the IPO moratorium, a complete *prohibition of new stock issuance to come the market and stop liquidity rushing out of existing stocks into new issues*. However, many SOE's, particularly the oil companies, started a parallel strategy, with listings in Hong Kong and even in New York. To pursue that purpose, they set up some special companies with *some of their most valuable assets*, strictly controlled by the mother company, and this appendix companies were listed abroad.

The **state-owned enterprises** underwent a deeper reform. In 1993, the government started a radical restructuring policy that reduced the number of jobs in these companies. At the same time, business legislation introduced different form of ownership -> the SOEs became *public limited companies*, or *limited liability companies*. The following years saw the first privatisation of the smaller SOEs, sold firstly to employees and managers, but also to foreign investors.

In 1997 the CCP Congress established that state intervention in the economy should be progressively limited exclusively to **certain strategic sectors**: *defence, communications, electricity, oil, aviation, and railways*. In 2003, President Hu Jintao, completed the reform of the SOEs, concentrating the 196 most important companies with the aim of creating around the 30 international important groups. For this purpose, state owned companies were placed under the control of a new organisation, the **State-owned Assets Supervision and Administration Commission**. The SASAC progressively reduced the number of companies under supervision -> In 2017, there were 116, while in 2019 there were only 96. The establishment of the SASAC was a direct consequence of another important reform that changed the *ministerial bureaucracy* -> *instead of a series of ministers*, each charged with the supervising the activity in terms of industrial sectors, there was *only a ministry of industry and information technology for all the industrial sectors*.

In December 2001, after 15 years of difficult negotiation, **China entered World Trade Organisation**. In 2002, the amendments to the party statues changed an important article, which had been unaltered since the party's foundation in 1921. It states that CCP represents the vanguard of Chinese society -> the *new Chinese private entrepreneurs could become members of the party*.

In 2001, China's security Regulatory Commission *published some initial rules concerning corporate governance*. The privatisation of the 1990s focused attention on the rules governing enterprise operations. Chinese commitments under the principle of the WTO added some urgency to taking corporate governance issues into a *comprehensive and systematic manner*. The model of corporate governance adopted some of the recommendation included in the OECD's principles, but with a stronger Chinese accent.

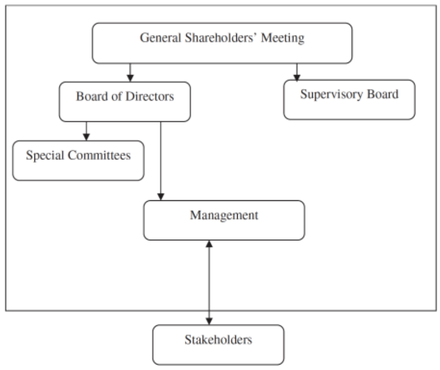
- A two-tier system was introduced, in which the supervisory board nominates the board of director as well as the CEO and the general manager.
- The board of supervisors in China is different from the other countries due to the lack of an audit committee -> the *board of supervisor* and the *board of directors* have similar authority levels.
- The supervisory board is comprised of shareholders representatives and a reasonable number of employee representatives. The **State and the party**, directly in the case of SOEs, and with a Chinese version of moral suasion elsewhere, has a direct influence in the formulation of a list of members of the Board of Supervisors. Since they are politically nominated, sometimes its *members have less experience* and *knowledge then the members of the board*, and even less than that of managers.
- PRC listed companies do appoint company secretaries, a *senior management position within the company*, appointed by the board of directors. Any board of directors and senior executives within the company are eligible for the position of company's secretary. This position is the unofficial representative of a Chinese Communist party. At least 1/3 of the members of the board should be independent. It was also suggested that one of them should be an accounting professional. Any shareholder with at least 5% of a share has the power to nominate border members.

Restructuring state owned enterprises will separate government administration from day-to-day management of business operation, a new step towards greater efficiency. Until early 2019, Chinese legislation *did not allow foreign direct investment in Chinese companies* that operate in key industries, such as Internet, education, and tele-communications. Many listed companies retain founder involvement: that reputation and equity commitment held by the founder is often key to an IPO's success. Founders typically use three primary tools to maintain a tight grip on the control of a listed SPV:

- a *dual share class structure granting them superior voting power*.
- *incorporation in management friendly jurisdictions*
- *dominating the board*, often via the key role of chairperson while retaining executive powers.

Because of the company low restrictions and profitability requirement of stock market, *domestic operational entities are not allowed to be controlled by listed companies abroad*. **VIE (Variable interest entity)** is used by Chinese Internet companies to list abroad. Through VIE, offshore company abroad can establish a fully owned enterprise instead of direct acquisition of domestic operating entity. The foreign owned enterprises could provide monopolistic consulting and management service. However, there is still a restricted area, a deny list of 48 sectors, which will not be open to foreign investment or, in some cases, not open without conditions or special permissions.

Despite many reforms and many efforts to implement them, the quality of Chinese corporate governance is still *relatively poor* according to the most important watchdog on this issue in Asia. China is not getting worse, but *it seems not able to improve*. In addition, most probably, their origin does not lie in the companies nor in the management. In September 2018, the China securities Regulatory Commission issued the **revised code of corporate governance for listed companies**.



- Requiring companies to establish party organisations (representative units of the Communist Party intended to play a political role in the company and ensure implementation of state objectives and policies) and incorporating the relevant requirements on party work into the articles of association of state-controlled listed companies (article 5)
- promoting board diversity (article 25)
- establishing environmental, social and governance requirements, such as green development and targeted poverty alleviation. Companies are encouraged to develop concepts of 'innovation, coordination, green development, openness, sharing' and social responsibilities (articles 3 and 86).

The anti-corruption campaign and corporate governance

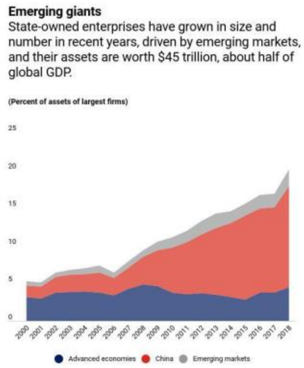
The issue involves not only the reforms now in effect but even the credibility of a power that once seemed unassailable. At the same time, the **intense battle against corruption**, which was launched several years ago, is achieving some results at the political level, but has somehow slowed private enterprises. *Supervision loopholes* are commonly observed among SOEs. Executives ignore the managerial operation and *maximise their own fortunes by insider trading, outsourcing to bribers*, *employing relatives or cronies*, and *privatising corporate assets*. Therefore, some SOEs are stuck in poor corporate governance and worsening operating performance.

In 2013, to increase their use of market criteria and efficiency, the *number one of SASAC was removed*. The accusations against him concerned the period when he was the chairperson of China National Petroleum Corporation. Insider trading is considered the *most dangerous* but also the *most common result of a situation where SOEs are still over dominating the market*. All these **bad practises of corporate governance** and firm management very much concerned the government. Although they are considered the biggest market manipulators; in China, a huge middle class has invested an important share of their savings in the Stock Exchange. *They should not only concern the quality of the Stock Exchange*, the *transparency of the operations*, and the *bad practises of corporate governance*. The most delicate point is the trade-off between the CCP and the middle class, and they need to *keep their reciprocal political and social trust in a society* that is still undergoing deep changes.

However, some recent novelties are partially changing the situation. At the end of April 2020, the central Commission for comprehensively Deepening Reform passed a plan to reform the ChiNext market. Information disclosure is now the core of registration system. As *value discovery and information perceptions are carried by the market*, every published information is likely to be reflected in the stock price fluctuation. Any tiny unfavourable information related to financial or operational situation of enterprises may plunge dramatically the price. In addition, there will be r*equested to increase effective company engagement* and *build a rational investment philosophy* under current mechanism. Under registration system, market autonomy is followed and the efficiency and freedom of the market are emphasised. The right to issue shares is owned by the enterprise instead of being empowered by the state. Under the approval system, the government substantively managers and judges stock listing. Registration system has a higher level of requirements for the issuer and financial institutions. Furthermore, it focuses more on the ex-post control and the compensation including the reorganisation of civil and criminal liability.

Leviathans as Owners: Governments in business and agency issues

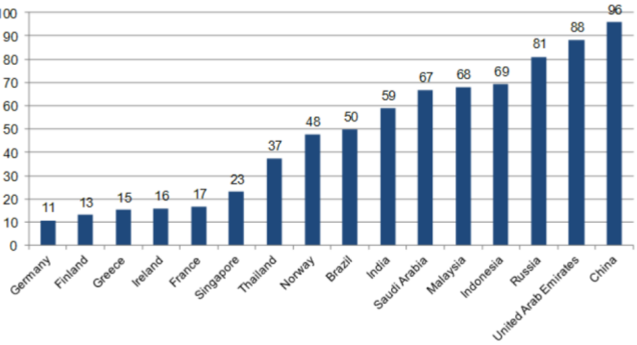
The relevance of State-ownership today



Recently, after the global crisis of 2007/8, there is a renewed interest in the different ways in which **States/Governments exert a direct control** over companies as their shareholders. Once considered as «*devices*» useful for accelerating economic development/convergence, and therefore mainly diffused among developing countries, they are now a stable component of the economic landscape of developing and developed economies, fulfilling a *wide array of purposes*. In several of the main «players» in the global economy, a private sector is complemented by the Government's direct control over the main players in strategic industries, such as in China, India, some South American economies, Russia, and, more recently, the EU.

State-owned companies are *increasingly pervasive*. In 2005 the companies controlled by Governments in the Fortune's Global 500 list were 49, while now they're around one hundred. *Covid-19* has further increased the necessity/opportunity for States' intervention through the direct ownership of companies, regardless to the degree of economic development of the country.

SOEs share among each country's top-10 firms (weighted average of SOEs shares of top-10 revenues, market value and total assets)



Why Governments become Entrepreneurs?

There are **several reasons** why governments should obtain the role of entrepreneurs:

- *Economic motives*:
  - Market imperfections/market failures: Governments become owners when *private capitals do not grant equal treatment/welfare* (the case of natural monopolies, such as the defence of a country -> because there isn't an economic incentive for a private individual/entity to offer this service, it becomes prerogative of the State to offer that service)
  - State-owned companies as «countercyclical devices»

- *Ideologic/political motivations*:
  - capital/production means belongs to workers/employees/citizens (the case of Russian privatizations post 1989)
  - populist/nationalist Governments may see State-ownership as a necessity for the nation's prominence and strength (the case of oil nationalizations in South America)
- *Social motivations*: State-owned enterprises as a way to preserve employment and welfare
- *Strategic motivations*: State ownership is mandatory in defence industries.

The «new» forms of State-ownership

After a long phase of *privatizations* (1985-2000), in Western Europe, State ownership is becoming pervasive again, but also assuming a peculiar physiognomy -> **mixed ownership forms** are now the rule more than the exception. The reasons:

- Privatizations strategies based on the IPO of *less than the totality of the capital*, in order to *leave to the privatizing government a strategic controlling stake*
- *Internationalization* strategies of *former domestic monopolists*, now needing additional resources.
- Strategies of external growth and diversification of SOEs which require additional resources
- Institutional investors keen to invest in companies solid and dominant in regulated/strategic industries

In the case of mixed-ownership, Governments **exert their control through**:

- *Pyramidal structures*
- *Under the control of economic agents* (Agencies, Funds, Institutional investors)
- In their turn *under the control of Administrative Bodies* (e.g. Ministries)
- When possible, *Control Enhancing Mechanisms* are widely in use (see for instance the Florange Law in the French case)

Governments and private shareholders

Similarly to what happened in the past, but today in a more explicit way, Government adopt *both forms of exclusive ownership* (100% full ownership), but also with *different degrees of involvement of private capitals*, particularly in the case of pyramidal groups controlled by Government Agencies/Holdings.

Full State Ownership (100%)	**Partial State Ownership (>50%) with private investors**	**Partial State Ownership (50%<) with private investors**	**Full Private Ownership**

Other investors include:

- *Retail investors* (in the case of listed companies)
- *Institutional investors* (institutional investors, SWFs)
- *Other companies*
- *Other Governments*

So, for example, if we consider the composition of shareholders of Eni S.p.A., we'll see that the public shareholder (both considering the Minister of Economy and Finance and Cassa depositi e prestiti, the Sovereign Wealth Fund of Italy), they own just 30% of shares, way less than 67% own by the market (both considering institutional and retail investors). In reality, if we look at the ownership of the company, we'll see that by far the shareholder that actually exercise the control.

Azionisti	Quota
Azionista Pubblico	30,10%
Investitori Istituzionali	56,28%
Investitori Retail	11,84%
Azioni proprie	1,34%
Segnalazioni nominative non disponibili	0,45%

Name	Country	Type		Ownership Direct %	Ownership Total %
CASSA DEPOSITI E PRESTITI	IT	B	↗	26.37	n.a.
MINISTERO DELL'ECONOMIA E DELLE FINANZE	IT	S	↘	3.93	n.a.
BLACKROCK, INC via its funds	US	B	↗	-	2.30
VANGUARD GROUP INC via its funds	US	F	↗	-	2.28
NORWAY via its funds	NO	S	=	-	1.56
NORGES BANK	NO	B	↘	1.55	n.a.
FRANKLIN RESOURCES, INC. via its funds	US	B	↘	-	1.10
PEOPLE'S BANK OF CHINA	CN	B	↘	1.01	n.a.

Multiple conflicts

When the **Government is the main shareholder**, the presence of *potential conflicts* between principal and agents is not eliminated. The conflict may rise between the *Government* and the *controlling body* (a classic principle-agent problem e.g. between the Italian Government as the Principle and CDP as the Agent) or between the *controlling body* and the *controlled company* (a classic Principle-Principal conflict, e.g. CDP vs. ENI). The reason is that public/governmental ownership, with its *social goals* (so, with the aim of protecting the collectively), may impact on the decisional autonomy of top management, damaging the interests of private minority shareholders. Other conflicts raise from the mixed nature of ownership -> requires specific, ad hoc practices of corporate governance.

The OECD Guidelines

In order to provide a reference for governance practices, starting from 2013 the OECD collects systematic information about State-controlled companies in more than 50 member states. In 2018 it has published *Ownership and Governance of State-Owned Enterprises. A Compendium of National Practices* which analyses the relevance of the public sector and the reasons for Governments' intervention

- *Analyses the models of control* (centralized/decentralized)

- *Proposes good practices* in order to grant fair competition (between State-owned and private companies)
- *Proposes a set of transparency rules*
- *Defines principles for Boards and Committees nominations*

Incident: Atlantia/Aspi vs. Italian Government

In the summer of 2020, two years after the collapse of the Morandi bridge in Genoa and following a political aut-aut (sell-off of "Autostrade Per l'Italia – ASPI" vs. the cancellation of the concession by the Government, the owner of ASPI, the listed Atlantia holding, facing a sharp decline in the value of its shares, agrees about selling its stake in ASPI (88.06%) (other stakes are in the portfolio of foreign investors, Allianz (6.90) and Silk Road Fund (5).

The solution is based:

- On the constitution of a NewCo (Holding Reti Autostradali SpA) - 51% CDP Equity, 24.5% Blackstone Infrastructures (US) and 24,5% Macquarie (AUS).
- The sale to HRA of Atlantia's stake for EUR 8 bn
- Allianz and Silk Road Fund intend to remain shareholders in ASPI
- There have been rumours of a possible future IPO of ASPI

The government announced an ambitious plan of infrastructural investments, and the reduction of tariffs and tolls. Is this feasible given the composition of the new ownership?

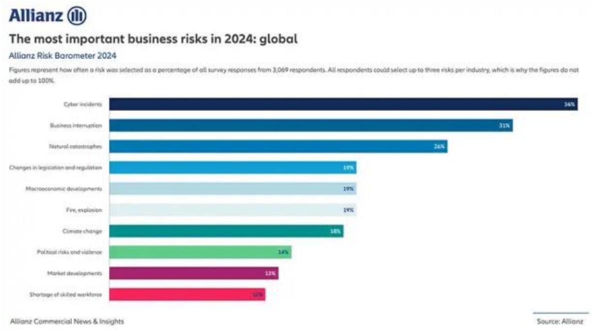
Governance and Ethics

Different types of risk

A company faces different types of risk during its lifetime, but what types of risks does it take? We can split them into two categories:

- Market risks (e.g. Financial)
- Non-market risks -> The risk that nonmarket actors (stakeholders) will take actions that make it more difficult/costly for you to implement and maximize returns from your strategies/business models. Examples of these risks are Political (for example, the request by local authorities to have specific certifications for conducting a specific activity), Institutional, Climatic (the risk that a new and unpredictable heat wave might ruin the harvest), Reputational...

➔ There are plenty of companies, including insurance companies that affirms that non-market risks are the most relevant risks a company might face



Reputational risk

One of the most relevant non-market risks is reputational risk, but what is reputation? Expected future behaviour based on demonstrated past behaviour of a company, institution or individual -> your actions and words will create expectations which will shape your ability to build in the future (for example, if a person is known for being someone who is always on time, people will expect you to be always on time). It is important that a company is consistent in what it says and does across stakeholders, because stakeholders communicate with each other. The most relevant characteristic of reputational risk is that it takes a lot of time and effort to build a specific reputation, but it takes a second to lose it. Example of reputational risk: a senior executive indicted for insider trading, a cashier caught on camera refusing service to a customer, a breach of your customers' personal data, a whistleblower (which is an individual or a group of individuals that within a company signal all the behaviours that go against company rules and/or legislation. They are so important that European Commission might require all EU countries to have a legislation that requires the presence of a whistleblower within the most important companies in that country), a scandal for not respecting environment and human rights (even though you have made a huge campaign explicating your commitment to these themes)

- ➔ they are all endogenous/internal factors -> even though we might believe reputational risk to be something that comes from the external environment of a company, most of the time these events occur by behaviours coming from internal factors.

Reputation is a matter of reality, as it changes beliefs and expectations of shareholders and stakeholders and it can increase or reduce the reputation-reality gap. In general, we can affirm that a factor that can influence negatively the reputational risk is the weak internal coordination or controls. Who is doing the perceiving? Every single stakeholder (Shareholders, employees, customers, social media, banks...), anyone who has some level of connection to the firm.

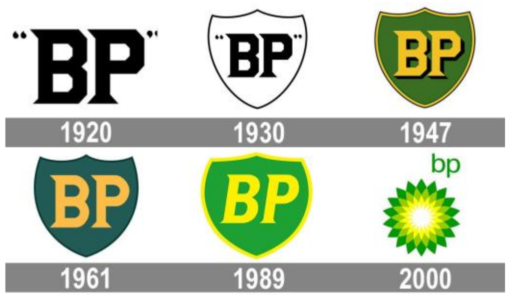
Is reputational risk measurable? With difficulty: Customer satisfaction (Brand value / ranking), Rating, NPS (Net Performance Score, it captures the number of customers that recommend your product/service to another person), employees' satisfaction (Those who leave / Silent quitters), media coverage (Sentiment analysis, the sentiment towards your brand), Stock price (the reputation of a company can increase or decrease the stock price of a company)

Who and where are you "on trial"? Courts vs Twitter

Who has access?	Actors recognized as having standing before the court	Anyone (almost) with access to the internet
What issues can be brought?	Issues where there is a legal case to answer or consider	Anything
What information can be brought?	Evidence that is true, accurate and legally relevant	Anything
What is success?	The court ruling your favor	Engagement? Endorsements? Awareness?
What determines success?	The weight of evidence and strength of legal argument	Number of views, likes, retweets?

➔ Court of law is clearly the easiest "tribunal" to deal with, as on social media you don't know who is talking about you and what they are saying, and when you know it is very difficult to make the counterpart to change its idea, and you never know when it is going to be over

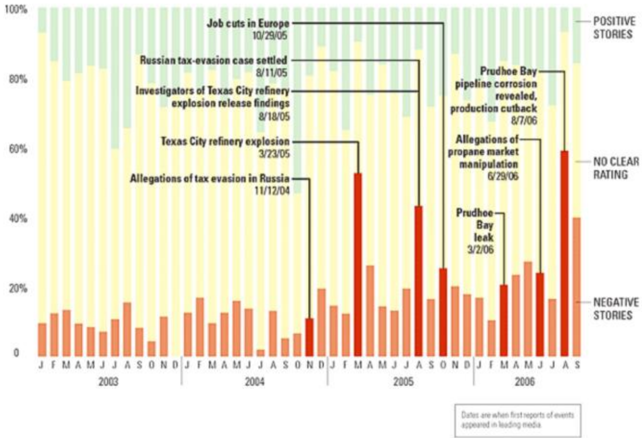
Reputation and image: the BP case



BP (British Petroleum) is a British company that extract and distribute petroleum all over the world, even though they do not work only with petroleum. Along year, they have changed multiple times their logo, to give to the company the impression of a sustainable and eco-friendly company, even though they were subject to a big scandal in the Gulf of Mexico -> there was a petroleum platform located in the Guld of Mexico which in 2010 had a damage and started splitting oil all over the sea and land, also contaminating the cost line of several countries and killing several fishes and birds -> it has been a famous scandal not only because of the damages that it caused but also because of the complexity of the recovering operations and because of the reaction of BP when the oil started spilling all over the sea. BP did nothing to prevent the catastrophe to happen, when the oil was starting to spill in the sea or even when the local governments requested to operate. They started doing something when the international stakeholders started complaining about the tragedy. Also when they decided to take action, they did not use their own money (they asked Mexico and other countries to lend some), they did not use their workforce (it was mainly the work of volunteers from all over the world), they did not do anything to compensate the local communities damaged by the accident (in particular the fisherman), all worsen by a video promotion the CEO of BP made for public apologies where he said a lot of lies (for example, he affirmed that no tax payers money will be used).

➔ The reputational damage for BP, as a consequence of the combination of both the catastrophe itself and the video that followed, was so big that we still talk about it today. It was claimed to be an abuse of the stakeholders -> ambiguous ads (such as displaying clear water even though the company started operating when the damage was done), exaggerated claims, psychological appeal.

BP's sinking reputation



IKEA

The core strategy of the company it to sell at low prices also entails low-cost sources

- WHO customers -> everyone
- WHAT product -> furniture, curtains, carpets…but also food
- HOW is it produced -> not produce in Sweden (it is very expensive to produce there because of labour, taxes, comply with regulations, raw materials…) but in Poland, India, Pakistan (cheaper labour, labour with experience in this sector, easier access to raw materials…)
- HOW is it sold -> rich countries (even when the country is distant and the shipping costs are high), where the purchasing power is higher -> strategy arbitrage (producing in low-cost countries and sell in countries where the purchasing power is higher)

There has been several scandals that regarded IKEA:

- In 2016, IKEA agreed to pay 40m£ because some toddlers were not safe to build and by falling, they killed 3 people
- There have been situations where in the chocolate cakes sold by the company, people found out they were contaminated by sewage, making IKEA take off the product from 23 countries
- Several accuses of child abuse

There are plenty of option -> stop production (because it represents 3% of revenues it is a choice the company can make. The problem with closing completely the production without knowing the reasons behind is that there is the risk it will occur again), relocate the production, increasing the social responsibility of the company (like building schools for children) …

They came to the tv show, they said that they did not know about them (because it was a supplier of a supplier) appointing Barner (who was the figure in charge of the rack division) as Children's Ombudsman (which is the figure responsible for the children's safety around the world reporting directly to Ikea's CEO) -> Advocates for Ikea's actions to be "in the best interests of the child". Ikea learns about unintended consequences of disengagement -> US Child Labor Deterrent Act results in 50,000 dismissals in Bangladesh and children move to hazardous jobs. Ikea starts partnership with UNICEF (Learning centres and by giving micro-credits to Women) and started partnership with WHO (Inoculation program)

➔ They are doing these practices both for recovering their reputation and creating a precedent so that in case further issues connected to previous ones will occur, they are going to be covered

Linkages between problems and how to address it

There are different types of linkages that regards a company:

- Linkages between different issues -> an Issue A can generate a further Issue B and vice versa, or maybe an issue occurred in one Business line can stigmatize the other Business lines of the company
- Linkages across time -> an Issue occurred in 2023 can generate a further Issue in 2024 and so on
- Linkages across space -> an Issue occurred in Italy can generate a further Issue in Sweden

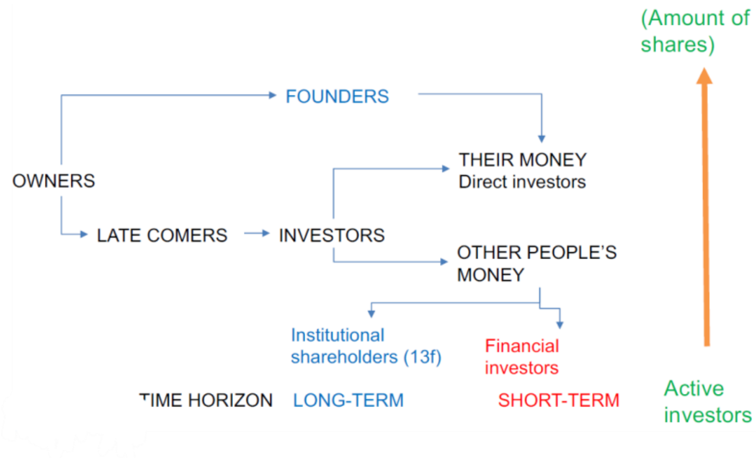
What to do? Analyze and understand!

1. Define the issue -> Managers are embedded in multiple stakeholder networks that form around different issues (such as the employees, suppliers…). These "issues" can entail many things such as particular technologies, clients, projects, performance objectives, regulations, etc. A critical first step in stakeholder anlaysis is defining the issue
2. Identify and map your stakeholders -> You have heard about shareholders, managers, board members. But there are plenty of actors that cares about the company, not only for the present but also for the future (a company that is involved in a significant scandal may find some difficulties to find money in the future). The government (the shape the rules and invest in innovation) Firms!

Are all investors equal? Firstly, we have the owners -> if they need money, they first try to lend money from a bank, than by using bond and, in case they do not raise any money, we issue new equity -> we have to make a distinction between founders (who have to invest their own money) and investors (who invest other people's money). Regarding the investors, we have to separate considering the time-horizon:

- Institutional shareholders -> they have to invest on the behalf of the future generations
- Financial investors -> short-term orientated, even some seconds

Is there any method a company can make to change the structure of its investors? Share buybacks, search for a white knight.



The "supremacy" of shareholders (value)? Stakeholders (incl. Shareholders) do not always agree about how they would like to see a firm managed: Young vs old shareholders, men vs women, family vs non-family, employees with firm-specific investments vs employees without, suppliers that have customized their products for a firm vs those who didn't…

Variance across stakeholders groups:

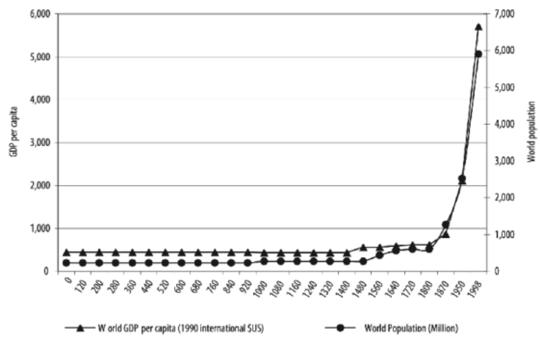
- Equity vs debt-holders
- Employees vs shareholders

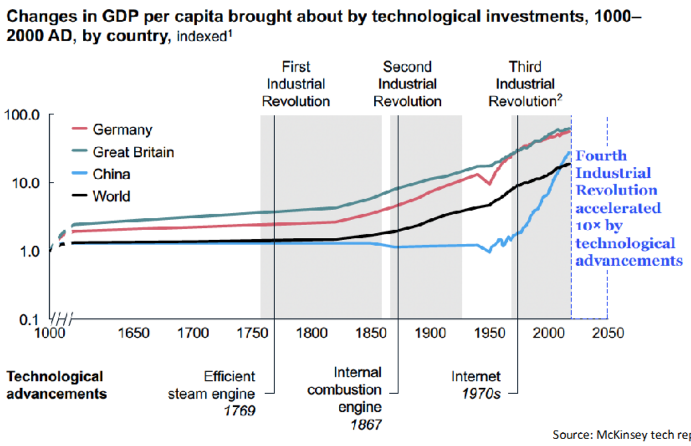
The degree of conflict among a firm's stakeholders is at least in part endogenous to firm actions (e.g. dividend payout policy affects the risk preferences of shareholders)

The role of governments, national and supra-national authorities -> when we speak about the importance of these institutions, it is very complicated to force companies to comply with CG rules and principles that are considered good by them (for example, both Google and British Telecom have been sued and split into different companies because they were having a monopolistic behaviour, but still these companies are present and stronger than before).

When the government "does not work": Institutional "voids" -> Emerging/developing markets are said to have weaker institutions or institutional "voids". They lack the type of institutions that makes business easier to conduct and lower transactions hazards (e.g. weak legal systems make contract enforcement difficulties, weak labor market institutions make it difficult to verify qualifications and identify institutional voids → Transaction costs

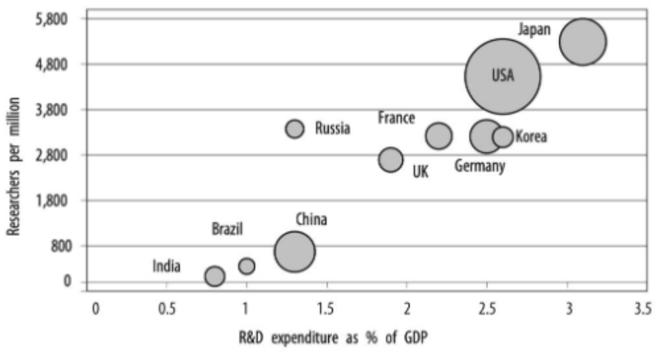
➔ Here, conglomerates work well





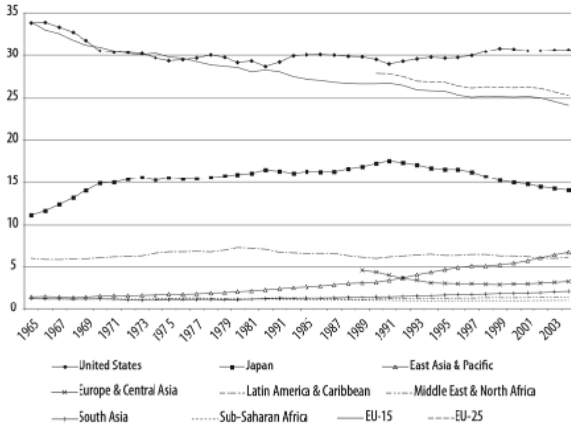
Source: McKinsey tech report 2023

Figure 4. Total gross domestic expenditure on R&D (PPP US$)



Source: Computed from data in World Bank (2006a).

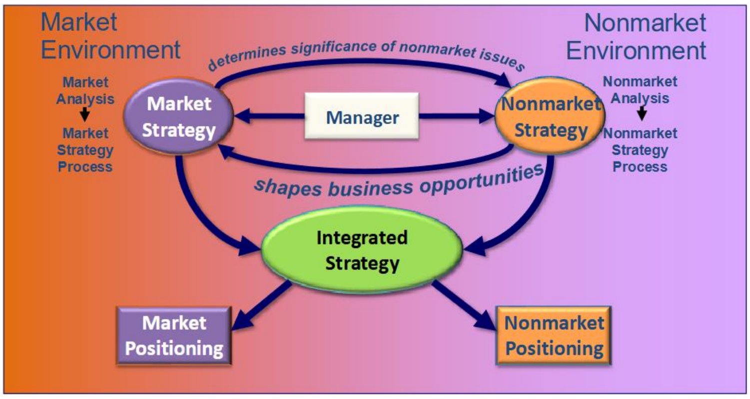
Figure 3a. Shares of different world regions in global value added (constant 2000 US dollars),%



Unicorns -> it is a term coined in 2013 for referring to 39 start-ups that had attained $1 billion in market value. In 2023, 2,500 of the companies founded over the last 20 years have achieved valuations > $1 billion (in the public and private markets) -> Made easier by the large amount of venture capital that has surged into the market over the past decade and by low interest rate that facilitated debt. Numbers are decreasing because investors prefer safe bets, favouring North American unicorns, specifically in the US, and reducing exposure to those in Asia.

How to protect yourself?

1. Strategy



2. Resilience -> the ability of a company to return to its normal operations after a disruption:
   a. Through redundancy (e.g., inventory, capacity, IT systems
   b. Through flexibility (e.g., interchangeability of production plants, product standardization, built-to-order & postponement (e.g., for last minute customization)

   Firms' fortunes in the face of business shocks depend more on choices made before a crisis than on actions taken during the crisis. Such resilience benefits firms every day, disaster or no disaster. Firms can increase security, reducing the likelihood of a disruption, with layered defences
3. Stage your investments: Real options approach -> A real option exists when a manager has the right but not the obligation to take action with regard to an investment or operation. It is a "real" option because it involves a tangible asset (e.g. machinery, land, inventory, patents). Two main types:

   a. Growth/incremental options: involve investments, assets or activities that can be scaled up, abandoned or sold off in the future
   b. Switching/flexibility options: investments, assets or activities among which one can redistribute resources to facilitate strategic change

   Real options are attractive in environments of high uncertainty because they provide flexibility and can keep initial commitments low

4. Controlling bodies & Insurance
5. CSR:
   a. Impression management:
      i. Show good faith, that you care about the general welfare of society
      ii. It indicates that you try to adapt to the local context or align with global meta-norms and expectations
      iii. It increases your legitimacy and reputation in front of stakeholders
   b. Acts as an insurance
      i. Helps to overcome nationalist sentiments in a host country
      ii. Allows for a general "license to operate" and greater buy-in from specific stakeholders when CSR activities are targeted at them -> it is a cheaper practice and has a wider coverage

SOVEREIGN WEALTH FUNDS AND THEIR IMPACT ON CORPORATE GOVERNANCE

Definition/Functions/Structure

They are ways for putting place policies nationally and internationally, both affecting companies and governments.

Definition (OECD)-> A pool of assets (they are multilateral investors, that invest mainly in financial assets but also in real estate, currencies...) owned and managed directly or indirectly (if they use a fund manager) by governments to achieve national objectives.

Alternative definition (PwC) -> All of the Government-related funds that are active in the global markets to achieve national objectives -> compared to the previous definition, PwC consider also the fact that sovereign wealth funds operates at global level too for achieving national objectives.

In general, a SWF is therefore an Institutional investment institutional investment fund owned by a government that are basically the opposite of hedge funds:

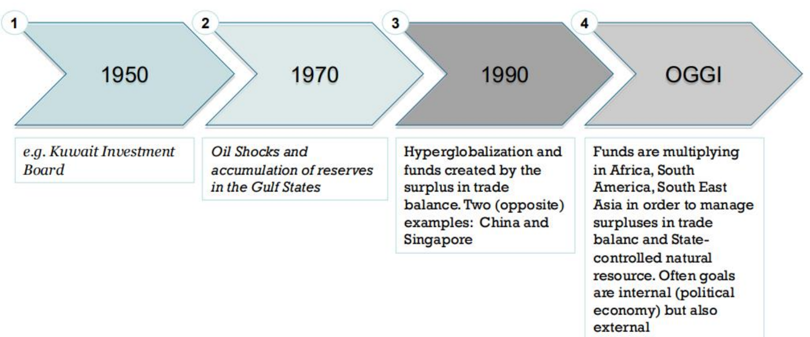
- they pursue investment strategies oriented in the long run
- have to manage the money of people
- they are particularly risk-averse (consequence of the previous two factors)

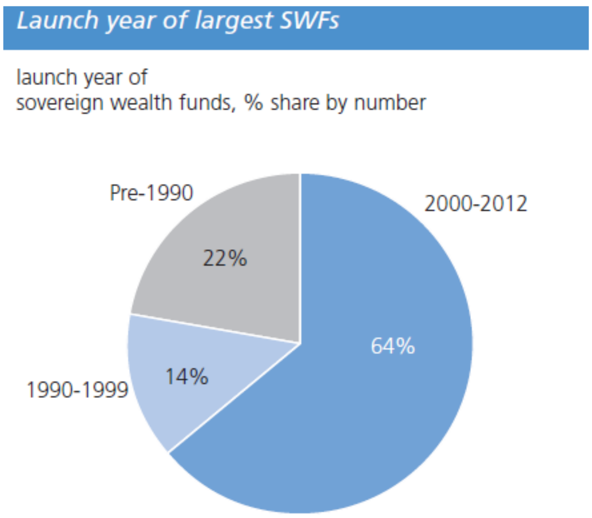
Where the resources managed by the fund generally come from? Three main sources (+ two controversial 3):

1. Surpluses in trade balance of manufacturing products or services -> when the exports are higher than the imports, we have a situation of surplus of resources that are put in the central bank and decide where to allocate this surplus, maybe to a SWF (such as in China or Singapore)
2. Sale of raw materials directly controlled by the State (for instance, non-renewable and renewable energy, or mining products) such as it happens in Middle East and in Africa.
3. Other resources directly generated by a State's balance
4. Controversial 1: State-Controlled Banks collecting savings among the public and investing in national companies for political economy reasons (such as controlling companies in strategic sectors)
5. Controversial 2: State-controlled pension funds (the biggest is the Japanese one, which collects and distribute the pensions of public workers)
6. Controversial 3: Central Banks Endowments (directly managed without a SFW's surplus and resources, but the principle of specialisation requires that there is a specific entity, the SWF, manging the resources, not a branch of a bank)

Trends

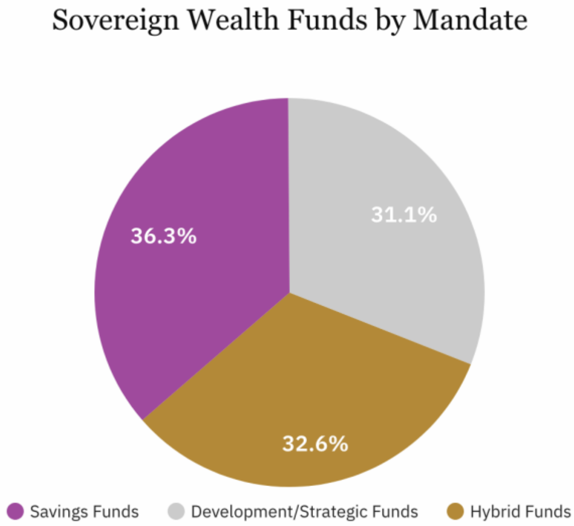
When did SWF emerge?





Kuwait Investment Board -> investments made abroad using the money generated by oil for making them profitable, not for the future generations. The same thing happened in 1970 when the oil shocks led to an accumulation of reserves for the Gulf States.

Taxonomy



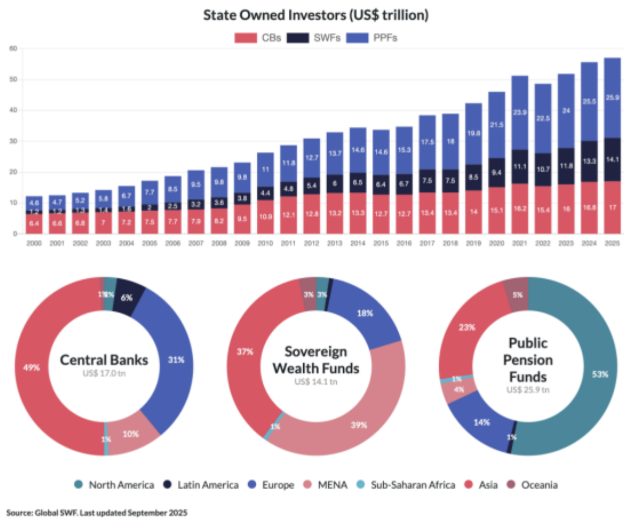
Almost all the Sovereign Wealth Funds fall into two main categories (not mutually excluding):

- By objective/goals: Countercyclical instruments (stabilizers), Savings/maximise resources for future generations (particularly important in countries where the non-renewable resources are very important), Economic policy goal (which can be of different nature, such as increase the soft power capability, prevent some foreign country to take control of a strategic sector, diversification of the economy), Mixed funds
- By the source of their endowment: Commodity (es. Oil, LNG, more recently CRM), Non-commodity (es. surplus from external trade of goods and services

➔ NB: the same country can have more than one SWF in general diversified according to the two dimensions above.

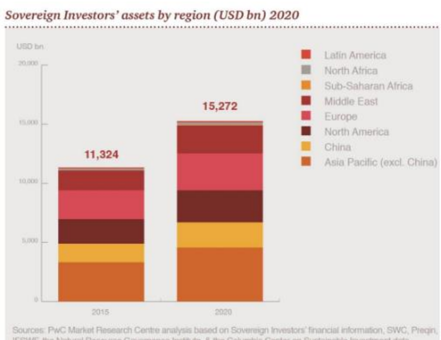
Relevance and Geography

According to the (still imprecise data) as shown above the number and the endowemet of SWFs has been growing constantly over time, even though they do not have a relevant weight compared to other institutional investors.



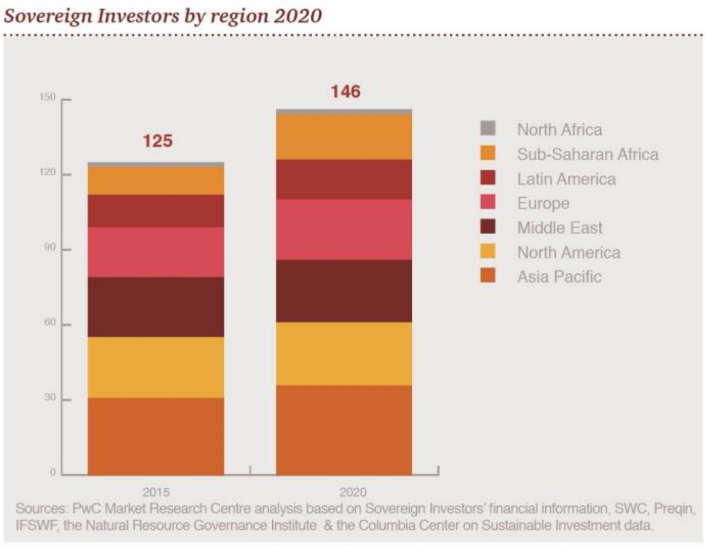
At the moment, Relevance notwithstanding the recent decision of developing countries to extablish SWFs (e.g. Indonesia, Taiwan), the ranking if SWF is still quire unequal. Around two-thirds of the DWF and PPF AuM Is managed by the first 15 entities

In terms of AuM amount, quite logical prevalence of Europe and Asia-Pacific (Russia included), a small portion coming from African countries (even though there is the possibility of building SWF



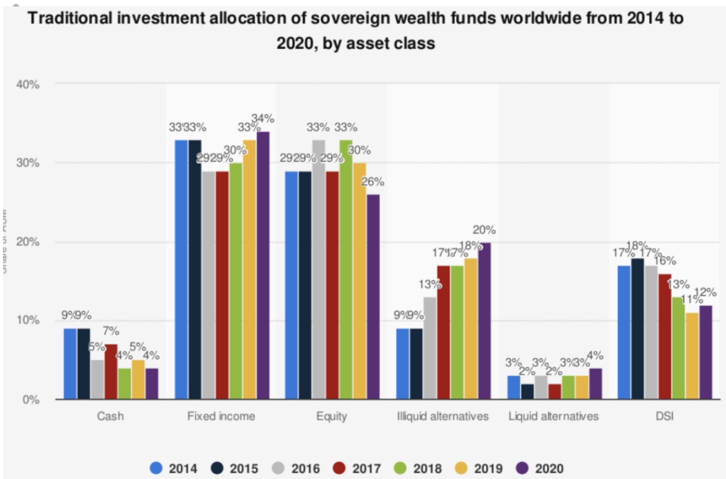
connected to rare material). Most of the time the investments are made in Europe and US, and usually they do not invest in their own country.

In numerical terms, developing countries are increasingly present



Asset allocation

There are several assets in which SWF invest their money, mostly Fixed income instruments, equity, illiquid alternatives (mostly real estate) and DSI (Direct Strategic Investments).



According to their main objectives and goals, SWF can invest:

- At home in order to support economic policy goals (e.g. infrastructure building, or for instance the turnaround of a too much specialized economy (e.g. Emirates Investment strategy)
- Abroad in order to maximize returns in different areas (generally strategic/high tech)

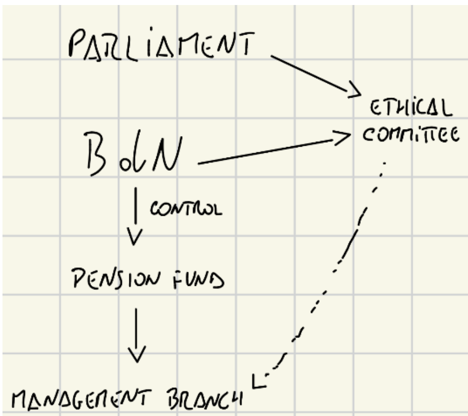
From economic policy to political economy

- Traditional view: a SWF is by definition a passive investor (exit over than voice). This is the heritage of the strategy of resource maximization (if you don't give enough money, I'll leave) and the awareness of being a foreign entity investing in a sovereign country (you are silent

because otherwise you may be perceived as a sovereign entity wanting to come to "invade" the hosting country)
- For some time -> defensive activism: SWF intervene and press the management of the company not to protect the profitability of the investment, but only when there is a long-term risk of management (like blocking managers to distribute net income but to reinvest it in the company)
- A key issue: in current times SWF can (and actually act) as instruments of soft power, particularly for geopolitical ends -> typical of SWF that are not very transparent (so they don't say clearly what are their investments and their purpose). Let's imagine we are a CFO who is targeted by a foreign SWF and we need money -> we have to be careful and verify what is the origin of those money, as they might come from an illegal source (like collecting money from collecting coal that pollutes the environment and abuse child labour). At the same time, we know that there are alternatives for collecting these money,

Sovereign Wealth Funds as Active Investors in Global Markets. Norges Bank Investment Management (NBIM): Engagement, Transparency and Ethics

1) Is it a big fund? 1.8tn $ AUM -> largest SWF in the world (if we don't consider the public fund for pensions in Japan). They started after few years the end of WWII when huge amounts of oil have been found in Norway, helped by British companies for extracting that oil -> they basically immediately decided to start using the revenues from that oil to fund the SWF
2) Are they investing in high percentage of companies or make small investments? Small percentages, average of 1.5% of each listed company that respect their standards
3) What is their strategy? Acceptable level of risk, long-term investment, but this does not mean that they do not care about the return -> it is possible to open a question about what is the level of acceptable risk
4) Ethical principles for investing -> deciding if an investment is ethical or not is not the responsibility of the CEO but the owner instead
5) Not investing in tabacco, weapon, not renewable, they invest in companies as active investors (even by disinvesting their investment in case the activity of the company changes and does not respects anymore the standards) -> they monitor each company in whichever sector in which they are present based on:
    a. Engagement with management by doing at least 3 meetings
    b. Transperency by publishing everything (how operational production is conducted, what is and how does it work your supply chain...)
    c. Ethical impact



Wrapping up

1. **Why was the Norwegian sovereign wealth fund originally established, and how does its purpose shape NBIM's investment strategy and active stewardship today?** The Norwegian sovereign wealth fund (the Government Pension Fund Global, GPFG) was established to manage Norway's oil and gas revenues prudently and sustainably. Following the discovery of

oil in the North Sea in 1969, Norway sought to avoid the "Dutch disease" and other risks associated with sudden resource wealth, such as macroeconomic instability, inflation, and corruption. The fund was legally created in 1990 and became operational in 1996, with a clear rule that petroleum revenues would be invested abroad and only the fund's long-term real return (around 3 percent annually) could be spent domestically. This long-term, intergenerational purpose directly shapes NBIM's investment strategy today. Because the fund is designed to preserve wealth for future generations, NBIM emphasizes long-term financial returns, risk management, and portfolio resilience rather than short-term gains. Active stewardship, through engagement, voting, transparency, and selective exclusions, is treated as a tool to protect and enhance long-term value by reducing ESG-related risks and improving corporate governance across global markets

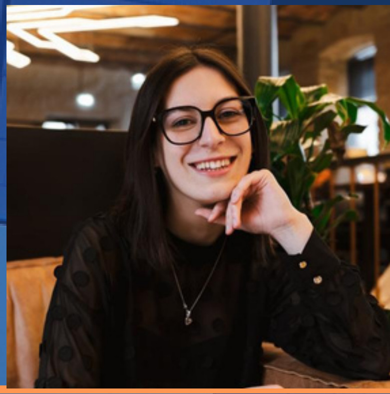
2. **Why can we say that NBIM is independent from political influence? What are they elements in its governance model that ensure an adequate separation?** NBIM is considered independent from political influence because of a deliberately layered governance structure that separates political decision-making from investment execution. While the GPFG is owned by the Norwegian state, day-to-day investment decisions are insulated from short-term politics through an arm's-length model. Key elements ensuring this separation include:
    a. *Parliament*: establishes the legal framework for the fund.
    b. *Ministry of Finance*: acts as the formal owner and sets the broad investment mandate and ethical guidelines.
    c. *Norges Bank (the central bank)*: is responsible for operational management.
    d. *NBIM*: a dedicated unit within Norges Bank, independently manages assets, exercises shareholder rights, and conducts company engagement without political instructions

    This structure ensures that political authorities define objectives and constraints, while professional managers execute investment and stewardship decisions autonomously.
3. **How does NBIM use active ownership to influence corporate behaviour? Provide one or two examples**. NBIM uses active ownership primarily through engagement, voting, and transparency. Engagement is systematic and ongoing, with structured dialogues involving boards and senior management of investee companies, particularly where governance or sustainability risks are material Examples include:
    a. *Executive remuneration*: NBIM frequently votes against excessive or poorly structured CEO pay packages. In 2023, it voted against more than half of U.S. CEO compensation packages exceeding USD 20 million, including Tesla's proposed USD 56 billion package for Elon Musk, citing concerns about size, structure, and risk management
    b. *Sustainability and human rights engagement*: Instead of immediately excluding UPL Ltd., an Indian agrochemical company flagged for child labour risks, NBIM engaged with the firm over five years. This led to strengthened policies, improved monitoring, and risk mitigation, after which exclusion was deemed unnecessary
4. **What criteria guide NBIM's ethical exclusions, and how do these decisions reflect the Fund's dual role as a financial investor and a norm-setting institution?** Ethical exclusions are guided by criteria set by the Ministry of Finance and operationalized through recommendations by the independent Council on Ethics. Companies may be excluded for producing certain products (e.g. tobacco, weapons, coal) or for conduct-related reasons such as serious human rights violations, corruption, environmental damage, or arms sales to conflict zones These decisions reflect the fund's dual role. As a financial investor, NBIM seeks to reduce long-term risk associated with unethical or unsustainable business practices. As a

norm-setting institution, it publicly discloses exclusions and their justifications to influence broader market standards and corporate behaviour beyond its own portfolio

5. **How can NBIM's decisions – such as exclusions – be perceived as political, even though its mandate is explicitly not?** NBIM's decisions can be perceived as political because their consequences often intersect with geopolitics and sensitive international issues, even if the intent is purely financial. For example, exclusions of companies linked to human rights violations in occupied territories or conflict zones, such as Israeli companies or firms operating in Africa, can be interpreted as implicit political statements, particularly when they align temporally with diplomatic developments or public debates. Moreover, NBIM's scale and transparency amplify the visibility of its actions. Publicly disclosed exclusions may affect reputations, capital access, and international perceptions, making them appear political despite being grounded in pre-defined ethical criteria and risk management logic rather than foreign policy objectives.
6. **Can NBIM truly remain neutral in a global landscape that is increasingly polarized and shaped by tensions and competing geopolitical interests?** NBIM is institutionally designed to remain neutral, as its mandate is purely financial and its governance structure separates political authorities from investment decisions. However, in practice, full neutrality is increasingly difficult. NBIM's use of engagement, transparency, and ethical exclusions often targets issues, such as human rights, conflict, and environmental harm, that are deeply intertwined with geopolitics. Given the fund's global scale and public disclosure of exclusions, its decisions can influence reputations and capital flows and are therefore easily perceived as political. As the case shows, NBIM can remain procedurally neutral and rule-based, but it cannot avoid political interpretations in an increasingly polarized global environment.

FOR DOUBTS OR SUGGESTIONS ON THE HANDOUTS



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