

Three Models of Corporate Governance from Developed Capital Markets

Introduction

The corporate governance structure of joint stock corporations in a given country is determined by several factors: the legal and regulatory framework outlining the rights and responsibilities of all parties involved in corporate governance; the *de facto* realities of the corporate environment in the country; and each corporation's articles of association. While corporate governance provisions may differ from corporation to corporation, many *de facto* and *de jure* factors affect corporations in a similar way. Therefore, it is possible to outline a "model" of corporate governance for a given country.

In each country, the corporate governance structure has certain characteristics or constituent elements, which distinguish it from structures in other countries. To date, researchers have identified three models of corporate governance in developed capital markets. These are the Anglo-US model, the Japanese model, and the German model.

Each model identifies the following constituent elements: key players in the corporate environment; the share ownership pattern in the given country; the composition of the board of directors (or boards, in the German model); the regulatory framework; disclosure requirements for publicly-listed stock corporations; corporate actions requiring shareholder approval; and interaction among key players.

The purpose of this article is to introduce each model, describe the constituent elements of each and demonstrate how each developed in response to country-specific factors and conditions. Readers should understand that it is not possible to simply select a model and apply it to a given country. Instead, the process is **dynamic**: the corporate governance structure in each country develops in response to country-specific factors and conditions.

The Anglo-US Model¹

The Anglo-US model is characterized by share ownership of individual, and increasingly institutional, investors not affiliated with the corporation (known as outside shareholders or "**outsiders**"); a well-developed legal framework defining the rights and responsibilities of three key players, namely management, directors and shareholders; and a comparatively uncomplicated procedure for interaction between shareholder and corporation as well as among shareholders during or outside the AGM.

Equity financing is a common method of raising capital for corporations in the United Kingdom (UK) and the US. It is not surprising, therefore, that the US is the largest capital market in the world, and that the London Stock Exchange is the third largest stock exchange in the world (in terms of market capitalization) after the New York Stock Exchange (NYSE) and Tokyo.

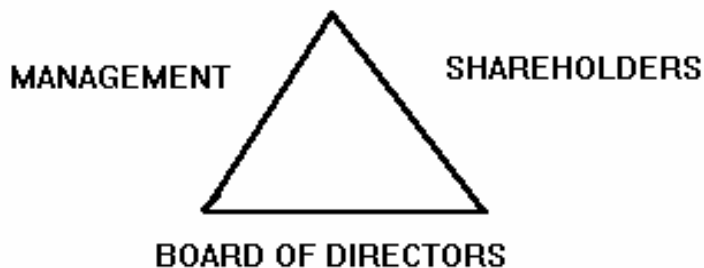
There is a causal relationship between the importance of equity financing, the size of the capital market and the development of a corporate governance system. The US is both the world's largest capital market and the home of the world's most-developed system of proxy voting and shareholder activism by institutional investors. Institutional investors also play an important role in both the capital market and corporate governance in the UK.

¹ The Anglo-US model governs corporations in the UK, the US, Australia, Canada, New Zealand and several other countries.

Key Players in the Anglo-US Model

Players in the Anglo-US model include management, directors, shareholders (especially institutional investors), government agencies, stock exchanges, self-regulatory organizations and consulting firms which advise corporations and/or shareholders on corporate governance and proxy voting.

Of these, the three major players are management, directors and shareholders. They form what is commonly referred to as the "corporate governance triangle." The interests and interaction of these players may be diagrammed as follows:



The Anglo-US model, developed within the context of the free market economy, assumes the separation of ownership and control in most publicly-held corporations. This important legal distinction serves a valuable business and social purpose: investors contribute capital and maintain ownership in the enterprise, while generally avoiding legal liability for the acts of the corporation. Investors avoid legal liability by ceding to management control of the corporation, and paying management for acting as their agent by undertaking the affairs of the corporation. The cost of this separation of ownership and control is defined as “**agency costs**”.

The interests of shareholders and management may not always coincide. Laws governing corporations in countries using the Anglo-US model attempt to reconcile this conflict in several ways. Most importantly, they prescribe the election of a board of directors by shareholders and require that boards act as **fiduciaries** for shareholders’ interests by overseeing management on behalf of shareholders.

Two diagrams at the end of this article explain the dynamics of the Anglo-US model in theory and in practice.

Share Ownership Pattern in the Anglo-US Model

In both the UK and the US, there has been a marked shift of stock ownership during the postwar period from individual shareholders to institutional shareholders. In 1990, institutional investors held approximately 61 percent of the shares of UK corporations, and individuals held approximately 21 percent. (In 1981, individuals held 38 percent.) In 1990, institutions held 53.3 percent of the shares of US corporations.²

The increase in ownership by institutions has resulted in their increasing influence. In turn, this has triggered regulatory changes designed to facilitate their interests and interaction in the corporate governance process.

² The term “capital market” is broad, encompassing all the markets where stocks (also known as shares), bonds, futures, derivatives and other financial instruments are traded. “Securities market” is more specific, referring to stocks and bonds. “Equity market” is most specific, referring only to stock, also known as equity.

Composition of the Board of Directors in the Anglo-US Model

The board of directors of most corporations that follow the Anglo-US model includes both “**insiders**” and “**outsiders**”. An “**insider**” is a person who is either employed by the corporation (an executive, manager or employee) or who has significant personal or business relationships with corporate management. An “**outsider**” is a person or institution which has no direct relationship with the corporation or corporate management.

A synonym for insider is **executive director**; a synonym for outsider is **non-executive director** or **independent director**.

Traditionally, the same person has served as both chairman of the board of directors and chief executive officer (CEO) of the corporation. In many instances, this practice led to abuses, including: concentration of power in the hands of one person (for example, a board of directors firmly controlled by one person serving both as chairman of the board of directors and CEO); concentration of power in a small group of persons (for example, a board of directors composed solely of “**insiders**”; management and/or the board of directors’ attempts to retain power over a long period of time, without regard for the interests of other players (entrenchment); and the board of directors’ flagrant disregard for the interests of outside shareholders.

As recently as 1990, one individual served as both CEO and chairman of the board in over 75 percent of the 500 largest corporations in the US. In contrast to the US, a majority of boards in the UK have a non-executive director. However, many boards of UK companies have a majority of inside directors: in 1992, only 42 percent of all directors were outsiders and nine percent of the largest UK companies had no outside director at all.³

Currently there is, however, a discernible trend towards greater inclusion of “**outsiders**” in both US and UK corporations.

Beginning in the mid-1980s, several factors contributed to an increased interest in corporate governance in the UK and US. These included: the increase in institutional investment in both countries; greater governmental regulation in the US, including regulation requiring some institutional investors to vote at AGMs; the takeover activity of the mid- to late-1980s; excessive executive compensation at many US companies and a growing sense of loss of competitiveness vis-a-vis German and Japanese competitors.

In response, individual and institutional investors began to inform themselves about trends, conduct research and organize themselves in order to represent their interests as shareholders. Their findings were interesting. For example, research conducted by diverse organizations indicated that **in many cases a relationship exists between lack of effective oversight by the board of directors and poor corporate financial performance**. In addition, corporate governance analysts noted that “outside” directors often suffered an informational disadvantage vis-a-vis “inside” directors and were therefore limited in their ability to provide effective oversight.

Several factors influenced the trend towards an increasing percentage of “outsiders” on boards of directors of UK and US corporations. These include: the pattern of stock ownership, specifically the above-mentioned increase in institutional investment the growing importance of institutional investors and their voting behavior at AGMs; and recommendations of self-regulatory organizations such as the Committee on the Financial Aspects of Corporate Governance in the UK and shareholder organizations in the US.

³ Data from “Board Directors and Corporate Governance: Trends in the G7 Countries Over the Next Ten Years,” a study prepared for Russell Reynolds Associates, Price Waterhouse, Goldman Sachs International, and Gibson, Dun & Crutcher, by Oxford Analytica Ltd. Oxford, England, September 1992.

Board composition and board representation remain important shareholder concerns of shareholders in the UK and US. Perhaps this is because other corporate governance issues, such as disclosure and mechanisms for communication between corporations and shareholders, have largely been resolved.

UK and US boards are generally smaller than boards in Japan and Germany. In 1993, a survey of the boards of the 100 largest US corporations conducted by the executive search firm Spencer Stuart found that boards were shrinking slightly; the average size was 13, compared with 15 in 1988.

Regulatory Framework in the Anglo-US Model

In the UK and US, a wide range of laws and regulatory codes define relationships among management, directors and shareholders.

In the US, a federal agency, the Securities and Exchange Commission (SEC), regulates the securities industry, establishes disclosure requirements for corporations and regulates communication between corporations and shareholders as well as among shareholders.

Laws regulating pension funds also have an important impact on corporate governance. In 1988, the agency of the Department of Labor responsible for regulating private pension funds ruled that these funds have a “**fiduciary responsibility**” to exercise their stock ownership rights. This ruling had a huge impact on the behavior of private pension funds and other institutional investors: since then, institutional investors have taken a keen interest in all aspects of corporate governance, shareholders’ rights and voting at AGMs.

Readers should note that because US corporations are registered and “incorporated” in a particular state, the respective state law establishes the basic framework for each US corporation’s rights and responsibilities.

In comparison with other capital markets, the US has the most comprehensive disclosure requirements and a complex, well-regulated system for shareholder communication. As noted above, this is directly related to the size and importance of the US securities market, both domestically and internationally.

The regulatory framework of corporate governance in the UK is established in parliamentary acts and rules established by self-regulatory organizations, such as the Securities and Investment Board, which is responsible for oversight of the securities market. Note that it is not a government agency like the US SEC. Although the framework for disclosure and shareholder communication is well-developed, some observers claim that self-regulation in the UK is inadequate, and suggest that a government agency similar to the US SEC would be more effective.

Stock exchanges also play an important role in the Anglo-US model by establishing listing, disclosure and other requirements.

Disclosure Requirements in the Anglo-US Model

As noted above, the US has the most comprehensive disclosure requirements of any jurisdiction. While disclosure requirements are high in other jurisdictions where the Anglo-US model is followed, none are as stringent as those in the US.

US corporations are required to disclose a wide range of information. The following information is included either in the annual report or in the agenda of the annual general meeting (formally known as the “**proxy statement**”): corporate financial data (this is reported on a quarterly basis in the US); a breakdown of the corporation’s capital structure; substantial background information on each nominee to the board of directors (including name, occupation, relationship with the company, and ownership of stock in the corporation); the aggregate compensation paid to all executive officers (upper management) as well as individual compensation data for each of the five highest paid executive officers, who are to be named; all shareholders holding more than five percent of the corporation’s total share capital; information on proposed mergers and restructurings; proposed amendments to the articles of association; and names of individuals and/or companies proposed as auditors.

Disclosure requirements in the UK and other countries that follow the Anglo-US model are similar. However, they generally require semi-annual reporting and less data in most categories, including financial statistics and the information provided on nominees.

Corporate Actions Requiring Shareholder Approval in the Anglo-US Model

The two routine corporate actions requiring shareholder approval under the Anglo-US model are elections of directors and appointment of auditors.

Non-routine corporate actions which also require shareholder approval include: the establishment or amendment of stock option plans (because these plans affect executive and board compensation); mergers and takeovers; restructurings; and amendment of the articles of incorporation.

There is one important distinction between the US and the UK: in the US, shareholders do not have the right to vote on the dividend proposed by the board of directors. In the UK, shareholders do vote on the dividend proposal.

The Anglo-US model also permits shareholders to submit proposals to be included on the agenda of the AGM. The proposals - known as **shareholder proposals** - must relate to a corporation’s business activity. Shareholders owning at least ten percent of a corporation’s total share capital may also convene an extraordinary general meeting (EGM) of shareholders.

In the US, the SEC has issued a wide range of regulations concerning the format, substance, timing and publication of shareholder proposals. The SEC also regulates communication among shareholders.

Interaction Among Players in the Anglo-US Model

As noted above, the Anglo-US model establishes a complex, well-regulated system for communication and interaction between shareholders and corporations. A wide range of regulatory and independent organizations play an important role in corporate governance.

Shareholders may exercise their voting rights without attending the annual general meeting in person. All registered shareholders receive the following by mail: the agenda for the meeting

including background information on all proposals ("proxy statement"), the corporation's annual report and a voting card.

Shareholders may vote by proxy, that is, they complete the voting card and return it by mail to the corporation. **By mailing the voting card back to the corporation, the shareholder authorizes the chairman of the board of directors to act as his proxy and cast his votes as indicated on the voting card.**

In the Anglo-US model, a wide range of institutional investors and financial specialists monitor a corporation's performance and corporate governance. These include: a variety of specialized investment funds (for example, index funds or funds that target specific industries); venture-capital funds, or funds that invest in new or "start-up" corporations; rating agencies; auditors; and funds that target investment in bankrupt or problem corporations. **See the diagram "Diversified Monitoring in Anglo-US Corporate Governance" for a pictorial explanation of this phenomenon.** In contrast, one bank serves many of these (and other) functions in the Japanese and German models. As a result, one important element of both of these models is the strong relationship between a corporation and its main bank.

The Japanese Model

The Japanese model is characterized by a high level of stock ownership by affiliated banks and companies; a banking system characterized by strong, long-term links between bank and corporation; a legal, public policy and industrial policy framework designed to support and promote "*keiretsu*" (industrial groups linked by trading relationships as well as cross-shareholdings of debt and equity); boards of directors composed almost solely of insiders; and a comparatively low (in some corporations, non-existent) level of input of outside shareholders, caused and exacerbated by complicated procedures for exercising shareholders' votes.

Equity financing is important for Japanese corporations. However, insiders and their affiliates are the major shareholders in most Japanese corporations. Consequently, they play a major role in individual corporations and in the system as a whole. Conversely, the interests of outside shareholders are marginal. The percentage of foreign ownership of Japanese stocks is small, but it may become an important factor in making the model more responsive to outside shareholders.

Key Players in the Japanese Model

The Japanese system of corporate governance is many-sided, centering around a main bank and a financial/industrial network or *keiretsu*.

The main bank system and the *keiretsu* are two different, yet overlapping and complementary, elements of the Japanese model.⁴ Almost all Japanese corporations have a close relationship with a main bank. The bank provides its corporate client with loans as well as services related to bond issues, equity issues, settlement accounts, and related consulting services. The main bank is generally a major shareholder in the corporation.

In the US, anti-monopoly legislation prohibits one bank from providing this multiplicity of services. Instead, these services are usually handled by different institutions: commercial bank - loans; investment bank - equity issues; specialized consulting firms - proxy voting and other services.

⁴ See Bergloef, Eric, 1993. "Corporate Governance in Transition Economies: The Theory and its Policy Implications." in Masahiko Aoki and Hyung-Ki Kim, editors, *Corporate Governance in Transitional Economies: Insider Control and the Role of Banks*. Washington, D.C.: The World Bank.

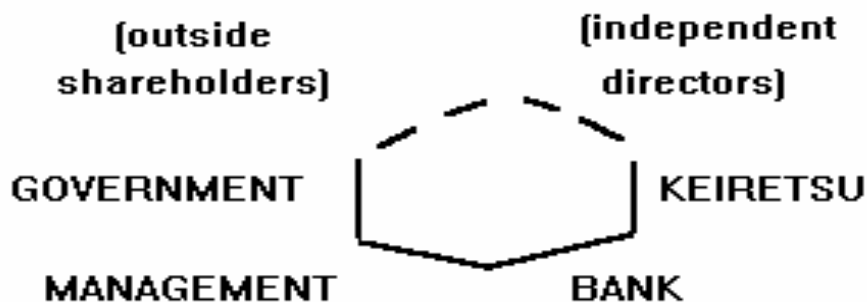
Many Japanese corporations also have strong financial relationships with a network of affiliated companies. These networks, characterized by crossholdings of debt and equity, trading of goods and services, and informal business contacts, are known as *keiretsu*.

Government-directed industrial policy also plays a key role in Japanese governance. Since the 1930s, the Japanese government has pursued an active industrial policy designed to assist Japanese corporations. This policy includes official and unofficial representation on corporate boards, when a corporation faces financial difficulty.

In the Japanese model, the four key players are: main bank (a major inside shareholder), affiliated company or *keiretsu* (a major inside shareholder), management and the government. Note that the interaction among these players serves to link relationships rather than balance powers, as in the case in the Anglo-US model.

In contrast with the Anglo-US model, non-affiliated shareholders have little or no voice in Japanese governance. As a result, there are few truly independent directors, that is, directors representing outside shareholders.

The Japanese model may be diagrammed as an open-ended hexagon:



The base of the figure, with four connecting lines, represents the linked interests of the four key players: government, management, bank and *keiretsu*. The open lines at the top represent the non-linked interests of non-affiliated shareholders and outside directors, because these play an insignificant role.

Share Ownership Pattern in the Japanese Model

In Japan, financial institutions and corporations firmly hold ownership of the equity market. Similar to the trend in the UK and US, the shift during the postwar period has been away from individual ownership to institutional and corporate ownership. In 1990, financial institutions (insurance companies and banks) held approximately 43 percent of the Japanese equity market, and corporations (excluding financial institutions) held 25 percent. Foreigners currently own approximately three percent.

In both the Japanese and the German model, banks are key shareholders and develop strong relationships with corporations, due to overlapping roles and multiple services provided. This distinguishes both models from the Anglo-US model, where such relationships are prohibited by anti-trust legislation. Instead of relying on a single bank, US and UK corporations obtain financing and other services from a wide range of sources, including the well-developed securities market.

Composition of the Board of Directors in the Japanese Model

The board of directors of Japanese corporations is composed almost completely of insiders, that is, executive managers, usually the heads of major divisions of the company and its central administrative body. If a company's profits fall over an extended period, the main bank and members of the *keiretsu* may remove directors and appoint their own candidates to the company's board. Another practice common in Japan is the appointment of retiring government bureaucrats to corporate boards; for example, the Ministry of Finance may appoint a retiring official to a bank's board.

In the Japanese model the composition of the board of directors is conditional upon the corporation's financial performance. A diagram of the Japanese model at the end of this article provides a pictorial explanation.

Note the relationship between the share ownership structure and the composition of Japanese boards. In contrast with the Anglo-US model, representatives of unaffiliated shareholders (that is, "outsiders") seldom sit on Japanese boards.

Japanese boards are generally larger than boards in the UK, the US and Germany. The average Japanese board contains 50 members.

Regulatory Framework in the Japanese Model

In Japan, government ministries have traditionally been extremely influential in developing industrial policy. The ministries also wield enormous regulatory control. However, in recent years, several factors have weakened the development and implementation of a comprehensive industrial policy. First, due to the growing role of Japanese corporations at home and abroad, policy formation became fragmented due to the involvement of numerous ministries, most importantly, the Ministry of Finance and the Ministry of International Trade and Industry. Second, the increasing internationalization of Japanese corporations made them less dependent on their domestic market and therefore somewhat less dependent on industrial policy. Third, the growth of Japanese capital markets led to their partial liberalization and an opening, albeit small, to global standards. While these and other factors have limited the cohesion of Japanese industrial policy in recent years, it is still an important regulatory factor, especially in comparison with the Anglo-US model.

In contrast, government agencies provide little effective, independent regulation of the Japanese securities industry. This is somewhat ironic, because the regulatory framework in Japan was modeled on the US system by US occupation forces after the Second World War. Despite numerous revisions, the core of Japan's securities laws remain very similar to US laws. In 1971, in response to the first wave of foreign investment in Japan, new laws were enacted to improve corporate disclosure. The primary regulatory bodies are the Securities Bureau of the Ministry of Finance, and the Securities Exchange Surveillance Committee, established under the auspices of the Securities Bureau in 1992. The latter is responsible for monitoring corporate compliance and investigating violations. Despite their legal powers, these agencies have yet to exert *de facto* independent regulatory influence.

Disclosure Requirements in the Japanese Model

Disclosure requirements in Japan are relatively stringent, but not as stringent as in the US. Corporations are required to disclose a wide range of information in the annual report and or agenda for the AGM, including: financial data on the corporation (required on a semi-annual basis); data on the corporation's capital structure; background information on each nominee to the board of directors (including name, occupation, relationship with the corporation, and ownership of stock in the corporation); aggregate data on compensation, namely the maximum amount of compensation payable to all executive officers and the board of directors; information on proposed mergers and

restructurings; proposed amendments to the articles of association; and names of individuals and/or companies proposed as auditors.

Japan's disclosure regime differs from the US regime (generally considered the world's strictest) in several notable ways. These include: semi-annual disclosure of financial data, compared with quarterly disclosure in the US; aggregate disclosure of executive and board compensation, compared with individual data on the executive compensation in the US; disclosure of the corporation's ten largest shareholders, compared with the US requirement to disclose all shareholders holding more than five percent of the corporation's total share capital; and significant differences between Japanese accounting standards and US Generally Accepted Accounting Practices (US GAAP).

Corporate Actions Requiring Shareholder Approval in the Japanese Model

In Japan, the routine corporate actions requiring shareholder approval are: payment of dividends and allocation of reserves; election of directors; and appointment of auditors.

Other common corporate actions which also require shareholder approval include capital authorizations; amendments to the articles of association and/or charter (for example, a change in the size and/or composition of the board of directors, or a change in approved business activities); payment of retirement bonuses to directors and auditors; and increase of the aggregate compensation ceilings for directors and auditors.

Non-routine corporate actions which also require shareholder approval include mergers, takeovers and restructurings.

Shareholder proposals are a relatively new phenomenon in Japan. Prior to 1981, Japanese law did not permit shareholders to put resolutions on the agenda for the annual meeting. A 1981 amendment to the Commercial Code states that a registered shareholder holding at least 10 percent of a company's shares may propose an issue to be included on the agenda for the AGM or EGM.

Interaction Among Players in the Japanese Model

Interaction among the key players in the Japanese model generally links and strengthens relationships. **This is a fundamental characteristic of the Japanese model.** Japanese corporations prefer that a majority of its shareholders be long-term, preferably affiliated, parties. In contrast, outside shareholders represent a small constituency and are largely excluded from the process.

Annual reports and materials related to the AGM are available to all shareholders. Shareholders may attend the annual general meeting, vote by proxy or vote by mail. In theory, the system is simple; however, the mechanical system of voting is more complicated for non-Japanese shareholders.

Annual general meetings are almost always pro forma, and corporations actively discourage shareholder dissent. Shareholder activism is restricted by an informal yet important aspect of the Japanese system: the vast majority of Japanese corporations hold their annual meetings on the same day each year, making it difficult for institutional investors to coordinate voting and impossible to attend more than one meeting in person.

The German Model⁵

⁵ The German model governs German and Austrian corporations. Some elements of the model also apply in the Netherlands and Scandinavia. Furthermore, some corporations in France and Belgium have recently introduced some elements of the German model.

The German corporate governance model differs significantly from both the Anglo-US and the Japanese model, although some of its elements resemble the Japanese model.

Banks hold long-term stakes in German corporations⁶, and, as in Japan, bank representatives are elected to German boards. However, this representation is constant, unlike the situation in Japan where bank representatives were elected to a corporate board only in times of financial distress. Germany's three largest universal banks (banks that provide a multiplicity of services) play a major role; in some parts of the country, public-sector banks are also key shareholders.

There are three unique elements of the German model that distinguish it from the other models outlined in this article. Two of these elements pertain to **board composition** and one concerns **shareholders' rights**:

First, the German model prescribes two boards with separate members. German corporations have a two-tiered board structure consisting of a **management board** (composed entirely of insiders, that is, executives of the corporation) and a **supervisory board** (composed of labor/employee representatives and shareholder representatives). The two boards are completely distinct; no one may serve simultaneously on a corporation's management board and supervisory board. Second, the size of the supervisory board is set by law and cannot be changed by shareholders.

Third, in Germany and other countries following this model, **voting right restrictions** are legal; these limit a shareholder to voting a certain percentage of the corporation's total share capital, regardless of share ownership position.⁷

Most German corporations have traditionally preferred bank financing over equity financing. As a result, German stock market capitalization is small in relation to the size of the German economy. Furthermore, the level of individual stock ownership in Germany is low, reflecting Germans' conservative investment strategy. It is not surprising therefore, that the corporate governance structure is geared towards preserving relationships between the key players, notably banks and corporations.

The system is somewhat ambivalent towards minority shareholders, allowing them scope for interaction by permitting shareholder proposals, but also permitting companies to impose voting rights restrictions.

The percentage of foreign ownership of German equity is significant; in 1990, it was 19 percent. This factor is slowly beginning to affect the German model, as foreign investors from inside and outside the European Union begin to advocate for their interests. The globalization of capital markets is also forcing German corporations to change their ways. When Daimler-Benz AG decided to list its shares on the NYSE in 1993, it was forced to adopt US GAAP. These accounting principles provide much greater financial transparency than German accounting standards. Specifically, Daimler-Benz AG was forced to account for huge losses that it could have "hidden" under German accounting rules.

Key Players in the German Model

German banks, and to a lesser extent, corporate shareholders, are the key players in the German corporate governance system. Similar to the Japanese system described above, banks usually play a multi-faceted role as shareholder, lender, issuer of both equity and debt, depository (custodian

⁶ The German term for joint stock corporation is *Aktiengesellschaft*; German and Austrian corporations use the abbreviation AG following their name, for example, Volkswagen AG.

⁷ In 1994, some 10 major German banks and corporations still had voting rights restrictions, although the recent trend in European Union (EU) countries has been to repeal them.

bank) and voting agent at AGMs. In 1990, the three largest German banks (Deutsche Bank AG, Dresdner Bank AG and Commerzbank AG) held seats on the supervisory boards of 85 of the 100 largest German corporations.

In Germany, corporations are also shareholders, sometimes holding long-term stakes in other corporations, even where there is no industrial or commercial affiliation between the two. This is somewhat similar, but not parallel, to the Japanese model, yet very different from the Anglo-US model where neither banks nor corporations are key institutional investors.

The mandatory inclusion of labor/employee representatives on larger German supervisory boards further distinguishes the German model from both the Anglo-US and Japanese models.

Share Ownership Pattern in the German Model

German banks and corporations are the dominant shareholders in Germany. In 1990, corporations held 41 percent of the German equity market, and institutional owners (primarily banks) held 27 percent. Neither institutional agents, such as pension funds (three percent) or individual owners (four percent) are significant in Germany. Foreign investors held 19 percent in 1990, and their impact on the German corporate governance system is increasing.

Composition of the Management Board (“Vorstand”) and Supervisory Board (“Aufsichtsrat”) in the German Model

The two-tiered board structure is a unique construction of the German model. German corporations are governed by a supervisory board and a management board. The supervisory board appoints and dismisses the management board, approves major management decisions; and advises the management board. The supervisory board usually meets once a month. A corporation’s articles of association sets the financial threshold of corporate acts requiring supervisory board approval. The management board is responsible for daily management of the company.

The management board is composed solely of “insiders”, or executives. The supervisory board contains no “insiders”, it is composed of labor/employee representatives and shareholder representatives.

The Industrial Democracy Act and the Law on Employee Co-determination regulate the size and determine the composition of the supervisory board; they stipulate the number of members elected by labor/employees and the number elected by shareholders.

The numbers of members of the supervisory board is set by law. In small corporations (with less than 500 employees), shareholders elect the entire supervisory board. In medium-size corporations (defined by assets and number of employees) employees elect one-third of a nine-member supervisory board. In larger corporations, employees elect one-half of a 20-member supervisory board.

Note these two key differences between the German model and the other two models. First, **the size of the supervisory board is set by law and cannot be changed.** Second, **the supervisory board includes labor/employee representatives.**

While the supervisory board includes no “insiders”, it does not necessarily include only “outsiders”. The members of the supervisory board elected by shareholders are usually representatives of banks and corporations which are substantial shareholders. It would be more appropriate to define some of these as **“affiliated outsiders”**.

For a pictorial explanation of board composition in the German model, please refer to the diagram of the German model at the end of this article.

Regulatory Framework in the German Model

Germany has a strong federal tradition; both federal and state (*Laender*) law influence corporate governance. Federal laws include: the Stock Corporation Law, Stock Exchange Law and Commercial Law, as well as the above-mentioned laws governing the composition of the supervisory board are all federal laws. Regulation of Germany's stock exchanges is, however, the mandate of the states.

A federal regulatory agency for the securities industry was established in 1995. It fills a former void in the German regulatory environment.

Disclosure Requirements in the German Model

Disclosure requirements in Germany are relatively stringent, but not as stringent as in the US. Corporations are required to disclose a wide range of information in the annual report and/or agenda for the AGM, including: corporate financial data (required on a semi-annual basis); data on the capital structure; limited information on each supervisory board nominee (including name, hometown and occupation/affiliation); aggregate data for compensation of the management board and supervisory board; any substantial shareholder holding more than 5 percent of the corporation's total share capital; information on proposed mergers and restructurings; proposed amendments to the articles of association; and names of individuals and/or companies proposed as auditors.

The disclosure regime in Germany differs from the US regime, generally considered the world's strictest, in several notable ways. These include: semi-annual disclosure of financial data, compared with quarterly disclosure in the US; aggregate disclosure of executive compensation and supervisory board compensation, compared with individual data on executive and board compensation in the US; no disclosure of share ownership of members of the supervisory board, compared with disclosure of executive and director's stock ownership in the US; and significant differences between German accounting standards and US GAAP.

One key accounting difference in Germany is that corporations are permitted to amass considerable reserves. These reserves enable German corporations to understate their value. This practice is not permitted under US GAAP.

Until 1995, German corporations were required to disclose shareholders holding more than 25 percent of the total share capital. In 1995, this threshold was lowered to 5 percent, bringing Germany in line with international standards.

Corporate Actions Requiring Shareholder Approval in the German Model

The routine corporate actions requiring shareholder approval under the German model are: allocation of net income (payment of dividends and allocation to reserves); ratification of the acts of the management board for the previous fiscal year; ratification of the acts of the supervisory board for the previous fiscal year; election of the supervisory board; and appointment of auditors.

Approval of the acts of the management board and supervisory board are basically a **"seal of approval"** or **"vote of confidence."** If shareholders wish to take legal action against individual members of either board or against either board as a whole, they refrain from ratifying the acts of the board for the previous year.

In contrast with the Anglo-US and the Japanese models, **shareholders do not possess the authority to alter the size or composition of the supervisory board. These are determined by law.**

Other common corporate actions which also require shareholder approval include capital authorizations (which automatically recognize **preemptive rights**, unless revoked by shareholder approval); affiliation agreements with subsidiaries; amendments to the articles of association and/or charter (for example, a change of approved business activities); and increase of the aggregate compensation ceiling for the supervisory board.

Non-routine corporate actions which also require shareholder approval include mergers, takeovers and restructurings.

Shareholder proposals are common in Germany. Following announcement of the agenda for the meeting, shareholders may submit in writing two types of proposals. A **shareholder counterproposal** opposes the proposal made by the management board and/or supervisory board in an existing agenda item and presents an alternative. For example, a counterproposal would suggest a dividend higher or lower than that proposed by the management board, or an alternative nominee to the supervisory board. A **shareholder proposal** requests the addition of an issue not included on the original agenda. Examples of shareholder proposals include: alternate nominees to the supervisory board; authorization of a special investigation or audit; suggestions to abolish voting rights restrictions; and recommendations for changes to the capital structure.

Provided that such proposals meet legal requirements, the corporation is required to publish these shareholder proposals in an amended agenda and forward them to shareholders prior to the meeting.

Interaction Among Players in the German Model

The German legal and public-policy framework is designed to include the interests of labor, corporations, banks and shareholders in the corporate governance system. The multi-faceted role of banks has been described above.

On the whole, the system is geared towards the interests of the key players. There is, nevertheless, some scope for participation by minority shareholders, such as the above-mentioned provisions concerning shareholder proposals.

There also exist several obstacles to shareholder participation, especially in terms of banks' powers as depositories and voting agents.

The majority of German shares are issued in bearer (not registered) form. Corporations with bearer shares are required to announce their annual general meeting in an official government bulletin and forward the annual report and agenda for meeting to custody banks. The banks forward these materials to the beneficial owners of the shares. This often complicates the procedure for receipt of materials, especially for foreign shareholders.

In Germany, most shareholders purchase shares through a bank, and banks are permitted to vote the shares of German they hold on deposit. The procedure is as follows: The beneficial shareholder grants a general power of attorney to the bank, and the bank is permitted to vote the shares for a period up to 15 months. The corporation sends the meeting agenda and annual report to its custody bank. The bank forwards these materials and its (the bank's) voting recommendations to the German shareholder. If the beneficial shareholder does not provide the bank with his/her specific voting instructions, the bank may vote the shares according to its own interpretation. This leads to a

potential conflict of interest between the bank and the beneficial shareholder. It also increases the potential voting power of the bank, because some shareholders might not provide specific voting instructions and the bank may exercise the votes according to its interpretation. Because the level of individual share ownership in Germany is very low, this is not a huge problem. Nevertheless, it reflects a certain pro-bank and anti-shareholder tendency of the system.

Other obstacles to shareholder participation include the above-mentioned legality of voting right restrictions, and the fact that shareholders may not vote by mail. As noted above, shareholders must either attend the meeting in person or to be represented in person, i.e., by their custodian bank.

Despite these obstacles, minority German shareholders are not inactive. In fact, they often oppose management proposals and present a wide range of counterproposals and proposals at the AGMs and EGMs of many German corporations each year. In Austria, minority shareholders are less active, perhaps because the Austrian government is, directly or indirectly, a large shareholder in many companies.

Conclusion

The article has introduced each model, describe the constituent elements of each and demonstrate how each developed in response to country-specific factors and conditions. It should reflect the fact that it is not possible to simply select a model and apply it to a given country. Instead, the process is **dynamic**: the corporate governance structure in each country develops in response to country-specific factors and conditions.

With the globalization of capital markets, each of these three models is opening (albeit slowly) to influences from other models, while largely retaining its unique characteristics. Legal, economic and financial specialists around the world can profit from a familiarity with each model.