Federico Cenzi Venezze

The Costs of Control-Enhancing Mechanisms: How Regulatory Dualism Can Create Value in the Privatization of State-Owned Firms in Europe

LLM Paper

Harvard Law School

Supervisor: Professor Mark J. Roe

August 29, 2013

ABSTRACT

Empirical studies show that ownership structures that separate control and cash flow rights create agency problems and are associated with reduced value for minority shareholders. Institutional investors recognize these inefficiencies and expect a discount on the share price of companies with control-enhancing mechanisms like multiple voting rights shares or pyramidal ownership structures.

In the US, corporate pyramids are discouraged through the taxation of intercompany dividends, whereas multiple voting rights shares are allowed but have to be issued before the firm goes public. Therefore controlling shareholders, who want to entrench themselves in control by retaining multiple voting rights shares, pay the costs of this inefficient capital structure when the firm initially goes public at a discounted price.

Some European countries – including Italy, Spain, Portugal and Greece – have adopted a diametrically opposite solution. Multiple voting rights shares are expressly prohibited by the legislator, but corporate pyramids are commonly used by listed companies and can be created following the IPO of the firm without approval from the shareholders. In this situation, if institutional investors expect that a pyramidal ownership structure will be created in the future, they will discount the price of the shares when the firm goes public. Therefore, if Italy, Spain, Portugal and Greece are willing to privatize some of their states-owned companies and want to maximize the price of their stocks, they should create the conditions to assure the market that these companies will not be controlled through pyramids in the future.

Because of strong opposition from national business elites, who control the largest corporate groups, it is very difficult to adopt strict regulations aimed at prohibiting – or at least limiting – the use of pyramidal ownership structures in a relatively short period of time. In order to solve this Olson problem I suggest that Italy, Spain, Portugal and Greece should use regulatory dualism to create new markets with enhanced corporate governance rules that prevent shareholders' control through pyramids.

Key Words: Corporate Governance, Ownership Structures, Control Enhancing Mechanisms, Pyramids, Multiple Voting Rights Shares, Privatizations, Regulatory Dualism.

The Costs of Control-Enhancing Mechanisms: How Regulatory Dualism Can Create Value in the Privatization of States-Owned Firms in Europe

Federico Cenzi Venezze

The Costs of Control-Enhancing Mechanisms: How Regulatory Dualism Can Create Value in the Privatization of State-Owned Firms in Europe

Federico Cenzi Venezze[*]

INTRODUCTION

According to economic theory an efficient corporate governance structure – one that effectively protects outside investors – maximizes the value of the shares listed in a public market. [1] This assumption leads rational owners of companies to adopt measures aimed at protecting outside investors before selling their shares in a public offering. When a government sells shares in order to privatize a state-owned firm, it can maximize the price by adopting a capital-market regulation that optimizes the protection offered to minority investors.

As some legal scholars have pointed out, [2] the effectiveness of different corporate governance arrangements depends substantially on the ownership structure of the firms. In continental Europe, where most listed companies are controlled, the most important feature of corporate governance is the protection of minority shareholders from the extraction of private benefits by the main stockholder.

The problem of private benefit of control extraction is particularly severe in situations where the voting rights of the controlling shareholders exceed their cash-flow rights. This divergence exacerbates the conflicts of interests inherent in the agency relationship between

[*] I am very grateful for the helpful comments and suggestion of Professors Luca Enriques, Reiner Kraakman and Mark J. Roe; the participants to the seminar on Empirical Studies on Corporate Governance (Harvard Law School, spring 2013); and Kobi Kastiel.

[1] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, *Investor protection and corporate valuation*, 57 J. FIN. 1147 (2002).

[2] Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1269 (2009).

managers and controlling shareholders, on the one hand, and minority shareholders, on the other hand.

The separation between voting rights and financial exposure by a controller can be achieved through different types of Control-Enhancing Mechanisms ("CEMs"). The most common among these mechanisms are the adoption of pyramidal ownership structures and the issuance of multiple voting rights shares. Both ownership structures effectively separate the ultimate economic risk and the voting rights of the controller. However different legal systems have adopted diverse solutions in regulating these two types of CEMs.

In the US, corporate pyramids are legally discouraged, whereas multiple voting-right shares are allowed and have been adopted by prominent public companies such as Ford, [3] Google, [4] Facebook [5] and Berkshire Hathaway. [6] Some European countries, including Greece, Italy, Portugal and Spain ("GIPS"), have adopted a seemingly opposite solution by prohibiting multiple voting-rights shares, but allowing listed companies to build corporate pyramids. Other countries are even more open – or closed – to the use of CEMs by controlling shareholders. In Sweden, for example, some of the richest families of the country use a combination of multiple voting rights shares and pyramidal ownership structures to control an extended and diversified group of companies. Israel follows yet another approach. After banning the use of multiple voting rights shares, the legislator now proposes to discourage the creation of new corporate pyramids and to dismantle the current ones.

---

[3] See: Ford Motor Company, Notice of 2012 Annual Meeting of Shareholders and Proxy Statement, available at: http://corporate.ford.com/doc/2012_proxy.pdf.

[4] Google Inc., Notice of 2012 Annual Meeting of Stockholders, available at: http://investor.google.com/pdf/2012_google_proxy_statement.pdf.

[5] Facebook Inc., 2012 Form 10-K, available at: http://investor.fb.com/secfiling.cfm?filingID=1326801-13-3&CIK=1326801.

[6] Berkshire Hathaway Inc., 2012 Form 10-K, available at: http://www.berkshirehathaway.com/2011ar/201110-K.pdf.

In this paper I first highlight the potential agency problems created by the separation between controllers' voting rights and cash flow rights. Then I compare the costs and benefits of prohibiting multiple voting rights shares and/or corporate pyramids. In the last part of the paper I look at solutions to reduce the separation of controlling shareholders' voting rights and cash flow rights by preventing the creation of corporate pyramids. In particular, I propose a solution for countries like the GIPS that are considering privatizing some of their state owned companies and want to maximize the price of their stocks.

Empirical data shows that, at least in developed economies, investors expect a discount on the share price of companies with CEMs. [7] If the market anticipates the creation of corporate pyramids following the privatization of state owned companies, investors will discount the price paid for these stocks at the beginning. Therefore, in order to increase the price of the stocks to be sold in the market, Greece, Italy, Portugal and Spain should adopt rules aimed at preventing the future adoption of CEMs and, in particular, the creation of pyramidal ownership structures that create substantial agency problems.

As the very recent Israeli initiative on pyramidal ownership structures shows, since current controlling shareholders of groups of companies are very powerful opponents of any regulations aimed at prohibiting the use of pyramids, it is very difficult for any government to approve a strict reform in a reasonable time-period. In order to deal with this Olson problem I suggest that GIPS take as their model the Brazilian "Novo Mercado", where "regulatory dualism" has allowed the creation of a new market with enhanced corporate governance rules adopted by the listing standards. In privatizing state-owned companies GIPS should create a

[7] See Section III.C.

new market with specific rules aimed at preventing the separation of shareholders' voting rights and cash flow rights. This new market should also be available for the IPO of other private companies willing to comply with its listing rules.

I. AGENCY COSTS AND POTENTIAL BENEFITS OF SEPARATING CONTROL FROM CASH-FLOW RIGHTS

A. Agency Costs of CEMs

The use of CEMs allows controlling shareholders to hold voting rights disproportionate to their cash flow rights. The separation between the controlling rights and the economic investment affects the agency relationship between controlling shareholders/managers and minority investors in two different but related ways. First, this separation misaligns insiders' interests from the maximization of the overall shareholders' value in taking some key management decisions. Second, the use of CEMs may allows insiders to retain enough voting power to prevent the threat of proxy contests or hostile takeovers which are the most powerful mechanisms to limit agency costs in diffused ownership structures.

1. Shareholders' Interests Misalignment

Professors Lucian Bebchuk, Reiner Kraakman and George Triantis have identified the agency costs associated with CEMs mainly "in three important contexts: choosing investment projects, selecting investment policy and the scope of the firm, and choosing to transfer control.” [8]

The first type of interests’ misalignment is illustrated by the case of a firm with two different projects, one of which is more valuable for the company than the other. In this scenario, the insider could force the firm to choose the sub-optimal project, if it provides the insider with enough private benefits to offset the portion of the economic loss attributed to his (low) cash flow rights. [9]

A second type of interests’ misalignment is produced because CEMs create a strong incentive to retain cash resources within the firm rather than share this money with minority shareholders. This creates a tendency to over-invest and expand the firm, even when there are only economically poor projects to pursue. [10]

The third type considers the controlling shareholders’ incentives to sell their controlling bloc of shares to a new investor. Control transactions could be governed by two different legal regimes: the “market rule” which is followed in many countries – including the United States – and the “equal opportunity rule”, that is endorsed among others by the European Union. [11] Under the “market rule” the main shareholder can sell its controlling participation at the highest possible price without sharing the controlling premium paid by the acquirer with the minority shareholders. A different approach is followed by the “equal

---

[8] Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock pyramids, cross-ownership, and dual class equity: The creation and agency costs of separating control from cash flow rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 301 (Randall K. Morck ed., 2000).

[9] Id. at 301-2.

[10] Id. at 302-3; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, *Agency Problems and Dividend Policies around the World*, 55 J. FIN. 1 (2000).

[11] Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957 (1994).

opportunity rule", which grants all shareholders the right to sell their shares at the same price offered to the controller.

In situations where the "equal opportunity rule" applies – either as a statutory provision, or as a contractual arrangement inserted in the corporate charter of companies otherwise subject to the "market rule" [12] – the controlling shareholder will have the incentive to reject some value enhancing control transactions. This is because they would be the only ones who lose their private benefits, as most of the efficiency gains would go to the other shareholders, who would receive a portion of the controlling premium paid by the acquirer proportionate to their cash-flow rights.

2. Reducing Constraints on Agency Costs

In companies with a dispersed ownership, bad managers who are not capable or willing to maximize shareholders' value can be replaced by the stockholders or outside investors. Managerial slack can convince otherwise passive equity investors to take action and start a proxy fight in the annual meeting to replace some or all the companies' directors.

Even if the current shareholders remain inactive, the market will sanction a firm's poor performances by reducing the price of the shares. This reduction, in turn, can provide opportunities for activist investors, such as hedge funds, to launch a hostile takeover or to buy a relevant participation in the target firm and start a confrontational discussion with poor

---

[12] See: In Re Delphi Financial Group Shareholder Litigation, 2012 WL 729232 (Del. Ch. Mar. 6, 2012). The litigation arised in a merger context in which the controller of the company tried to negotiate for a higher price for his Class B stock despite a Charter's provision which endorsed a sort of "equal opportunity rule" by prescribing that:

> [I]n the case of any distribution or payment… on Class A Common Stock or Class B Common Stock upon the consolidation or merger of the Corporation with or into any corporation… such distribution payment shall be made ratably on a per share basis among the holders of the Class A Common Stock and Class B Common Stock as a single class.

managers, or even challenge them in the annual meetings. These corporate governance mechanisms are ineffective, however, when management holds enough voting power to insulate it from proxy fights or a hostile takeover. The use of CEMs allows managers/controlling shareholders to entrench themselves, without investing an amount of money proportionate to their voting rights. [13] Therefore, in companies with CEMs, minority shareholders must rely on other constraints of agency costs such as legal enforcement - where managers breach their fiduciary duties - or reputational costs for the controlling shareholders who grossly misbehave. [14]

B. Potential Benefits of CEMs

1. Controlling Shareholders Monitoring the Management

Some scholars have also identified potential benefits associated with the adoption of CEMs. [15]

Market based mechanisms, such as the threat of a hostile takeover or a proxy fight initiated by activists investors, require a significant drop in the market price of shares in order to operate. Therefore, such mechanisms intervene only when managerial slack is so pervasive

[13] Lucian A. Bebchuk, Reinier Kraakman & George Triantis, supra note 8, at 301 ("Unlike in [dispersed ownership] structures, where controlling management may have little equity but can be displaced, the controllers of… companies [adopting CEMs] face neither proxy contests nor hostile takeovers").

[14] Id. at 305:

> The fact that CMS structures [i.e. controlling-minority structures or CEMs] can impose significant agency costs is well known, even if the magnitude of these costs is not. It follows that CMS controllers who return to the equity market must pay a price for the expected agency cost of CMS structures unless they can establish a reputation for sound management.

See also: Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchanges*, 60 STAN. L. REV. 633, 648 (2007).

[15] Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms versus Ex Post Transaction Review*, 169 J. INST. THEOR. ECON. 160 (2013).

that the potential benefits created by a different board exceed the costs associated with a takeover bid or a proxy fight.

Having a controlling shareholder, who has a deep knowledge of the corporation business and the economic incentives to monitor managers' performance effectively – allows a more effective and timely control over the management than is possible with dispersed ownership. As Ronald Gilson and Alan Schwartz have argued, "[l]everaged control permits controlling shareholders to exploit economies of scale and scope in monitoring and managerial talents. Leverage also reduces the extent of firm specific risk the controlling shareholder must bear and for which he otherwise would have to be compensated." [16]

2. Reducing Controlled Companies Constraints in Raising Economic Resources in the Equity Market

If controlling shareholders cannot use CEMs to secure their control following an IPO or a secondary public offering, they could prefer to keep their firms private or issue a lower amount of shares in the market. These strategies, in turn, would reduce the financial resources available for expanding firms' activities and pursuing new business opportunities. Alternatively, these firms would be forced to increase their indebtedness, adopting an inefficient capital structure that would br more expensive and increase the riskiness of bankruptcy.

[16] Ronald J. Gilson & Alan Schwartz, supra note 15 at 162. See also, Ronald J. Gilson & Alan Schwartz, *Report Concerning Recommendations of the Committee on Enhancing Competitiveness*, 7-8 (December 1, 2011), available at: http://mof.gov.il/Lists/CompetitivenessCommittee_2/Attachments/96/Gilson.pdf:

> [C]ontrolling shareholders are an effective alternative to market policing of the agency cost of managerial lack of diligence and poor performance that result from the specialization of risk bearing and management. Pyramids, and other means of expanding the reach of a controlling shareholder's authority, thus capture economies of scale associated with monitoring management's diligence and performance.

From this perspective the adoption of CEMs allows an efficient bargain between insiders and outside investors in situations where controllers are not willing to allow the issuance of more equity that would jeopardize their control, even when this refusal would impair the growth and financial stability of their enterprise. [17]

C. CEMs' Effects on the Market Value of shares

The agency problems associated with the separation between controllers' cash flow rights and voting rights are easily recognized by sophisticated investors. These investors therefore discount the price that they are willing to pay for the shares issued by companies thar adopt CEMs.

According to a 2007 survey involving 445 institutional investors worldwide that collectively managed more than 4.9 trillion in assets (the "ISS Report"), "80% of investors would expect a discount on the share price of companies with CEMs. This discount ranges from 10% to 30% of the share price for the majority of investors who attempted to quantify it." [18]

---

[17] Alessio M. Pacces, F*eaturing Control Power: Corporate Law and Economics Revisited*, 13 (2008), available at http://ssrn.com/abstract=1089406, ("Entrepreneurs concerned with idiosyncratic private benefits may only go public with an ownership structure that supports ongoing exercise of corporate control and its protection from hostile takeover."); John C. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporation Be?*, *in* REFORMING COMPANY LAW AND TAKEOVER LAW IN EUROPE 677, 690 (Guido Ferrarini et al. ed, 2004). Arguing that in situations where the "Break-Through" rule applies and the board cannot take defensive mesures against hostile takeovers:

> [B]oth existing or new public firms that have both a conventional one-share/one-vote structure and a single (or small group) of controlling shareholders may simply turn down net present value projects if they would require the shareholders to put their control at risk.

[18] Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, *Report on the Proportionality Principle in the European Union*, 6 (2008), available at: http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf.

This finding argues strongly that the potential benefits created by CEMs are not considered material by investors when compared to the agency costs caused by the same ownership structures.

II. CONTROL ENHANCING MECHANISMS ACROSS DIFFERENT LEGAL SYSTEMS

Controlling shareholders can use several legal devices in order to separate their voting rights from their ultimate economic risk in a firm. CEMs include the issuance of non-voting shares and/or "golden shares", the use of depository certificates, cross-shareholdings and shareholders agreements. However, the most effective and commonly used CEMs are the issuance of multiple voting rights shares and the adoption of pyramidal ownership structures. In this paper I will focus my analysis and policy recommendations on these two CEMs only.

Multiple voting-rights shares provide different voting power to the owners of different types of stocks. For example, a company could issue A-shares with one vote per unit of par value and B-shares with ten votes per unit of par value. An alternative, although very similar, arrangement could be to provide A-shares with one vote per any 10 units of par value and B-shares with one vote per unit of par value. Both capital structures allow the holder of a substantial amount of B-shares to exercise control over the company without carrying a proportionate economic risk.

The same gap between voting rights and cash flow rights can also be achieved through the adoption of a pyramidal ownership structure. In this case the main shareholder holds a controlling stake in a company that in turn has a majority participation in another company, which controls a third company, and so on. The use of different companies – which are participated also by minority shareholders – allows the main shareholder to exercise a very strong, or complete, control of even very large listed companies situated at the bottom of the pyramidal structure without investing an amount of money proportionate to their voting power in the same firms.

Even though multiple voting rights shares and pyramidal ownership structures are generally used to achieve the same goal – i.e. separating ownership and control – and create similar agency problems, [19] different legal systems treat these two types of CEMs in radically different ways. The following paragraphs describe the four different kinds of regulation that prevail in the US, the GIPS, Sweden and Israel.

A. Multiple Voting Rights Shares in the US

Empirical studies have documented that pyramidal ownership structures are extremely rare in the United States. [20] Randal Morck has provided historical evidence that corporate pyramids disappeared almost completely in the 1930s, when the Roosevelt administration

---

[19] Lucian A. Bebchuk, *Corporate Pyramids in the Israeli Economy: Problems and Policies: A Report Prepared for the Committee on Increasing Competitiveness in the Economy*, at 4 (March 2012), available at: http://mof.gov.il/Lists/CompetitivenessCommittee_4/Attachments/3/Opinion_2.pdf (the "Final Report"):

> Corporate pyramids are closely related to dual-class stock companies. They are both mechanisms which separate cash flow rights and voting rights, and which enable a party to control corporate assets while contributing only a minority (and sometimes a small minority) of the equity capital funding these assets. Indeed, in some situations, a pyramid and a dual-class stock structure would produce an economically identical result.

[20] Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 501 (1999); Bellen Villalonga and Raphael Amit, *How Are U.S. Family Firms Controlled?*, 22 REV. FIN. 3047, 3075-6 (2009) (using as sample all the firms that were listed in the Fortune 500 in the period 1994-2000 they found that only eleven firms exhibit pyramidal ownership); Ronald W. Masulis, Peter Kien Pham, and Jason Zein, *Family Business Groups around the World: Financing Advantages, Control Motivations, and Organizational Choices*, 24 REV. FIN. STUD. 3556, 3570, Table 2 (2011) (in 2002 only 1.03 percent of all U.S. public companies were controlled through a pyramidal structure)

introduced intercompany dividend taxation that made these corporate structures more burdensome for controllers than before. [21]

The dismantling of pyramidal ownership structures in the US cannot be considered merely an involuntary and marginal side effect of the Federal income taxation reform: The legislative history shows that "the New Deal Congress taxed dividends to dismantle ownership structures". [22]

The US aversion to corporate pyramids is not driven by opposition to the separation between voting rights and cash flow rights. U.S. law permits separation by means of the issuance of multiple voting shares held by the controlling shareholder. According to a recent research, "[o]verall, dual-class firms comprise about 6 percent of the number of public companies and 8 percent of the market capitalization". [23] In the most frequent arrangement, common shares have only one vote per share, while the superior class of shares has ten votes per share. [24] However, in some cases the gap between votes assigned to common and superior shareholders is much higher. For example, the Ford company's Class B Stock held by the

---

[21] Randall Morck, *How to Eliminate Pyramidal Business Groups—The Double Taxation of Inter-Corporate Dividends and Other Incisive Uses of Tax Policy*, 19 TAX POL. ECON. 135 (2005); Randall Morck and Bernard Yeung, *Dividend Taxation and Corporate Governance*, 19 J. ECON. PERSP. 163, (2005); see also Randall Morck, *The Riddle of the Great Pyramids*, *in* THE OXFORD HANDBOOK OF BUSINESS GROUPS (Asli M. Colpan & Takashi Hikino ed., 2009). For an alternative explanation of the rarity of corporate pyramids in the US see Steven Bank & Brian R. Cheffins, *The Corporate Pyramid Fable*, 84 BUS. HIST. REV. 435, 458 (2010) (their "research indicates that the relative rarity of corporate pyramids in the U.S. likely cannot be attributed to intercorporate taxation of dividends… in the case of utilities, the one sector where pyramids were commonplace, regulation, namely the Public Utility Holding Company Act of 1935, was pivotal").

[22] Mark J. Roe, STRONG MANAGERS, WEAK OWNERS: A POLITICAL THEORY OF AMERICAN CORPORATE FINANCE 107 (1994), ("It is a part of a pattern from antitrust and financial regulation that seeks fragmentation and arm's-length dealing and has continuing effects today").

[23] Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1057 (2010).

[24] *See*: Bellen Villalonga and Raphael Amit, supra note 20 at 3066; Paul A. Gompers, Joy Ishii & Andrew Metrick, supra note 23 at 1056 :

> On average, the insiders of dual-class firms own a majority of the voting rights (about 60%) and a significant minority of the cash-flow rights (about 40%). Nearly all of these voting rights come from the superior voting class stock: less than 15% of the insiders' voting rights come from the inferior voting class.

Ford family has 40 percent of the general voting power. In the 2012 shareholders' meeting this arrangement had the effect that each of the 70,852,076 outstanding shares of Class B Stock was entitled to 35,238 votes. [25]

B. Pyramidal Ownership Structures in Greece, Italy, Portugal and Spain.

GIPS have adopted a completely different approach towards CEMs. All of these countries generally endorse the "one share-one vote" principle [26] and prohibit multiple voting rights shares. [27] Paradoxically, however, these legal systems also permit the creation of large pyramidal ownership structures, which allow the creation of substantial gaps between controllers' voting rights and economic exposure.

In Italy, the reforms in corporate law introduced in the last fifteen years to strengthen minority investors' protection have been coupled with a significant reduction in the use of pyramidal ownership structures by controlling shareholders. [28] However, corporate pyramids

---

[25] *See* Ford Motor Company, supra note 3 at 2.

[26] The "one share-one vote" principle is note absolute and without exceptions in these countries. In Italy and in Spain, for example, multiple voting rights shares are expressly prohibited, but, on the other hand, companies are allowed to issue non-voting shares having a par value up to half of their nominal share's capital. See: Article 2351 of the Italian Civil Code; Mara Faccio & Larry H. P. Lang, *The ultimate ownership in western European corporations*, 65 J. FIN. ECON. 365, 386-7 (2002); Marcello Bianchi and Magda Bianco, *Italian Corporate Governance in the last 15 years: From Pyramids to Coalitions?*, Finance Working Paper no. 144. ECGI, 10-12 (2006) available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952147, ("In 2005 only 14% of the [Italian] companies issued non voting shares; their value was 4% of total shares on the market.")

[27] *See* Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18; OECD Steering Group on Corporate Governance, Lack of Proportionalit Between Ownership and Control: Overview and Issues for Discussion, 21 (2007), available at: www.oecd.org/dataoecd/21/32/40038351.pdf; Deminor Rating, Application of the one share - one vote principle in Europe, A survey Commissioned by Association of British Insurers (2005), available at: http://va.issproxy.com/resourcecenter/publications/European_General_Reports/ABI_DEMINOR_full%20 report.pdf.

[28] Three major reforms have mainly contribuited to the improvement of Italian corporate governance regulation. The Financial Markets Consolidated Act (also called "*Legge Draghi*") in 1998 has provided an extensive reform of listed companies' corporate governance and disclosure requirements. The general reform of companies' law ("*Riforma del diritto societario*") in 2003 and the Investor Protection Act ("*Legge sul Risparmio*") in 2005, wich have generally improved minority shareholders protections. See: Luca Enriques, *Corporate governance reforms in Italy: what has been done and what is left to do*, 10 EU. BUS. ORG. L. REV. 477 (2009); Marcello Bianchi, Magda Bianco and Luca Enriques, *Pyramidal Groups and the Separation Between Ownership and Control in Italy, in* THE CONTROL OF

still control many of the largest Italian listed companies. According to a very recent survey made by Consob (the Italian securities regulation commission), in 2012 20.3 percent of the Italian listed companies – representing 62.2 percent of the overall market capitalization – were controlled through pyramids. [29]

Corporate pyramids are also commonly used in Spain. Mara Faccio and Larry Lang document that, in the 1996-1999 period, 16 percent of all Spanish companies were controlled through pyramids. [30] The ISS Report shows that in 2006, four of the twenty largest companies featured this kind of CEM. [31]

Corporate Pyramids are also diffused in Portugal (Faccio's and Lang's survey reports that they represent 10.91 percent of the listed companies [32]) and they represent "the most common CEM in recently listed Greek companies". [33]

CORPORATE EUROPE 154, 183-4 (Fabrizio Barca & Marco Becht ed., 2001); Guido Ferrarini, *Corporate governance changes in the 20th century: a view from Italy*, Law Working Paper no. 29, ECGI (2005); Francesca Cuomo, Alessandro Zattoni & Giovanni Valentini, *The Effects of Legal Reforms on the Ownership Structure of Listed Companies*, IND. CORP. CHANGE 22 (2012) (Their "results show that [in Italy, in the 1985-2005 time period,] an increase in the protection of investors' rights is associated with a decrease in the use of CEMs and in the separation between control and cash flow rights").

[29] CONSOB, RAPPORTO 2012 SULLA CORPORATE COVERNANCE DELLE SOCIETÀ QUOTATE ITALIANE, 7 (2012), available at: www.consob.it/documenti/Pubblicazioni/Rapporto_cg/rcg2012.pdf (In 1998, 38.9 % of the Italian listed companies – representing 78.2 % of the overall market capitalization – were controlled through pyramids). On the relevance of corporate pyramids in Italy see also: Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, supra note 20, at 501; Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18, at 59-61 (in 2008, nine of the twenty largest Italian listed companies feature a pyramid structure); Marcello Bianchi and Magda Bianco, supra note 26 at 10-12, (Noting that, even if they have decreased in number and in depth, "pyramidal groups are still a relevant feature of Italian listed companies ownership structure"); Mara Faccio & Larry H. P. Lang, supra note 26, at 389-91.

[30] Mara Faccio & Larry H. P. Lang, supra note 26, at 389.

[31] Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18, at 71-72 (the four big listed companies controlled through pyramidal ownership structures are: Abertis (Industrials) and ACS (Industrials), FCC (Industrials) and Gas Natural (Oil & Gas)); See also Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, supra note 20, at 501.

[32] Mara Faccio & Larry H. P. Lang, supra note 26, at 389

[33] Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18, at 49-50 ("Pyramid structures were identified in 15% of large companies and 64% of recently listed companies");

C. Multiple Voting Rights Shares and Pyramidal Ownership Structures in Sweden

Swedish corporate law is particularly "friendly" towards the use of CEMs by controlling shareholders in order to separate their voting rights from their cash-flow rights. Corporate pyramids and multiple voting rights shares are extremely common in the Swedish capital market. Indeed, in "the early 1990s, the two dominant ownership groups in Sweden had used these instruments to control 50 percent of the market cap of the Stockholm Stock Exchange (SSE) based on a mere two percent of the dividend rights". [34]

This situation does not seem to have changed much today: recent data shows that in 2006, 16 of the 20 largest Swedish companies issued multiple voting rights shares and 13 members of the same group used pyramidal ownership structures. [35] As Peter Högfeldt's pointed out:

> [D]espite the very significant increase of institutional capital and foreign capital, corporate ownership is as entrenched as ever in Sweden since the largest firms are still controlled by an old financial nobility of the third to fifth generation and by banks, but to a much lesser extent by institutions that provide the majority of the capital. [36]

---

[34] Magnus Henrekson & Ulf Jakobsson, *The Swedish corporate control model: convergence, persistence or decline?*, 20 CORP. GOV. INT. REV. 212, 213 (2012).

[35] Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18, 74-76; Clas Bergstrom & Kristian Rydqvist, *Ownership of Equity in Dual Class Firms*, 14 J. BANK. FIN., 237, 260 (1990) (in Sweden "the proportion listed dual-class firms has increased from 32% in 1968 to 74% of the listed firms in 1986").

[36] Peter Högfeldt, *The History and Politics of Corporate Ownership in Sweden*, *in* A HISTORY OF CORPORATE GOVERNANCE AROUND THE WORLD: FAMILY BUSINESS GROUPS TO PROFESSIONAL MANAGERS, 517, 538 (Randall K. Morck, ed., 2005). But see also: Magnus Henrekson & Ulf Jakobsson supra note 34 at 220, (Noting that even if "the traditional Swedish corporate control model based on "old capital" and a large wedge between control rights and cash-flow rights… is still dominant on the SSE [i.e. the Stockholm Stock Exchange]…[in the last years] there is far less pyramiding and use of dual-class shares").

D. Prohibition of Multiple Voting Rights Shares and Proposed Limitation of Pyramidal Ownership Structures in Israel

Until the 1980's the Israeli corporate governance model had some features similar to those seen in the Swedish economy. Corporate pyramids and shares with different voting rights were both allowed and commonly used in Israeli listed companies. Shmuel Hauser and Beni Lauterbach report that "[a]t the end of 1989, about 40% of the firms traded on the Tel Aviv Stock Exchange (TASE) had dual-class stocks. The superior vote stocks were always 'one share one vote' stocks, while the inferior vote stocks were typically 'five shares one vote' stocks". [37]

Starting from January 1990, however, a regulatory reform required any Israeli company seeking to raise equity for the first time on the TASE to issue only superior class stocks (i.e. one share-one vote common stocks). [38] Since then, dual shares have almost completely disappeared from the Israeli stock market. [39]

The use of corporate pyramids was also widely spread among controlling shareholders before the introduction of limitations on dual-shares. [40] Even today this CEM is extremely diffused in the Israeli economy. A recent survey conducted by the "Committee on Increasing

---

[37] Shmuel Hauser & Beni Lauterbach, *The Value of Voting Rights to Majority Shareholders: Evidence from Dual-Class Stock Unifications*, 17 REV. FIN. ST. 1167, 1169 (2004).

[38] Shmuel Hauser & Beni Lauterbach, supra note 37, at 1169; Beni Lauterbach & Yishay Yafeh, *Long term Changes in Voting Power and Control Structure following the Unification of Dual Class Shares*, 17 J. CORP. FIN. 215 (2011).

[39] Beni Lauterbach & Yishay Yafeh, supra note 38, at 216:

> Following this regulatory change, by the year 2000, over 80 of the 109 dual class firms listed on the TASE in 1990 unified their shares. Most of the remaining dual class firms were delisted, merged or unified their shares in recent years, so that by the beginning of 2009 dual class stocks have become almost extinct. (Only seven dual class share firms still trade).

[40] Beni Lauterbach & Yishay Yafeh, supra note 38, at 227 ("Business groups, a common feature in Israel's economic landscape, have not been used to replace dual class shares").

Competitiveness in the Economy" appointed by the Prime Minister of Israel, the Minister of Finance, and the Governor of the Bank of Israel in October 2010 (the "Committee on Increasing Competitiveness") has identified:

> 24 major business groups controlling about 136 out of 596 listed companies (23%), and approximately 68% of total stock market capitalization. According to [a report prepared by the Committee on Increasing Competitiveness], the 10 largest business groups' market capitalization amounts to 41.3% of total stock market capitalization. The biggest business group holds assets equal to approximately 19.4% of GDP; the five largest business groups hold assets equal to approximately 62.8% of GDP. [41]

The Committee was *inter alia* "asked to recommend advisable policy measures with emphasis on […] the issue of the control of a public company using a pyramid holding structure". [42] As we will see in section IV.C of this paper, the Committee has proposed the introduction of new rules aimed at reducing pyramidal ownership structures by preventing the creation of new business groups in Israel, and at simplifying the structure of existing pyramids by limiting the permissible "layers" of companies.

---

[41] Lucian A. Bebchuk, supra note 19 at 4. See also: Konstantin Kosenko, *Evolution of Business Groups in Israel: Their Impact at the Level of the Firm and the Economy*, 5 ISRAEL ECON. REV. 55 (2007):

> Using panel data on 650 public companies from 1995 to 2006, [he] identify twenty major business groups controlling about 160 listed companies and close to a half of total stock market capitalization, while the 10 largest groups' segment of the market capitalization is among the largest in the western world and amounts to 30 percent. These groups are family-controlled and highly diversified across different industries with common pyramidal structure of ownership: roughly 80 percent of all group-affiliated companies belong to business pyramids.

[42] See: Committee on Increasing Competitiveness in the Economy, press release on February 18, 2012, available at http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/publications/PressRelease.pdf.

III. PYRAMIDAL OWNERSHIP STRUCTURES VS. MULTIPLE VOTING RIGHTS SHARES

The adoption of opposite normative solutions to regulate corporate pyramids and multiple voting rights shares in different developed economies has been driven by historical events, political choices, dissimilar development of financial institutions and capital markets, and path dependence. [43] Therefore, it cannot be assumed that the regulation in place in any of these legal systems is the most rational and efficient, given the specific features of the country's economy and capital market development.

For this reason in the next paragraphs I analyze the main costs and benefits of pyramidal ownership structures and multiple voting right shares. This analysis makes possible to understand whether the current regulation adopted by GIPS is the most efficient – and therefore would maximizes the price of their state controlled companies to be privatized in their stock market – or if these countries should consider other normative solutions more similar to the ones seen in the US or Sweden, or the one proposed in Israel.

A. Costs and Benefits of Multiple Voting Rights Shares

1. Costs of Allowing Firms' Control Through Multiple Voting Rights Shares

Empirical studies have documented the agency costs associated with the issuance of multiple voting rights shares even in countries with a developed legal system. For example,

[43] Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN L. REV. 127 (1999); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV.1642, 1644-5 (2006); Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L. Q. 327, 332 (1996):

> the path dependent characteristics of a given national governance system confront the disciplining effects of the operative selection mechanisms. In the end, institutions are shaped by a form of corporate governance plate tectonics, in which the demands of current circumstances grind against the influence of initial conditions

using a sample of 2,440 firm-year observations from 1995 to 2003 for 503 U.S. dual-class companies, Ronald W. Masulis, Cong Wang and Fei Xie, find that:

> [A]s the insider control rights–cash flow rights divergence becomes larger, outside shareholders raise the discount on an extra dollar of corporate cash holdings, CEOs receive greater compensation, and managers engage in more inefficient empire-building activities such as acquisitions and large capital expenditures. These results are consistent with larger excess control rights leading to both greater private benefits of control and reduced market value to outside shareholders. [44]

2. Costs of prohibiting Multiple Voting-Rights Shares.

Given the agency problems created by multiple voting rights shares, it might seem surprising that some of the most successful U.S. firms like Google, Facebook, LinkedIn, GroupOn and Zynga have adopted this corporate governance structure in their recent IPOs. This choice might seem even more surprising if we consider that the costs of multiple voting rights shares are easily recognized by professional investors, who therefore discount the price paid for these shares. In a recent survey titled "The Tragedy of The Dual Class Commons", the ISS analyzed the Facebook IPO as follows:

> [E]ven a strong distaste among institutional investors for the company's retrograde governance practices is unlikely to diminish the economic success of the IPO. In-

---

[44] Ronald W. Masulis, Cong Wang and Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1722 (2009). *See* also: Paul A. Gompers, Joy Ishii & Andrew Metrick, supra note 23 at 1084, ("In a series of single-stage regressions, [they] find that firm value is positively associated with insiders' cash-flow rights and negatively associated with insiders' voting rights, and negatively associated with the wedge between the two"); Scott B. Smart, Ramabhadran S. Thirumalai and Chad J. Zutter, *What's in a vote? The short- and long-run impact of dual class equity on IPO firm values*, 45 J. ACC. ECON. 94, 113 (2008) (Their "results suggest that investors discount dual-class shares because the superior voting rights held by insiders makes it difficult for outsiders to replace incumbents").

vesting is ultimately about return. While good corporate governance practices, by increasing board and management accountability, can provide a robust framework to drive shareholder value, this IPO event itself presents a Hobson's choice: accept governance structures which diminish shareholder rights and board accountability, or miss out on what appears to be one of the hottest business models of the internet age.[45]

But if these "retrograde governance practices" are proven costly and inefficient, why doesn't the U.S. regulator follow the GIPS and Israel by endorsing the "one-share one-vote" principle? A possible explanation could be that this ownership structure is inefficient *ex post,* but a mandatory provision prohibiting its adoption would be even more costly *ex ante*.

Looking at the Facebook case, we can imagine that if Mark Zuckerberg had been prevented from maintaining control of the company through Class-B Shares, he would have received a higher price for the common shares in the IPO. In addition, he would have felt more pressure from the market to manage the business in the most effective way. Unsatisfied stockholders would have had the power to remove him as CEO through a proxy contest, or other investors could have challenged his control by launching a hostile takeover. Therefore, an absolute prohibition of multiple voting right shares would have been efficient from an *ex post* perspective.

---

[45] Intitutional Shareholders Services, *The Tragedy of the Dual Class Commons* (February 13, 2012), available at http://online.wsj.com/public/resources/documents/facebook0214.pdf. For similar comments about Google's IPO see: Simon London, *U.S. pension fund criticizes Google's IPO structure. Financial Times*, (May 4, 2004), available at http://www.nbcnews.com/id/4900355/#.UTuos6XT0jQ :

> TIAA-Cref, the New York-based teachers' pension fund with $300 billion under management, said that corporate governance weaknesses would be reflected in the price it was willing to pay for Google stock. "There should be a substantial discount for corporate governance deficiencies," said Peter Clapman, senior vice-president and chief counsel for corporate governance.

However, the *ex ante* costs of this solution should also be considered. Knowing that he cannot secure his control after an IPO, Zuckerberg might have decided to keep Facebook private or issued fewer shares to be listed in the market. [46] This strategy would have reduced the financial resources available to the company for expanding its business, or it would have induced the firm to rely more on debt to finance its activities, thereby increasing the leverage and the riskiness of bankruptcy. [47]

This solution would have been economically inefficient both for the firm – since it will lack the financial resources to grow and prosper – and its controller – because, should he has sold the control in the IPO, he would had maximized the value of his participation. However, at least in some cases, non-monetary private benefits – such as securing control of the company the manager has founded and that has rendered him famous and respected – can offset the costs of a sub-optimal economic decision. [48] In this situation, issuing multiple voting right shares allows the company to raise equity capital on the market without

---

[46] See Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 828 (1987)

> Dominant shareholders of [companies in growing markets with large additional cash flow needs] are faced with a dilemma. If they finance growth by further sales of an existing single class of common stock, their control of the firm will be diluted. But if they avoid dilution by purchasing enough new shares themselves to retain the same percentage of ownership they will suffer an uncompensated increase in the unsystematic risk of their investment in the company. In either event, this form of financing growth imposes a cost on dominant shareholders that is not shared by public shareholders.

[47] See for similar considerations: William T. Allen, *Comments Respectfully Submitted to the Committee for Increasing Competitivness of the Economy of the State of Israel*, 5 (Nov. 24, 2011) (Document on file with the author).

[48] Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control*, Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 260, available at: http://lsr.nellco.org/harvard_olin/260 :

> Private benefits might be also nonpecuniary. Control might provide larger such benefits to the controller when the controller founded the firm, when control of the firm has always resided with the controller's family, or when control of the firm provides the controller with prestige. Thus, other things equal, antitakeover charter arrangements should be more common in such situations.

See also: John C. Coates IV, supra note 17 at 692, reporting that:

> [I]n high technology companies, … part of the incentive for innovators is their sense of ownership over the technology itself, in all its possible uses (or, more often, from their perspective, misuses), and the initial innovators are very plausibly the highest-valuing owners of the rights to dispose of technology they have created.

depriving the dominant shareholder of the non-monetary private benefits that he gains through his control. [49]

B. Costs and Benefits of Pyramidal Ownership Structures

1. Costs of Allowing Firms' Control Through Pyramidal Ownership Structures

Even though corporate pyramids "formally" comply with the one-share one-vote principle – because they don't require the issuance of different kinds of shares – they allow controlling shareholders to achieve the same separation between cash flow rights and voting rights created by multiple voting rights shares. The entrenchment of the controlling shareholders and the agency costs created by this ownership structure have a negative effect on the firm's performance and on the value of its stocks.

In his final report to the Committee on Increasing Competitiveness, Lucian Bebchuk provides empirical evidence showing that public investors are negatively affected by the adoption of pyramidal ownership structures. The data reported also shows that the pregiudice suffered by the minority shareholders, measured in terms of reduction in value of their stock, is directly related to the degree of the separation between the controller cash flow rights and his voting rights. [50]

---

[49] See Ronald J. Gilson, supra note 46, at 828.

[50] Lucian A. Bebchuk, supra note 19, at 11; *See* also Rejie George and Rezaul Kabir, *Business groups and profit redistribution: a boon or bane for firms?*, 61 J. BUS. RES. 1004, 1012 (2008), ("The analysis shows that group-affiliated firms perform poorly relative to independent firms"); Sung Wook Joh, *Corporate governance and profitability: Evidence from Korea before the economic crisis*, 68 J. FIN. ECON. 287, 318 (2003), using a sample of 5,829 Korean firms subject to outside auditing during 1993–1997, he found evidence that:

> Firms with lower controlling family ownership or higher differences between control rights and ownership rights showed lower performance. […] In addition, Korean firms affiliated with business groups in the mid-1990s showed lower profitability than independent firms did.

Pyramids create a misalignment between the interests of the controller – who usually has an interest in over-investing [51] – and the interests of all other shareholders. In addition, the main shareholder usually controls many different companies that do not deal with each other on a clear arms' length basis. And the lack of transparency associated with these "baroque, opaque, and costly structures" [52] also provides great opportunities for tunneling (i.e. transferring, directly or indirectly, assets and profits of a firm to its controlling shareholder). [53]

These intricate and unclear controlling structures push investors to rely on the reputation and track record of controlling shareholders, who are usually established families with relevant social and political connections. But understanding these social relationships usually proves to be very difficult and costly, especially for foreign investors. [54] Three

---

See also: An Buysschaert, Marc Deloof, Marc Jegers and An Rommens, *Is Group Affiliation Profitable in Developed Countries? Belgian Evidence*, 16 CORPS. GOV. INT. REV. 504, 514 (2008), using a sample that includes 247 group companies, belonging to 16 different Belgian groups, they found that:

> The results for net income/total assets confirm the findings […] that (1) group companies are significantly less profitable than stand-alone companies; (2) group companies have more volatile profits than stand-alone companies; and (3) receiving group financing is negatively related to the profitability of group companies.

[51] Martin Holmén & Peter Hogfeldt, *Pyramidal Discounts: Tunneling or Agency Costs?*, 9 INT. REV. FIN. 133, 172 (2009) (Corporate pyramids tend "to systematically overinvest since they have access to a relatively inexpensive source of capital with lower and softer return requirements than the external capital markets."). *See* also: Abe De Jong, Douglas V. DeJong, Ulrich Hege and Gerard Mertens, *Leverage in Pyramids: When Debt Leads to Higher Dividends,* ECGI - Finance Working Paper No. 261/2009 (2010), at 8, available at 30: http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=1461492 (Finding that, when the holding company is highly leveraged, the "dividend payouts [necessary to repay the controller's debt] may exceed the efficient payout level for the bottom company").

[52] Luca Enriques, supra note 28 at 507.

[53] Simon Johnson, Rafael La Porta, Florencio Lopez-de- Silanes, and Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000). *See* also: Vladimir Atanasov, Bernard Black and Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 13 (2011) ("[P]yramidal and circular ownership structures… provide both incentives and opportunities for the controller to tunnel profits up to the top level of the pyramid."); Jae-Seung Baek, Jun-Koo Kang and Inmoo Lee, *Business Groups and Tunneling: Evidence from Private Securities Offerings by Korean Chaebols*, 61 J. FIN. 2415 (2006); Kee-Hong Bae, Jun-Koo Kang and Jin-Mo Kim, Tunneling *or Value Added? Evidence from Mergers by Korean Business Groups*, 57 J. FIN. 2695 (2002); Marianne Bertrand, Paras Mehta and Sendhil Mullainathan, *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121 (2002).

[54] Christian Leuz, Karl V. Lins & Francis Warnock, *Do foreigners invest less in poorly governed firms?,* 22 REV. FIN. STUD. 3245, 3253-54 (2009).

> Understanding these control structures and the family motives requires intricate social and institutional knowledge, which many foreigners lack or find costly to obtain. As a consequence, firms with

economists, using a sample of 4,409 firms from twenty-nine countries found that "U.S. investors, which comprise about half of all foreign portfolio investment worldwide, do in fact hold fewer shares in foreign firms where managers and their families have high levels of control and hence ownership structures that are more conducive to expropriation by controlling insiders." [55]

The agency costs created by pyramidal ownership structures and the lack of transparency they create cause the minority shareholders who are still interested in investing in these companies to demand a discount on the price of their shares. This discount is not registered only in legal systems characterized by a low level of investor protection. Even though pecuniary private benefits of control are generally considered lower in Sweden than in the United States and the United Kingdom, [56] two Swedish economists found that:

> One effect of the highly leveraged control structure is that the 25% average discount on Swedish [holding companies] between 1986 and 2000 is 13–17% larger than for portfolio-oriented UK and US [holding companies]. The extra discount is thus a rough direct measure of the costs of pyramidal control imposed on other shareholders. But it does not include the negative indirect effects of pyramiding on the value of portfolio firms (discounts). [57]

potentially problematic governance structures are particularly taxing to foreign investors in terms of their information and monitoring costs.

[55] *Id* at 3246.

[56] See: Tatiana Nenova, The value of corporate voting rights and control: A cross-country analysis, 68 J. FIN. ECON. 325, 334 (Table 3) (2003); Alexander Dyck and Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J. FIN. 537 (2004).

[57] Martin Holmén & Peter Hogfeldt, supra note 51 at 144; Konstantin Kosenko, supra note 41 at 89 (In Israeli corporate pyramids "the financial value of affiliated companies is significantly lower. These findings are indicative of market discounting with respect to affiliated companies").

In some situations the affiliation with corporate pyramids can prove to be economically efficient for the firms and their shareholders, but detrimental for the market and the society. Large business groups controlling companies engaged in related businesses can use their strong position in the relevant market to decrease competition to the detriment of the consumers and other stakeholders. [58] In addition to this problem, families controlling large pyramids are more effective in obtaining political representation and governmental support that are especially valuable in highly regulated business sectors. [59]

2. Costs of Prohibiting Pyramidal Ownership Structures

The industrialization of emerging economies requires the simultaneous development of many related business activities (the so called "big push"). [60] Pyramidal groups' "diversification gives them a presence in every critical industry needed for big push type growth". [61]

Corporate pyramids can also be considered efficient in providing financial resources to new firms in emerging markets that are characterized by poor corporate governance, lack of transparency and still undeveloped financial intermediaries. In this case, young firms face

---

[58] Lucian A. Bebchuk, supra note 19, at 18; Randall Morck & Masao Nakamura, *Business groups and the big push: Meiji Japan's mass privatization and subsequent growth*, 8 ENTERP. SOC. 543, 548 (2007), ("State orchestrated collusion, protectionism, and ready subsidies limit the competitive pressures on business groups, permitting inefficient operations to survive and compromising economic growth"); Tarun Khanna and Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LIT. 331, 359 (2007) ("[A]s business groups accumulate political and economic influence, the nature of their relations with government tends to change–from government protégés to a strong lobby with often captured regulators"); Randall Morck, Daniel Wolfenzon and Bernard Yeung, *Economic Entrenchment and Growth*, 43 J. ECON. LIT. 655, 657 (2005):

> [E]ntrusting the governance of huge slices of a country's corporate sector to a tiny elite can bias capital allocation, retard capital market development, obstruct entry by outsider entrepreneurs, and retard growth.

[59] Lucian A. Bebchuk, supra note 41, at 18; See Morck, Wolfenzon, and Yeung, supra note 58, at 693-699.

[60] Paul Rosenstein-Rodan, *Problems of Industrialisation of Eastern and South-Eastern Europe*, 53 ECON. J. 202 (1943).

[61] Randall Morck & Masao Nakamura, supra note 58, at 547 (2007); Randall Morck, supra note 21.

difficulties in raising external capital because of minority investor expropriation concerns. Therefore these firms can be financed more efficiently by controlling shareholders who can use their pyramids' internal capital for this purpose. [62]

Ronald Gilson has also argued that in markets where commercial law is bad and contractual obligations are difficult to enforce, affiliation with family groups can provide value for controlled firms. In this context, exchanges are operated in a "reputation market" and "the presence of family ownership, facilitates the development and maintenance of the reputation necessary for a corporation's commercial success." [63]

Prohibiting or even discouraging the formation of pyramidal ownership structures might therefore be considered undesirable from a cost and benefit perspective in developing countries. However, in more developed economies with more efficient capital markets, there are fewer opportunities for tunneling and more sophisticated financial intermediaries. Thus the benefits provided by corporate pyramids affiliation are less evident and are greatly outweighed by the agency costs created by the controllers' conflict of interests. [64] This

---

[62] Ronald W. Masulis, Peter K. Pham & Jason Zein, *Family business groups around the world: financing advantages, control motivations, and organizational choices*, 24 REV. FIN. STUD. 3556, 3572 (2011); Stijn Claessens, Joseph P. H. Fan and Larry H. P. Lang, *The benefits and costs of group affiliation: Evidence from East Asia*, 7 EM. MARK. REV. 1, 23 (2006) (Finding that in "East Asian countries other than Japan …for a firm with the control stake of the largest owner exceeding its ownership stake, valuation gains from group affiliation arise if the firm is older and slower-growing; in contrast, value losses arise if the firm is younger and has higher growth."); Tarun Khanna and Krishna Palepu, *Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups*, 55 J. FIN. 867, 887 (2000) (Their "research suggests that the most diversified business groups add value by replicating the functions of institutions that are missing in […] emerging market"); Tarun Khanna and Jan W. Rivkin, *Estimating the Performance Effects of Business Groups in Emerging Markets*, 22 STRAT. MGMT. J. 45, 68 (2001) (Using "data from 14 emerging markets in Asia, Latin America and South Africa [they] find that business groups affiliates earn higher accounting profits than do otherwise comparable unaffiliated firms").

[63] Ronald J. Gilson, supra note 14 at 636.

[64] *See*: Sung Wook Joh, supra note 50 at 318 ("As the economy develops, the potential benefits of overcoming these market imperfections decreases while the cost of agency problems and conflicts of interest between controlling family shareholders and minority shareholders can increase"); Ronald W. Masulis, Peter K. Pham & Jason Zein, supra note at 3589, note 39 ("[I]n an unreported test, [they] find that the valuation discount of group firms is actually lower in emerging markets than in developed markets.")

explains why, in developed countries, group affiliation is usually associated with a reduced share value and is therefore considered inefficient by outside investors. [65]

Even if pyramids, like multiple voting rights shares, are inefficient *ex post*, their prohibition can nevertheless create some costs *ex ante*. In particular, in countries where other kinds of CEMs are also prohibited, if families cannot secure control of their companies following an IPO they might decide to keep the firms private. And, even if listed, these companies might be reluctant to issue new shares when the controllers lack the financial resources required to avoid a dilution of their participation, despite the fact that their reluctance would cause the company to forego profitable business opportunities. Alternatively, controlled companies unable to secure financial resources through equity offering would have to rely more heavily on debt to finance their activity, thereby increasing leverage to inefficient levels. [66]

C. The Cost of Adopting CEMs: Multiple Voting Rights Shares vs. Pyramidal Ownership Structures.

Different CEMs have peculiar features that might be more or less suitable for specific market conditions. However, in developed countries, both pyramidal ownership structures and multiple voting rights shares are associated with increased agency problems. These problems affect the price that minority investors are willing to pay for the shares. As

[65] See supra note 50.

[66] Lucian A. Bebchuk, *Interim Report Prepared for the Committee on Increasing Competitiveness in the Economy* (October 9, 2011), available at: http://www.law.harvard.edu/faculty/bebchuk/Policy/Bebchuk-Shani-Report.pdf, at 13: ("If controllers continue holding their large groups using other people's money, but switch from outside equity financing to outside debt financing, leverage levels would rise above their current high levels, exacerbating systemic risk concerns").

empirical evidence suggests, the discount is directly related to the separation of ownership and control, whereas the adoption of any specific kind of CEM is not very relevant. [67]

Looking more specifically at the sensitivity of institutional investors towards these two kinds of CEMs, a very similar negative perception is registered: "[o]n a scale of +1 (very positive) to -1 (very negative), […] Pyramid structures (-0.57) are cited as the third most negative CEM according to investors. Multiple voting rights are [also] perceived very negatively (-0.55) by investors". [68] However, the discounts that institutional investors apply to these two kinds of CEMs operate in a different way.

In the U.S., the controlling shareholders, who want to secure their control by adopting multiple voting rights shares, generally have to issue the preferred shares at the time of the IPO. In addition, existing common shares cannot be exchanged with non-voting shares when the firm is already listed, although the firm can issue new classes of limited voting or no-voting stocks.

These strict regulations are the result of the SEC introduction of rule 19c-4 in the 1980s. [69] Even though this provision had been struck down by the D.C. Circuit Court [70] -

---

[67] Stijn Claessens, Simeon Djankov, Joseph P. H. Fan, and Larry H. P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2744 (2002) (Using a sample of East Asian corporations).

[68] Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18, at 85. According to this survey the first and the second most negative CEMs are: (i) the "priority shares" (-0.66) (i.e. shares that "grant their holders specific powers of decision or veto rights in a company, irrespective of the proportion of their equity stake"); and (ii) the "golden shares" (-0,64) (i.e. "priority shares issued for the benefit of governmental authorities").

[69] Stephen M. Bainbridge, *The Short Life and Resurrection of Rule 19c-4,* 69 WASH. U. L. Q. 565 (1991).

[70] Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. 1990).

which had considered it beyond the Commission's regulatory authority - it was in fact nevertheless introduced in the NYSE, AMEX and NASDAQ listing requirements. [71]

The reason of this regulation is described by an influential article written by Ronald Gilson, where he argues that "as long as the public shareholders are dispersed, so that efforts to organize resistance are costly and no single share-holder owns enough stock to make a difference", the insiders would be able to coerce the approval of transactions that transfer value from outside investors to controllers. [72]

However, if the multiple voting right shares can only be issued before the IPO, in this case the outside investors apply the discount caused by this sub-optimal ownership structure when they initially buy their shares and hence the controllers/sellers pay the cost of the price reduction. [73]

Pyramid structure can instead be built even after an IPO. An investor can simply create a pyramid and then use that structure to buy enough shares of a widely held firm to secure its control. Controlling shareholders who kept proportionate voting rights and cash flow rights in an IPO can also reduce their economic exposure at a later stage by building up a pyramid that

---

[71] See: WILLIAM T. ALLEN, REINER KRAAKMAN AND GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, (N.Y. 2012), 187; Scott B. Smart, Ramabhadran S. Thirumalai and Chad J. Zutter, supra note 44 at 95; Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 698 (2002); Stephen M. Bainbridge, *The Scope of the SEC's Authority Over Shareholder Voting Rights,* UCLA School of Law Research Paper No. 07-16 (2007), at 8, available at: http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=985707, ("Specifically, SEC Chairman Arthur Levitt successfully pressured the three principal domestic securities exchanges—NYSE, AMEX, and NASDAQ—to adopt a uniform voting rights policy essentially tracking Rule 19c-4").

[72] See: Ronald J. Gilson, supra note 46 at 834; Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice,* 76 CALIF. L. REV. 1, 40 (1988) (noting that before the amendment of the NYSE, AMEX and NASDAQ listing requirements "[i]n most cases this super-voting stock receive[d] reduced dividends, most commonly, 10% less than [was] paid to limited-voting stock. … After the new class of common [was] authorized, the firm conduct[ed] a one-time exchange offer, in which shareholders may exchange their ordinary common for the super-voting common, typically on a one-for-one ratio."); WILLIAM T. ALLEN, REINER KRAAKMAN AND GUHAN SUBRAMANIAN, supra note 71 at 187.

[73] The same reasoning explains why – unlike the multiple voting rights shares – non voting or limited voting shres can be issued (but not exchanged) in "mid-stream". In this case, the issuance of the new class of shares is not coercive, because the insiders cannot exploit the collective action problem.

hold the participation in the listed firm. [74] When the "equal opportunity rule" does not apply or is not triggered, they can also sell their controlling bloc at a premium to an existing pyramid or a pyramid created *ad hoc*.

Therefore, minority shareholders who have invested in company with efficient corporate governance can find themselves owning stocks in a firm controlled through a pyramid. In this situation – in countries like the GIPS that allow the creation of pyramids – rational investors will consider the likelihood that this kind of CEM will be adopted following an IPO and apply the discount caused by this ownership structure when the firm initially goes public. Hence, the more it is likely that a listed company will be controlled through a pyramid in the near future, the higher the discount that outside investors will apply at the time of the IPO.

If we look at this problem from the perspective of the seller of the shares in the IPO, we can argue that he would maximize the value of the participation sold if he could credibly commit to the market that his firm will not be controlled in the future through a pyramid.

IV. Privatizations in Italy, Spain, Portugal and Greece: How the Value of the Privatized Firms Can be Increased by Limiting Control Enhancing Mechanisms

The sovereign debt crisis of some European countries, including GIPS, and the pressure to reduce their fiscal deficits are pushing governments to consider divesting state-owned companies. [75]

---

[74] See: Alessio Pacces, Rethinking Corporate Governance: The Law and Economics of Control Powers, 210 (2012):

> One or more layers could be added on *top* of the pyramid, thereby diluting the controller's ownership stake in any lower layer. Minority shareholders of existing layers cannot but be harmed by such a strategy; but again they are powerless. In contrast, new outside investors are more easily found on top rather than at the bottom of a pyramid.

In July 2013, the Italian Prime Minister announced a plan to privatize some state-owned companies, including: Poste Italiane S.p.A. (the former monopoly of the postal service, with an overall group's revenue of more than €24 billion – *i.e.* $32 billion – in 2012 [76]), Ferrovie dello Stato S.p.A. (the primary train operator in Italy, with revenues of more than €8 billion – *i.e.* $10.5 billion – in 2012 [77]), and Fincantieri – Cantieri Navali Italiani S.p.A. (the largest ship-builder in Europe, with revenues of more than €2.3 billion – *i.e.* $3 billion – in 2012 [78]). [79] And according to a recent report:

> The newly-elected conservative Greek government reaffirmed, in June 2012, plans to raise at least €19 billion ($25 billion), and perhaps as much as €42 billion ($55 billion), from the sale of state assets before the end of 2015…. Additionally, the national governments of … Spain, Portugal … and Italy have all articulated multi-year, multi-billion-dollar divestment plans to be launched (or re-launched) once market conditions improve. [80]

---

[75] Laura Cabeza-García and Silvia Gómez-Ansón, *Post-privatisation Ownership Concentration: Determinants and Influence on Firm Efficiency*, 39 J. COMP. ECON. 412:

> Privatisation became a priority on government agendas in the past few decades and remains of high importance despite the current global financial crisis. In fact, European countries such as Poland, Greece, Portugal and Spain are stepping up their divestment programs, in search of greater revenue to help reduce fiscal deficits.

[76] See: Poste Italiane S.p.A. Financial Statement 2012, available at: http://www.posteitaliane.post/resources/english/editoriali/pdf/Annual_Report_2012.pdf.

[77] See: Ferrovie dello Stato S.p.A. Financial Statement 2012, available at: http://www.fsitaliane.it/cms-file/allegati/fsitaliane/Financial_Statements_FSItaliane_2012.pdf.

[78] See: Fincantieri – Cantieri Navali Italiani S.p.A. Financial Statement 2012, available at: http://www.fincantieri.com/CMS/Data/pages/files/000177_resource1_orig.pdf.

[79] See: Alessandro Barbera, *Letta riapre la pratica privatizzazioni: Si parte da Fincantieri, Fs e Poste*, LA STAMPA, Jul. 19, 2013, available at http://www.lastampa.it/2013/07/19/economia/letta-riapre-la-pratica-privatizzazioni-si-parte-da-fincantieri-fs-e-poste-2LM9DOcEC4XrbvMmSWmWjN/pagina.html; Marco Cobianchi, *Eni, Enel, Finmeccanica, Ferrovie, Poste: obiettivo privatizzazioni,* PANORAMA, Jul. 19, 2013, available at http://economia.panorama.it/aziende/eni-enel-finmeccanica-poste-privatizzazioni-saccomanni; Laura Bonadies, *Moretti (Fs): pronti alla privatizzazione*, MILANO FINANZA, Aug. 18, 2013 available at http://www.milanofinanza.it/news/dettaglio_news.asp?id=201308181633201290&chkAgenzie=TMFI.

[80] Privatization Barometer, *The PB Report 2011*, 4-5, available at: http://www.privatizationbarometer.net/PUB/NL/4/9/PB_Report_2011.pdf; Guy Dinmore, *Italy Sells Off State Sssets to*

If the GIPS are really willing to sell the shares of the companies they own, they should first create the best conditions to maximize their value in the market. In particular, given the current economic downturn in the EU, which has reduced the resources available to national investors, GIPS should create the conditions required to attract foreign investors.

A. How will Allowing the Creation of Corporate Pyramids Reduces the Value of State-Owned Companies to be Privatized?

1. Ownership Structures in the GIPS

In the GIPS, companies with dispersed ownership are quite rare. In Italy, for example, in 2012 fewer than 10% of the industrial and service companies (representing only 2,8% and 0,8% of their respective market capitalization) were widely held. In Spain, Portugal and Greece companies with a controlling shareholder are also by far the majority. [81]

Several factors push towards concentrated ownership structures in these countries. A first explanation is based on the high level of monetary and non-monetary private benefit of control in these markets. [82] Other possible explanations consider the benefits of having a controlling shareholder monitoring the management of the company [83] or countervailing the demands of strong labor unions. [84]

In the context privatizing state-owned companies, the lack of companies with dispersed ownership in the GIPSs' markets is particularly relevant because outside investors should

---

Reduce Debt, FINANCIAL TIMES (June 15, 2012), available at http://www.ft.com/intl/cms/s/0/769178de-b701-11e1-bd0e-00144feabdc0.html#axzz2QZPMGoro.

[81] Mara Faccio & Larry H. P. Lang, supra note 26.

[82] Tatiana Nenova, supra note 56 at 334; Alexander Dyck and Luigi Zingales, supra note 56 at 551.

[83] See supra Section I.B.

[84] MARL J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).

expect that some – or even most – of the companies sold by the government will also be driven to adopt a concentrated ownership structures.

The "equal opportunity rule", which applies in the GIPS, provides some protections for minority investors when a shareholder acquires a controlling bloc. However, the mandatory bid is triggered only when an investor exceeds a threshold level – between 30 and 33 percent – of the company's share capital. And – as some practitioners have noted – this threshold "is set too high because, in many cases, shareholders are able to control a European company (and either block or have a nearly insurmountable advantage against other bidders) by accumulating ownership of shares just below the threshold". [85]

In the worst scenario for institutional investors, a corporate raider may use a pyramidal ownership structure to acquire a bloc of shares that, even without reaching the threshold triggering the mandatory bid, will assure him a very strong – or even complete – control over the company. The Telecom Italia case, summarized below, exemplifies this scenario.

2. The Telecom Italia case

In the period between 1992 and 2000 Italy has privatized some of the largest state-owned companies. In several cases this result has been achieved through the dispersion of the controlling stake on the market. However, most of these firms did not remain publicly held for a long time, and soon after the privatization they were acquired by existing business groups or pyramids created *ad hoc*. [86]

---

[85] Skadden, Arps, Slate, Meagher & Flom LLP, *Europe M&A: The Evolving Takeover Landscape*, available at http://www.skadden.com/sites/default/files/public ations/Europe_MandA_The_Evolving_Takeover_Landscape.pdf.

[86] Marcello Bianchi and Magda Bianco, supra note 26 at 11.

Following the privatization of the Italian state-owned telecommunication company Telecom Italia ("the sixth largest telecommunication company in the world by turnover") [87] the firm remained widely held for less than two years (from 1997 to 1999) before a pyramid controlled by Matteo Colaninno acquired the majority of its share capital through a tender offer. After acquisition, the controller tried "to strip Telecom Italia of its most-valued asset, the highly profitable cellular phone unit, Telecom Italia Mobile, and transfer it to Tecnost, the Olivetti subsidiary used by Mr. Colaninno to purchase control of Telecom Italia". [88] In 2001, when this attempt to restructure the pyramid failed, Mr. Colaninno sold 23% of the share capital of Olivetti – the wedge company controlling Telecom Italia – to another pyramid controlled by Marco Tronchetti Provera at a 80% premium over the market price – a premium that was not shared with the minority shareholders. [89]

As Luca Enriques and Paolo Volpin have documented, Mr. Tronchetti Provera used a pyramidal ownership structure, which involved four other companies (two of them listed), that in 2005 controlled 18% of the voting rights in Telecom Italia – i.e a controlling bloc – while holding only 0,7% of the firm's cash flow rights. [90]

---

[87] Michele Meoli, Stefano Paleari and Giovanni Urga, *When Controlling Shareholders Live Like Kings. The Case of Telecom Italia* (January 24, 2006), available at: http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=883655.

[88] John Tagliabue, *Move by Olivetti Backfires With Sotck Traders,* Oct. 1, 1999, N.Y. TIMES, available at: http://www.nytimes.com/1999/10/01/business/international-business-move-by-olivetti-backfires-with-stock-traders.html.

[89] Paul Maidment, *Pirelli, Benetton Team Up To Grab Olivetti*, FORBES, July 27, 2001, available at http://www.forbes.com/2001/07/30/0730telecomitalia_print.html, (Noting that Mr. Tronchetti Provera was "effectively gaining control of Italy's leading industrial group, with a stock market capitalization of 55 billion euros, for 7 billion euros in cash."); Greg Burke, *All In The Families,* TIME MAGAZINE, Aug. 13, 2001, available at http://www.time.com/time/magazine/article/0,9171,170116,00.html#ixzz2QHSAb16P:

> By keeping their share of Olivetti under 30%, Pirelli [a company controlled by Mr. Tronchetti Provera] and Benetton [one of his allies] were not obliged to offer the buy-out to all investors. Minority shareholders are understandably furious, especially since Olivetti dropped 15.3% the first day after the deal.

[90] Luca Enriques and Paolo Volpin, *Corporate Governance Reforms in Continental Europe,* 21 J. ECON. PERSP. 117, 121 (2007).

The bottom line is that the outside investors who bought the stocks of Telecom Italia when it was privatized soon found themselves holding shares in a company with an inefficient ownership structure that allowed the controlling shareholder to use a very wide pyramid to control the company while maintaining a trivial economic stake in it.

3. Why Would Prohibiting Corporate Pyramids Increase the Value of the Privatizations?

If institutional investors understand that widely held firms in the GIPS are relatively unstable, [91] and that it is possible – or even likely – that other investors will be able to take control of these companies without triggering the "equal opportunity rule", they will evaluate their possible ownership structures and the agency costs they create in the controlled companies.

In particular, institutional investors considering buying shares in the privatizations of state owned companies in the GIPS will evaluate the risky possibility that, in the near future, these companies will be controlled by pyramidal ownership structures, as it has happened in the Telecom Italia case. If these investors fear that the investee company could – or is likely to – become a member of a pyramid, they would not buy any participation in that company, or they would ask for a discount on the shares price. [92]

Therefore, if GIPS want to maximize the price of the shares of state-owned companies in the privatization process – and, in particular, if they want to attract foreign investors who

---

[91] Lucian A. Bebchuk, supra note 48, at 37 ("When control is valuable, leaving it up for grabs will invite attempts to grab it and will not constitute an equilibrium.")

[92] See supra Section III.B.I.

are extremely adverse to corporate pyramids [93] – they should prevent the subsequent adoption of this kind of ownership structure. From this point of view, it would be rational for the GIPS, which have already issued regulations prohibiting the adoption of multiple voting right shares, to endorse an even stricter application of the proportionality principle and to tackle the widespread use of pyramid structures in their economies.

B. The Olson Problem: the Resistance of Established Economic and Political Elite to Changes in Corporate Governance

Even if political institutions in the GIPS come to recognize the costs created by corporate pyramids – i.e, come to understand why the United States at the beginning of the last century, and, more recently, Israel, came to adopt reforms aimed at discouraging the creation and retention of pyramids – it will be extremely difficult for them to approve any reforms aimed at solving this problem in a relatively short period of time. This is because the families that control pyramidal groups will use their economic power and influence over the political process to oppose any reform against their interests.

As Ronald Gilson recognized with regards to developing economies based on relational exchanges, an "Olson problem" [94] arises when, for example, controlling "families will have both the incentive and the resources to make more difficult or to block, the

[93] See Christian Leuz, Karl V. Lins & Francis Warnock, supra note 54 at 3253-4.

[94] According to the theory elaborated by Mancur Olson, small groups can act to advance their common interest more easily than large ones. Large groups face collective action problems that reduce their ability to act in furthrance of their interest. On the other hand, member of small groups receive a higher per capita participation on the benefits of their common action and therefore have lower cost in organizing their efforts. Therefore, in some situations special interest lobbys are able to advance their benefits even if the mesures advocated are inefficient for the market and the economy. See: Mancur Olson, The Rise and Decline of Nations (Yale Univ. Press 1982)

development of formal institutions that devalue the families' investment in relation-supporting institutions". [95]

With regard to the use of CEMs by controlling shareholders, a case in point is the European Commission's unsuccessful attempt to enhance the "one-share one-vote" principle in the EU internal market. [96] A "draft of the EU takeover directive, which threatened to limit the use of super-voting shares in cases of takeovers... was tabled in late 2001, the Swedish owner-families – led by the Wallenbergs – successfully lobbied the [Swedish] government in order to defend voting right distortions against EU legislation". [97]

---

[95] Ronald J. Gilson, suora note 14 at 653; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, *Investor protection and corporate governance*, 58 J. FIN. ECON. 3, 21 (2000) ("What the reformers see as protection of investors, the founding families call 'expropriation of entrepreneurs'. No wonder, then, that in all countries - from Latin America to Asia to Europe - the families have opposed legal reform"); Lucian A. Bebchuk and Zvika Neeman, *Investor Protection and Interest Group Politics*, 23 REV. FIN. STUD. 1089 (2010) (They identify several "factors that push toward suboptimal investor protection, including corporate insiders' ability to use public firms' assets to influence politicians, and institutional investors' inability to capture fully the value of investor protection for outside investors."); Gerhard Schnyder, *Varieties of Insider Corporate Governance: the determinants of business preferences and govenrance reform in the Netherlands, Sweden and Switzerland*, 19 J. EUR. PUB. POL'Y 1434, 1447 (2012):

> while electoral pressures may push parties to cater for the needs of minority shareholders where these constitute a large part of the electorate, the preferences of the business élite constitutes a second channel through which ownership structures influence the politics of corporate governance reforms. Which one of these pressures ultimately prevails is an empirical question which depends on additional variables, such as the power and preferences of centre-left parties, the salience of an issue and the intensity of business lobbying.

[96] See: Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, Brussels, 21.5.2003 COM (2003) 284 final, at 14; Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Brussels, 10 January 2002; Tobias Buck, *Eu to endorse 'one-share, one- vote' principle,* Oct. 16, 2005, FINANCIAL TIMES, available at http://www.ft.com/intl/cms/s/0/2f2a10c0-13cb-11dc-9866-000b5df10621.html#axzz2QJ6ajbPU (Reporting that Charlie McCreevy – the EU internal market commissioner – publicly said "[i]t is my goal to get the one share, one-vote principle accepted across the 25 member states").

[97] Gerhard Schnyder, supra note 95 at 1445; *Keeping shareholders in their place: Bosses around the world celebrate a series of victories over shareholder activists*, Oct. 11, 2007, THE ECONOMIST, available at http://www.economist.com/node/9961252, (The European Commission had to abandon the proposed reform mainly because of the strong opposition of "lobbyists for big shareholders such as Sweden's Wallenberg family, which uses special shares to retain control of the dynasty's businesses"); André Nilsen, *The EU Takeover Directive and the Competitiveness of European Industry*, The Oxford council on Good Governance, OCGG Analysis, n°1, (2004), at 4, (Reporting that the proposal for "expanding the scope of Article 11 [of the EU Takeover Directive] to outlaw multiple classes of common stock carrying different voting rights" was abandoned "[f]ollowing intense lobbying by the Wallenberg family and the rest of the Swedish establishment in 2003").

C. The Israeli Approach to Existing Pyramidal Ownership Structures

As we have seen in section II.D of this paper, Israel has embarked on a public debate over the economic costs of pyramidal ownership structures, the systemic risks that they create, and possible ways to reduce or eliminate them from the Israeli economy.

In 2009 the Bank of Israel suggested that:

> To contend with the acute concentration and the pyramid structure of ownership in the Israeli economy, one may consider imposing a dividend tax on capital transfers between firms (as was done in the US in the 1930s) or strengthening the direct linkage between ownership and control of affiliated companies (a British solution from the 1960s) by setting a minimum threshold for direct ownership.[98]

Following the appointment of the Committee on Increasing Competitiveness, Lucian Bebchuk wrote an Interim Report in 2011 and a Final Report in 2012, each of which advanced a different approach to reducing the importance of pyramids in the Israeli economy.

1. The Market Based Solution Proposed in the Interim Report

In the Interim Report to the Committee on Increasing Competitiveness, Bebchuk proposed to adopt solutions aimed, *inter alia*, at: increasing the independence of outside investors, expanding the authority of the audit committee, requiring the approval by a majority of outside investors to enter into certain corporate transactions, creating a "'mandatory bid' mechanism tailored for the protection of public shareholders in the event of

[98] Bank of Israel, Annual Report, 2009 (Jerusalem, 2010), 174, available at http://www.boi.org.il/en/NewsAndPublications/RegularPublications/Documents/Doch2009/pe_4.pdf.

wedge-creating transfers", [99] providing an exit right to minority shareholders of a controlled company and putting a "cap on voting not backed by cash flow rights". [100]

In particular, the proposed exit right for outside investors was a "market based mechanism" that would be triggered "in the event that a premium offer for all the shares of … [a] company that [outside investors] find attractive is blocked by the [company's] controller." [101] According to the proposed regulation, this exit right was conditioned on: (i) the existence of a hostile tender offer - providing for at least a 10 percent market's premium – that was conditioned on obtaining control of the company; (ii) the acceptance of that offer by the majority of minority shareholders; and (iii) the controller's refusal to sell its shares causing the failure of the takeover. In such a case, the controlling shareholder who blocked the offer would be forced to buy the shares of minority shareholders who are willing to sell at the same price and conditions offered by the initial bidder.

The cap on voting rights not backed by cash flow rights for which the Committee on Increasing Competitiveness "decided to seek public comment" recommends that "the votes attached to a block of 25% or more will count beyond 25% only to the extent they are backed by cash flow rights". [102] However, as Bebchuk suggests, "[a] stronger version of this mechanism – which would be more effective vis-à-vis wedge companies in which the controller has only a small minority of the cash flow rights – would require that the holder of any block of 5% or more would be allowed to cast votes only up to the level backed by the

[99] Lucian A. Bebchuk, supra note 66, at 9-10.
[100] Id at 10.
[101] Id at 8.
[102] Id at 11.

blockholder's cash flow rights." [103] As expected, the proposals contained in the Interim Report were strongly challenged by Israeli pyramidal groups. [104]

2. The Solution Proposed in the Final Report

During the consultations which followed the publishing of the Interim Report some members of Israeli business groups and some academics criticized the reforms proposed, highlighting their possible implementation costs. [105]

These remarks were considered in the Final Report submitted to the Committee on Increasing Competitiveness in 2012, in which Bebchuk proposed the adoption of a more straightforward regulation that simply prohibits the creation of new pyramids with more than two layers of companies, and requires existing pyramids to reduce their structure to maximum three layers in a four years period of time. [106] This because by reducing the permitted levels in a pyramidal ownership structure, the proposed reform increases the economic investment that the main shareholder need to hold in the operating company in order to secure his control. [107]

---

[103] Id .

[104] Among the opponents of the proposals contained in the Interim Report: Professors Ronald J. Gilson and Alan Schwartz had been retained by Israeli corporate groups Norstar Holdings Inc., Gazit Globe Ltd. and Alony Hetz Properties & Investments Ltd. to write a divergent report that highlights the possible drawbacks of Bebchuk's solutions and in which they propose to contrasts the agency costs created by Israeli pyramid by strengthening the ex-post judicial review; and Professor William T Allen had also been asked by the Association of Pubibly Traded Companies to review the Interim Report. See: Ronald J. Gilson and Alan Schwartz, supra note 16; William T. Allen supra note 47.

[105] The Committee on Increasing Competitiveness in the Economy, Final Recommendations and Supplement to the Interim Report (March 18, 2012) at 14, available at: http://www.israeltrade.org.au/final-recommendations-and-expert-opinions-of-the-committee-on-increasing-competitiveness-in-the-economy/.

[106] Lucian A. Bebchuk, supra note 19, at 21-25.

[107] Id at 23.

3. Why GIPS Should Follow a Different Approach to Reform from the One Endorsed by Israel

The legislative process to adopt the proposals made by Committee on Increasing Competitiveness has not been completed. It is difficult to predict whether the Israeli government will succeed in introducing this reform in a relatively short period of time in the face of strong opposition from the families that control the affected business groups. However, even if the Israeli government can achieve this result, the GIPS are unlikely to overcome organized lobbies of pyramid controllers.

Given the Olson problem explained before, in order to overcome the interested groups' resistance a great political support to these reforms is required. In the US, the great depression created the conditions for the New Deal Congress to introduce the intercompany dividends that caused – or at least accelerated – the dismantlement of pyramids. [108] In Israel, because "pyramidal groups bring under one command firms that operate in different markets … [they] increase the opportunities for a wide range of multi-market interactions that can result in reduced competition and higher pricing." [109] In addition to this internal market competitiveness issue, the large, interconnected and highly leveraged pyramidal groups create systemic risks for its economy. Therefore, the Israeli Government was strongly motivated to reduce the threat posed to the economy by corporate pyramids.

The economic crisis that has affected the GIPS in the last years can constitute a strong incentive to consider reforms aimed at strengthening their firms and attract foreign investors. However, given the weakness of their political institutions, and the strong power that leading

---

[108] See previous section II.A.

[109] Lucian A. Bebchuk, supra note 19, at 18.

industrial families enjoy in these countries, it is unlikely that these kinds of reforms can be promulgated soon-enough to meet the GIPS financial needs.

Even if the GIPS could deal with the Olson problem, it should also be considered that any reform aimed at dismantling all current pyramids – and/or preventing the creation of new ones – would also cause some costs and inefficiencies, as we have seen in section III.B.2 of this paper. In particular, if controlling shareholders are prevented from using pyramidal ownership structures to secure their control, some of them might choose to keep their firms private, or issue fewer shares in the market, and rely more on debt to finance their firms' activities.

Alternatively, firms that are controlled through pyramids could also take advantage of the right of "freedom of establishment" in the European Union – as the European Court of Justice has broadly interpreted this principle following the *Centros* case [110] – and choose to incorporate their firms in other European countries where CEMs are still permitted, such as Sweden or the Netherlands. [111]

[110] See: Case C-127/97 Centros Ltd. v Erhvervs-og Selskabsstyrelsen, [1999] ECR, I-1459; Case C-208/00 Überseering B.V v Nordic Construction Baumanagement GmbH [NCC], [2002] ECR, I-9919; Case C-167/01 Kamer van Koophandel en Fabriken voor Amsterdam v Inspire Art Ltd., [2003] ECR, I-10155; Case C-210/06 Cartesio Oktató Szolátató bt [2008] ECR, I-9641. See also: Wolf-Georg Ringe, *Corporate Mobility in the European Union – A Flash in the Pan? An Empirical Study on the Success of Lawmaking and Regulatory Competition*, 6 (April 9, 2013). Oxford Legal Studies Research Paper No. 34/2013, available at: http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=2247323:

> The *Centros* case law has had a significant impact on company activity in Europe. With every free movement judgment handed down from Luxembourg, enterprises became increasingly assured that the freedom of establishment indeed allowed them to register in Member State A, while conducting their business exclusively in Member State B. In this manner, the Court of Justice has created a market for corporate forms within the European Union, granting de facto a choice between the legal forms of Member States.

[111] In these two countries, for example, insiders can use both corporate pyramids and multiple voting rights shares to secure their control over the company. Cfr. Institutional Shareholder Services, Sherman & Sterling and the European Corporate Governance Institute, supra note 18.

D. Regulatory Dualism: What Brazilian "Novo Mercado" Can Teach to Old Europe

In order to solve the deadlock situation that is likely to arise if the governments of the GIPS try to challenge the control that powerful families exercise over their corporate groups, and to avoid the costs that would be caused by a general prohibition from adopting pyramidal ownership structures, these countries should use regulatory dualism to maximize the value of their state-owned enterprises. "Regulatory dualism seeks to avoid, or at least mitigate, the Olson problem by permitting the existing business elite to be governed by the prereform regime, while pursuing development by allowing other businesses to be governed by a reformed regime". [112]

This regulatory strategy was used successfully in Brazil a decade ago, when the São Paolo Stock Exchange introduced the "Novo Mercado" listing standard. In the last fifty years of the last century, the development of an efficient capital market in that country was impeded by the lack of a sufficient level of investors protection. As Ronald Gilson, Henry Hansmann and Mariana Pargendler report, any reform aimed at improving the efficiency of Brazilian corporate law had been jeopardized by the families controlling the largest listed firms, who – through their lobbying group, the Brazilian Association of Public Companies – had been able to block any enhancement of investor protection that would have reduced their private benefits of control. [113]

In order to solve this deadlock situation and improve investor protection, at least in the companies that were to be listed in the future, in 2000 the São Paolo Stock Exchange created

[112] Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S. and the EU*, 63 STAN. L. REV. 475, 478 (2011).

[113] Id at 482-6.

three new markets with improved corporate governance standards (Novo Mercado, Level I and Level II). [114]

The Novo Mercado has the highest level of investors' protection, requiring the listed firms to have:

> [O]nly common shares (no non-voting preferred shares); a minimum of 25% free float (shares not controlled by the majority shareholders); a board of directors having non-staggered terms of two years or less; financial statements prepared following U.S. GAAP or IFRS; takeout rights for minority shareholders in a transfer of the controlling stake; in a freezeout or delisting, a tender offer must be made for minority shares at their economic values; trades by controlling shareholders and senior managers must be disclosed; and disputes with minority shareholders are settled by the Brazilian arbitration panel Câmara de Arbitragem do Mercado. [115]

These requirements are imposed only on the firms that voluntarily choose to be listed in the Novo Mercado. Other firms can continue to be listed in the old market or in one of the other two new markets – Level I or Level II – with lower level of investor protection. Because the established industrial families were not directly affected by this reform, they had fewer incentives and arguments to oppose the introduction of the new markets.

---

[114] Id at 486; Bernard S. Black, Antonio Gledson De Carvalho and Joelson Oliveira Sampaio, *The Evolution of Corporate Governance in Brazil,* Northwestern Law & Econ Research Paper No. 12-22 (2012), available at: http://ssrn.com.ezp-prod1.hul.harvard.edu/abstract=2181039.

[115] Bernard S. Black, Antonio Gledson De Carvalho and Joelson Oliveira Sampaio, supra note 114 at 5; Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, supra note 112 at 489.

The data available shows the success of the Novo Mercado. From 2004 to 2009, 105 companies, representing 72% of the IPOs registered in that period of time, chose this market.[116]

E. Listing State-Owned Companies in a New Market with Enhanced Corporate Governance Rules Limiting Control-Enhancing Mechanisms

1. Introducing Regulatory Dualism in Italy, Spain, Portugal and Greece

If GIPS want to privatize some of their state-owned companies – or want to sell the controlling bloc of already-listed firms through dispersion of the shares in the public market [117] – and they want to achieve the highest possible price and in a relatively short period of time, they should reflect on the Brazilian experience with the Novo Mercado, and use regulatory dualism to create one or more new markets with high corporate governance standards that would attract foreign institutional investors.

The new markets could be created at a national level or even at a multinational or European level. Having a multinational or European market with enhanced corporate governance rules would help to promote the reliability and stability of the initiative. However, creating transnational political convergence over this project could also prove to be difficult and delay the reform.

[116] Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, supra note 112 at 495.

[117] If the State own just a controlling bloc of a listed firm, and the "equal opportunity" rule does not apply, the private placement of the participation would create more value than the dispersion on the stock in the market, because the seller receive the controlling premium without sharing this value with outside investors. In this scenario, since this premium is closely related to the private benefit of control that the buyer can extract, in order to mazimize the price received, it would be better for the seller to avoid any improvement of outside shareholders rights. Therefore firms that are controlled by the State and could be sold at an higher price through private placement should not be listed in the new market with improved corporate governance standards.

This new market should be used by national governments for the IPOs of their state owned companies that are still private, and also to sell their participation in already-listed firms that are willing to migrate to the new market. The new market should also be open to any other firm that is willing to comply with the high corporate governance standards imposed by its listing rules. Having an improved capital market with effective investor protection rules designed to attract foreign institutional investors would be especially useful for small and medium-size firms that are financially constrained and that because of their size and lack of track record, face a high cost of capital in the regular equity market. [118]

The introduction of a new market could enhance the venture-capital and private equity activity in the GIPS because it would create a more economically efficient exit strategy for venture capital and private equity funds that have invested in successful high-growth start-up or small firms. [119]

[118] With regards to Italy, in 2012, only 279 Italian companies were listed in the Milan stock exchange, while in Frankfurt the German companies were 665, in Paris the French ones were 862 and in London the British ones were 2,179. In the same year the market capitalization devided by the GDP was only 23.9% in Italy, while in the UK was 124%, in France 69.8% and in Germany 43.7%. These numbers are particulary impressive if we consider that according to Assonime (the Assciation of Italian Companies) more then one thousand Italian companies already have the characteristics required for listing in a stock market but prefer to remain private.

In Portugal and Greece the market capitalization devided by the GDP is also considerably low (30.8 in Portugal and 17.9 in Greece in 2012), while Spain is the only economy among the GIPS with a relatively developed capital market (73.7% of the GDP in 2012).

See: data available on the World Bank web-site: http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS/countries/1W?display=default; Luigi Abete, *Audizione del Presidente dell'Assonime: Indagine Conoscitiva sui Mercati degli Strumenti Finanziari,* (May 3, 2011), available at: http://www.assonime.it/AssonimeWeb2/servletAllegati?numero=3772.

[119] Bernard S. Black and Ronald J. Gilson, *Venture capital and the structure of capital markets: banks versus stock markets*, 47 J. FIN. ECON. 243, 245 (1998):

> Other countries have openly envied the U.S. venture capital market and have actively, but unsuccessfully, sought to replicate it. We offer an explanation for this failure: We argue that a well developed stock market that permits venture capitalists to exit through an initial public offering (IPO) is critical to the existence of a vibrant venture capital market.

2. The Most Relevant Rule of the New Market: a Cap on Voting Rights not Backed by Cash Flow Rights

As shown by the data mentioned in section III above, institutional investors consider the ownership structure of a firm carefully when they evaluate the price of its shares. If that company is controlled through a pyramid – or if it is possible that it will be in the future – institutional investors will require a discount on the price they pay in order to compensate for the agency costs created by this inefficient ownership structure.

To deal with this issue – and to assure outside investors that controlling shareholders will be required to hold a proportionate amount of cash flow rights and voting rights – I suggest that the new market to be introduced resemble some of the characteristics of the reform proposed by Professor Bebchuk in the Interim Report for Israel.

In particular, the provision of a 5 percent cap on voting rights not backed by cash flow rights – establishing that "the votes attached to a block of […] 5 percent or more will count beyond […] 5 percent only to the extent they are backed by cash flow rights" [120] – would be extremely effective in avoiding the creation of pyramids. This because this percentage is too low to enable an investor to exercise effective control over a company, yet it would also allow existing groups to invest in these firms by acquiring a minority participation (below 5 percent) with voting rights proportionate to their economic investment.

This cap on voting rights not backed by cash flow can be introduced by requiring all entities holding more than 5 percent of the stocks to provide at the record date – which should not be too close to the meeting (i.e. ten or fifteen working days before it) – a statement

[120] Lucian A. Bebchuk, supra note 66, at 11.

describing their ownership structure and the existence of any equity derivative having the effect of separating their voting rights from their economic exposure in the same firm. [121] Then the Internal Audit Committee – to be composed entirely of independent directors, including one director elected by the minority shareholders [122] – will have to determine what the cash flow rights are of the ultimate owner of the pyramid, calculate the voting rights that could be exercised in the shareholders' meeting, and communicate the decision to the market. If that shareholder – or other investors of the firm – disagree with this determination, they should have the right to have this decision subject to judicial review by an arbitration panel similar to the Câmara de Arbitragem do Mercado created by the Novo Mercado. [123] This arbitration panel should decide any disagreement regarding the cap on voting rights in a few days, before the shareholders meeting.

3. Other Relevant Provisions Aimed at Protecting Outside Investors: Ex ante control of self-dealing transactions

In addition to limiting the voting rights of pyramids, the new market should also establish a superior set of corporate governance provisions. These rules should have a focus

[121] On the possible use of equity derivatives in order to separate investors' voting rights from their ultimate economic exposure in the same firm see: Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* 156 U. PA. L. REV. 625 (2008).

[122] In Italy the Investor Protection Act ("*Legge sul Risparmio*") introduced in 2005, have required all listed companies to adopt a "*voto di lista*" mechanisms that allows minority shareholders to elect at least one member of the board. In Spain and in Portugal the adoption of mechanisms similar to the "*voto di lista*" is authorized but not required. See, for Italy, Article 147-*ter* of the Financial Markets Consolidated Act ("Testo Unico della Finanza") as amended in 2005; for Spain Article 137 of the Anonimous Companies Act ("*Ley de Sociedades anonimas*", Royal Legislative Decree 1564/1989); See also, Simone Alvaro, Giovanni Mollo e Giovanni Siciliano, *Il voto di lista per la rappresentanza di azionisti di minoranza nell'organo di amministrazione delle società quotate*, 16-17 (2012) Consob, Quaderni Giuridici, available at: http://www.consob.it/main/consob/pubblicazioni/studi_analisi/quaderni_giuridici/qg1.html.

[123] See Section IV.E.4.

on insider dealing transactions that are particularly relevant in markets, like the GIPS, where concentrated ownership is very common. [124] This is because "[w]hen the targets of expropriation by large investors are other investors, the adverse incentive effect of such expropriation is the decline of external finance". [125]

In particular the listing standards should, *inter alia*, provide: (a) enhanced mandatory disclosure regarding related parties transactions, because – as Justice Brandeis said almost a century ago – "[s]un-light is said to be the best of disinfectants, electric light the most efficient policeman"; [126] (b) that the negotiation of the terms of any material related parties transaction should be delegated to the Internal Audit Committee, which should have adequate resources to hire its own legal and financial consultants, and should negotiate on an arms' length basis; [127] (c) in addition (and not as an alternative) to (b), the approval by the majority of the minority shareholders should also be required for the most important related parties transactions.

---

[124] Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, *The law and economics of self-dealing*, 88 J. FIN. ECON. 430 (2008).

[125] Andrei Shleifer and Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 760 (1997).

[126] Louis D. Brandeis, *Other People's Money and How The Bankers Use It*, 92 (Augustus Kelley ed., 1971) (1914).

[127] In Italy the Consob Regulation n. 17221 on Related Party Transactions introduced in 2010 has already substantially improved the corporate governce rules on this issue. However, Italian listed companies still enjoy some degree of freedom in "opting-up" or "opting-down" some of the default rules provided in the new regulation. In this case the new market should restrict the companies' freedom to "opt-down" from the default rules and require the adoption of the strictest procedures aimed at avoiding tunneling through related parties transactions. See: Angela Ciavarella, Luca Enriques, Valerio Novembre and Rossella Signoretti, *Regulation and Self-Regulation of Related Party Transactions in Italy,* (2012) (working paper on file with the author).

4. Improving Ex Post Judicial Review Through the Appointment of an Arbitration Panel

As Professors Ronald Gilson and Alan Schwartz emphasize, the "effectiveness of judicial review – both the quality of the judges and the institutional structure that provides an unbiased outcome within a commercially reasonable period of time – is more important than the detail of the legal standard that a country adopts."

The Chancery Court of Delaware – the state where more than half of the U.S. listed companies are incorporated [128] – has become famous among corporate lawyers and international institutional investors for its competence and promptness in handling even the most complex corporate and securities' litigations. [129] In the GIPS, however, the general perception of the effectiveness of the judicial systems is far less positive than in Delaware. For example – due to the lack of available resources and the excessive and heterogeneous caseload that Italian Judges must decide – the "dominant impression concerning Italy is that private enforcement [*i.e.* shareholders' suits] is under-developed because courts are extremely slow and inefficient." [130]

In order to improve judicial enforcement, the listing rules of the new market should establish the appointment of an arbitration panel, composed of scholars and/or practitioners

---

[128] Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L. J. 553, 567 (2002) (Reporting that at the end of 1999, 3771 of 6530 US public companies were incorporated in Delaware).

[129] Ronald J. Gilson, Charles Sabel and Robert E. Scott, *Contract and Innovation: The Limited Role of Generalist Courts*, 88 N.Y.U.L. REV. (forthcoming 2013):

> The specialization of the [Delaware] court together with its equitable powers assure parties that, despite the impossibility of codifying particularized decision rules, judicial decisions will be taken with the fullest possible awareness of current and evolving understandings of good practice.

[130] Guido Ferrarini and Paolo Guidici, *Financial Scandals and the role of Private Enforcement*: *The Parmalat Case in After Enron*, *in* AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION 158, 194 (John Armour & Joseph A. McCahery eds. 2006).

specialized in corporate governance issues regarding listed companies. The Panel should be required to decide competently and in a timely manner any disputes among shareholders and between the shareholders and the firm. In order to improve the predictability of its decisions the arbitration panel should also be bound by its own precedents.

5. How to Guarantee Firms Compliance with the Listing Rules

In order to guarantee outside investors that the firms will continue to comply with the improved corporate governance standards imposed by the new market, [131] these provisions should be inserted in the corporations' charters. To amend the charters the approval by investors representing a vast majority of the voting rights exercisable in the shareholders' meeting (e.g. 75 percent of the overall voting rights), should be required. [132]

In addition to this supermajority requirement to amend the charter, listed firms should also face some constraints on delisting or switching to other listing markets. This result can be achieved by requiring any person wishing to delist a firm from the new market to launch a tender offer for all the company's shares at a price at least equal to the highest among the

---

[131] On the importance od requiring a strong commitment by the listed firms to comply with the high standards of corporate governance imposed by the new market see: Edward Rock, supra note 71:

> [He] argue[s] that the existing SEC system can be understood as providing issuers with a mechanism for making a credible commitment to high quality, comprehensive disclosure for an indefinite period into the future. This credible commitment device is particularly useful to new domestic issuers and to foreign issuers seeking to tap the U.S. capital markets. This credible commitment justification explains the striking but little discussed practical and formal asymmetry between the ease of entry into the SEC system and the difficulty of exit from it.

[132] In case of companies' mergers – in order to avoid hold-up problems that could jeopardize value-enhancing business combinations – the chater could also provide, as an alternative to the supermajority approval, a positive vote by a majority of the minority investors.

following two parameters: (i) a 10 percent premium over the 3 months average market price; or (ii) the highest price paid in the last 6 months by the controlling shareholder. [133]

If the regulatory authority decides that a company should be delisted for violations of the listing rules, investors should have an appraisal right to cash-out their investment at a fair market price. As in the Novo Mercado, the regulatory authority should also be allowed to "impose fines and suspend stock trading in case of noncompliance with the segment's standards." [134]

CONCLUSION

Empirical studies have documented the agency costs associated with the separation between controlling shareholders' voting rights and their cash flow rights. These costs lead institutional investors to expect a discount on the share price of companies adopting CEMs. The GIPS have already recognized this problem and have prohibited the adoption of some kinds of CEMs, such as multiple voting rights shares. However, pyramidal ownership structures – which are allowed and widely used in these countries – can be used to achieve the same entrenchment in control. Furthermore, corporate pyramids can be adopted following the firm's IPO without requiring the consent of the minority investors.

These inefficient ownership structures are particularly aversed by foreign institutional investors, who are in a disadvantaged position vis-à-vis national investors in obtaining information regarding the reputation and track record of families controlling the pyramid.

---

[133] *See* Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, supra note 112 at 492 ("[p]ersons wishing to delist a firm from the Novo Mercado must first launch a tender offer for the firm's shares at a price at least equal to their economic value").

[134] Id.

Therefore if the GIPS governments want to maximize the value of their state-owned companies and attract foreign investors, they should put in place normative tools aimed at discouraging the creation of pyramids controlling these companies. In the New Deal period, the United States used the taxation of intercompany dividends to oppose the use of pyramids, while Israel has recently proposed a reform aimed at reducing the permissible layers of companies in these structures. However, because the business elites that control pyramidal groups strongly oppose any regulation that affects their interests, these reforms need strong political support and are very difficult to adopt in a relatively short period of time.

In order to reduce this Olson problem, I suggest that GIPS' governments should use regulatory dualism to create a new market with enhanced corporate governance rules aimed at improving outside investors' protection and avoiding the adoption of pyramidal ownership structures. In particular, I propose that the listing standards of the new market adopt a cap on voting not backed by cash flow rights, similar to the one proposed by Lucian Bebchuk in Israel. This rule should "require that the holder of any block of 5 percent or more would be allowed to cast votes only up to the level backed by the blockholder's cash flow rights". [135]

The compliance with this provision should be guaranteed by an Audit Committee, composed entirely of independent directors, including one director elected by the minority shareholders. The Committee should be required to verify the correspondence between the voting rights of any shareholders holding a block of more then 5 percent and his cash flow rights. Any disagreement about the decision taken by Audit Committee should be solved in a

[135] Lucian A. Bebchuk, supra note 66, at 11.

timely manner before the shareholders meeting by an independent arbitration panel instituted and regulated by the listing standard of the new market.