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Ownership Structure and Investor Protection: Myths

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1 - Introduction: The "old" story

Whenever there are legal owners of a company – its shareholders – who entrust the management of the company to somebody else, there arises, in very general terms, an agency problem. The owners are the principals, who find themselves in an agency relationship with the manager, who is their agent. An agent however may pursue objectives and defend interests that do not coincide, or are even in contrast with, the objectives and the interests of his principals. The perception of such actual or potential divergence of interests on the part of investors affects the supply of risk capital: the agency cost takes the shape of a sub-optimal financing structure and a higher cost of capital.

Corporate governance, in its wider meaning, is a technology comprising legal and extra-legal rules and legal and extra-legal institutions aimed at reducing the gap between the principals' and the agent's interests.

It is useful to consider two polar situations in the agency problem. We have at one extreme a multitude of small and dispersed shareholders, whose agent is a "pure" manager: i.e. a manager who, though he may own shares, does not have a controlling stake in the company. At the other extreme there is one shareholder who owns a controlling share of the company (not necessarily the absolute majority) while the rest of the ownership is dispersed amongst minority investors.

For quite a long time, ever since Berle and Means, it was the first situation (ownership without control) that caught the attention. A "collective action problem" arising from externalities prevents an adequate monitoring of the manager's operations: while each individual investor has neither the power nor the resources to perform it, there are no incentives to a collective monitoring

action. It was also realized that diffuse ownership was prevalent only in the US and in the UK, whereas to a various extent and in different guise concentration of ownership and/or control was prevalent in all other rich nations, as well as in the developing countries.

It was thought for a while that a concentrated ownership structure was to be preferred. A majority shareholder is in a position to monitor the manager's operations closely – or to run the company himself. As his interest to the company's security benefits is aligned with that of the minority shareholders, he internalises the costs and benefits affecting the latter and shares his monitoring privilege with all the other equity owners.

It was soon recognized, however, that, along with the shared monitoring benefits, the existence of a control position may generate substantial costs for minority shareholders. Control provides the majority shareholder with the opportunity of extracting revenues and wealth from the company for his own personal benefit: leaving aside perks and privileges, which also the "pure" manager can attribute to himself, the extraction of private benefits may occur, for instance, by means of transfer pricing in the purchase and sale of good and services or of assets or privileged credit relations between the listed company and another company wholly owned by the controlling shareholder. Ownership concentration, moreover, reduces the depth of the market for the company's shares and therefore causes a liquidity cost to the smaller shareholders. The shared monitoring benefits of a majority stake may thus be offset, and more than offset, by the *private benefits* of control and by the liquidity costs.

It was thus sensibly concluded that minority shareholders are faced with a trade-off: higher ownership concentration, while yielding higher shared benefits of monitoring an otherwise unaccountable manager, increases on the other hand the opportunity of expropriating minority shareholders, as well as their liquidity costs. Good corporate governance will improve the terms of this trade-off, by introducing more adequate checks on the managerial freedom and legal obstacles to the appropriation of private benefits. Ownership structures that are less simple than the two polar cases we have considered may make the trade-off better or worse. Thus the presence of another powerful block-holder along with the controlling shareholder limits the controller's freedom to "steal" from the company. On the contrary, the separation of control rights from ownership rights (achieved by means of multiple vote shares, cross holdings, and especially pyramidal structures), offers the same opportunity to reap private benefits with less security rights, and hence with a reduced incentive to monitor the controlled entity.

These can be the ingredients of a very open model. While agency costs for small, dispersed shareholders can never be eliminated, their nature will depend on the ownership structure, while their size will be affected by the protection provided by the institutions of corporate governance

from an unaccountable manager, on the one hand, and from a rapacious controller, on the other. There is no presumption that one ownership structure is to be preferred to another and there is room for multi-varied explanations of the differences in the degree of concentration that can be observed in different countries.

2 – A new story

In the past decade or so the view that there are costs as well as benefits associated to different ownership structures was all but forgotten by a relevant part of the law and economics and of the financial economics literature, also on the strength of some influential quantitative research - just as it had been neglected at the time when the Berle and Means tradition was in fashion. In essence, it is now argued that the "best" structure is one with no controlling shareholder and the highest degree of ownership dispersion – just as the virtues of a powerful controlling shareholder were claimed before attention was drawn to the costs of concentration in terms of private benefits and liquidity. It is not by chance that the new story developed in the American environment of the 1990's, featuring accelerating expansion, corporate growth in double digit figures, new technologies and a stock market boom – just as the admiration for the dominant-stockholder-cum-monitoring model of German or Japanese description was the fashion when Japan and Germany were growing fast and the US were lagging behind.

The essence of the new story, dubbed as the corporate law theory, is the following. If the legal institutions (or markets, in the Chicago version) only ensure weak investor protection, "stealing" from the company is easier and hence private benefits are higher. When this is the case not only is ownership control more attractive, but there is a disincentive for the initial owner of a firm to relinquish control by selling a stake to a plurality of minority shareholders: as there will always be candidates to acquire control in order to grab the private benefits, a dispersed ownership structure would be unstable. Aware of this, and aware of the lower liquidity of the company's shares if ownership is more concentrated, small investors will be more reluctant to invest. The lower price that his shares can command represents a further disincentive for the initial owner to abandon a controlling position. It follows that the weaker the protection granted to minority investors, the higher the degree of ownership concentration and the lower the depth and width of the securities market.

This argument, by itself, only allows us to conjecture that weak investor protection is a *sufficient* condition for ownership concentration. But, implicitly or explicitly, the argument has been carried a step further. Holding a large block of a company entails an undiversified risk for which

there must be a compensation, to be paid, in one way or the other, by the minority shareholders: but if the latter are adequately protected no such compensation can be extracted, there will be no incentive to hold majority stakes and ownership will necessarily be dispersed. Protection is provided by appropriate legal institutions (or, in the Chicago version by the existence of competitive and efficient markets). Ownership structures are thus viewed as an equilibrium response to the domestic legal environment (or to the market environment). We are thus presented with the much stronger, and operationally more relevant, conclusion that weak investor protection, directly or indirectly, is a *necessary*, as well as a sufficient, condition of concentration. The implication is a two-way relationship between ownership structures and investor protection, concentration being the inevitable result, and hence a symptom, of weak protection, whereas dispersed ownership is the necessary attribute of strong protection.

A large body of empirical research, based on an impressive (and unprecedented) collection of institutional data for a very large number of countries, has been developed to buttress these conclusions. Measures of investor protection have been identified and quantified for each country. It has further been observed that countries belonging to different legal families are characterized by different values of a legal protection index: higher for the countries of common law systems, lower for those of civil law, with German and Scandinavian regimes in the middle. A (negative) cross-country relationship has been established between measures of investor protection (and hence between legal families) and the degree of ownership concentration. Attempts have been made to endogenize the measures of legal protection by relating them to other cultural and socio-political variables. More interestingly, some researchers have sought to provide some proxy measures of private benefits, once more establishing a (positive) relationship between the size of the latter and the degree of ownership concentration.

This summary does little justice to the width and depth of the empirical research that has been undertaken in recent years. What matters here, however, is that almost invariably, it has been used to buttress the conclusion, already present in the American law and economics literature, of a superiority, in terms of investor protection and of the growth of financial markets, of dispersed over concentrated ownership, and hence of the Anglo-American over the continental European (and indeed rest-of-the-world) model.

In what follows I wish to argue that the strong version of the "new" story, which this conclusion implies, meets with many criticisms, both conceptually and factually. In the next section I shall briefly examine the nature of the agency costs arising from lack of monitoring of managerial decisions in a situation of dispersed ownership: though it is problematic to appraise them *ex ante* as they are often perceived only when an episode of corporate failure has occurred, they nonetheless

exist and can be sizeable. In section 4 I shall use a simple formalization to show that, if managerial agency costs are explicitly taken into account, along with the costs of private benefits and of reduced liquidity for the minority shareholders and of lack of diversification for the block-holder, there appears to be no unique relationship between ownership concentration and the possibility of extracting private benefits. As the outcome varies depending on the relative value of the relevant parameters that reflect *all* the cost items (hence also lack of monitoring, liquidity and diversification), no *a priori* reasons can be found to establish a link between the effectiveness of protection against the appropriation of private benefits and the degree of concentration, and even less to infer the degree of investor protection from a given ownership structure. It is thus plausible that the ownership structure may depend on factors other than the degree of investor protection, such as path dependence, the time horizon of the investment, or the specific characteristic of firms and industries and the conditions under which they operate, as argued by earlier American and by European literature. The existence of a relationship between the degree of concentration, on the one hand, and the protection against, or the size of, private benefits has however been documented by empirical research. In section 5, therefore, I shall turn to examining the measures that have been used in this research: I shall argue that they are lacking in significance and, because of relevant omissions, in robustness.

My conclusion is that the “legal” explanation of ownership structures around the world is flawed because it either fails to consider the existence, nature and size of actual or potential managerial agency costs or implicitly, and arbitrarily, assumes that the latter are invariant with the ownership structure.

3 – The nature of managerial agency costs

Leaving aside perks and personal benefits (golf clubs, private planes, fat pension schemes and the like) which both the “pure” manager and a controlling shareholder can attribute to themselves, the agency costs of a manager unconstrained by adequate monitoring are essentially of two types. The first, and more obvious, is managerial “shirking” or sloppiness, leading to inefficiency in the conduct of a company’s business and in the allocation of its resources. Insofar as it is perceived that there is room for improvement with better management, the market for corporate control or shareholders’ activism provide the remedies. Note however that neither is compatible with the persistence or existence of fully dispersed ownership: a takeover leads to the assumption of control, while, to oust a manager in a shareholders’ meeting, some substantial block-holder must lead the pack.

A more interesting, more relevant and possibly more frequent instance of managerial costs is that of a hard-working and alert manager who sets, and efficiently pursues, objectives for the company that are at odds with the interests of the shareholders. If power for its own sake plays a prominent role in the manager's objective function, and is associated, as always is, with the size and reach of the company's activities, imperialistic ambitions will prevail, to be fulfilled by means of massive investment, mergers and acquisitions. The manager's hubris introduces a bias in the assessment of such projects, that are financed by using the company's free cash flow or by incurring debt, and hence at the expense of the current or future cash flow rights of the shareholders.

Shareholders are often impotent. First, insofar as investment decisions are only subject to the approval of the board, they have no say and are given no chance to express their view on the use of the company's resources. Second, even if they had, they would be hard put to express an informed view: on the one hand, when a company indulges in an acquisition spree, it becomes objectively difficult to evaluate its underlying health before the dust settles; on the other hand, shareholders have to rely on the manager's appraisal of his projects, which tends to err on the side of optimism when the projects are inspired by empire-building motivations with the prospect of being at the helm of a larger and more powerful ship, Third, whereas the intrinsic opportunity that a controlling shareholder has of appropriating private benefits is taken for granted, and discounted by the market, there is no similar presumption in the case of a dynamic manager running a widely held company. Investment decisions and acquisitions that extend the company's reach and mission are always given plausible motivations and may even turn out to be successful, at least initially, generating the presumption that success breeds success: thus, unlike the costs inflicted by a majority shareholder that can be priced in *ex ante*, the risk of the manager's decisions is perceived when failure has occurred and it is too late.

Finally, and importantly, legal institutions, *per se*, provide more adequate protection against the appropriation of private benefits on the part of a controlling shareholder than against the managerial agency costs which I have indicated. Leaving aside cases of gross misdemeanour in patent violation of the fiduciary duty, managerial mistakes and wrong business decisions are not actionable by shareholders under the "business judgement rule" followed by the American jurisprudence. The solid foundation of this rule is that the market is the only tribunal competent for sanctioning mistaken decisions and investors cannot be protected from the consequences of their own choices. But it implies that no *legal* sanctions are conceivable when the pursuit of power causes a gap between the objectives of an unaccountable manager and the shareholders' interests, even though a manager's hubris is often a major ingredient of which extravagant business decisions are made.

It can correctly be objected that, leaving legal remedies aside, the solution to these problems may be found in the working of other institutions of corporate governance. A well designed accounting system, transparent periodic financial reporting, effective controls by audit committees and by the auditors, incentive based compensation systems for the executives, environmental controls should all contribute to constrain the excesses of managerial freedom. But, as recent events in the US (and in some cases in Europe) have shown, the efficient functioning of this set of constraints rests on an incentive structure that can be severely distorted when the manager pursues his objectives with sufficient determination. even without considering the pathology of fraud and patent violation of the law (though this is often the end result).

A rising stock market which provides the suitable environment for a manager's expansionary drive. In general, when the going is good fewer questions are asked, as there is fat for everybody. More specifically, "acquisition accounting", whereby drastic initial write-offs of the acquired assets are followed by substantial revaluations that flatter future profits and justify further acquisitions, can only thrive in a rising stock market. There is thus an incentive for a manager who blindly (and in good faith) believes in the value of his expansionary projects not to let disappointing quarterly figures or problematic financial statements stand in his way.

Accounting is to some extent an art that always leaves some room for creativity and discretionary choices. Financial innovation, by opening possibilities that are not covered by conventional standards, broadens the opportunities for elusive and creative accounting and provides new means by which earnings projections can be flattered, risks concealed and a smooth record of profit growth portrayed. Two examples are off-balance sheet arrangements and transactions (e.g. securitization arrangements or transactions with related but unconsolidated entities), by which goods, services and assets can be transferred at prices different from their fair value, and contracts for which there is no reliable market benchmark and therefore lend themselves to highly judgemental estimates. Use of *pro-forma* financial reporting often serves the purpose to present a glossy picture of the company's core performance. Even good accounting standards have difficulties in preventing elusion, if not abuse. If, like the US Gaap's, they strive to achieve completeness by setting a rule for every conceivable case, the ambition of drawing a map of scale 1:1 is frustrated by the ever emerging new territory of financial innovation and the possibility of elusive conducts that comply with the form but not with the substance. If, on the other hand, they state principles, rather than detailed rules, as the International Accounting Standards (IAS) do, the burden lies on a judgemental appraisal of whether each specific case is in accordance with the principles.

The incentive problem may deeply affect the working of the checks and balances that are charted in the institutions of corporate governance. If the incentive structure degenerates, audit committees, even if composed of non-executive, independent directors, and external auditors may easily become captive of the all-powerful manager: the directors, because they depend on him for their well-paid appointment in the company's board as well as in other inter-locking boards; the auditors, if they are allowed to obtain well remunerated consulting jobs alongside their auditing task. Similar instances of incentive degeneration have occurred in the case of incentive based compensation schemes and in particular of stock options – an instrument that in principle was designed to align the interests of the managers with those of the shareholders: even leaving aside the issue of their expensing, the setting of convenient strike prices (usually at the money) and the absence of lock-in clauses may encourage manipulation and insider dealing, while practices such as re-pricing, buy-backs to shore up share prices, and the like may actually increase the gap between the objectives of the management and the interests of the shareholder.

Finally, the quality of environmental controls may also be compromised. As a result of financial innovation, banks, while unloading their credit risk onto the public by means of securitization, become well paid providers of financial architectures and services when managers need room for discretionary accounting: in such cases the bank no longer monitors the manager, but connives with him. If analysts work within the banks, they behave accordingly.

Thus managerial agency costs, consisting of the costs for the shareholders of corporate failure, do indeed exist and may be relevant. Lacking adequate monitoring, they are incurred as a result not only, and perhaps not so much, of shirking and sloppiness in the conduct of business, as of an unsustainable expansion of the company's activities in the pursuit of managerial ambitions. As long as the decisions from which they arise fall under the business judgement rule, legal remedies provide no protection, while the other institutions of corporate governance may be ineffective. Once managerial agency costs are given proper consideration, the strong version of the relationship between ownership structure and investor protection no longer holds. In the next section I shall attempt to show this in general terms by means of a very simple formalization. Since that link rests also on empirical analysis, in section 5 I shall turn to examining the significance and robustness of the quantitative measures that have been proposed..

5 – A formal illustration

4.1 Consider a publicly listed company, which, if properly monitored, has a value of V (in terms of discounted cash flows). Dispersed minority shareholders, who are unable individually and

collectively to monitor the management, own $(1-\gamma)V$ of that company, while γV is owned by a block-holder, with $0 \leq \gamma \leq 1$.

There are costs arising from lack of monitoring. Such costs, M, are decreasing with ownership concentration, and hence with γ: the presumption is that the block-holder's interest and power to exercise the monitoring, increase with his ownership share. We (reasonably) assume that when the block-holder is in full (legal) control of the company, with a share of 50 percent. or more, the (managerial) cost due to lack of monitoring falls to zero. Up to $\gamma = 0,5$ we establish a simple linear relationship between concentration and monitoring:

$$(1) \qquad M = \begin{cases} (1 - 2\gamma)mV & \text{if } \gamma \leq 1/2 \\ 0 & \text{if } \gamma \geq 1/2 \end{cases}$$

This specification implies certain knowledge of the *potential* costs due to lack of monitoring. I have instead argued above that the cost of the manager's wrong decisions are often only perceived *ex post*, when failure has occurred. A more plausible specification should consider the probabilities assigned by investors to a "wrong" outcome.

Holding a large stake in the company allows the block-holder to appropriate private benefits, B, at the expense of the company, and hence of minority shareholders. We assume (reasonably) that the opportunity of appropriation increases with the share of the company owned by the block-holder and is fully reaped when the latter has full control, with $\gamma \geq 1/2$. Postulating again a linear relationship, we have:

$$(2) \qquad B = \begin{cases} 2b\gamma V & \text{if } \gamma \leq 1/2 \\ bV & \text{if } \gamma \geq 1/2 \end{cases}$$

For minority shareholders there is a liquidity cost, L, arising from ownership concentration: the less shares are traded in the market, the greater the bid-ask spread and the higher the effects of a sale or purchase on the share's price. We thus posit:

$$(3) \qquad L = l\gamma V.$$

The block-holder, on the other hand, bears a cost, R, due to the fact that the investment of a sizeable share of his wealth is concentrated in one company and is not diversified. This cost depends on market's volatility and on the company's β. More simply we posit:

$$(4) \qquad R = r\gamma V$$

4.2 Monitoring costs are shared by all the stockholders: hence the cost for the minority shareholders is $(1-\gamma)M$, while γM is borne by the block-holder.

The block-holder's private benefits are a cost for the other shareholders. There are two possibilities here. If B is extracted from the whole of the company's value, the loss for the minority shareholders is $(1-\gamma)B$, which is also a net benefit (a negative cost) for the controller (while γB cancels out, being at the same time a loss and a benefit for him). If on the other hand the controller is able to milk the minority shareholders without affecting the value of his own stake in the company (a less likely case), the cost for the latter, and the benefit for the former, is B. We shall refer in the text to the first possibility, while reporting summarily on the properties of the second.

Let C_M and C_C be respectively the costs borne by the minority shareholders, to be subtracted from $(1-\gamma)V$, and by the block-holder (for whom they may be positive or negative), to be subtracted from γV. We have:

$$
(5) \qquad \begin{aligned} C_M &= (1-\gamma)(M + P) + L \\ C_C &= \gamma M - (1-\gamma)P + R \end{aligned}
$$

Considering (1) – (4), we have

$$
(6) \qquad \left.\begin{aligned} C_M &= \{(1-\gamma)[m(1-2\gamma) + 2b\gamma] + l\gamma\}V \\ C_C &= [\gamma m(1-2\gamma) - (1-\gamma)\, 2b\gamma + r\gamma]V \end{aligned}\right\} \text{ if } \gamma \leq 1/2 \qquad \left.\begin{aligned} C_M &= [(1-\gamma)b + l\gamma]V \\ C_C &= [r\gamma - (1-\gamma)b]V \end{aligned}\right\} \text{ if } \gamma \geq 1/2
$$

Note that the total costs borne by *all* the shareholders, and affecting the total value of the company, are the sum of the monitoring costs (positive as long as $\gamma<1/2$, zero otherwise), the liquidity costs and the (lack of) diversification costs: private benefits cancel out, as they only imply a redistribution among shareholders.

We shall for simplicity consider the ratios $c_M = C_M/V$ and $c_C = C_C/V$.

4.3 As is obvious, the cost for the minority shareholders increases with m and b, which both depend on the effectiveness of investor protection provided by the law and by the institutions of corporate governance, and with l, which reflects the efficiency of markets. The cost of the block-holder, while increasing with m and r, decreases with b.

There is however no unique relationship between the degree of ownership concentration, γ, and the value of b, or of each individual parameter. To illustrate this, without going into tedious elementary algebra, consider some properties of the cost functions (6).

In the relevant interval $0\leq\gamma\leq1/2$ the intercepts are:

for $\gamma = 0$, $c_M = m$, $c_C = 0$;

for $\gamma = ½$, $c_M = 1/2\,(b+l)$, $c_C = (r-b)$.

Whether the cost for minority shareholders is greater when a majority shareholder is in full control or when ownership is fully dispersed depends on the *relative* values of the three coefficients b, measuring the extent of appropriation of private benefits, m, measuring the costs arising when there is no monitoring, and l, measuring the liquidity costs; for the block-holder it depends on b and r, the cost arising from lack of diversification of the investment. Note that in the case of small shareholders a decrease in b – perhaps because of better protection – with m unchanged makes high concentration relatively more attractive (or relatively less unattractive) than full dispersion.

Next consider the benchmark case $m = b$. For $l<b$, c_M, the cost for the minority shareholder, decreases monotonically in the relevant interval of γ, whereas c_C, the cost for the block-holder, increases or decreases according to whether r is greater or smaller than b.

If $m<b$, c_M may increase with γ up to a maximum in the relevant interval and then decrease, being lowest at $\gamma=0$; but, as long as b and l are not too high, it may also decrease continuously. The cost for the block-holder, c_C, while negative in most instances (as private benefits more than offset the other costs), may increase or decrease continuously with the size of his stake, or reach a minimum at $\gamma<1/2$, depending on the value of r.

If $b<m$, the cost for the minority shareholders, c_M, is continuously decreasing in the relevant interval for reasonable values of the liquidity cost; if l exceeds the other two parameters, c_M may fall initially and reach a minimum at $\gamma<1/2$. Depending on the value of r, the cost for the block-holder, c_C, may increase or decrease continuously in the relevant interval, or increase to a maximum and then decrease.

Absence of liquidity costs does not affect the freedom in the behaviour of c_M as ownership concentration increases: c_M may increase or decrease, according to the value of the *ratio* between the coefficient of managerial costs and that of private benefits, though $b>m$ is a sufficient condition for c_M to be a minimum at $\gamma=0$. The lowest cost solution for the controller is always at $\gamma=1/2$.

If private benefits do not affect the controller's share of the company's value, the cost for the minority shareholder may increase or decrease with γ, or fall to a minimum within the relevant interval, while the cost for the controller may also increase or decrease with γ, or rise to a maximum within the relevant interval.

The level of γ at which the cost for the block-holder is at a minimum or a maximum always decreases as b increases. That at which the cost for minority shareholders is at a minimum or a

maximum increases with *b* if private benefits affect all shareholders, decreases if they only affect the minority shareholders.

Note finally that the (harmful) consequences of separation of control rights from security rights are reflected by a uniform rise of *b*.

4.4 All this is very tedious, but serves to confirm what was argued before. First, the ownership structure that minimizes the costs for the minority shareholders is not necessarily one of full dispersion without control: depending on the relative size of *m* and *b*, as well of the liquidity cost, the preferred solution may be one in which $0<\gamma\leq 1/2$. Second, and more important, reducing *b,* the coefficient of private benefits, without affecting *m,* the coefficient of monitoring costs, makes greater concentration more attractive for the minority shareholders. Third, the preferred situation for the block-holder may well coincide with that for the minority shareholders. Fourth, the premium paid by a block-holder to increase his stake in the company may reflect not only the benefits he expects to reap from control, but also those that are shared with the minority shareholders.

This summary analysis, which features proper consideration of the (lack of) monitoring costs, appears to show that the are no *a priori* grounds to support the received wisdom of the new literature.

5 – Measures

Empirical research has sought to define measures of investor protection , or, more directly, of private benefits. Cross-country analysis, conducted on a rich panel of data, has endeavoured to establish an inverse relationship between the protection pf investors against the greed of majority shareholders, and ownership concentration, and, conversely, a direct relationship between the latter and a direct measure of private benefits. I shall argue in this section that such measures are unsatisfactory also because of relevant omissions.

5.1 *Measures of investor protection*

In empirical research legal investor protection is assessed and measured in terms of shareholders' anti-director rights and of the quality of accounting standards. The index of anti-director rights assigned to each country in the panel includes the following six items (with 1 or 0 according to the presence or absence of each): possibility to mail proxy votes; no requirement of a prior deposit of the shares to attend the shareholder's meeting; oppressed minority mechanisms allowing shareholders to sue directors; possibility for minorities (no more than 10 percent.) to call extraordinary shareholders meetings; shareholders' pre-emptive rights. Does such index provide a convincing measure of shareholders' protection?

Note first that five out of the six items included in the index concern either the shareholders' ability to express their voice or legal remedies enabling them to start litigation. As has been noted by many authors, voice and litigation, though important, are not particularly effective means of protection. Even in the US, where activism is greater than in other countries, institutional investors tend to be silent and shareholders' meetings more often than not end up by rubber-stamping the board's and hence the CEO's proposals: surveys of empirical studies conclude that shareholder activism has on the whole a negligible impact on corporate performance. As for the possibility of bringing suits against the board, this is a remedy of last resort, which operates only when the law has been violated and which therefore does not cover mismanagement. Even in the US moreover the frequency and relevance of shareholders' suits is low and those which are successful appear to benefit less the shareholders than their lawyers.

Actually, any attempt to use the broad map of the cross-country econometric relationships based on this index in order to understand the position of individual countries in the forest of panel data meets with considerable difficulties. Canada, on the one hand, and Germany and particularly Scandinavian countries, on the other, do not seem to fit in the two-way link between investor protection and ownership structure. To add another casual, but perhaps telling observation, as a result of the 1998 financial markets reform, the legal index of investor protection for Italy jumped from an unflattering value of 1 to a more acceptable level of 5; in spite of this, the very high level of concentration of Italian listed companies has remained unchanged between 1998 and 2002 and shows no sign of decreasing.

If the items included in the index are of doubtful significance, some omissions are surprising. As I have argued in section 3, legal remedies *per* se are unable to prevent the worst consequences of uncontrolled managerial behaviour, or even to provide an adequate sanction if the business judgement rule prevails. The quality of internal controls and of external auditing, the accuracy of financial reports, the standards of transparency and the requirements of ongoing and periodic disclosure of material information, the strength of external monitoring are means of protection at least as relevant as the expression of voice at shareholders' meeting or the access to litigation, and probably more so. It is important to distinguish between form and substance in assessing corporate governance institutions and disclosure requirements. As we have seen above, wrong incentives may cause deep and unexpected fault lines in a seemingly impeccable system of checks and balances, in which case compliance with formal requirements is not sufficient to assess the quality of investor protection.

True, an index of the quality of accounting standards, along with that of legal anti-director rights, has been used as an explanatory variable of the ownership structure, with a rating based on

how many of ninety items are included in each country's companies accounts. This index, however, though perhaps useful to assess the quality of reporting in a developing country, is much less suitable to draw comparisons between advanced countries. It again makes form prevail over substance, as exemplified by the shortcomings of a detailed rule-based accounting system, brought to light by recent corporate events in the US: even the presence of all the chose items may not prevent the use of (often legitimate) expedients that flatter revenues and sweep losses under the carpet.

It will be objected that, unlike the counting of the presence of specific legal measures in each country, an assessment of the quality of corporate controls and of financial reporting does not lend itself to easy measurement for the purpose of the econometrics of panel data. This may be true, but econometric requirements are hardly a sufficient reason for neglecting relevant variables: doing so takes a toll on the robustness and significance of the results.

5.2 *The measurement of private benefits*

The relationship between an index of legal protection and the ownership structure of listed companies bypasses the problem of measuring private benefits, the assumption being that the latter are necessarily high, leading to concentration, if legal protection is weak. There have been interesting attempts, however, to identify variables directly proxying private benefits. The first to be proposed was the so-called voting premium, that is the premium at which shares with full voting rights trade over those which have limited or no voting rights. There are actually several arrangements, especially in continental Europe, that violate the principle of one-share-one-vote: categories of shares with multiple voting rights in Scandinavian countries; or savings shares with no voting right in Italy. The rationale for using the premium as a proxy for private benefits is that the greater the opportunity of extracting private benefits, the higher the value of a majority stake, and hence the higher the relative value of voting shares for somebody attempting to grab control. One trouble with the premium measures reported in the literature is that they are assessed at a certain date for a panel of countries: to be significant, they should exhibit a reasonable stability over time. At least in the case of Italy, however, the value of the premium has been extremely volatile and its behaviour, moreover, appears to depend also on variables that have little to do with the benefits of control.

A more interesting measure, recently proposed, is the block premium: the difference between the price paid for acquiring a big block of shares off the market and the market price of the shares immediately after the transaction has been announced. The size of this difference – the argument goes – depends on the expectation to extract benefits that are at least equivalent if the

control position acquired through the purchase: such benefits are assumed to consist in the company's resources that the controller can appropriate at the expense of the minority shareholders. The levels of block premiums reported at a certain date for different countries are then related both to measures of investor protection and to the ownership structure: it is found that the level of the premium is negatively related to the index of investor protection and positively to ownership concentration.

Such premium may however reflect shared as well as private benefits of control: it may, in other words, be due to an assessment (on the part of the Warren Buffets of this world) that the company is being run inefficiently or recklessly by the existing management and that better monitoring by a controller may increase its value. As shown in our elementary formalization of section 4, the acquisition of a higher stake by a block-holder may not only increase his own benefits, but also lower the agency cost of minority shareholders. The answer to this objection is that the proposed measure does away with the possibility that the acquisition of control may yield also shared benefits, because the premium is determined with respect to the market price immediately *after* the transaction. This answer is unconvincing, being based on the presumption that the market immediately discounts the potential monitoring benefits accruing to all the shareholders and hence on the assumption of fully efficient markets with perfect foresight and perfect knowledge of the managerial problems besetting the company. First, as we have seen, the public is often unable to detect such problems (investors were happily flocking into fancy new-economy start ups or in the Enrons of this world, which a Warren Buffett would not touch); second, the assumption of perfect foresight is ill suited to the length of time it takes to improve a company's performance and to the uncertainties surrounding the process. Even allowing for this, on the other hand, it must be recognized that country differences are relevant and deserve explanation.

6 – Back to the old story

I have argued above that the recent literature purporting to show that the ownership structure depends on a measure of investor protection or, more directly, of private benefits always omits consideration and measurement of managerial agency costs, as if the latter did not exist or could be assumed away. That omission, or that assumption, seriously flaws the conclusion on the optimality of fully diffused ownership drawn from those relationships. The fact that managerial costs, unlike the potential for the extraction of private benefits can only be imperfectly appraised and discounted *ex ante* and are therefore hard to measure is not a good reason for neglecting them. The recent cases of corporate failures in the US are a glaring proof of their existence and provide some evidence that,

though belatedly and *ex post factum*, they are somehow discounted by the market: the difference with respect to Treasuries between the spreads of triple A corporate bonds in the US and in Europe has increased sharply after the collapse of Enron and especially after that of Worldcom.

Recent events have come as a sobering reminder that the world is somewhat more complicated than many lawyers and scholars would lead us to believe. Having witnessed destruction of shareholders' value "on an epic scale" – as has been said – in companies where ownership was fully diffused, it is now hard to accept that ownership structure, *per se*, is a reliable proxy of investor protection. If this was the case, the US Congress would not have felt the urge to enact new and tougher legislation, affecting also corporate law, thereby recognizing the insufficiency of the much praised 1934 act.

Law-makers and regulators should not aim at achieving one or the other model of corporate ownership. Their task should be to offer better protection to investors both from the rapacity of majority shareholders and from the managers' unchecked discretion, bearing in mind that the prevailing ownership structure, at least in the medium term, is a given that depends on many factors neglected by the simple econometrics of corporate finance. They should therefore lay the emphasis of their intervention on the remedies that are most suited in each case and which may be different according to the ownership structure existing in their own country. Some American scholars of law and economics have theorized the necessary convergence of industrialized countries to a *pax americana* in the field of corporate governance and of ownership structures of listed companies: it is a myth that can offer no guidance to policy.